The international and European setting

Developments in the world economy

Persistent slowdown in the world economy

In the spring months the global economic climate continued to cool off, with no major economic region left untouched. World trade is hardly likely to have increased. However, there are considerable differences in terms of the starting level, the pace and the determining factors of the slowdown in the business cycle. In the industrial countries, seasonally adjusted macroeconomic production is likely to have only inched up slightly in the second quarter of 2001, on the heels of a distinct slowdown. At any rate, industrial production went down again in the period from April to June; its 12-month decrease amounted to 2½%. However, this continued to contrast with moderate growth in services. High energy prices and several special factors put pressure on prices in many places and contributed substantially to the sluggishness of real domestic demand. The labour markets have increasingly been coming under the spell of the economic slump. However, so far major layoffs and downsizing are likely to have been limited to subsectors.

Given sluggish economic activity in the second quarter and the continued absence of signs of a turn for the better, opinion is becoming entrenched that major downward revisions will have to be made to the economic forecasts for the current year published at the beginning of spring. However, the updated economic forecasts still assume that the economy will recover perceptibly next year.

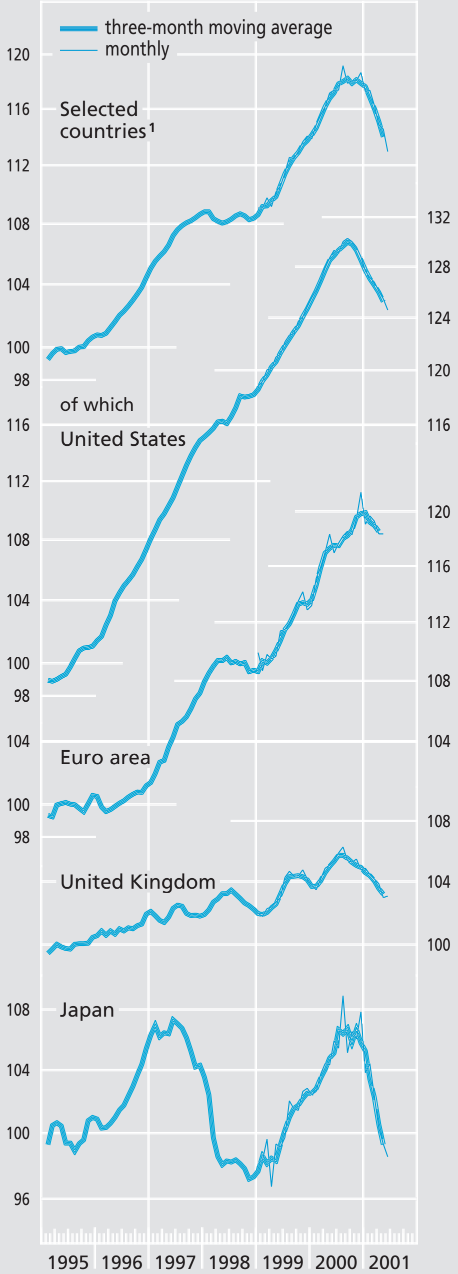
The worldwide slump in the demand for information and communications technology goods had a particularly severe effect on the emerging economies in south-east Asia, which are heavily dependent on exports of those products. By contrast, the Chinese economy continued to experience strong growth following the turn of 2000-2001. Latin America has likewise been affected (though in varying degrees, depending on the intensity of trade relations) by declining US demand for imported goods. This has been exacerbated by the fact that Argentina is still mired in a grave financial and economic crisis which has not only impaired trade in goods with its neighbouring states, in particular, but is also potentially contagious. On top of that, the Brazilian economy is suffering from a pronounced energy crisis which might cause its growth to take a hit this year, too. The economic slowdown in the industrial countries has also adversely affected the current situation and the future outlook in the central and east European transition countries. By contrast, crude petroleum and natural gas exporters have been benefiting from the high energy prices. This group of countries includes Russia; however, its economic growth, at an estimated 5 ½ % for the first half of the year, did not quite match its average for 2000 (+ 7 ½ %).

Slowdown in the oil markets towards mid-year...

The outlook for the world economy has become a bit brighter as of late insofar as crude oil prices have been distinctly on the decline since the beginning of June. The decision by OPEC in July to cut oil production once again had little impact on oil prices. There are some signs that the global growth-hindering effects of last year's increases in oil prices will weaken gradually during the second half of the

Industrial production *
in selected countries

1995=100, seasonally adjusted, log. scale



Source: National statistics, Eurostat and the Bundesbank's own calculations. — * Including mining and energy, excluding construction. — 1 In addition to euro-area countries and countries already listed, the list includes Denmark, Greece, Norway, Sweden, Switzerland and Canada; weighted with the respective share in gross value added of industry in those countries in 1995.

Deutsche Bundesbank

... and stabilisation of purchasing power in western Europe, ...

year. Moreover, it is becoming apparent that in western Europe special factors, which in spring had caused food prices to skyrocket and additionally depleted consumers' purchasing power, are diminishing in importance. Then, the uplifting effects of the tax reforms that entered into effect at the beginning of the year in several euro-area countries, which so far have been cancelled out to a great degree by price increases, will probably become more and more pronounced.

... but economic turnaround in the United States not yet in sight

However, a sustained global recovery can only be expected once the US economy, whose importance for the world economy is greater than ever, begins to take off again. However, there are currently no signs that this will happen, and this view is shared by the US Federal Reserve. Important business indicators have been showing a downward trend as of late. Industry (which, however, accounts for less than one-fifth of overall value added) was in a deep recession in mid-year. In June, seasonally adjusted production went down for the ninth consecutive month, with new orders of durables likewise decreasing perceptibly. The results of the latest industry and consumer surveys indicated a renewed outbreak of pessimism in July following an inkling of an improvement in the preceding months. This was confirmed by the wave of profit warnings announced by enterprises. An economic recovery in the US is therefore not likely to occur until sometime in autumn at the earliest, when the interest-rate cuts take greater effect and tax relief becomes perceptible.

Macroeconomic production in the second quarter

According to initial estimates, real US GDP in spring was only up ¼ % on the previous period, after adjustment for seasonal and working-day variations. In the entire first half of the year it only went up by an annualised rate of just under 1½ %. In a year-on-year comparison, second-quarter growth, at 1¼ %, was lower than at any time since the end of 1991. Unlike in the winter months, where reductions in inventories, in particular, slowed down the pace of expansion, in spring private final demand lost steam. Industrial investment was hit hardest; it went down by a seasonally adjusted 3 ½ %, failing to reach its previous year's level for the first time since early 1992. Growth in real consumer spending by households went down from a seasonally adjusted winter level of + ¾ % to ½ %, yet it has remained relatively robust. Investment in new housing construction, which benefited from falling interest rates, once again showed strong growth, going up by 1¾ % from the previous period. Seasonally adjusted real net exports, despite weaker import activity, again slid somewhat deeper into deficit. The main reason was the reduction in exports caused not only by the strength of the dollar but also by the repercussions of second-round effects on the United States.

Revision of US national accounts

During a revision of the national accounts data going back to 1998, some GDP growth rates were distinctly revised downwards. For instance, expansion in 2000 is "only" 4.1% compared with 5.0 % prior to revision. Under the new method of calculation, average 1998-2000 growth, at 4.2 %, is 0.3 percentage point lower than if the old approach is used. The GDP data were revised primarily to take account of adjustments in software investment, investment in inventories and private consumption. At the same time the saving ratio for households was increased. The particularly pronounced revision for 2000, from – 0.1% to 1.0 %, is especially a reflection of a considerable increase in disposable income and a reduction in consumer spending. Using the new method of calculation, the ratio for the second quarter of 2001 was a seasonally adjusted 1.2 %. Another consequence of the revision in the national accounts data was that productivity growth was scaled back; non-farming productivity growth went down by one-half percentage point to 2 ½ % as an average of the period from 1998 to 2000. This has also done something to put the "US productivity miracle" into perspective. Unit wage costs under the new method of calculation went up by just over 2 ½ % per anno since 1998, compared with 1¾ % prior to the revision.

Labour market and prices

In spring 2001 the outlook in the US labour market became distinctly gloomier. Employment tended to decrease, and the seasonally adjusted unemployment rate reached 4.5 % in July, returning to its summer 1998 level. The easing of the labour market situation caused wage pressure in the private sector to recede a bit. Inflation decelerated from 3.6 % in May to 3.2 % in June. The main reason was the moderation in oil prices which could be observed since the beginning of June; in terms of the tendency, this seems to have held steady for the time being. By contrast, core inflation (i.e. excluding energy and food prices) rose from 2.5 % in May to 2.7 % in June.

The expansionary effects of the tax reform

Hopes of a revival of the US economy rest for one thing on the reduction of inventories, which was begun following the turn of 2000-2001, ending soon. For another, the sharp reduction in central bank lending rates by a total of 275 basis points since the beginning of 2001 and the tax reform that entered into effect on 1 July 2001 are expected to have an expansionary impact as the second half of the year progresses. The tax reform package envisages the gradual reduction of income tax rates, especially for medium and high-income families, by 2006. In the first stage, the tax reduction will be accompanied by tax relief for the "first" US$ 6,000 of taxable income for unmarried persons and US$ 12,000 for married couples, retroactive to 1 January 2001. In the summer months, most US households will receive tax refunds of up to US$ 300 and US$ 600, respectively. On the whole, this will result in estimated income tax relief for 2001 coming to just under ½ % of GDP; in terms of the second half of the year, when they have an impact on household income, it will be nearly 1% of GDP.

The envisaged tax reductions are part of a longer-term reform programme, and experience has shown that they will bolster households' further income expectations. They are therefore likely to boost private consumption, taken by themselves. However, they are up against factors which put a strain on consumer confidence and thus on consumers' propensity to spend. The short-term "net effect" of tax reform is therefore difficult to assess. Another problem is that the macroeconomic disequilibria in the United States, reflected particularly in the high current account deficit and the low level of household saving, have not been noticeably reduced during the present economic downturn.

Japan

In the spring, the Japanese economy was likewise mired in a pronounced slump. During the period from April to June industrial production once again took a tumble; it was a seasonally adjusted 4% below its first-quarter level and thus 5¼% lower than in the previous year. One key factor was that the export slump that had broken out in the second half of 2000 continued and worsened in the spring. The fact that the bottom fell out of the demand for IT goods around the world played an especially important role. The other key factor was that investment in machinery and equipment, which had supported the economy in the past year, has probably slackened. This is certainly indicated by the perceptible decline in domestic deliveries of investment goods in April-May – national accounts data for the second quarter are not yet available. Housing construction tended downwards as well. The decline in households' propensity to consume held firm throughout; this is generally attributable to pessimism concerning the labour market and the worsening income outlook. It is fitting that consumer prices in the period from April to June, despite the rise in crude oil prices, once again went down, by ½% on the year. On the whole, there are few signs so far that the Japanese economy will recover in the near future. Strong expansionary effects can probably only be expected from external sources. The chances of domestic demand reviving in the near future are very slight on the whole, not least because neither monetary policy nor fiscal policy has any tangible room for manoeuvre and because the recently announced reform measures will take effect only in the longer term.

United Kingdom

In the United Kingdom, macroeconomic growth continued to decelerate in the spring. Real GDP grew by a seasonally and working-day adjusted ¼% from the first quarter of the year, when it had gone up by ½%. On the year it went up by 2%. The services sector did not expand as dynamically as it had in the past, and industry remained in the grip of a recession; second-quarter production went down by a seasonally adjusted 1% from the first quarter and was just over 1½% lower than a year before. The worsening of the world economic climate, particularly the cyclical weakness in the United States and continental Europe, as well as the strength of the pound sterling, were important factors. The recent interest-rate cuts by the Bank of England should be seen in that light.

The most important demand-side pillar of the British economy has been private consumption, which – measured in terms of retail turnover – went up in the second quarter by just over 2%, seasonally adjusted, and by well over 7% on the year. One reason is that labour market developments have continued to be positive. Another is that the considerable decline in mortgage lending rates has freed up funds for additional consumer spending. At first glance the favourable development in consumption contrasts with weak industrial production. A closer look, though, reveals that imports picked up strongly and that probably inventories were reduced as well.

Throughout the year as a whole, the expansion of government spending on infrastructure, education and health envisaged in the 2001 budget is likely to stabilise the UK economy. The rise in retail prices (excluding mortgage lending rates) picked up from 2.0 % in April to 2.3 % in the period from May to July. The major reason was the temporary sharp rise in energy and food prices; after mid-year these prices went back down.

Macroeconomic trends in the euro area

Underlying momentum of economic activity continuing to slump

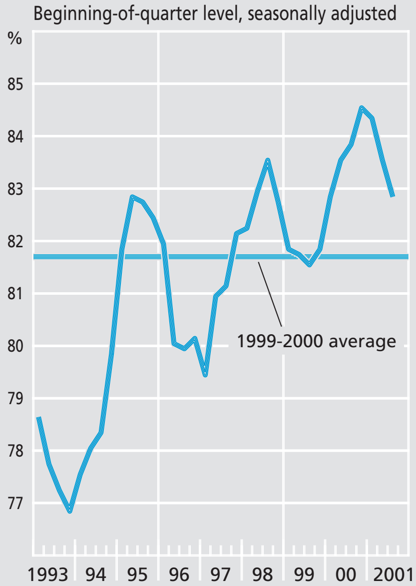
Economic activity in the euro area continued to cool off over the course of the first half of 2001. Macroeconomic output in the first quarter was a seasonally adjusted ½ % up on the previous period, a pace similar to that of the two preceding quarters. However, the underlying momentum of economic activity in the euro area is slowing down. In the context of the national accounts, the seasonally adjusted GDP growth in the first three months of this year is due almost exclusively to a perceptible decline in imports. By contrast, domestic demand and exports virtually came to a standstill. Year-on-year growth decelerated from 3 ½ % in the summer half of 2000 to 2 ½ % in the first quarter of 2001. (Comparable data are not yet available for the second quarter of the year.)

In spring the economic slump in the euro area continued, according to the available information so far. In April-May industrial output went down once again after seasonal adjustment, falling ¾ % below its level of the first quarter of the year. Its year-on-year growth was a paltry ½ %. The sluggish state of industry is also expressed in the latest results of the EU survey, according to which capacity utilisation in the manufacturing sector has continued its slide. In July 2001 it was over 1½ percentage points lower than in October 2000, when it last peaked, yet it continued to outpace its average for the nineties. The industry confidence indicator slipped continuously since September 2000; in July of this year it fell below its long-term average. By contrast, one welcome development is that industry's propensity to invest remained stable in the winter half of 2000-2001. According to the investment survey in March-April 2001, enterprises are adhering to their autumn 2000 plans to increase real expenditure on new equipment and plant by 3 % after having spent 6 % more in 2000. Consumer confidence, having been quite robust up to the beginning of spring, weakened distinctly since that time. That is undoubtedly a consequence of the depletion of purchasing power caused by the extreme increase in crude oil and food prices. However, the price relief which is already in sight is also likely to have a positive impact on the climate for consumption. Consumption did not receive any stimuli from the labour market as of late. The decline in unemployment came to a standstill in spring. In June, as in the two preceding months, the standardised unemployment rate was a seasonally adjusted 8.3 %.

Heterogeneity within the euro area

Within the euro area, the extent of the slowdown in economic activity has varied widely from one country to another. Most southern European countries' economies continued to grow in the winter of 2000-2001 at a healthy

Capacity utilisation in the manufacturing sector of the euro area



Source: European Commission business surveys.

Deutsche Bundesbank

pace. In the past few months, though, the retarding forces seem to have increasingly been gaining the upper hand. Germany will this year probably be one of the countries having the lowest level of economic growth. The most remarkable thing about it is that the growth differential vis-à-vis France, which is likewise one of the core countries and is beset with similar structural problems, especially regarding the labour market, went back up since mid-2000 (for more details see the "Appendix" on pages 21 ff.).

Gloomy price climate

As mentioned above, the price climate has grown distinctly gloomier in the spring months despite a slowdown in business activity. Consumer prices were over 1% up on their first-quarter levels, after seasonal adjustment; the annual percentage change accelerated from 2.6 % to 3.2 %. The key factor behind the rise in inflation was that food prices went up sharply, under the spell of animal diseases and the extremely wet and cold weather that afflicted some countries in the early spring. Energy prices went back up after having been down perceptibly in the winter months. Even the prices of industrial goods and services, which are typically more stable and which are less strongly affected by special factors, went up at annual rates of more than 2 %. In the second quarter, inflation rates ranged from 2.3 % for France to 5.2 % for the Netherlands. Thus, no country was in the stability corridor defined by the Eurosystem any longer. Relief seems to be in sight for prices in the summer months. Energy prices have already tumbled owing to lower oil prices, and food prices seem to be pointed downwards as well. A decisive factor in the sustainability of this moderating trend in prices will be whether labour costs in the euro area remain at current levels.

Current account and exchange-rate trends in the euro area

Foreign trade with non-euro-area countries

Due to the unfavourable world economic environment, euro-area foreign trade lost steam in the spring. In the March-May 2001 period, euro-area[1] countries' exports to non-euro-area countries were up by 11½ % from their previous year's level. While this increase was certainly still steep, it did not match last year's

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.

average growth of nearly 20 %. According to seasonally adjusted figures which the European Central Bank has published for the first time, which provide a better picture of current developments than a simple year-on-year comparison, euro-area countries' exports have remained virtually unchanged in the past few months. The value of euro-area imports from non-euro-area countries, according to the seasonally adjusted figures, stagnated in the spring months, after having gone down distinctly at the beginning of the year.

Current account

The euro area's trade surplus has remained nearly constant in the past few months following the sharp rise at the beginning of this year. In the three-month period from March to May 2001 it was a seasonally adjusted € 17½ billion, and thus € 5 billion higher than the comparable preceding period (December to February). This reduced the euro area's current account deficit, although net spending on "invisible" current account transactions was up by just over € 3 billion in the period under review. On balance, the euro-area current account deficit in the March-May reporting period, at (a seasonally adjusted) € 4 billion, was € 1½ billion less than in the preceding period.

Exchange-rate movements

From the beginning of the year to the beginning of summer the euro went down perceptibly. Only just recently has the euro been able to recover and to regain some of its lost value. As usual, its rate against the US dollar was the focus of action on foreign-exchange markets.

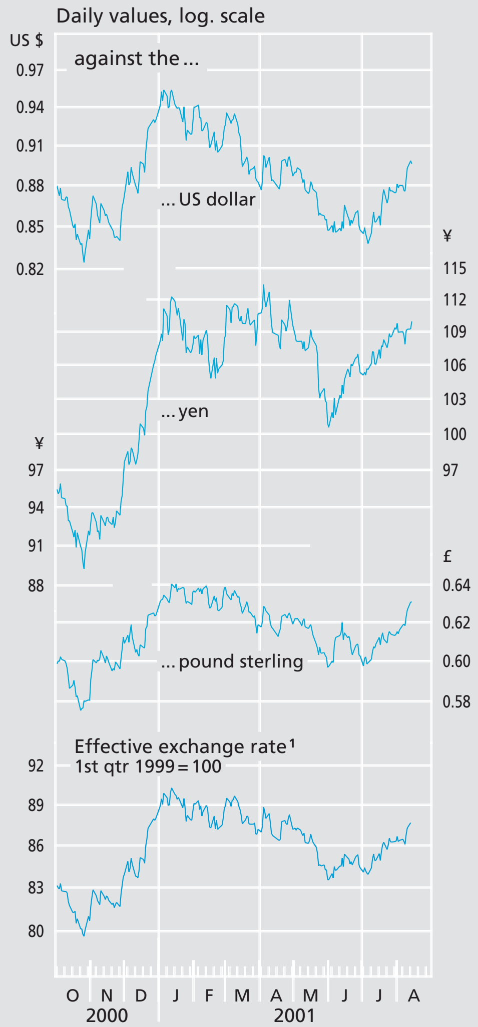
US dollar

The euro, after having fallen below US$ 0.90 by the beginning of May, seemed to stabilise at that level. However, after the Federal Reserve cut interest rates in mid-May, the euro lost even more of its value. The measure apparently reawakened confidence that the US economy would soon recover, whereas the outlook for euro-area growth tended to become more pessimistic. It was only when the euro hit the US$ 0.85 mark that some resistance became perceptible in early June; however it was broken once again following the Federal Reserve's next interest-rate move near the end of June. That caused the euro to fall to just under US$ 0.84 in the first few days of July, nearly reaching its nadir of last October (US$ 0.83). In the following period, however, concerns became greater as to the long-term impacts the extremely easy-money policy of the United States would have on price developments. However, only the Federal Reserve's pronouncement of mid-July – that risks to the US economy continued to exist – was capable of triggering an abrupt turnaround in the euro's fortunes. The euro was most recently quoted at around US$ 0.90, thus slightly surpassing its level of early May. However, this still represents a drop of 5 % below the euro-US dollar rate as at the beginning of the year.

Yen

In spring the euro started out by falling sharply against the yen before recovering the lost ground in the following period. After having been quoted at just under ¥ 109 at the beginning of May, in June the euro fell below the ¥ 101 mark, and thus more strongly than against the US dollar. In that period, the US dollar was also under selling pressure vis-à-vis the yen. The change of government in

Exchange rate of the euro



1 According to ECB calculations against the currencies of 13 countries (12 countries from 2001).

Deutsche Bundesbank

Japan had awakened hopes of a thorough and rapid implementation of the urgently needed structural reform and had caused the Japanese economy's outlook for growth to return to a more favourable light. However, at the beginning of June the yen came under devaluation pressure vis-à-vis nearly all currencies after the Bank of Japan, in its "tankan" [2] survey, which is closely watched around the world, indicated that Japanese economic sentiment would become gloomier and revised its assessment of the economic situation downwards. In mid-August the euro was quoted at just over ¥ 110 against the yen, thus slightly surpassing its level of early May.

Pound sterling

Against the pound sterling, the euro has been moving since early May in a corridor between around £ 0.63 and just under £ 0.60. Speculation that the United Kingdom would soon join the euro area placed the pound sterling under selling pressure only briefly.

The euro's effective exchange rate

As a weighted average of the currencies of the euro area's 12 most important trading partners, the euro regained at least part of the ground it had lost after having slumped in the spring months and at the beginning of summer; viewed in itself, this was similar to what the euro did against the US dollar. In mid-August the effective exchange rate was slightly up on its level of early May and thus around 1½ % below its value at the beginning of the year. [3] Thus, the depreciating euro's negative impacts on the domestic price climate have receded a bit from the external side; this ultimately also strengthens domestic purchasing power without putting unwel-

2 The Bank of Japan's "tankan" survey is published quarterly and is based on a regular comprehensive survey conducted among Japanese enterprises by the Bank of Japan.
3 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, pages 29 ff., and European Central Bank, The nominal and real effective exchange rates for the euro, Monthly Bulletin, April 2000, pages 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.

come strains on European exporters' international competitiveness.

Monetary policy and financial markets in the euro area

No change in the Eurosystem's interest rates

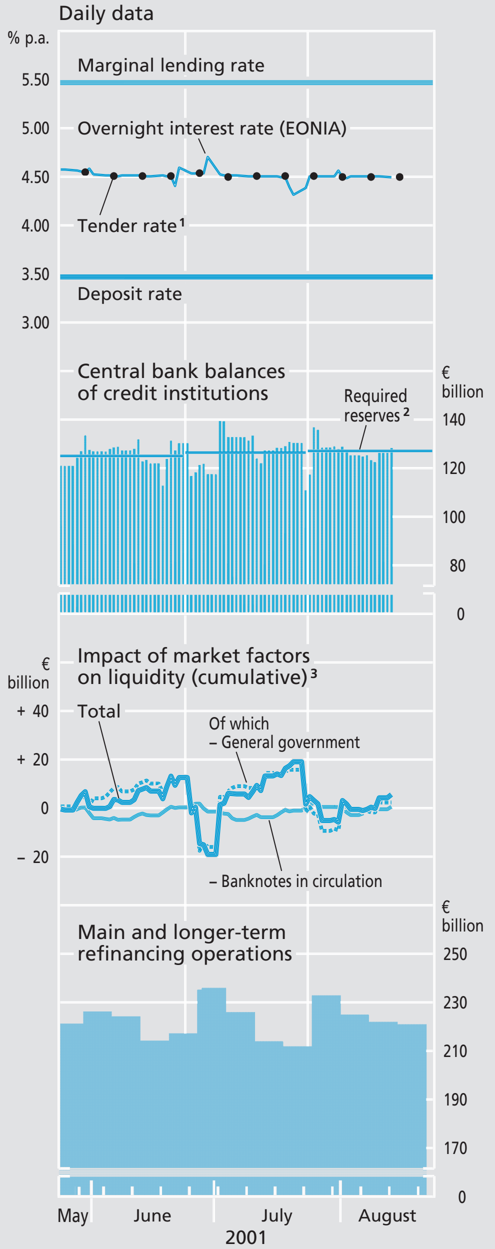
Following the interest-rate cut on 10 May 2001, the Governing Council of the ECB left the Eurosystem's interest rates unchanged. Since then, the Eurosystem's main refinancing operations have been conducted as variable-rate tenders with a minimum bid rate of 4.50 %; the interest rates on the marginal lending facility and the deposit facility have been 5.50 % and 3.50 %, respectively, since 11 May. Monetary and macroeconomic conditions both argued in favour of this steady course in interest-rate policy. M3 growth accelerated again in the past few months; however, much of that was due to portfolio shifts. Even so, inflationary risks have diminished over the medium term. Price pressure, having peaked under the influence of special factors in May, began to diminish in June and July. At the same time, economic growth has slowed down. On the whole, the "steady-as-she-goes" interest-rate policy appears to have been suited to maintaining price stability over the medium term and thus to ensuring ongoing economic growth.

Yield curve on the money market still inverted

During the period under review time deposit rates went down, with interest rates on six-month to twelve-month funds declining more rapidly than shorter-term rates. In mid-August money market rates fell around 10 to 35 basis points below their level of mid-May. Thus, the yield curve on the money market

Interest-rate movements and liquidity management in the Eurosystem

Daily data



1 Interest rate for main refinancing operations; uniform (for fixed-rate tenders) or marginal (for variable-rate tenders) allotment rates. — **2** Maintenance periods: 24 May to 23 June, 24 June to 23 July, and 24 July to 23 August 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	2001 24 May to 23 June	24 June to 23 July	24 May to 23 July
I. Provision (+) or absorption (–) of central bank balances by			
1. Change in banknotes in circulation (increase: –)	+ 1.6	+ 0.3	+ 1.9
2. Change in general government deposits with the Eurosystem (increase: –)	– 1.9	– 1.2	– 3.1
3. Change in net foreign exchange reserves 1	+ 0.6	+ 12.6	+ 13.2
4. Other factors 2	+ 0.0	– 11.3	– 11.3
Total	+ 0.3	+ 0.4	+ 0.7
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	+ 17.7	+ 0.2	+ 17.9
b) Longer-term refinancing operations	± 0.0	+ 0.8	+ 0.8
c) Other operations	– 17.0	–	– 17.0
2. Standing facilities			
a) Marginal lending facility	– 0.2	+ 0.0	– 0.2
b) Deposit facility (increase: –)	+ 0.2	– 0.0	+ 0.2
Total	+ 0.7	+ 1.0	+ 1.7
III. Change in credit institutions' current accounts (I. + II.)	+ 0.9	+ 1.4	+ 2.3
IV. Change in the minimum reserve requirement (increase: –)	– 0.9	– 1.4	– 2.3
Memo items 3			
Main refinancing operations	161.7	161.9	161.9
Longer-term refinancing operations	59.1	59.9	59.9
Other operations	–	–	–
Marginal lending facility	0.2	0.2	0.2
Deposit facility	0.4	0.4	0.4

* 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 in 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.

Deutsche Bundesbank

continued to be inverted. That means market participants expect the Eurosystem to cut key interest rates once more sometime before the end of the year.

Allotment rates close to minimum bid rate

The marginal allotment rates in the Eurosystem's main refinancing operations started out slightly above the minimum bid rate in the period under review; since the beginning of July both interest rates have often been identical. Although the number of bidding credit institutions has gone back down a bit, the bidding volumes have always been distinctly higher than the adequate allotment amounts.

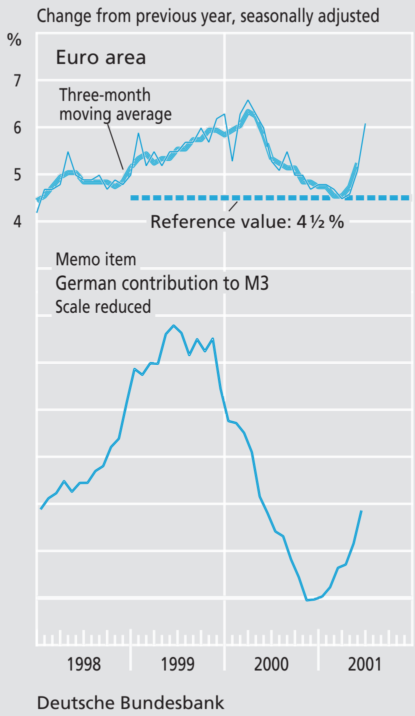
Liquidity management through main refinancing operations

In the summer months, liquidity management consisted exclusively in the use of main tenders. When gauging them, the Eurosystem needed to take particularly great account of the high volatility of general government deposits. On the whole, it offset the liquidity effects of autonomous market factors in quite a timely fashion and enabled credit institutions to maintain their minimum reserves relatively constantly. Against that background, the volatility of the overnight interest rate (EONIA) remained tightly in check. Only at the end of the reserve maintenance periods and, as usual, at the end of the half-year mark did the overnight interest rate deviate relatively sharply from the Eurosystem's minimum bid rate.

Little change in liquidity needs

On the whole, € 0.7 billion flowed to credit institutions (see adjacent table) in the period from May to July owing to autonomous factors determining bank liquidity. This development, atypical of the season, is attributable for one thing to the change in general government deposits, the impact of which was relatively non-contractionary. Another reason is that the number of banknotes in circulation did not go up as it normally does in the summer months but instead went down in connection with the upcoming introduction of euro banknotes following the turn of the year. By contrast, the minimum reserve requirements went up by € 2.3 billion. The volume of open market transactions was accordingly stepped up. Besides an increase in longer-term refinancing operations to the envisaged total volume of € 60 billion, the amount of main tenders outstanding was raised sharply. Account needed to be taken of the fact that the one-week other refinancing operation concluded at the end of April reached maturity. Recourse to standing facilities remained muted and was concentrated on the end of the reserve maintenance periods.

Growth of the money stock M3 in the euro area



Monetary developments still marked by portfolio shifts

Seasonally adjusted euro-area M3 rose in the second quarter of this year by a margin similar to the first quarter. Portfolio shifts made a key contribution to this development. Continuing uncertainty in the equity markets and the flat yield curve led investors to prefer short-term liquid assets. At the end of June area-wide M3 surpassed its previous year's level by 6.1%, compared with 4.5 % at the end of March; the three-month moving average of twelve-month rates was 5.3 % in April-June, compared with 4.6 % in January-March. The aforementioned rates have been adjusted for purchases of money market fund shares by non-euro-area residents;[4] additionally they take account of the problem of appearing calendar effects by being calculated on the basis of time series adjusted for seasonal and working-day variations.[5] However, when interpreting statistically reported monetary growth in the euro area, account should be taken not just of the aforementioned portfolio shifts but also of the fact that liquidity expansion in the euro area is overstated owing to the non-inclusion of purchases of money market paper by non-euro-area residents to date. At present these purchases probably add ¾ percentage point to the annual M3 growth rate.[6] In June it was also increased by a base effect.

Components of the money stock

Unlike in the preceding quarter, during the period under review components remuner-

4 See European Central Bank, Press release, Monetary developments in the euro area: April 2001, 30 May 2001.
5 See European Central Bank, Press release, Monetary developments in the euro area: June 2001, 26 July 2001.
6 See European Central Bank, Monthly Bulletin, August 2001, page 7.

ated at close to market interest rates were not alone in benefiting from investors' pronounced propensity to invest in short-term funds. It is true that marketable instruments, and particularly debt securities having a maturity of up to two years, went up strongly once again in the second quarter. However, sight deposits received a healthy dose of replenishment as well. Therefore, the seasonally adjusted monetary aggregate M1 rose somewhat faster than in the preceding quarter, despite the continuing decline in currency in circulation in the light of the approaching currency changeover date. At end-June it was up 3.8 % on the year. On the whole, other short-term bank deposits rose relatively moderately from April to June, seasonally adjusted; however, it was particularly the reduction of these deposits in May which had a pronounced impact.

Balance-sheet counterparts

Lending to the private sector became noticeably sluggish in the second quarter. At the end of June, MFI lending to the private sector was up 8.4 % on the year compared with 9.4 % at the end of March. Particularly MFI loans to enterprises and households rose, at a seasonally adjusted annual rate of 5 ½ %, distinctly slower from April to June than in the preceding quarter (8 ½ %). At the end of June they surpassed their previous year's mark by 7.8 %, following 8.7 % at the end of March. MFI loans to general government were reduced in the second quarter, too. Monetary capital formation, which had been relatively strong in the preceding quarter, decelerated during the period under review. There were minor outflows of funds in payments by euro-area residents with counterparties outside the euro area.

German contribution

The German contribution to euro-area M3, having already grown more strongly in the first quarter (seasonally adjusted) than the overall aggregate, went up somewhat more sharply than total euro-area M3 in the second quarter, too, despite a slight deceleration in the rate of growth. In June its year-on-year increase was 3.8 %, following a March figure of 1.3 %. However, this rate probably slightly distorts the actual supply of liquidity in Germany owing to purchases of money market paper and short-term bank debt securities by investors from outside the euro area.[7] By analogy with the euro-area context, the development of the German contribution to M3 was marked by a sharp rise in debt securities issued by German MFIs having a maturity of up to two years; domestic investors likewise replenished their overnight deposits perceptibly. In addition, there was a marked increase in short-term time deposits (see page 34).

Capital market rates fell slightly, on balance, given contrasting stimuli

On balance, long-term capital market rates in the euro area went down a bit during the period under review. As an average of the entire euro area, ten-year government bond yields were just under 5 % in mid-August. That meant that they were just over ¾ percentage point lower than in mid-May. Both in May and at the end of June long-term capital market rates picked up at times, to be sure,

7 Since the outstanding amount of such 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 are included in the monetary aggregate M3.

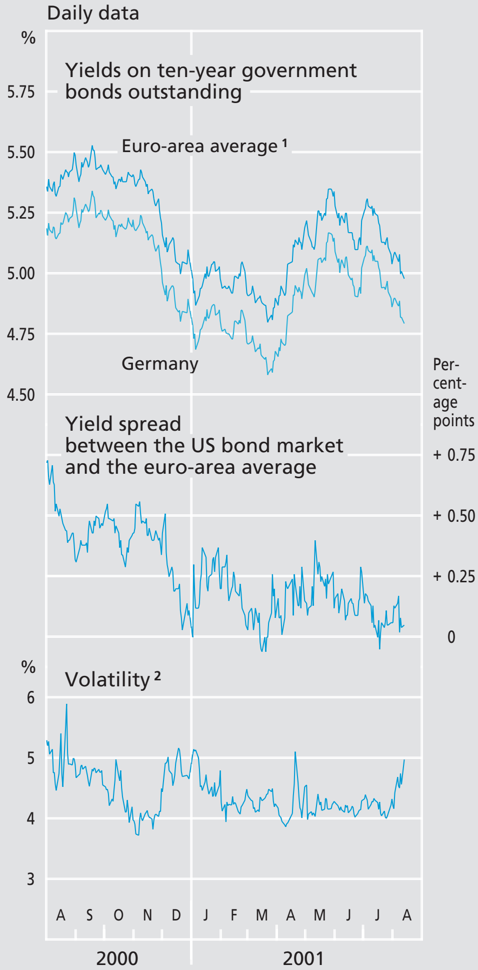
when market participants' inflation expectations temporarily worsened in connection with the unexpectedly sharp rise in consumer prices and oil price inflation. Owing to the dampened business outlook, however, they went back down somewhat more sharply. The more critical assessment of the profit outlook in business also lead to an increase in the yield spread between lower-quality corporate bonds and government bonds. The interest differential between the capital market and the money market generally followed the ups and downs of capital market rates. As this Report went to press, the gap between long-term and short-term rates, at just under ⅔ percentage point, was around the same level as in mid-May. Despite the partly contrasting movements of individual factors influencing yields, market participants' uncertainty on the future movements in bond prices, expressed in the implied volatility of options on the Bund future, was relatively low and largely constant. That has been helped along by the steady monetary policy of the Eurosystem and the recently receding inflation rates.

Difference between US and euro-area yields almost completely erased

The gap between the yields on ten-year US Treasuries and those on comparable euro-area bonds (just over one-quarter percentage point in mid-May) has been almost completely erased. The interest-rate cuts by the US Federal Reserve in May and June were each accompanied by a temporary rise in US capital market yields that was sharper than in the European capital market, causing the yield spread between US and European bonds at times to grow somewhat. Apparently long-term inflation expectations in the United States, after having clouded over at the beginning of the second quarter, took a turn for the better; at least this is the conclusion that may be drawn from comparing the yields on nominal and inflation-indexed US Treasury bonds. In July the yields on ten-year government bonds in the United States likewise went down more sharply than in Europe.

Bond market yields in the euro area

Daily data



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

Equity markets continuing their nosedive

After having nosedived, share prices in the euro area entered the second quarter by regaining some of their lost ground. However, this recovery proved unsustainable. Beginning in mid-May, in an environment of dampened growth and profit expectations, uncertainty concerning the valuation level, expressed in the implied volatility of options on the Dow Jones Euro STOXX share price index, went back up. The share prices of many public limited companies came under heavy pressure. On balance, the rates of European shareholdings in other enterprises continued their slump. Since its all-time high in March 2000, the Dow Jones Euro STOXX share price index has lost a total of more than one-quarter of its value. The gloomy sentiment in the market was once again reflected in particularly large mark-downs of high-tech shares. Share price movements in European equity markets were generally in line with those of other major equity markets during the period under review; in Japan, since mid-May prices fell even more sharply than in the euro area. However, as of late the otherwise rather close parallelism of movements between European and US share prices has perceptibly loosened. In terms of the Standard and Poor's 500 index, US share prices went down only to a limited extent. Share prices in the tech-heavy Nasdaq remained rather stable, unlike those of European high-tech stocks. The sharp interest-rate cuts by the US Federal Reserve over the course of this year probably contributed to the somewhat more favourable price movements.