The international and European setting

Developments in the world economy

Persistent slowdown in the world economy

So far this year, the world economic climate has continued to cool off. The United States is still the central force slowing the pace of growth. Real gross domestic product (GDP) in the United States rose at an annualised rate of 1½% in the winter half of 2000-01, its slowest growth since 1991. As a result, the preceding considerable overextension of macroeconomic production capacities has declined perceptibly. There are additionally many signs that the US economy has not yet reached its cyclical trough. The sharp reduction in central bank lending rates since the beginning of 2001 might be having a positive impact on consumer confidence and the business climate. However, it demonstrates yet again just how difficult it is to take an economy which has built up a need for adjustment following a period of conjunctural tension and considerable excesses in its equity markets and to redirect it towards a soft landing.

The braking effects emanating from the United States, which are being transmitted primarily via foreign trade and international financial markets, have in the meantime also impaired the current situation and future outlook of other economic regions, albeit to varying degrees. The slowdown in growth of the IT sector, in particular, has meant that the east Asian economies which specialise in these export products have had to clamp down perceptibly on growth. It is true that most of that region's emerging economies are still on a path of growth. However, the Japanese economy has taken yet another hit; domestic demand, particularly private consumption, has been too weak to offset the dampening of export activity. The Latin American countries present a rather mixed picture. Countries having close trade relations with the United States, such as Mexico, were hit particularly hard by the slumping US economy, whereas other countries with a less-dense network of trade relations but with large US-dollar-denominated foreign debt, such as Brazil, seemed to benefit, on balance, from the US Federal Reserve slashing its interest rates. Argentina is a special case because it is undergoing a difficult economic and financial crisis. The main causes of this crisis are the overvaluation of the peso and the government's serious budget problems. The worldwide economic slowdown left its mark in the central and east European countries, too. In the Russian case, the fall in crude oil prices and the real appreciation of the rouble are additional dampening elements.

The euro area is in a more favourable position relative to the US and Japanese economies. All the same, the euro area's business cycle has slowed down. Besides the negative influence from the United States, the worsening of the terms of trade – in connection with the sharp rise in oil prices and the euro's weakness – contributed to this slowdown. The depletion of purchasing power from households and enterprises in the euro area picked up again this year following a short respite. The inability of the euro to recover against the US dollar in a sustained manner and the sharp rise in international quotations for mineral oil products were the two main reasons.

IMF forecasts for 2001 and 2002

Item	1999	2000	2001	2002
Real gross domestic product	Change from previous year in %			
Advanced economies 1	+ 3.4	+ 4.1	+ 1.9	+ 2.7
of which				
United States	+ 4.2	+ 5.0	+ 1.5	+ 2.5
Japan	+ 0.8	+ 1.7	+ 0.6	+ 1.5
EMU	+ 2.6	+ 3.4	+ 2.4	+ 2.8
Consumer prices 2				
Advanced economies 1	+ 1.4	+ 2.3	+ 2.1	+ 1.8
of which				
United States	+ 2.2	+ 3.4	+ 2.6	+ 2.2
Japan	− 0.3	− 0.6	− 0.7	0.0
EMU	+ 1.2	+ 2.4	+ 2.3	+ 1.7
Unemployment	Number of unemployed as % of the labour force			
Advanced economies 1	6.4	5.9	5.9	5.9
of which				
United States	4.2	4.0	4.4	5.0
Japan	4.7	4.7	5.3	5.2
EMU	9.9	9.0	8.4	8.1

Source: IMF, World Economic Outlook, May 2001. — **1** Industrialised countries plus Israel, China (Taiwan), Hong Kong (Special Administrative Region), Republic of Korea and Singapore. — **2** Consumer price index.

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IMF spring forecast remains relatively favourable, ...

Against that background, the International Monetary Fund (IMF) recently made a significant downward revision in its forecast; however, there are no expectations of a worldwide recession. Global output, at 3¼% for 2001, is expected to continue its perceptible growth, even if at a slower pace than in 2000, when it increased by just under 5%. According to the IMF staff prediction, the general phase of weakness will only last a relatively short time. The upward forces in the United States may gain the upper hand as early as in the second half of 2001. The forecast also states that next year the economic situation in Japan will brighten up. In Europe's case, the IMF forecasts that the pace of growth, in the light of generally robust domestic demand boosted by tax relief in the major euro area countries, will likewise pick up. On the whole, the prospects that the world economy may return to its path of potential growth in 2002 are considered to be quite favourable. According to the IMF forecast, though, the increase in world trade will slow down to 6½% this year and next, after having been as high as 12½% in 2000.

... yet considerable downside risks

However, this scenario is fraught with considerable risks. There is still quite a danger that the bottom may fall out of the US economy and that structural weakness in Japan may persist. In addition, one cannot rule out the risk that the large external imbalance of the United States may be given more attention by the markets than in the past, which could lead to increased volatility in the foreign exchange markets. Moreover, given weaker growth, the structural problems existing in some emerging economies may become more prominent once again. That could create uncertainty in financial markets; if the worst came to the worst, it could even trigger destabilising capital transactions.

Price developments in industrialised countries

In April 2001 consumer prices in the industrialised countries were up an average of 2¼% on the year, representing a slight increase in the rate of inflation, which had been 2% in March. Excluding Japan (which, given its slightly declining price levels, pushes the average value down significantly), price pressures were considerably stronger (3%). The major reason for the most recent clouding-over of the price climate was the sharp increase in prices for mineral oil products in April. In addition, other sources of energy, especially gas, whose prices trail heating oil quotations with a certain time lag owing to contractual pegs, became more expensive as of late. Quotations in the crude oil markets themselves held steady in the first four months of this year, mostly within a relatively close range of US$ 24 to US$ 27 per barrel of North Sea Brent, remaining distinctly below the peak of US$ 34 reached in November 2000. Since the end of April, though, prices have been inching upwards. According to the IMF forecast, consumer price inflation (starting from the average of 2.3% for all of 2000) will slow down this year and next to 2.1% and 1.8%, respectively. However, this presupposes that quotations in oil markets and the price of mineral oil products go back down in the near future and that the home-made price pressures remain within tight boundaries.

United States

According to initial estimates, real GDP (adjusted for seasonal and working-day variations) in the United States rose in the winter months of 2001 by ½% from its level of autumn 2000, considerably exceeding expectations. Its previous year's level was surpassed by 2¾%. Seasonally adjusted private consumption once again showed strong growth, at ¾%, a surprise considering the distinct worsening of consumer sentiment in the winter half of the year. It is also remarkable that commercial investment and housing construction went back up following a sluggish trend in the autumn. Final demand, i.e. total demand less stockbuilding, was even just over 1% higher than in the previous period. However, this contrasted with a destocking, which put a considerable damper on growth. The change in stockkeeping, though, is a positive sign insofar as this constitutes an important precondition for the economy recovering in the near future. Foreign trade exerted an expansionary influence for the first time in a long while. At a seasonally adjusted 2¾%, imports weakened considerably more than exports (½%). As a consequence, the deficit in the real foreign balance diminished perceptibly. However, this also demonstrates just what an impact the US economy has on the other economies via foreign trade.

However, it would be premature to interpret favourable GDP growth as indicating that economic recovery is just around the corner. Apart from statistical uncertainty in the national accounts when performing the first estimate of a quarterly result, the situation in the labour market seems to have clouded over significantly. The number of employed persons plummeted in the past few months, with the unemployment rate rising from its October nadir by well over one-half percentage point to 4.5% as of late. In April, seasonally adjusted industrial output went down for the seventh month running. In the first quarter, new orders for durables were 4½% lower than in the last quarter of 2000 and down by just over 7% on the year. Moreover, the positive development in foreign trade at the beginning of the year cannot be expected to continue apace. Year-on-year consumer price inflation, after having eased distinctly in March, went back up to 3.3% in April. The rise in prices for mineral oil products mentioned at the beginning of the article was a key factor. In contrast, core inflation went down slightly, to 2.6%.

Japan

In the second half of 2000, the Japanese economy stagnated, after seasonal adjustment. However, real GDP was still 1½% higher than a year earlier. The main factor behind the renewed weakness of the economy was that private domestic demand remained anaemic, even falling below its level of the first half of the year, whereas export activity suffered a considerable loss of steam, with import activity remaining brisk. Following the turn of 2000-01, the downturn continued. Nominal exports fell by a seasonally adjusted ½% from their level in the fourth quarter. Deliveries of IT goods and cars abroad plummeted, contributing in large part to the decline in industrial output in the first quarter of the year, which amounted to a seasonally adjusted 3¼% compared with the previous quarter. The year-on-year decline was 1%. Households' demand likewise tended to be sluggish in the past few months. In addition, private investment is having less and less of a stabilising impact. Given a considerable volume of involuntary stockbuilding in the electronics sector, the negative pattern of output is likely to continue in the near future.

Japanese hopes rest all the more on the United States recovering quickly and thoroughly and on a new economic policy which will promote the process of reform. Macro policy instruments have done all that they can. The central bank has practically used up its room for manoeuvre by returning to a zero-interest-rate policy, and fiscal policy will not be able to continue the expansionary course it has been taking for much longer owing to the high government debt it has already run up. After a short interruption at the beginning of the year, consumer prices have been inching downward since February. However, this is only partly a reflex of the weak economy. The streamlining of distribution networks and deregulation in the telecommunications sector have also contributed to that development.

United Kingdom

In the United Kingdom, in the first quarter of 2001 seasonally and working-day adjusted real GDP only rose by ¼ % from the previous period, according to initial estimates. This meant that its year-on-year growth was 2 ½ %. The services sector remained on a path of growth, whereas industry had to continue to gradually reduce its output. In addition, macroeconomic development was severely strained by the drastic reduction in agricultural production. Animal production, having already taken a hit due to the BSE crisis, saw the bottom fall out owing to the spread of foot and mouth disease. However, the weakening in growth does not seem to have had a tangible influence on UK households' propensity to consume. At any rate, retail turnover continued its strong rise in the winter months, and consumer confidence in the first quarter of 2001 was at a level it had not attained for quite a long time. Private consumption received an important boost from positive developments in employment and by the rather high wage rises. So far, they have not had a sustained negative impact on the consumer price climate. In terms of the retail price index, excluding mortgage lending rates, consumer price inflation in April was 2.0 %, well below the Bank of England's inflation target of 2.5 %.

Macroeconomic trends in the euro area

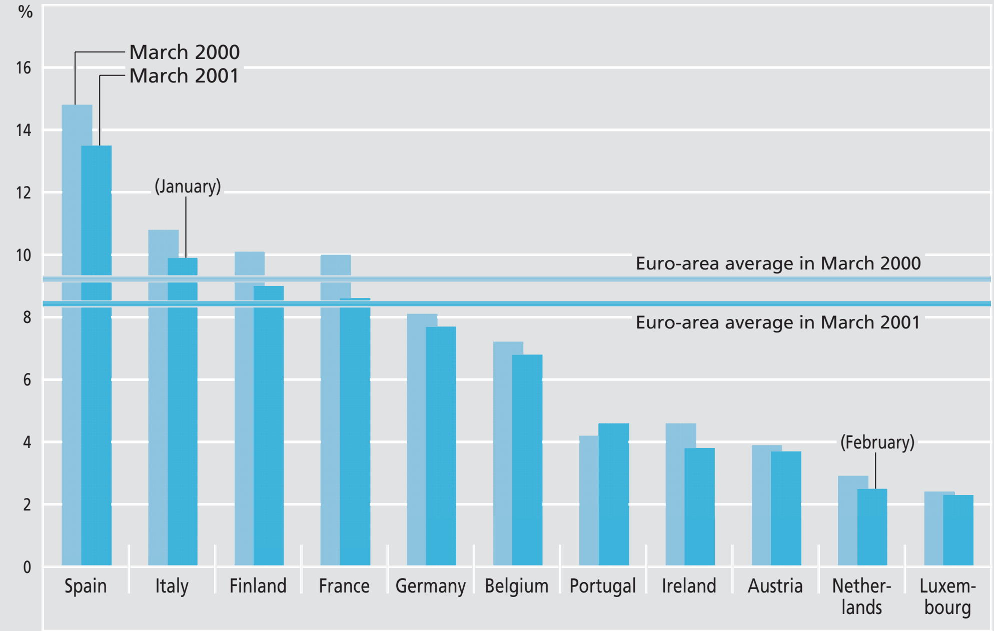
Slower growth in the euro area

In the winter half of 2000-01, the overall conjunctural situation in the euro area worsened distinctly. At first glance, this would seem to contrast with the relatively strong real GDP growth from last autumn; at a seasonally adjusted ¾ % from the previous period, this growth was even somewhat stronger than in the summer quarter. However, it was particularly those demand components such as government consumption and investment in stockbuilding (which are difficult to interpret as business indicators or which give mixed signals) which grew more strongly. In addition, the seasonally adjusted result for the last quarter could also have been distorted upwards by the fact that the fourth quarter saw a relatively positive working-day influence and that not all euro area countries adjust GDP for working-day variations.

The stagnation of industrial production in the first quarter of 2001 (seasonally adjusted) relative to the last quarter of 2000 is another sign that the business cycle is calming down. In this important sector, year-on-year growth slowed down from 5 ½ % in autumn 2000 to 4 ¼ %. Fittingly enough, seasonally adjusted capacity utilisation in the euro area manufacturing sector was once again on the decline in January-April 2001 in all euro area countries save Ireland and Greece. However, it was still above the average of the nineties. Industry sentiment, measured in the EU survey, has clouded over almost continuously since it last peaked in June 2000. The ratio of negative to positive responses was more glum in April than at any time since September 1999. Con-

Unemployment

Standardised unemployment rates, seasonally adjusted



Sources: OECD, Eurostat.

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sumer confidence, however, has held firm at a very high level throughout. This may have been helped along considerably by the tax reductions that came into effect in some euro area countries at the beginning of the year. As of late, the situation in the euro area countries' labour markets has improved only slightly owing to the economic downturn. The seasonally adjusted standardised unemployment rate went down since October of last year by only 0.2 percentage point to 8.4 % in March 2001.

Prices

Under the influence of the renewed rise in prices of mineral oil products in the international markets, increases in administered prices, bad weather and the agricultural crises, consumer prices rose at a seasonally adjusted and annualised rate of 3½ % between December 2000 and April 2001; the latest year-on-year rate was 2.9 %. Food, drink and tobacco prices were up 4.4 % on the year. Unprocessed foods, which were hit by the bad weather and the impacts of the animal epidemics, saw a year-on-year price rise of 7.3 %. Energy prices were up 7.8 % on the year, having started from an already high price level. Services saw a 2.4 % price rise on the year, with the sharp rise in administered prices and taxes in some countries playing a major role. By contrast, industrial goods inflation, at 1.4 %, remained within tight limits, even though an upward trend can be noticed. The inflation differential in the euro area has increased once again. France, as it has for some time, once again had the lowest rate of inflation, at 2.0 % on the year. In the Netherlands, the price trend, at + 5.3 %, was particularly unfavourable; an increase in the value-added tax contributed to that development.

Current account and exchange-rate trends in the euro area

Exports to non-euro-area countries

Despite the decline in world economic growth, euro area suppliers' exports continued to witness persistently strong turnover growth in non-euro-area export markets even at the beginning of this year. In the last three months for which such figures are available (December 2000-February 2001), euro-area countries'[1] exports surpassed their previous year's value by 17½%. A significant increase in earnings per unit (caused by the depreciation of the euro) and large growth in volumes both played a part in this development.

Imports from non-euro-area countries

At the same time, though, the figures for imports from non-euro-area countries rose sharply. In the months of December-February, the value of imports was up 19% on the year. However, higher import prices were the main reason for this increase. It was particularly the relatively high energy prices which made euro area imports from non-euro-area countries expensive. On balance, the (nominal) foreign trade surplus of the euro area during the period under review continued to shrivel (to € 2½ billion, following € 5½ billion in the same period of the previous year).

Current account

"Invisible" current account transactions in the euro area closed with a deficit of € 18 billion. This represents an improvement over the same period in the preceding year of € 2½ billion and is attributable to a lower shortfall in current transfers and in factor income. On the whole, during the months under report the euro area current account ran a deficit of around € 15½ billion, i.e. around the previous year's level.

Exchange-rate movements

After recovering distinctly at the turn of 2000-01, the euro's position in the foreign exchange markets weakened a bit once again in the first few months of the new year. The euro had to relinquish some of its previously achieved gains against the US dollar, in particular, whereas it was relatively able to hold its own against the other currencies. After being quoted at up to US$ 0.95 in January of this year, the rate, given sometimes extreme fluctuations, fell to US$ 0.88 by mid-May.

US dollar

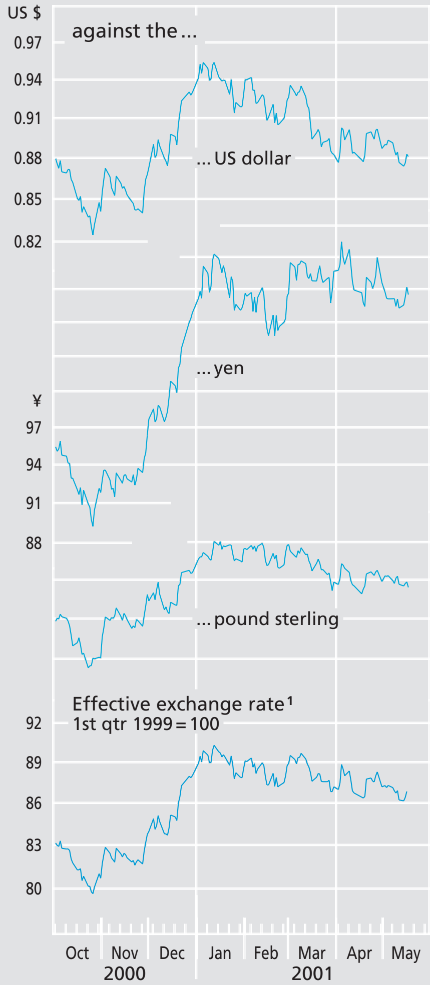
The renewed drop in the exchange rate was a bit of a surprise. For one thing, the growth advantage of the United States, which was at times one of the driving forces behind movements in the euro-US dollar exchange rate, has shifted since the end of last year in the euro area's favour, and for another, the interest differential has changed to the euro's advantage following the Federal Reserve Board's interest-rate moves. The exchange-rate movements of the past few months have therefore apparently been fuelled less by current yield spreads and growth differentials and more by a series of factors, often of varying importance, which have influenced market players' expectations regarding further trends. The first three interest-rate cuts made this year by the US Federal

1 From January 2001, euro area including Greece. Year-on-year data from 2000 were supplemented with Greece's trade with non-euro-area countries and adjusted for Greece's trade with the euro area.

Reserve Board have apparently shed a more favourable light on the US economy's outlook for growth, whereas recent figures for the euro area seemed to be more of an indication of the existing conjunctural risks. The fact that international organisations and economic research institutes downgraded the outlook for growth is a fitting example. By contrast, the Fed's surprise interest-rate cut in mid-April tended to be considered by various observers as a sigh that the Federal Reserve does, in fact, expect a relatively lengthy and powerful recession in the United States. The concern that the expansionary thrust of monetary policy may generate new dangers of inflation may also have played a role. At any rate, longer-term capital market interest rates rose in the period immediately thereafter, and the euro recovered somewhat. Following the unexpectedly favourable figures for US economic growth in the first quarter (which, however, should be interpreted with caution), though, the euro once again came under some pressure. On the whole, since mid-March the euro has been hovering within a tight corridor between US$ 0.88 and US$ 0.90. That trend also continued following the latest interest-rate moves taken by the European Central Bank and the US Federal Reserve.

Exchange rate of the euro

Daily values, log. scale



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).

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Yen

The euro suffered distinct losses against the yen, too, but was able to make them up in the following period. After averaging ¥ 110 in January, the euro fell to as low as ¥ 105 in February. Major repatriations of Japanese Euro-deposits towards the end of the Japanese fiscal year may have played a role. Yet soon afterwards, the yen lost ground against practically all other currencies upon increased fears among market players that the Japanese economy, following a temporary recovery, could once again slide into a recession and be strained by a rising number of bad loans. When the Bank of Japan took on a very expansionary monetary policy stance at the end of March, the pessimistic mood on the markets became entrenched, causing the yen to continue its slide at first. In mid-May, the euro, at ¥ 108, had almost returned to its

January average, putting it just under 21½ % above its nadir of October.

Pound sterling

By contrast, the euro's movement against the pound sterling was much more stable in the first few months of this year, with the euro having stabilised distinctly up until then. However, in the past few weeks it lost some ground against the pound sterling, too, when market players gave the UK economy's growth outlook a somewhat more positive assessment following the interest-rate cut by the Bank of England. At £ 0.61, the euro was still just over 5 ½ % above its end-October level.

Effective exchange rate of the euro

As a weighted average against the currencies of the euro area's twelve most important trading partners, the euro went down by slightly less than 3 % between the beginning of January and mid-May, though it was still 8 ½ % above its end-October nadir.[2] However, the renewed fall of the euro against the US dollar – in spite of the shift in growth in favour of the euro area – has shown that the markets still consider the US economy to be the more robust and efficient of the two, whereas the growth potential of the euro area is still being viewed with scepticism owing to the persistent structural weaknesses. Therefore, it is all-important that the member states do not waver in their efforts to pass reforms, but that they instead continue along the path of growth-enhancing structural reform full speed ahead, thereby strengthening investor confidence in the economic future of the euro area.

Monetary policy and the financial markets in the euro area

Interest-rate cut in May

In the spring months, the ECB Governing Council initially adhered to the "steady-as-she-goes" interest-rate policy it had introduced in autumn 2000. At its meeting on May 10, 2001, it then cut all key interest rates by one-quarter percentage point. The interest rates for the marginal lending facility and the deposit facility have stood at 5.50 % and 3.50 %, respectively, since May 11; the main refinancing operations have been conducted since May 15 as variable-rate tenders with a minimum bid rate of 4.50 %. The assessment of medium-term risks to price stability in the euro area based on the two-pillar monetary policy strategy of the ECB argued in favour of cutting interest rates. The trend towards slower monetary growth continued. Given the statistical distortions of the money stock, monetary growth is currently lower than the reference value of 4 ½ % (see page 18), which means that there are no more dangers to price stability emanating from the monetary side. The slowdown in economic growth was accompanied by a reduction in the risks to price stability in terms of the second pillar of the ECB strategy, too. The current, and relatively high, rate of price increase is largely a result of special influences

2 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 the year, only the 12 remaining currencies have been taken into account since then when calculating this index.

and one-off effects. It is due to subside gradually and without any negative effects on inflation expectations.

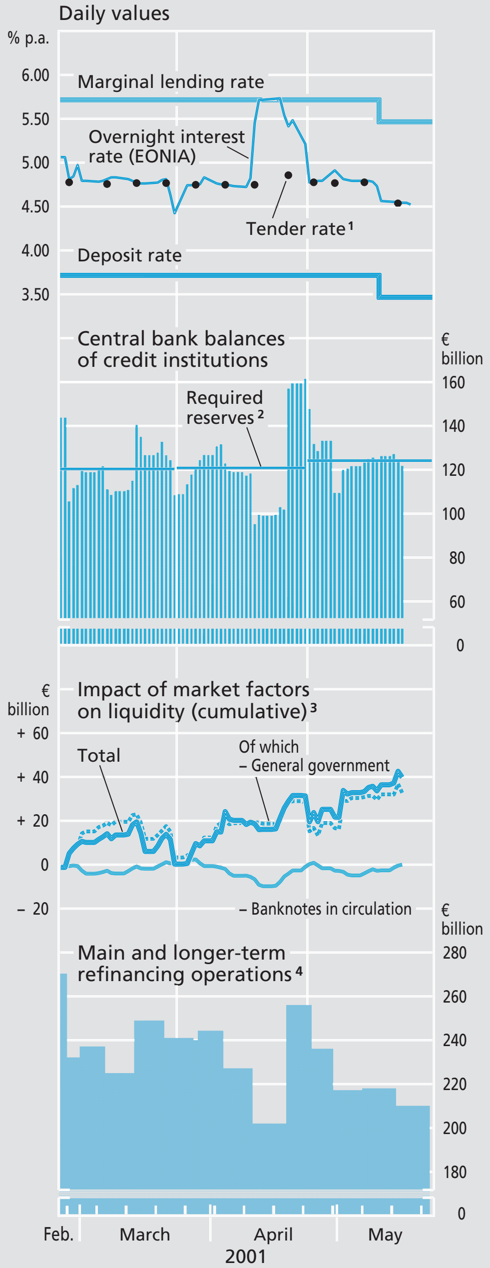
Money market rates were volatile

Quotations in the money market were very volatile in the past few months. Against the background of persistent expectations in the market that interest rates would be reduced, particularly longer-term notations fell initially starting in end-February. In the run-up to the Governing Council meeting at the end of March, rates in all maturity segments continued to decline distinctly, and the yield curve in the money market was extremely inverse. Yet when the Eurosystem left key interest rates unchanged, market players' expectations of lower central bank rates in the near future sagged, and money market rates generally rose sharply. Following the cut in key interest rates in May, quotations for fixed-term deposits went back down.

Bidders were "on strike" in April ...

Over the course of March, the overnight interest rate (EONIA) and the marginal allotment rate of the weekly tender operations went down to the level of the minimum bid rate. Owing to that interest-rate constellation and the prevailing expectations of interest-rate cuts, the number of credit institutions participating in main tenders decreased. In the April 11 main refinancing operation, the bid volume – much like in February – fell well short of the credit institutions' short-term liquidity needs. Yet unlike in February, this time the banks did not expect any fine-tuning operations by the Eurosystem; they immediately took major recourse to the marginal lending facility over the Easter holidays. For the first time, EONIA rose as high as the mar-

Interest-rate movements and liquidity management in the Eurosystem



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, 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. — **4** Including a one-week operation from April 30 to May 6, 2001.

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Factors determining bank liquidity *

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

Item	2001 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: –)	+ 1.8	– 1.6	+ 0.2
2. Change in general government deposits with the Eurosystem (increase: –)	+ 4.0	+ 3.5	+ 7.5
3. Change in net foreign exchange reserves 1	– 2.3	+ 6.5	+ 4.2
4. Other factors 2	– 1.4	– 1.4	– 2.8
Total	+ 2.1	+ 7.0	+ 9.1
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	– 3.7	– 12.8	– 16.5
b) Longer-term refinancing operations	+ 4.3	+ 4.3	+ 8.6
c) Other operations	–	–	–
2. Standing facilities			
a) Marginal lending facility	– 2.2	+ 1.8	– 0.4
b) Deposit facility (increase: –)	– 0.1	+ 0.0	– 0.1
Total	– 1.7	– 6.7	– 8.4
III. Change in credit institutions' current accounts (I. + II.)	+ 0.3	+ 0.4	+ 0.7
IV. Change in the minimum reserve requirement (increase: –)	– 0.2	– 0.4	– 0.7
Memo items 3			
Main refinancing operations	185.2	172.4	172.4
Longer-term refinancing operations	54.1	58.4	58.4
Other operations	–	–	–
Marginal lending facility	0.4	2.2	2.2
Deposit facility	0.5	0.5	0.5

* 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 as an average of the maintenance period under review or the last maintenance period.

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ginal refinancing rate; the allotment rates of the main tenders that followed were once again above the minimum bid rate.

... which made money market management via main tenders difficult

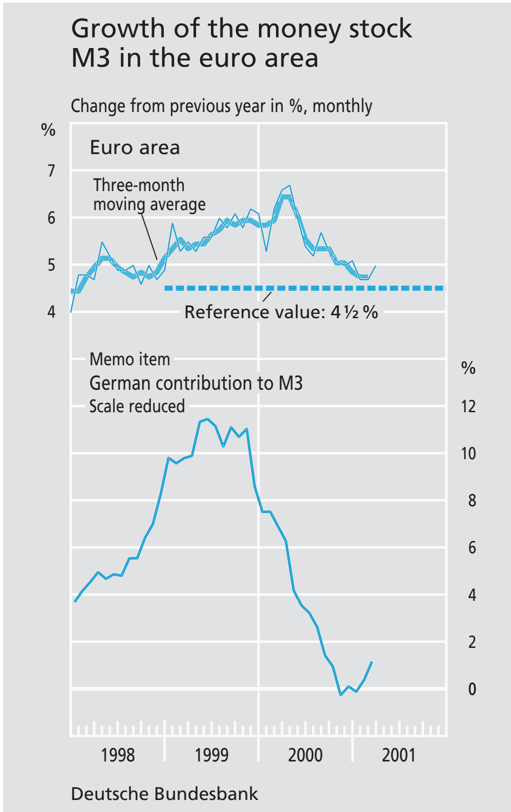
During the period under review, ongoing money market management in the Eurosystem continued to be geared towards offsetting the liquidity effects of autonomous market factors on credit institutions' central bank balances in the timeliest manner possible. It was also conducted with a view to gradually bringing the allotment amounts of the two main tenders, which had been diverging sharply since February, into alignment. Following the insufficient volume of the bids submitted by banks in the April 11 tender operation, it was not possible to guarantee that those objectives could be achieved merely by means of the usual main refinancing operations. Therefore, on April 30, the Eurosystem, at the same time as its two-week main tender operations, conducted an "other" one-week refinancing operation (which was likewise a standard tender according to the fixed-rate tender procedure). This measure proved successful in closing the gap between the individual tender volumes, and the Eurosystem regained the ability to provide liquidity in a flexible and needs-based manner via main refinancing operations.

Decline in liquidity needs

On the whole, the autonomous factors determining bank liquidity caused € 9.1 billion to flow to credit institutions between February and April (see the adjacent table). The transfer on April 4 of the Bundesbank's profit for the year 2000, which amounted to just over € 8 billion, is reflected in those inflows. By contrast, the minimum reserve requirements went up by € 0.7 billion. In accordance with a decision taken in December 2000 by the ECB Governing Council, the outstanding volume of longer-term refinancing operations was increased to just under € 60 billion. The main tenders were reduced by € 16.5 billion. Increased recourse to the deposit facility was taken by banks as the end of the reserve maintenance period in March approached; their recourse to the marginal lending facility was focused on the Easter holidays.

Monetary growth characterised by portfolio shifts

In seasonally adjusted terms, the euro area money stock M3 again grew somewhat more strongly in the first quarter of this year than in the last quarter of 2000. In both February and March, money holdings grew strongly. Falling stock prices in the equity markets contributed to that growth. In the light of the inverse shape of the yield curve at the short end and the further decline in interest rates, apparently many investors preferred to hold their assets in more liquid forms. At the end of March, M3 in the euro area as a whole surpassed its previous year's level by 5.0 %, compared with 5.1 % at end-December 2000. The three-month moving average of year-on-year rates was 4.8 % between January and March 2001, as opposed to 5.1 % between October and December 2000. Thus, monetary growth has continued to approach the reference value of 4½ %. When interpreting monetary growth in the euro area, in addition to the aforementioned portfolio shifts, it must likewise be borne in mind that the recorded rates, owing to purchases of money market fund certificates and money market paper by non-euro-area residents which have so far not been recorded in the statistics, overstate liquidity expansion in the euro area.[3] In March working-day effects, which distort the twelve-month rate upwards, entered into the mix. If the purchases of negotiable paper by non-euro-area residents are eliminated, growth of the money stock M3 is currently below the reference value. Foreign purchases of money market fund certificates are alone enough to increase the twelve-month growth rate for M3 at present by around one-half percentage point. Purchases of money market paper by non-euro-area residents, which are statistically more difficult to estimate, have likewise reached a significant magnitude.[4]



3 Since the outstanding amount of marketable instruments is reported exclusive of the holdings of euro area 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.
4 See European Central Bank, Monthly Bulletin, May 2001, page 5 ff.

Components of the money stock

In the first quarter of this year, among the individual components of the money stock M3, it was particularly those components carrying rates of interest which are comparatively closely in line with market conditions which benefited from investors' propensity to "park" their funds in short-term deposits. This applies both to fixed-term deposits with an agreed maturity of up to two years and to marketable financial instruments – particularly money market fund certificates and money market paper, as well as repo transactions. Currency and sight deposits stagnated, seasonally adjusted, after having already witnessed anaemic growth in the fourth quarter of 2000. At end-March the money stock M1 was only 2.1 % up on its previous year's level. Deposits with an agreed maturity of up to three months continued to be reduced.

Balance-sheet counterparts

As regards the balance-sheet counterparts, monetary growth in the euro area continued to be fostered, above all, by lending to the private sector. Credit to the private sector at end-March was 9.2 % up on the year, as opposed to 10.2 % at end-December 2000. MFIs' loans to enterprises and individuals went up at a seasonally adjusted annualised rate of 8 % between January and March; this growth was even a bit stronger than in the preceding quarter (where it was just over 7 %). At end-March they were 8.6 % higher than their previous year's level. By contrast, the public sector reduced its borrowing from domestic MFIs. On the whole, monetary capital formation, which had come to a virtual standstill in the final quarter of 2000, increased in the first quarter of this year, but it has recently distinctly lost steam. Payment transactions of resident non-MFIs with non-euro-area residents saw considerable outflows of funds in the first quarter of this year.

German contribution

The German contribution to euro area M3, which had been growing more sluggishly than the euro area aggregate since the end of 1999, grew more sharply in the first quarter of 2001 than the euro area aggregate, after seasonal adjustment. Its year-on-year rise at the end of March was 1.2 %, following 0.2 % at the end of December 2000. However, that rate probably overstates to some degree the actual supply of liquidity in Germany owing to purchases of money market paper and shorter-term bank debt certificates by non-euro-area investors. Unlike at the euro area level, the development of the German contribution to M3 was characterised by domestic depositors sharply increasing their overnight deposits (see page 25 f.).

Capital market rates up slightly

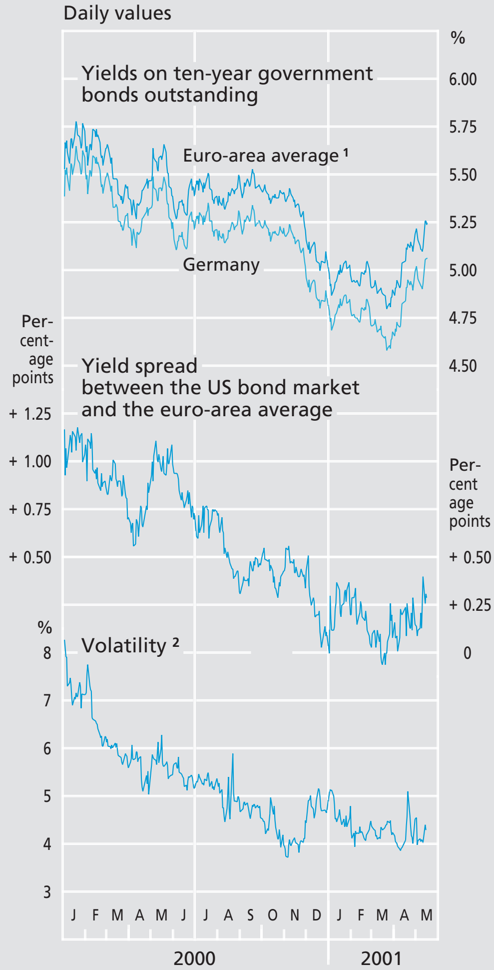
Capital market rates in the euro area rose slightly in spring 2001, on balance. From mid-February to mid-March, the yield on ten-year government bonds in the euro area countries initially went down by 20 bp to just over 4¾ %. Thereafter, it went back up. As this Report went to press in mid-May, the yield was at 5¼ %. Owing to pronounced expectations of interest-rate cuts on the part of market participants, the rate of three-month funds temporarily fell much more strongly than capital market rates, causing the yield spread between the capital market and the money market to widen again following its low of eight basis points on March 21, 2001. The Eurosystem's interest-rate move on May 10 additionally widened the gap between long-term and short-term interest rates. In mid-May the gap was around ⅔ percentage point. The implied volatility of the Bund future, which indicates the price fluctuations expected by market participants in the futures market in the near future, held steady, initially without any major fluctuations, at a low level between mid-February and mid-April. At the end of April the Fed's surprise interest-rate move, as well as unexpectedly high money stock and inflation figures in the euro area, caused a resurgence of relatively strong interest-rate uncertainty in the capital markets.

Volatile interest-rate movements in the United States exerting an influence

The pattern of long-term interest rates in Europe since the beginning of the year has largely reflected, albeit to a lesser degree, interest-rate movements in the United States. After the yield on ten-year US Treasury bonds outstanding fell by one-half percentage point between mid-February and mid-March, it went back up just days after the Federal Funds Target Rate was reduced for the third time on March 20. A further surprise interest-rate cut on April 18 was accompanied by rising long-term interest rates as well. A comparison of the yields of nominal and inflation-indexed US Treasury bonds shows that this rise in interest rates was fuelled primarily by heightened inflationary expectations. Portfolio shifts towards stocks likewise played a role. The real yield on ten-year indexed bonds, by contrast, has gone down since March. Seen in isolation, this does not indicate that market participants are giving the long-term outlook for growth a more positive assessment. Owing to the relatively strong fluctuations in capital market interest rates in the United States, its

Bond market yields in the euro area

Daily values



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

interest-rate advantage over the euro area at the long end initially vanished completely before reappearing and growing. All the same, though, the spread between yields on US and European government bonds was, at currently just over one-quarter percentage point, still very small.

Stock prices in the euro area continued their slide in the first quarter of the year. In terms

Stabilisation in the equity markets

of the Dow Jones Euro STOXX, the prices of European shares at the end of March were around 30 % below their peak level of spring 2000. Since that time, the situation in the stock markets has brightened up considerably, and by mid-May prices had risen by around 12 %. In addition, share price uncertainty, measured in terms of the implied volatility of options in the Dow Jones Euro STOXX, has been on the decline since mid-March, which indicates that stability is returning to European equity markets. Since the end of March, share prices from the high-tech segment have been rising particularly sharply. This is likely to have improved the financing situation of that innovative sector somewhat. However, the highly volatile nature of those stocks' prices indicates the difficulty of correctly valuing high-tech stocks, which react more violently to changes in sentiment than stocks from "old economy" sectors. Developments in European equity markets have largely mirrored those in US equity markets. The US Standard & Poor's 500 index took a tumble once again in April but has been on the rise since that time. In particular, stocks listed on the tech-heavy NASDAQ have risen strongly since the beginning of the second quarter, gaining in value by over 18 % in the month of April alone.