The economic scene in Germany around the turn of 2000-01

The international and European setting

Developments in the world economy

Downturn in the world economy

The world economy cooled off distinctly last autumn. The main reason was the sharp slowdown in growth in the United States. The hitherto fast pace of expansion began to slacken after mid-year, and this slide accelerated in the fourth quarter. In addition, the Japanese economy tended to weaken after a short period of recovery; hopes entertained at the beginning of 2000 of a lasting upswing have not materialised so far. In western Europe, growth has remained strong; however, the economy has latterly lost some of its momentum. Since the growth stimuli from the industrial countries, particularly the United States, are no longer so strong as they used to be, the east Asian emerging economies likewise seem to be returning to normal expansion after the very high growth rates recorded at times in the past two years. This has been highlighting the persistent structural problems that continue to beset some economies. The picture surrounding Latin America tends to be mixed. In countries with intensive trade links with the United States, such as Mexico, the retarding foreign trade effects predominate. By contrast, other countries, especially those whose currencies are pegged to the US dollar, but which have less strong trade links with the US economy, seem to be benefiting from the cut in US central bank rates and the ensuing depreciation of the US dollar against the euro.

The central and eastern European countries have latterly remained on an expansionary path. Russia is a prime example; its growth rate, estimated at 7 ½ % in 2000, has been at its highest level since the beginning of the nineties. This has owed a great deal to the sharp rise in income from oil and gas exports.

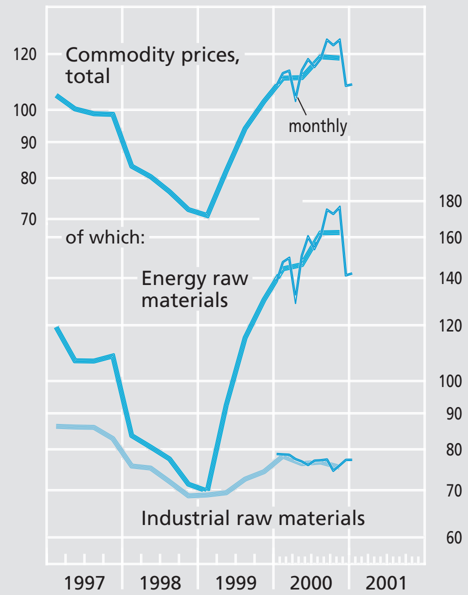
Main reasons for the worldwide moderation of growth

The downturn in global growth can be traced back to several causes, whose importance varies from one region to another. The after-effects of the crude-oil-price surge are a particularly significant reason. In the oil-consuming countries, it led to considerable losses in real income, which put a strain on private consumption and corporate profitability. German economic research institutes estimate the drain caused by higher oil prices at ⅓ percentage point of GDP in the United States and Japan, and at over ⅔ percentage point in the euro area. The brunt had to be borne in the second half of the year, especially since many households, owing to the rises in the prices of energy sources (which lasted into the autumn), were increasingly less able or willing to respond by reducing saving. In addition, in the enterprise sector, the "recycling of petrodollars" through heavier imports by oil-producing countries from the OECD area did little to offset the drain.

Moreover, financing terms, especially in the United States, were no longer as favourable as they had once been. Facing increasing signs that the economy was overheating, the US Federal Reserve raised its interest rates several times up to mid-2000. In addition, owing to a reassessment of the credit risk by investors, the yield spread between US corporate bonds and US government bonds, in particular, widened sharply in the second half of last year, and banks' lending rates rose perceptibly from a relatively low level. Especially

International commodity prices

In terms of US dollars, 1995 = 100, log. scale



Source: Hamburg Institute of International Economics.

Deutsche Bundesbank

the nosedive in equity prices in the major stock markets, triggered by a reassessment of profit expectations and risk premiums, exerted a dampening effect. That made it more difficult to borrow additional funds. In the United States, consumer demand, which reacts relatively strongly to changes in asset holdings, was also adversely affected.

Positive corrections

One particular reason why sentiment clouded over so much within a short time is the strong leverage exerted by the international financial markets. The higher energy costs, changed terms of finance, and especially the revised sales and earnings expectations, were all very quick to have an impact on the markets. However, one should not lose sight of the fact that the corrections expected by many market players have positive aspects, too. For instance, the euro has been able to regain some ground in the foreign exchange markets, and conditions on the international oil markets have generally eased. The corrections of excessive profit expectations or the changes in the assessment of corporate risks – particularly in the "new economy" – are, in principle, likewise to be seen quite positively for allocative reasons. Besides, examples from the past go to show that the financial markets tend to fluctuate rather strongly when new technologies are subject to an economic evaluation.

To that extent, the developments of recent months may certainly be construed as a return to normal, which will ultimately manifest itself in the growth process, too. However, if abrupt market corrections accumulate, this may give rise to a considerable risk to real economic performance. Up to now, though, there have been no signs of such "overshooting", which might culminate in a relatively lengthy downturn. It should also be noted here that growth began its deceleration from what was, on the whole, a relatively high degree of capacity utilisation.

The United States' importance in the world economy

The extent to which world economic growth will slow down this year probably depends chiefly on further developments in the US economy. The fact that the US economy accounts for over one-fifth of global output and – according to data up to 1999 – absorbs over one-sixth of global imports is more than ample evidence of that. Moreover, US stock exchanges exert a strong influence on international financial markets.

The economic situation in the United States ...

Views on the US economy are being dominated right now by the strong downward trend being displayed by major indicators of sentiment. The Conference Board consumer confidence index, for instance, went down in January for the fourth time in a row. Latterly, it has been lower than at any time since the end of 1996. In addition, the decline in the purchasing manager index, which attracts great attention in the United States, accelerated after the turn of 2000-01. According to initial estimates, real GDP grew in the fourth quarter by ¼ % over the third, after adjustment for seasonal and working-day variations. This made it 3 ½ % higher than at the end of 1999. In this connection, the early and violent onset of winter in large parts of the country, leading at times to major production losses, must also be taken into account. Real GDP went up by an average of 5 % in 2000, making this the strongest GDP growth since 1984. In the last quarter, households' demand boosted aggregate output; however, viewed over time, its increase (at ¾ %) was distinctly more moderate than in the preceding period. By contrast, gross capital formation and exports were unable to sustain their levels of the summer quarter. Since imports stagnated at the previously reached high level, the deficit on foreign trade and payments continued to climb.

The manufacturing sector has been hit particularly hard by the economic downturn, though it accounts for only one-sixth of aggregate output. Industrial output decreased consistently from October to January, its average being a seasonally adjusted ½ % below the level of the summer quarter. This was accompanied by a decline in capacity utilisation, which, in January, after factoring out seasonal variations, was lower than at any time since 1992. However, the services sector has latterly been growing rapidly, and has also created new jobs. This has thus more than made up for job losses in manufacturing. The seasonally adjusted unemployment rate rose perceptibly in January, for the first time in a long while, but, at a seasonally adjusted 4.2 %, it is still running at a very low level. Price trends changed but little in the autumn. The rate of price increases at the consumer level has been running at 3.4 % since October, and core inflation (excluding food and energy prices) has been holding steady at 2 ½ % since mid-2000.

... and the outlook for 2001

The IMF has recently revised downwards its forecast for the growth of the US economy this year by ¾ percentage point to 2 ½ %, which is still considered to be a "soft landing". However, the possibility of a "hard landing" – i.e., according to prevailing opinion, a slowdown in the growth rate to less than 2 % – cannot be ruled out. The turnaround in sentiment in the United States probably also owes something to the fact that US consumers and investors are apparently having difficulty in adjusting to a more sluggish pace of growth after a long succession of years in which the economy performed exceptionally well. However, there are hardly any signs so far that the economy might slide into a broadly-based, self-sustaining process of contraction or a prolonged period of marked underutilisation of overall production capacities. The strong growth in output which is still to be expected over the longer term, the general decrease in oil prices since the beginning of December and the two reductions in central bank interest rates in January will probably buttress the economy over the medium term.

Japan

After strong growth in real GDP in the first half of 2000, economic activity in Japan has been showing renewed signs of slackening. In the third quarter, real GDP went down by a seasonally adjusted ½ % against the second, meaning the year-on-year rise was only ½ %. Industrial output, after having displayed a perceptible upward trend in the summer, rose only marginally in the fourth quarter. The slowdown in export growth, following on the heels of weaker economic expansion, particularly in the United States and the eastern Asian emerging economies, was presumably the main factor in that development. The last quarter of 2000 saw no expansionary stimuli from private consumption, either. However, private investment seems to have continued to boost the economy. In October-December the domestic orders received by the mechanical engineering industry were up 2 ½ %, seasonally adjusted, on their level of the summer, exceeding their 2000 level by around one-fifth. All in all, the outlook for growth in 2001 must be assessed cautiously. Bearing that in mind, it is unlikely that the current year will witness any significant home-grown upward pressure on prices. However, in the meantime the period of falling consumer prices has come to an end, owing to the higher import prices caused by the latest depreciation of the yen.

United Kingdom

In the United Kingdom, too, the economy lost momentum in the second half of 2000. According to initial estimates, in the fourth quarter real GDP was up ¼ % on its third-quarter level, after adjustment for seasonal and working-day variations; in the third quarter the corresponding rise had been ¾ %. The year-on-year growth rate was 2 ½ %. Manufacturing once again took centre stage in this economic slowdown, but the services sector saw a slackening of the expansionary forces, too. Even so, the labour market appeared to remain in pretty good shape, the seasonally adjusted (standardised) unemployment rate standing at 5 ¼ % at the end of 2000. The rate of consumer price increases (excluding mortgage rates), at 1.8 % in January, despite the sharp rise in oil prices in the space of one year, was actually a little more moderate than twelve months before, and was thus distinctly below the Bank of England's inflation target of 2.5 %.

Macroeconomic trends in the euro area

Declining economic momentum, ...

The growth rate of the euro-area economies likewise slackened after mid-year. In the summer, real GDP was just over ½ % up on the spring level, seasonally adjusted. This increase was no longer as strong as in the four preceding quarters, when the growth rate was around 1 % per quarter. The diminishing pace of consumption owing to the oil-price-related depletion of purchasing power was the main factor in this development. In the last quarter of the year, for which data are not yet available, the pace of economic activity in the euro area seems to have decelerated once again. Industrial output continued to rise in October-November, generally speaking, yet the year-on-year increase slowed from 6 % in the summer months to 4 ¼ %. Seasonally adjusted capacity utilisation in the manufacturing sector fell slightly during the period between October 2000 and January 2001, but latterly it has still distinctly exceeded its long-term average. The industry confidence index dropped relatively sharply in January. By contrast, consumer confidence, after having plummeted in the preceding months owing to the oil-price increases, improved somewhat in December-January. With economic conditions clouding over in the euro area, the reduction in unemployment also slowed down in the second half of 2000. The standardised seasonally adjusted unemployment rate in December was 8.7 %, compared with 9.0 % in mid-year and 9.6 % a year before.

... yet euro area still on a path of growth

From today's vantage point, the calmer pace of growth of the euro-area economy since mid-2000 is not to be seen as the harbinger of a pronounced, lasting economic downswing. Rather, there is some evidence that euro-area output will continue to grow. In particular, the tax-relief measures that came into force in some member states at the beginning of 2001 will contribute materially to boosting domestic demand. The terms of financing do not constitute an impediment to such a development. Moreover, the room for manoeuvre in households' and enterprises' spending has increased owing to the downward trend in oil prices. In addition, the favourable course of employment, which seems to be continuing at a moderate pace, will probably continue to buttress private con-

Capacity utilisation in the euro area's manufacturing sector *

Seasonally adjusted data, %

Country	Annual averages (AA) from 1990 to 2000	2000 Total	2000 April	2000 July	2000 October	2001 January	January 2001 compared with AA from 1990 to 2000 in percentage points
Euro area 1	81.7	83.8	83.6	83.9	84.6	84.4	+ 2.7
of which							
Belgium	79.9	84.0	84.5	84.2	84.5	84.8	+ 4.9
France	84.4	87.4	86.3	87.9	89.1	88.8	+ 4.4
Germany	84.2	85.8	86.1	86.0	86.3	86.9	+ 2.7
Italy	77.0	78.8	79.1	78.9	79.8	79.5	+ 2.5
Netherlands	84.0	84.7	84.6	85.0	84.6	85.2	+ 1.2
Spain	77.8	80.6	80.5	80.3	80.8	80.1	+ 2.3
Memo item							
EU 1	81.8	83.4	83.2	83.6	84.0	84.0	+ 2.2

* Source: EU business survey. — 1 Weighted overall results from data for each country.

Deutsche Bundesbank

sumption. However, it must be conceded that cyclical risks are on the rise in Europe, too. In particular, a "hardish landing" by the US economy could have massive repercussions on euro-area economies at times.

Prices

HICP (Harmonised Index of Consumer Prices) inflation in the euro area, after having picked up during the summer half of last year, was particularly high in November, hitting a year-on-year rate of 2.9 %. In December, inflation diminished perceptibly again, under the impact of falling quotations on the international crude-oil markets and the appreciation of the euro; however, at 2.6 %, it was still above the level recorded in mid-year (2.4 %). Excluding energy sources and seasonal foods, whose prices are especially volatile, the rate of inflation has latterly been 1.6 %. The further outlook for price movements is largely dependent on the extent to which the second-round effects of the oil-price increase which occurred in 2000 can be kept in check. Moderate wage settlements, like those agreed last year in Germany, are an essential prerequisite for that.

Current-account and exchange-rate trends in the euro area

Exports to non-euro-area countries

Under the impact of the strong growth in the world economy, which lasted well into the late summer, euro-area suppliers' exports registered strong and continued turnover growth. In the last three months for which such figures are available (September-November 2000), exports surpassed their previous year's value by just over 21 %. Euro-area exporters had already recorded similar success in their sales in the preceding months. The heavier foreign sales partly reflect rising export prices, to be sure, but in real terms exports likewise showed exceptionally dynamic growth, going up on the year by an estimated 12 %.

Imports from non-euro-area countries

The figures for imports from non-euro-area countries, by contrast, were inflated much more strongly by higher prices. This is particularly true in the field of sources of energy. In the three-month period from September to November, imports rose by just over 24 %, and thus even faster than the value of exports. In real terms, however, import growth, at an estimated 4 %, is likely to have been distinctly lower than that of exports. Even so, the (nominal) foreign trade surplus of the euro area continued to decline during the months under review (to € 18½ billion, against € 20½ billion in the previous year).

Current account

The impact of this trend, though, did not affect the balance on the euro area's current account, since the deficit on "invisible" current account transactions between euro-area countries and non-euro-area countries declined more sharply than the surpluses from trade in goods. In the last three months (September-November), that deficit was € 21½ billion, compared with € 26 billion a year before. In particular, net payments of factor income to recipients outside the euro area, at just under € 4½ billion in the months under review, were much lower than a year before (€ 8½ billion). The shortfall in the balance of services, at just under € 3½ billion, was likewise somewhat lower than a year earlier (nearly € 4 billion), whereas the deficit on current transfers remained unchanged, at € 14 billion. Altogether, the euro-area current account showed a deficit of € 3 billion, compared with € 6 billion over the same period of the previous year.

Euro exchange rate

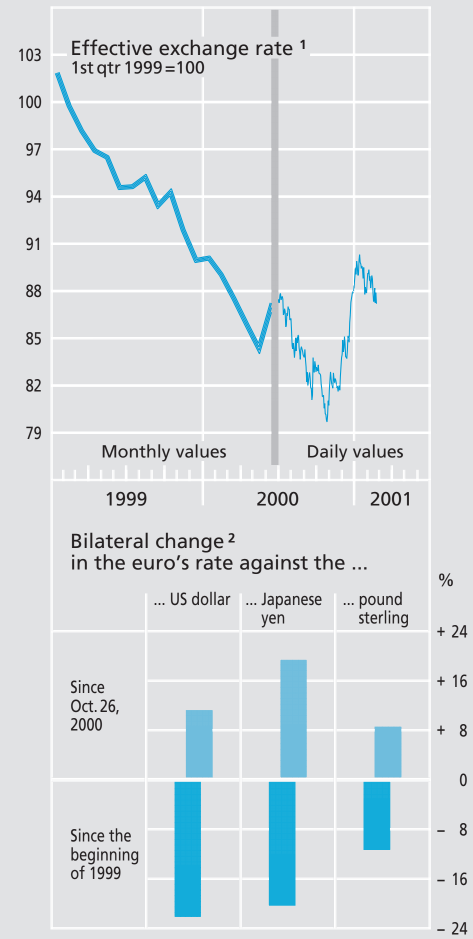
Since the end of last October, when it reached its all-time low, the euro has appreciated distinctly. At times, euro exchange rates rose so sharply in the dying weeks of last year that the quotations at the beginning of 2001, despite the long preceding bout of weakness, once again surpassed their value of twelve months before. This trend continued in the first two weeks of the new year, though in attenuated form; in the period thereafter, however, the euro forfeited those gains.

US dollar

The development outlined above was chiefly marked by the changes in the euro's rate against the US dollar. The turnaround in the euro's rate against the dollar began at the end of October, when it became known that third-quarter growth in the United States was unexpectedly low, reaching less than half of its second-quarter rate. Along with the bunching of unfavourable reports from the US corporate sector, which had already ushered in a reversal of price movements in the equity market, that gave market participants reason to fear that the US economy might be in for a "hard landing". The rapidly worsening sentiment in the markets was further exacerbated at the end of November and in December by the news that the figures for third-quarter growth were to be revised downwards once again. Other impediments, such as the mounting current account deficits and the high level of debt of US households, have attracted closer attention under the changed market conditions. By contrast, the euro-area countries' growth outlook is now being rated more favourable than that of the United States, for the first time in quite a long while. At the beginning of 2001, the euro was again quoted at US$ 0.94, an appreciation of over 13 % from its all-time low of US$ 0.83 near the end of October 2000.

The adjustment of the exchange rate was buttressed after the turn of the year by the Fed's surprise decision early in January to cut interest rates by one-half percentage point. Since then, though, the euro has fallen a bit because market participants have been downscaling their forecasts for euro-area countries from their preliminary estimates last autumn, though without fundamentally calling in question the shift in the thrust of economic growth momentum in favour of the euro-area countries. Moreover, following the pronounced price corrections, profit-taking in the foreign exchange markets may also have played a role. Following the renewed ½-percentage-point reduction in interest rates by the Federal Reserve, the euro did firm against the US dollar briefly, but it has latterly fallen back below its level of the beginning of the year.

Exchange rate of the euro



1 According to ECB calculations made using the weighted averages of the euro exchange rates against the currencies of 13 countries (12 countries from 2001). — **2** Appreciation of the euro: +. Latest position: February 14, 2001.

Deutsche Bundesbank

Yen

In the past few months, the euro has recovered more strongly against the yen than it has against the US dollar. At the beginning of 2001 the euro was trading at ¥ 108; thus, the rate was just over 21 % higher than at its nadir at the end of October (¥ 89). As early as last autumn, the continuation of the Japanese economic recovery seemed doubtful, once corporate failures pushed the unresolved structural problems besetting the Japanese economy more strongly to the fore. As January progressed, the yen firmed somewhat in parallel with the US dollar; however, at ¥ 105, the euro was still 18 % above its nadir of October.

Pound sterling

Against the pound sterling, the euro has likewise regained ground in the last few months. The close interrelationships between the UK and US economies, and the largely parallel movement of the two currencies in the past few years as a result, have made such a trend not unlikely. At times, moreover, speculation that the Bank of England might cut interest rates has weakened the pound sterling – though that move did not take place until early in February this year. On balance, the euro rose by about 9 % from its October nadir of £ 0.58 to £ 0.63 at the beginning of 2001. Since that time, it has largely held steady, fluctuating a little around that level.

Greece's participation in the Eurosystem

At the turn of the year, Greece became the twelfth country to join the Eurosystem, after a convergence assessment by the European Council last May and a recommendation to that effect. The conversion rate is 340.750 Greek drachmas to the euro, corresponding, as announced, to the central rate agreed for the drachma in January 2000 in the context of the European exchange-rate mechanism (ERM II). Now that the euro has been introduced in Greece, only the Danish krone is left in the European exchange-rate mechanism; since the transition to stage three of monetary union, the krone's rate against the euro has remained virtually unchanged.

Effective exchange rate of the euro

As a weighted average against the currencies of the euro-area countries' major trading partners,[1] the exchange rate of the euro rose last autumn from its nadir towards the end of October up to the beginning of 2001 by just under 12 %. The further slight gains in value at the beginning of January had been cancelled out by the end of that month, with the result that in mid-February the euro was being quoted about 10 % above its level at the end of October. Measured in terms of the considerable undervaluation of the euro last autumn, its appreciation represents a desirable correction. It makes it easier for the European Central Bank to pursue its stability-oriented policy stance, and simultaneously reduces the exchange-rate-related competitive distortions.

Monetary policy and the financial markets in the euro area

No changes in the Eurosystem's interest rates

In the past few months, the Governing Council of the ECB has pursued a "steady-as-she-goes" interest-rate policy, and has left the Eurosystem's key interest rates unchanged. Since the last interest-rate increase on October 5, 2000, the interest rates for the marginal lending facility and the deposit facility have stood at 5.75 % and 3.75 %, respectively; since that time, the Eurosystem's main refinancing operations have all been conducted as variable-rate tenders with a minimum bidding rate of 4.75 %. Both monetary and macroeconomic conditions have argued in favour of a continuation of the monetary-policy stance. Growth of the money stock and of

1 Up to the turn of the year, this nominal effective exchange rate of the euro was calculated against the currencies of 13 trading partners of the euro area, including the Greek drachma (see European Central Bank, Effective exchange rates for the euro, Monthly Bulletin, October 1999, page 29 ff., and European Central Bank, The nominal and real effective exchange rates for the euro, Monthly Bulletin, April 2000, page 39 ff.). Since the drachma has given way to the euro at the beginning of this year, only the 12 remaining currencies have been taken into account since then when calculating this index.

lending has slackened in the past few months, which means that the dangers to price stability emanating from the monetary side have meanwhile abated. Oil prices have declined a bit, and the euro's external value has risen since the late autumn. The trend has been for economic growth to moderate somewhat. Altogether, the inflation rate has slowed, although the uncertainty surrounding further price movements has remained high.

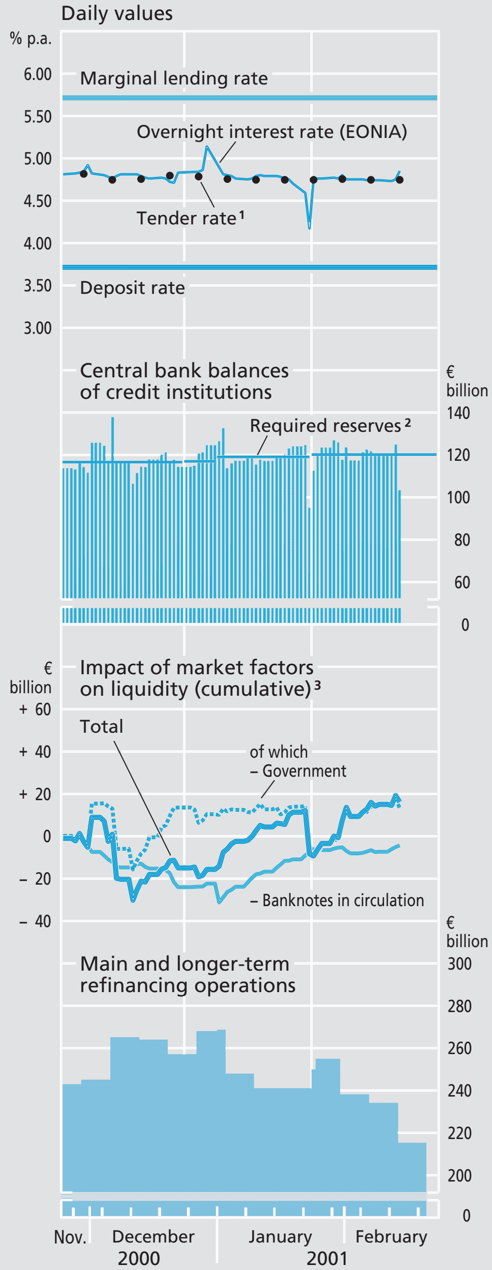
Inverse yield curve in the money market ...

In the money market, the overnight interest rate (EONIA) changed little against the background of the stable minimum bidding rate for main tender operations; by contrast, the interest rates on fixed-term deposits have declined significantly since the beginning of November, particularly in the longer-term segments. The yield curve in the money market has been inverse since the beginning of December. Following the Fed's decision to cut key interest rates at the beginning of this year, the decline in the euro money-market rates temporarily accelerated. In mid-February, fixed-term deposits were quoted at around 15 to 65 bp below their level of early November. That no doubt primarily reflects the fact that, in the medium term, market participants are expecting lower central bank interest rates in the euro area, too.

... affects credit institutions' bidding behaviour

Against this background, in weekly variable-rate tender operations, the difference between the marginal allotment rate and the minimum bidding rate decreased as last year drew to a close, and since the turn of the year it has all but vanished. The credit institutions' bids focus on a very few interest-rate

Interest-rate movements and liquidity management in the Eurosystem



1 Interest rate for main refinancing operations. — **2** Maintenance periods: November 24 to December 23, 2000, December 24, 2000 to January 23, 2001, and January 24 to February 23, 2001. — **3** Banknotes in circulation, government deposits with the Eurosystem, net foreign currency reserves of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances.

Deutsche Bundesbank

Factors determining bank liquidity *

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

Item	2000/2001 Nov. 24 to Dec. 23	Dec. 24 to Jan. 23	Nov. 24 to Jan. 23
I. Provision (+) or absorption (–) of central bank balances by			
1. Change in banknotes in circulation (increase: –)	– 7.7	– 7.9	– 15.6
2. Change in general government deposits with the Eurosystem (increase: –)	– 11.3	+ 8.9	– 2.4
3. Change in net foreign exchange reserves 1	– 4.2	– 10.7	– 14.9
4. Other factors 2	– 1.9	+ 16.9	+ 15.0
Total	– 25.1	+ 7.2	– 17.9
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	+ 26.7	– 5.1	+ 21.6
b) Longer-term refinancing operations	– 0.0	± 0.0	– 0.0
c) Other operations	–	–	–
2. Standing facilities			
a) Marginal lending facility	+ 0.2	+ 0.1	+ 0.3
b) Deposit facility (increase: –)	– 0.0	– 0.4	– 0.4
Total	+ 26.9	– 5.4	+ 21.5
III. Change in credit institutions' current accounts (I. + II.)	+ 1.7	+ 1.7	+ 3.4
IV. Change in the minimum reserve requirement (increase: –)	– 1.6	– 1.9	– 3.5
Memo items 3			
Main refinancing operations	210.4	205.3	205.3
Longer-term refinancing operations	45.0	45.0	45.0
Other operations	–	–	–
Marginal lending facility	0.4	0.5	0.5
Deposit facility	0.2	0.6	0.6

* For longer-term trends and the contribution of the Deutsche Bundesbank, see pages 14* and 15* of 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 (outright transactions and the issuance of debt certificates). — 3 Levels on an average of the maintenance period under review or the last maintenance period.

Deutsche Bundesbank

stages near the minimum bidding rate. At the same time, the bidding volumes and the number of bidders have been declining. In the case of longer-term refinancing operations, too, credit institutions' bidding has tended to be muted.

Money-market management via main tenders

Over the turn of the year, too, ongoing money-market management in the Eurosystem was conducted exclusively through the use of main refinancing operations. The ECB sought to limit the fluctuations in the credit institutions' daily central bank balances to around the level of the required minimum reserves, and to make it possible for the banks to meet their reserve requirements evenly. The provision of funds by the Eurosystem was primarily geared to typical calendar variations in the circulation of banknotes, and to the pronounced fluctuations in the public sector's deposits with the Eurosystem. Moreover, the increase from € 15 billion to € 20 billion in the outstanding volume of longer-term refinancing operations approved in December by the Governing Council of the ECB for 2001 had to be taken into account. Integrating Greece into the Eurosystem on January 1, 2001 posed no problems. Altogether, the volume of the Eurosystem's regular open-market operations increased by € 21.6 billion between November and January. This served to offset market-related liquidity withdrawals totalling, on balance, € 17.9 billion, as well as to finance the rise in the level of required minimum reserves, amounting to € 3.5 billion.

On balance, the overnight money market has presented a very even picture. Only at the

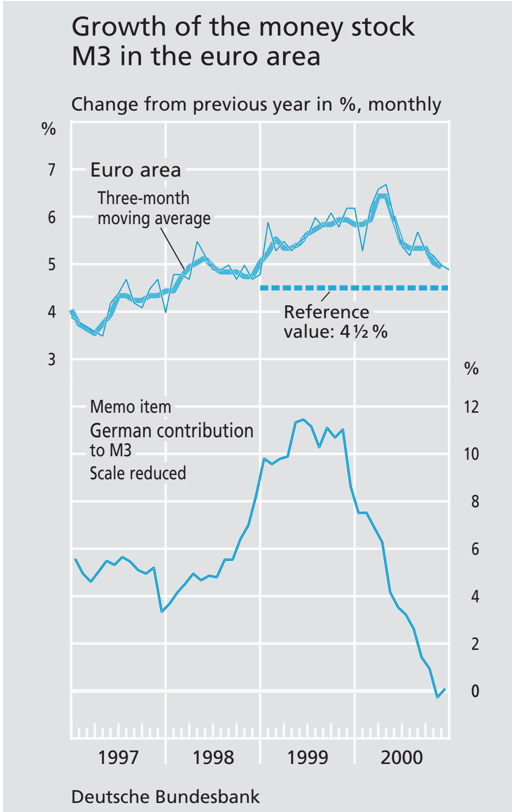
Credit institutions' assistance operations

end of the year did EONIA go up quite sharply, as usual. Towards the end of the January reserve maintenance period, however, EONIA dropped distinctly for a short time on account of a sizeable liquidity surplus. Average bank recourse to the standing facilities did increase a bit during the period under review; however, such recourse continued to focus on the end of the maintenance periods.

Abated monetary growth

Monetary growth in the euro area slowed down again in the fourth quarter of 2000, after having picked up somewhat in the preceding quarter in connection with the auction of UMTS licences in Germany. Especially in December, seasonally adjusted money holdings rose very moderately. Over the whole fourth quarter, they rose at a seasonally adjusted annual rate of 4 %. At the end of December, the money stock M3 surpassed its 1999 level by 4.9 %, compared with 5.3 % at the end of September. The moving three-month average of the year-on-year rates was 5.0 % during the October-December period, in contrast to 5.4 % from July to September and 6.5 % from February to April. Thus, it has manifestly approached the reference value of 4½ %, which was reaffirmed for 2001 by the Governing Council of the ECB at its December 14, 2000 meeting. That applies all the more if one considers that those rates slightly overstate the liquidity expansion in the euro area, owing to the purchases of money-market paper and money-market-fund certificates by non-euro-area residents (which are not statistically recorded).

Among the individual components of the money stock M3, cash and overnight deposits



Components of the money stock M3

grew only sluggishly, seasonally adjusted, in the fourth quarter after having been augmented somewhat more strongly in the third. At the end of December the year-on-year rise in the money stock M1 was 5.5 %, compared with 6.2 % at the end of September. The diminished propensity of investors to hold liquidity probably owes something to the rise in short-term interest rates, which fostered portfolio shifts into higher-yielding assets. The marketable financial instruments included in the money stock M3 benefited in particular measure from that development. Other shorter-term bank deposits rose moderately between October and December, seasonally adjusted. Whereas fixed-term deposits with an agreed maturity of up to two years made substantial gains, the reduction in deposits with an agreed notice of up to three months persisted – apart from the rise in December, owing to interest payments.

Balance-sheet counterparts

In the fourth quarter of 2000, monetary growth was fostered in particular by lending to the private sector, although that, too, weakened a bit. At the end of December, the year-on-year rise in overall lending to the private sector was 10.3 %, compared with 10.9 % at the end of September. Loans to enterprises and individuals went up at a seasonally adjusted annual rate of just over 7 % between October and December, compared with just over 10 % between July and September, when a fairly large volume of funds had been raised to finance the purchase of UMTS licences. Lending to the public sector was also reduced in the fourth quarter, albeit to a lesser extent than in the two preceding quarters. On balance, this was entirely due to a decline in lending against securities; loans by MFIs to the public sector, by contrast, picked up again during the period under review. Monetary capital formation, relatively strong during the preceding quarter, came to a virtual halt between October and December, statistically speaking. Payments by resident non-MFIs to non-euro-area residents had little impact on monetary growth in the fourth quarter. Overall, outflows totalled € 2.7 billion, and were thus much lower than in the same period of the previous year (€ 36.2 billion).

German contribution

The German contribution to M3, which has been growing more sluggishly than the euro-area aggregate since the end of 1999, again declined slightly in the fourth quarter of 2000, after seasonal adjustment.[2] Its year-on-year rise at the end of December was 0.2 %. During the period under review, monetary growth in Germany was curbed, in particular, by weak lending to the private sector by MFIs. In December, some individual transactions also played a role; as a result, the current movement of lending tends to understate the trend (see page 28).

Capital-market rates tending to fall

Capital-market rates in the euro area showed a downward trend around the turn of the year. Between mid-November and the end of 2000, the yield on ten-year government bonds in the euro-area countries[3] initially went down by ½ percentage point to under 5 %, hitting a low at the beginning of January, at the same time as the Federal Open Market Committee (FOMC) of the US Federal Reserve, in a surprise move, cut the federal funds rate. Afterwards, the yield inched back up, though fluctuations did occur. When this Report went to press in mid-February, the yield was just under 5 %. The low capital-market rates in Europe suggest that market participants are assessing long-term inflation expectations as moderate. Accordingly, the interest-rate differential between the capital market and the money market declined in the fourth quarter from just over 40 bp to under 20 bp. Mounting expectations of an economic downturn and increasing speculation that interest rates may be cut engen-

2 On the longer-term development of the German contribution to M3, see page 19 of this Report.
3 Since the beginning of 2001 the euro-area capital-market rate has been calculated including Greece and using 1999 GDP weights. Though the yield on Greek government bonds is still distinctly higher than that of the other euro-area countries, no significant break in the series can be discerned, owing to their low weight in the calculation of the overall rate of interest.

The development of the German contribution to M3

For some time now, the pace of monetary growth in Germany has been perceptibly weaker than in the euro area as a whole. Euro-area M3 grew by 4.9 % last year, whereas the German contribution rose by only 0.2 %, i.e. practically stagnated. These disparate growth rates do not have a single explanation, but may rather be attributed to several factors. First of all, there has been a trend towards normalisation in monetary expansion in Germany. One reaction following the launch of monetary union in 1999 was major and, in part, temporary portfolio shifts in components of the German contribution to M3. Immediately upon the transition to monetary union, uncertainty was heightened, and with it came a general increase in the propensity to hold liquid funds. Furthermore, owing to changes in the minimum reserve regulations, large amounts of funds previously lodged in Luxembourg and the United Kingdom were repatriated to the German banking system. That resulted, in particular, in the ballooning of the volume of overnight deposits in Germany. Sales of money-market paper likewise rose sharply, fostered by a certain "need to catch up" compared with the other euro-area countries, and by heavy demand from non-euro-area countries. Towards the end of the year, these factors were joined by a Y2K-related search for safe investment vehicles. Against that background, Germany's contribution to M3 rose in 1999 by 8.7 %, i.e. distinctly faster than the euro-area aggregate (6.2 %).

Last year, that trend reversed. Euro-deposits were replenished, whereas overnight deposits were run down from the spring onwards owing to interest-rate considerations, among other things. Sales of money-market paper also returned to some semblance of normal. If both years are taken together, Germany's contribution to M3, which grew at an annual rate of 4.3 %, expanded less than euro-area M3 (5.5 %). This implies that the tendency of liquid holdings to return to normal is not in itself enough to account for the perceptible weakening of monetary expansion in Germany in 2000. Recent developments serve to corroborate this impression. In the past six months, the German contribution to M3 has decreased at a seasonally adjusted annual rate of 1½ %, whereas euro-area M3 has grown at a rate of just over 4½ %. The disparity between these trends probably owes something to the rise in short-term interest rates since the end of 1999, which has triggered a variety of adjustment measures in the individual euro-area countries (depending on the pattern of cash holdings and their specific rates of interest). A relatively large percentage of the German contribution to M3 consists of deposits bearing little interest; the interest-rate increase has therefore been accompanied by a relatively sharp rise in the opportunity cost of holding cash, and a correspondingly greater dampening of monetary expansion than in other countries.

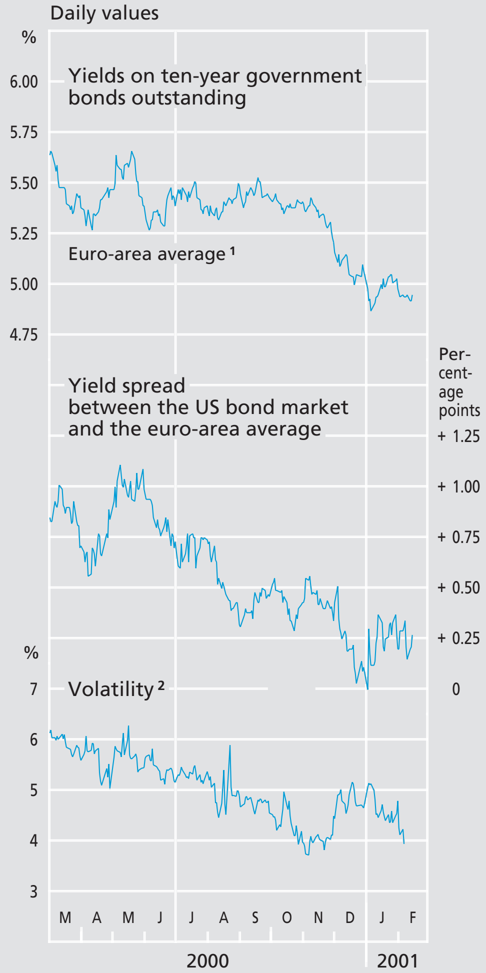
The individual components of the German contribution to M3 most affected by this development are overnight deposits and deposits with an agreed maturity of up to three months. The latter, after having been greatly enlarged in the past few years because banks paid a rate of interest on them that exceeded the minimum interest rate, are now being transformed to a great extent into longer-term savings deposits, and also into other higher-yielding investment vehicles issued by domestic and foreign borrowers. Apparently, foreign investment-fund certificates are meeting with exceptionally keen interest.

Besides portfolio adjustments by investors, relatively sluggish bank lending to the private sector has likewise been a factor contributing to the weak growth of the German contribution to M3. Whereas loans by MFIs to households and enterprises in EMU rose by 9.5 % in 2000, their growth rate in Germany was only 4.5 %, and barely 3½ % in the second half of the year (expressed as an annual rate). There are two probable reasons for this. One is the dampening impact of higher interest rates and the slowdown in the economic upswing. The other is that, in 2000, German enterprises increasingly procured funds through affiliated foreign enterprises. Moreover, the ongoing downturn in housing construction, traditionally the largest category of borrowers from banks, is making itself felt.

Finally, monetary growth in Germany in 2000 was also curbed by funds flowing out of the country. Not only outflows to non-euro-area countries (a situation affecting the rest of the euro area, too) played a role, but also outflows to other euro-area countries, from which substantial sums had poured into Germany in 1999. There, they tended to promote monetary growth.

Deutsche Bundesbank

Bond market yields in the euro area



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

Deutsche Bundesbank

dered greater uncertainty in the capital market towards the end of the year. Thus, the implied volatility of the Bund future, which indicates the price fluctuations expected by market participants in the futures market in the near future, rose until early January 2001; since that time, though, it has been back on the decline.

US interest-rate advantage marked by cyclical factors

The yield spread between ten-year US Treasury bonds and comparable bonds from euro-area countries narrowed during the fourth quarter from ½ percentage point to less than 10 bp at times, and thus hit a low not reached since the beginning of monetary union. When this Report went to press, this differential, at ¼ percentage point, was still very low. The reason for this minuscule interest-rate differential is that long-term rates in the United States dropped somewhat faster than in Europe. In mid-February 2001, the yield on ten-year US government bonds outstanding was almost ¾ percentage point lower than it was as late as November last year. This decline in interest rates was driven, in particular, by mounting signs of a looming economic downturn in the United States and concomitant expectations of a cut in central bank rates. Stimuli towards interest-rate cuts were also imparted by price adjustments in the US equity market, which gathered pace in the fourth quarter, and which unleashed increased demand by investors for fixed-rate instruments.

Equity prices down at first, followed by a slight rally; price movements volatile on the whole

Since the autumn of last year, share prices in the euro area have continued to fall. Measured in terms of the Dow Jones Euro STOXX broad index, in mid-February European equities were quoted at 8 % below their level in mid-November 2000. They have dropped some 18 % below their all-time high at the beginning of March 2000. The prime factor behind this development is a sharp decline in prices up to the end of 2000, followed by a slight rise starting early in January. Broken down by sectors, distinct differences may be observed between the movement of share prices from more traditional sectors and prices from the high-tech segment. Both the price fall up to the end of 2000 and the rise in prices starting at the beginning of this year were more pronounced in the high-tech sector. European stock markets largely follow the lead of Wall Street, as reflected in the fact that US price movements are running slightly ahead of the Euro STOXX. On the whole, between mid-November and mid-February, the Standard & Poor's 500 index fell by 5 %, whereas investors in the tech-heavy NASDAQ saw their stock prices drop by 19 %. Uncertainty surrounding prices, measured in terms of the implied volatility of the next futures contract due in each broad index, was higher in Europe than in the United States during the period under review.