The international and European setting

Developments in the world economy

First signs that the global economy is stabilising

The world economy remained weak in the final quarter of 2001. The advanced economies saw a further fall in their industrial production, and in many places unemployment continued to rise. However, signs of a gradual stabilisation of the world economic situation have now also appeared. In the world's two largest economic zones, North America and western Europe, the expectation components of major indicators of sentiment have recently brightened noticeably. In the United States new orders for durable goods tended upwards in December 2001. Since reaching a low point in September immediately after the terrorist attacks, equity markets have likewise recovered visibly. However, they have remained fairly prone to disruptions throughout, largely as a result of the spectacular collapse of some US companies.

According to initial calculations, overall economic production in the United States did not go down any further in the autumn of 2001 – contrary to general expectations. However, this result was strongly influenced by special factors that will be discussed below. The contractionary tendencies now seem to have dissipated. In the euro area, for which no such recent data on GDP are yet available, industrial production in December seems to have recovered after tumbling in the two preceding months. In addition, households' demand for consumer goods has held quite firm on both sides of the North Atlantic so far; in some countries, it has even risen visibly. That is remarkable in the light of losses in asset values associated with the corrections in stock market prices since the spring of 2000 and the mostly visible rise in unemployment.

Framework has improved considerably...

In addition, important conditions for a cyclical recovery have improved considerably over the past few months. Oil prices have stabilised at a relatively low level, strengthening consumers' purchasing power and taking pressure off companies' costs. The depletion of inventories has made further progress. In both North America and western Europe interest rates are relatively low although capital market yields have picked up, buoyed by expectations of a cyclical turnaround. Moreover, fiscal policy in the United States has been stimulating economic growth. Besides the tax reform introduced in 2001, other measures worth mentioning include those to support the economic sectors hit hardest by the 11 September terrorist attacks and those to strengthen domestic and external security. Fiscal policy in the euro area, which still has to take considerable consolidation requirements into account, is stabilising the economy by accepting cyclically induced budget deficits. In addition, the political risks which had severely strained the general economic climate owing to the events of 11 September 2001 are now being assessed as less grave. On the whole, a number of cyclical indicators and the more favourable environment are thus lending support to the prevailing forecast that expansionary forces will regain the upper hand in the spring. Especially as a result of the lower level of output at the end of 2001, however, this is not likely to have a perceptible impact on the annual average growth of global gross domestic product (GDP) for 2002. The December forecast of the International Monetary Fund (IMF) says that world economic growth, at 2.4%, will not be any higher than in 2001, and that the expansion in real world trade will rise to no more than 2.2%.

IMF forecast for 2002 *

Item	1999	2000	2001	2002
Real gross domestic product	Annual percentage change			
Advanced economies 1	+ 3.3	+ 3.9	+ 1.1	+ 0.8
of which				
United States	+ 4.1	+ 4.1	+ 1.1	+ 0.7
Japan	+ 0.7	+ 2.2	– 0.4	– 1.0
Euro area	+ 2.6	+ 3.4	+ 1.5	+ 1.2
Consumer prices 2				
Advanced economies 1	+ 1.4	+ 2.3	+ 2.3	+ 1.3
of which				
United States	+ 2.2	+ 3.4	+ 2.8	+ 1.6
Japan	– 0.3	– 0.8	– 0.7	– 1.0
Euro area	+ 1.1	+ 2.4	+ 2.7	+ 1.4
Unemployment	Number of unemployed persons as a percentage of the labour force			
Advanced economies 1	6.4	5.8	6.0	6.6
of which				
United States	4.2	4.0	4.8	6.0
Japan	4.7	4.7	5.0	5.7
Euro area	10.0	8.9	8.5	8.6

***** Source: IMF, World Economic Outlook – Special Issue, December 2001; information for 2001 partly estimated by the IMF. — **1** Including Taiwan, the Hong Kong Special Administrative Region, and the republics of Korea and Singapore. — **2** Consumer price index.

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... yet considerable risks still exist

These recognisable positive signals should not blind us to the risks that continue to exist, particularly those threatening the corporate sector. It is therefore still difficult to say to what extent the overcapacities created during the boom in the late 1990s, especially in the US information and communication technologies (ICT) sector, have either already been reduced or can still be put to economic use. A lastingly high or rising net investment ratio can be expected only if the economy either follows a steeper growth path or shifts to a higher trend rate. This is closely linked to the future importance of the new economy not only to the US economy but also to the rest of the world. If it turns out that the high expectations associated with the new economy which emerged in the late 1990s need to be further adjusted downwards and that the investment-stimulating decline in the relative prices of capital goods recedes, the commercial sector's propensity to invest, despite monetary stimuli which have at times been considerable, could be revived less quickly and less powerfully than many forecasters are currently expecting.

Problem countries: Argentina and…

Moreover, there are considerable weak links in the world economy. Argentina is in the middle of a major economic contraction process triggered by the financial crisis with no end in sight. As seen from today's perspective, however, the risk of contagion effects spilling over to other emerging economies in general and to Argentina's Latin American neighbours in particular seems to be limited. This is indicated by the fact that this crisis is largely "home-made" and has been looming on the horizon for quite some time. Financial markets have reacted reasonably to the Argentine government's moratorium on debt service payments.

…Japan

The persistently critical state of the Japanese economy is extremely worrisome. Japan is grappling with a battered financial system, a bloated government deficit and deflationary tendencies. Even if it is possible to avoid further destabilisation, Japan will probably not make any contribution to world economic recovery but instead will once again act as a brake on economic growth, particularly in east Asia. According to the IMF forecast, overall production in 2002 will shrink by 1%, a larger decline than in the preceding year (-½%).

In the third quarter of 2001 seasonally adjusted real GDP in Japan continued to slide; it was down ½% from both the preceding period's level and that of the same time a year before. In the last quarter of the year the unfavourable overall economic development seems to have continued. Industrial production went down by a seasonally adjusted 2½%, a year-on-year decline of no less than 12½%. The number of unemployed persons rose sharply during the last few months of the year, with the seasonally adjusted unemployment rate hitting an all-time high of 5.6% in December. The weakness in demand has hit all components of domestic demand; even government investment, which had been expanded sharply at times during the 1990s with the aim of stabilising the economy, tended downwards in the autumn of 2001. In October-November real exports did rise in the aggregate. However, this recovery was partly linked to the short-lived boom in the US car market – which will be explained in greater depth below – and is unlikely to last.

Consumer prices in January were 1.5% lower than a year before; they have dropped by around 3% since the autumn of 1998. Seen in isolation, real consumer purchasing power has increased. Viewed in a macroeconomic context, however, the drawbacks of mounting deflationary pressure weigh more heavily than the advantages: consumer are encouraged to take a wait-and-see attitude, the real debt burden rises and real factor prices go up. It is questionable whether the most recent depreciation of the yen – which will probably lead to higher import prices – can stop this. For the above reasons, hopes for the Japanese economy rest very much on a rapid and strong recovery of the world economy and particularly the US economy.

US GDP influenced by special factors in autumn 2001

According to initial calculations overall US economic output in the fourth quarter stagnated at its previous year's level after adjustment for seasonal and working-day variations. The US economy grew at an annual average rate of 1.1% in 2001 compared with 4.1% in each of the two preceding years. Owing to various expansionary special factors, though, real GDP growth in the autumn of 2001 does not reflect the basic cyclical trend, which initially had still been pointing downwards. Two factors particularly worth mentioning are that, firstly, major purchases were postponed following the events of 11 September and, secondly, car sales were encouraged by extremely attractive financing rates offered by major car manufacturers and dealers. They made a major contribution to raising household spending on durable goods in the fourth quarter by 8½% – at constant prices and after seasonal adjustment – compared to the summer months when demand had barely risen. Consequently, the growth rate of private consumption rose to slightly less than 1½% (seasonally adjusted). However, during the current quarter this stimulus will either vanish entirely or, due to the expected slump in the demand for cars, even turn around and have an adverse impact. The strong growth in consumption was accompanied by a decline in households' saving ratio to ½%. Real general government expenditure, which grew by well over 2% after seasonal adjustment, also boosted domestic demand. It was particularly supported by considerably greater spending on domestic and external security, which is likely to contain part of the cost of the military intervention in Central Asia. As announced by Washington, government expenditure will become increasingly important in future.

On the whole, many signs indicate that the economic slump persisted initially in the autumn; only towards the end of the year did business sentiment seem to recover. The decline in industrial equipment expenditure worsened to 3½% in the fourth quarter, seasonally adjusted, and to over 9% on the year. Investment in housebuilding also declined in seasonally adjusted terms. In the last quarter of 2001 the depletion of inventories was especially pronounced; this was due in particular to the aforementioned sales campaigns conducted by car manufacturers. Real exports likewise went down, though no longer as sharply as in the summer. The declining trend in imports has flattened even further, causing the real foreign balance to slide further into deficit than in the preceding quarter.

Labour market and prices in the USA

The US labour market is currently showing a mixed picture. In January 2002 the number of employed persons went down even further, falling 1.8% below its level at the turn of 2000-2001, which marked the cyclical peak. Despite job shedding, the seasonally adjusted unemployment rate went down in January by

0.2 percentage point to 5.6% since the labour force was distinctly smaller than in December. On the year, the rate of price increases declined from 3.7% in January 2001 to 1.6% in December. Falling crude oil prices played a major role in this development. Core inflation, which represents price movements excluding energy and foods, was, at 2.7%, around the same level as at the beginning of 2001, which meant it was still higher than in the boom years of 1997-2000.

United Kingdom

In 2001 the United Kingdom's economy grew by 2.4%, which was the highest rate of growth among the G-7 countries. The marked drop in industrial output was more than offset by dynamic expansion in the services sector. It is also worth mentioning that the UK economy continued to grow at a relatively fast pace in the first three quarters of last year even as the economy in important partner nations was already beginning to fade noticeably. According to initial calculations, though, real quarter-on-quarter GDP growth in the final quarter was only ¼% because the recession gripping the manufacturing industry had a stronger impact on the overall economic result than in the past. Since its peak in August 2000 industrial output has gone down by 6%. In the autumn unemployment rose for the first time since early 1993. However, the standardised unemployment rate of 5.2% was still rather low by international standards. Despite the downturn in the labour market, consumption remained exceptionally lively throughout. The main reasons were probably the continued rise in the value of residential property and the fall in homeowners' repayments owing to decreasing mortgage lending rates. In the October-December period retail turnover was no less than 6½% up on the year. Consumer price inflation (excluding mortgage lending rates) went up from 1.9% in December to 2.6% in January; one of the reasons for this was the sharp rise in food prices owing to inclement weather.

Macroeconomic trends in the euro area

Economic slump continued following mid-2001 ...

As in the second quarter, seasonally adjusted overall economic output in the euro area came to a virtual standstill in the third quarter of last year. Its year-on-year growth rate went down to 1.4%. Private consumption, having gone up noticeably in the first half of the year, hardly expanded any further after that, and the depletion of inventories was stepped up once again. These two factors caused domestic activity, in particular, to cool down further in the summer months. Weak domestic demand dragged down the demand for imported goods and services. Exports, by contrast, only decreased slightly during that period. The positive change in net imports thus buttressed GDP growth in the third quarter and stabilised overall economic capacity utilisation.[1]

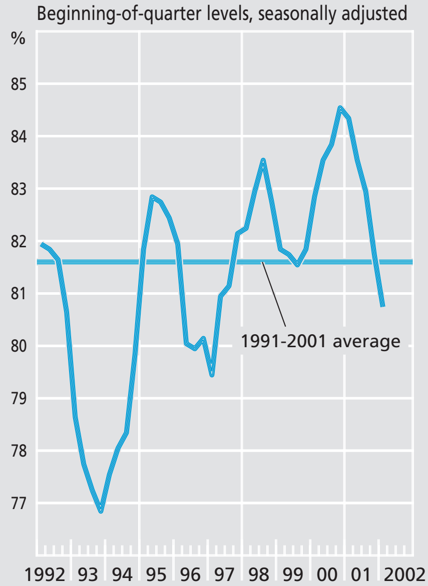
The economic slowdown in the euro area continued in the autumn of 2001, according to information available so far. Industrial production continued to decrease in the October-December period, falling 1.7%

1 It should be noted here that exports and imports as defined in the national accounts also include cross-border trade in goods and services between euro-area countries.

below its third-quarter level and 3.7% on the year. The fact that industrial capacity utilisation likewise declined once again between October 2001 and January 2002 is consistent with this picture. As of late, capacity utilisation was at its lowest point since early 1997, also falling below its multiyear average. All the same, production capacity in industry is still being utilised considerably better than in the 1992-93 and 1996-97 periods during which the economy was weak. In the last few months of last year the economic slump made a relatively distinct impact on the labour market for the first time. In December seasonally adjusted unemployment was 8.5%, 0.1 percentage point higher than in the summer. On average for 2001, 8.5% of the euro-area labour force was unemployed, as against 8.9% a year before.

Capacity utilisation in the manufacturing sector of the euro area

Beginning-of-quarter levels, seasonally adjusted



Source: European Commission business surveys.

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... though recent signs indicate turnaround in sentiment

Since the turn of 2001-2002, the euro area has seen positive economic signals, too. The industrial confidence indicator showed a distinct improvement in January following a slight improvement in December. In addition, the situation regarding new orders was considered less unfavourably than in October, and export expectations have equally brightened up. Consumer confidence seems to have stabilised at its depressed level of the past autumn.

Prices

After seasonal fluctuations are factored out, consumer prices rose in the last quarter of 2001 by an annualised rate of only around 1% from their level during the summer months. That was considerably less than in the preceding quarters. However, the year-on-year rise was still as much as 2.2%. The lower overall rate was caused mainly by reductions in the prices of sources of energy and decreasing food price rises. By contrast, the prices of industrial goods (excluding energy) and services underwent a somewhat less favourable development than in the third quarter. Therefore the rate of price increase, excluding the volatile elements of energy and unprocessed foods, again went up slightly in the third quarter to 2.4%. On average for 2001 the Harmonised Index of Consumer Prices (HICP) was up 2.6% on the year; excluding energy and foods the rise was 2.2%.

In January of this year the rate of price increase, according to initial – and provisional – "flash" estimates by Eurostat, went up by 0.4 percentage point from December's figures to 2.5%. Increases in taxes and administrative prices in some member states and higher prices for fruit and vegetables on account of inclement weather in the southern euro-area countries played a major role here. By contrast, studies so far indicate that the changeover to the euro only had a limited impact on prices in the euro area.

Euro-area current account and exchange-rate developments

Foreign trade

In the autumn of last year the unfavourable state of the world economy and the palpable weakening of domestic demand put a visible damper on turnover in the euro area's foreign trade. Whereas export activity remained virtually unchanged well into the summer, exports from the euro area have gone down sharply since then. In the last three months for which such information is available (September-November 2001) they were down 3½% from the figure for the preceding three-month period, in terms of value and after seasonal adjustment. In terms of their value, imports fell even further during that same period (by more than 6%); part of that decline, however, is probably due to lower import prices, especially for energy commodities. The euro area's export surplus thus continued to rise despite the discernible downturn in exports during the autumn; in the September-November period the euro area's balance of trade closed with a seasonally adjusted surplus of €23 billion, or just under €6 billion more than in the preceding three-month period (June-August 2001).

Current account

That also caused the euro area's current account to improve, especially since in the field of invisible current transactions with non-residents net expenditure, at €18½ billion, was €4½ billion lower than in the preceding period. On the whole, the September-November period saw a surplus of €4½ billion, following a deficit of €5½ billion in the preceding three-month period.

Exchange-rate developments

The euro's position in the foreign exchange markets changed relatively little over the last few months of the past year and in the first few weeks of 2002. After temporarily stabilising on several occasions, most recently following the smooth introduction of euro banknotes and coins at the beginning of this year, the euro was promptly forced to surrender its gains. As usual, the euro's rate against the US dollar was at the centre of the markets' attention. Once the market uncertainty triggered by the 11 September terrorist attacks had died down somewhat, the euro's rate against the US dollar fluctuated until mid-January in a relatively narrow band between US\$0.88 and US\$0.91. The exchange-rate movements primarily reflected changing market assessments of the economic outlook for the United States. At times, confidence in rapid economic recovery in the USA buoyed the US dollar, as did the reduction in interest rates by the US Federal Reserve at the beginning of November. However, at the end of November the US dollar again lost ground after new figures painted a somewhat less rosy picture of the state of the US economy. At year's end, sentiment swung back in favour of the US dollar when, following the publication of unexpectedly positive early

US dollar

US economic indicators, the opinion increasingly prevailed that the US economy had bottomed out. In the light of the smooth euro cash changeover, the euro temporarily recovered at the beginning of 2002, making up some of its previous losses. But by the second half of January the euro had again lost substantial ground; as this report went to press, the euro was being quoted at US$0.87.

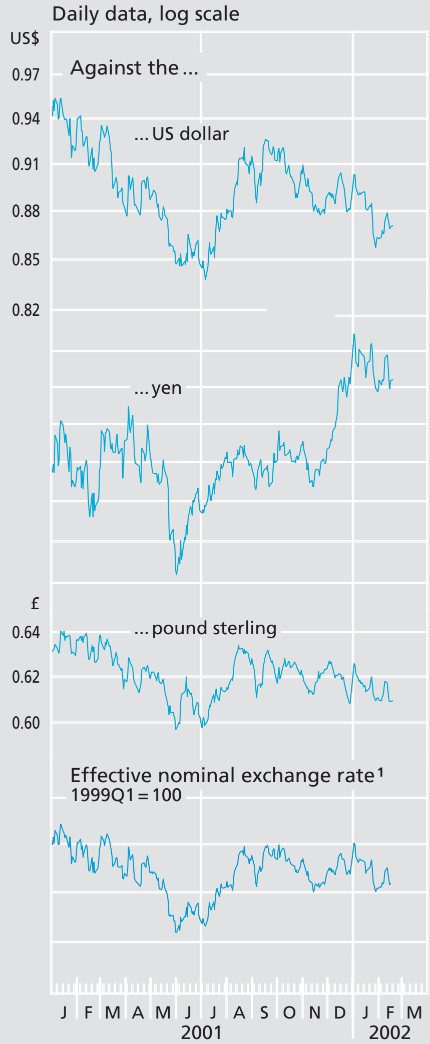
Yen

The euro's depreciation against the US dollar was balanced out to a certain extent by its gains against the Japanese yen, which slipped dramatically against all major currencies following news that the Japanese economy's recessionary trend in the third quarter of last year had continued. Vanishing prospects of a speedy recovery of economic growth subsequently caused the yen to lose more ground. Only towards the end of January did the yen recover somewhat against the euro; as of late the exchange rate was just under ¥116 to the euro.

Pound sterling

In contrast to the euro's movements against the yen, its rate against the pound sterling remained confined to a rather tight band between £0.61 and £0.63 during the period under review. In November and December the euro gained temporarily against the pound sterling after the publication at the beginning of November of data on the unexpectedly sharp drop in UK industrial production and the upcoming introduction of euro banknotes and coins triggered speculation that the UK would soon join EMU. Once new data on the relatively robust economic growth in the UK was published, the euro again declined against the pound sterling in

Exchange rate of the euro



1 According to ECB calculations, against the currencies of 12 countries.

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January. When this report went to press, the exchange rate was £0.61 to the euro.

The euro's effective exchange rate

Measured in terms of a weighted average, the exchange-rate movements of the past few months have largely balanced out against the currencies of the euro area's twelve most important trading partners. As of late, the euro's effective exchange rate was just slightly below its early-September levels prior to the terrorist attacks. This may come as a surprise in the light of the economic slump, the impact of which was greater outside the euro area than inside. However, it shows once again that currency market players are guided not so much by the current state of the economy at a given moment as by subjective expectations and forecasts of future opportunities for profit and growth in the respective economic zones. Investors are apparently still largely sceptical of the euro area's flexibility and efficiency. The euro-area countries could strengthen investors' confidence in the euro area's economic future by tackling or credibly continuing the structural reforms necessary to foster growth in spite of the economic downturn. That is likely to be a major boost to euro-area countries' growth, especially since the euro's exchange rate is currently at a relatively low level.

Monetary policy and financial markets in the euro area

Eurosystem interest rates unchanged

In the past few months the Governing Council of the ECB has pursued a steady-as-she-goes interest-rate policy. Since the latest interest-rate reduction on 8 November 2001 the interest rates for the marginal refinancing facility and the deposit facility have remained unchanged at 4.25% and 2.25% respectively. Since then, main refinancing operations have all been conducted as variable-rate tenders with a minimum bid rate of 3.25%. The monetary and macroeconomic situation both indicated that central bank interest rates did not need to be changed. Although monetary growth has been strong in the past few months, it has reflected a particularly pronounced and in all likelihood temporary liquidity preference on the part of investors, against the background of an economic and financial environment fraught with uncertainty. The sharp monetary growth is currently unlikely to be indicative of any major threat of inflation. However, the monetary situation will need to be thoroughly analysed in the months to come. The economic slump in the euro area has continued, but there have been initial signs that economic activity is gradually recovering. It should not be associated with upside risks for price developments. Instead, the trend decline in inflation rates – albeit with brief fluctuations – is predicted to continue this year. Over the medium term, too, the price outlook remains favourable provided wage moderation continues.

Yield curve on the money market

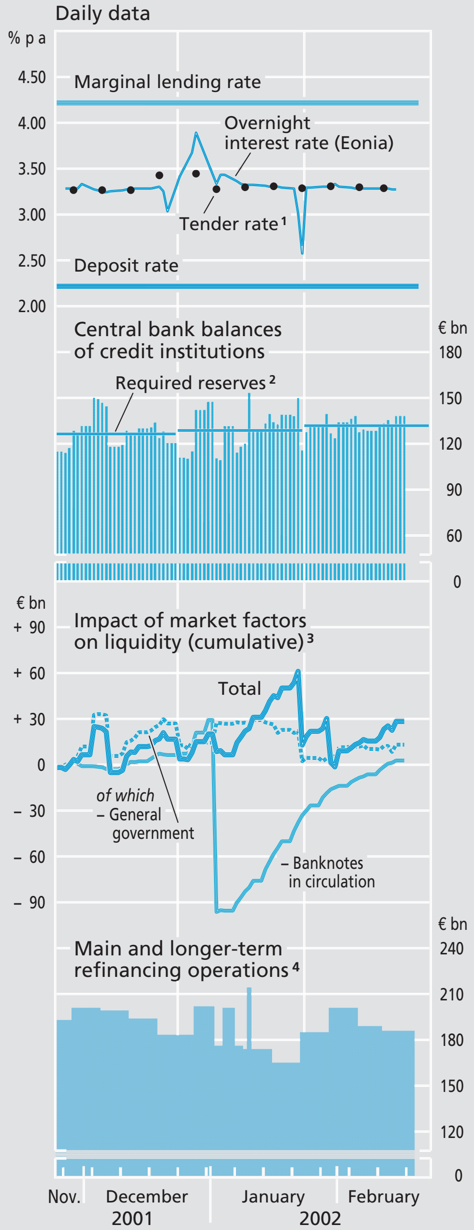
The forward rates in the shorter-term segment of the money market have changed little since mid-November. Longer-term quotations, though, have risen by about 20 basis points since the turn of the year. The yield curve on the money market, which was still flat in late autumn, has been pointing slightly upwards since January. That means market players are no longer expecting further reductions in interest rates over the medium term.

Flexible management of the money market during introduction of euro banknotes and coins

At the turn of the year, the Eurosystem's ongoing management of the money market needed to cope, in particular, with the enormous and unprecedented impact of the introduction of euro banknotes and coins on bank liquidity. The reduction in the volume of banknotes in circulation, which accelerated as the year came to a close, was predictable with a fair degree of reliability, and its liquidity effects could be offset almost immediately simply by properly adjusting the main tenders. From 1 January 2002, by contrast, it was almost impossible to make short-term forecasts of the extent to which the volume of banknotes in circulation would develop over time. When a shortage of liquidity began to loom owing to the unexpectedly large volume of banknotes in circulation, the Eurosystem executed liquidity-providing three-day and one-day quick tenders on 4 and 10 January, respectively, in order to enable credit institutions to maintain their required holdings in a relatively steady manner and to curtail the volatility of Eonia. When gauging main tender operations, the Eurosystem additionally had to consider that the value of frontloaded euro notes and coins was debited to the credit institutions with a predetermined time-lag: the full value was debited in three equal parts on 2 January, 23 January and 30 January. Euro banknotes, which were included in the Eurosystem central banks' financial statements on 2 January but not yet invoiced, were matched by a corresponding volume of non-interest-bearing Eurosystem loans to banks until their value was completely debited at the end of January. In January the volumes of the main tenders diverged sharply once again. Following a similar development in November caused by speculative underbidding, the Eurosystem settled a one-week additional refinancing operation simultaneously with the regular main tender to realign the allotment amounts as at 28 November. The gap between Eonia and the marginal allotment rates at the minimum bid rate opened up temporarily in January

Interest-rate movements and liquidity management in the Eurosystem

Daily data



1 Interest rate for main refinancing operations. — 2 Maintenance periods: 24 Nov to 23 Dec, 24 Dec 2001 to 23 Jan 2002 and 24 Jan to 23 Feb 2002. — 3 Banknotes in circulation, net position of general government vis-à-vis the Eurosystem, net foreign currency reserves of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances. — 4 Including a seven-day tender from 28 Nov to 4 Dec 2001 and quick tenders from 4 to 6 Jan and 10 Jan 2002.

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Factors determining bank liquidity *

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

Item	2001–2002 24 Nov to 23 Dec	24 Dec to 23 Jan	24 Nov to 23 Jan
I. Provision (+) or absorption (–) of central bank balances by			
1. Change in banknotes in circulation (increase: –)	+ 13.3	– 46.3	– 33.0
2. Change in general government deposits with the Eurosystem (increase: –)	+ 2.6	+ 5.2	+ 7.8
3. Change in net foreign exchange reserves 1	– 1.3	+ 1.5	+ 0.2
4. Other factors 2	– 16.2	+ 55.1	+ 38.9
Total	– 1.6	+ 15.5	+ 13.9
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	– 9.8	– 4.0	– 13.8
b) Longer-term refinancing operations	± 0.0	– 0.0	– 0.0
c) Other operations	+ 12.4	– 8.7	+ 3.7
2. Standing facilities			
a) Marginal lending facility	+ 0.3	– 0.1	+ 0.2
b) Deposit facility (increase: –)	– 0.5	+ 0.2	– 0.3
Total	+ 2.4	– 12.6	– 10.2
III. Change in credit institutions' current accounts (I + II)	+ 0.7	+ 3.0	+ 3.7
IV. Change in the minimum reserve requirement (increase: –)	– 0.3	– 2.3	– 2.6
Memo items 3			
Main refinancing operations	122.5	118.5	118.5
Longer-term refinancing operations	60.0	60.0	60.0
Other operations	12.4	3.7	3.7
Marginal lending facility	0.5	0.4	0.4
Deposit facility	0.8	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 the *Monthly 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.

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owing to the uncertain liquidity development, yet Eonia did not undergo any major fluctuations except at the end of the maintenance periods and, as usual, at the end of the year.

Decline in liquidity needs

From November to January the autonomous factors determining bank liquidity generated €13.9 billion of net inflows to credit institutions (see the adjacent table). This was caused, *inter alia*, by the declining number of banknotes denominated in legacy currencies and the time-lag in debiting frontloaded euro currency to credit institutions' accounts. Also, the reduction in general government deposits with the Eurosystem had an expansionary effect. The reserve requirement, though, went up by €2.6 billion. Owing to the decline in liquidity needs, the Eurosystem, on balance, reduced the volume of open-market transactions during the period under review.

Rapid monetary growth persists

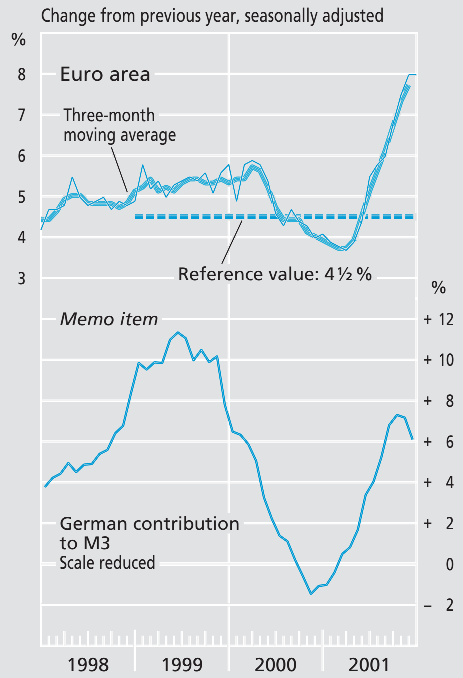
Overall euro-area M3 expansion in the fourth quarter of 2001 was about as strong as in the third quarter, when M3 growth accelerated owing to the events of 11 September, among other reasons. In December, however, M3 growth was rather muted owing to a sharp decline in the volume of currency in circulation. Monetary developments in the fourth quarter of 2001 were once again marked by portfolio shifts. Low interest rates and the persistently high level of uncertainty in business and the financial markets have continued to promote the "parking" of funds in liquid and safe investment vehicles. At year's end, the year-on-year rise in M3 (adjusted for negotiable financial instruments held by non-euro-area residents) was 8.0% compared with 6.8% at the end of September. In the

October-December period the three-month moving average of annual growth rates was 7.8% as against 6.2% in the July-September period. Given the aforementioned portfolio influences, the large increase in the money stock does not indicate any risk of future inflation, an assessment which is also evidenced by the further decline in lending. However, ongoing monetary developments must be monitored carefully in future.

Components of the money stock

Of the individual components of M3, currency in circulation went into a virtual free fall in the fourth quarter. As the introduction of euro banknotes and coins approached, it declined from its September level by €68.7 billion, or just over 22%. In numerous cases cash holdings were probably shifted to overnight deposits, which, at €148.7 billion, rose sharply. On balance, seasonally adjusted M1 increased only slightly; its end-of-December level was 5.0% up on the year. Other short-term bank deposits again showed strong growth during the period under review. Against the background of falling interest rates, emphasis shifted from deposits with an agreed maturity of up to two years to deposits with an agreed period of notice of up to three months. In addition, the latter probably also benefited from the decline in currency in circulation. Of the negotiable financial instruments (which likewise rose perceptibly), it was money market fund shares/units which gained most in the fourth quarter; there were hardly any net sales of money market paper and short-term bank debt securities.

Growth of the money stock M3 in the euro area



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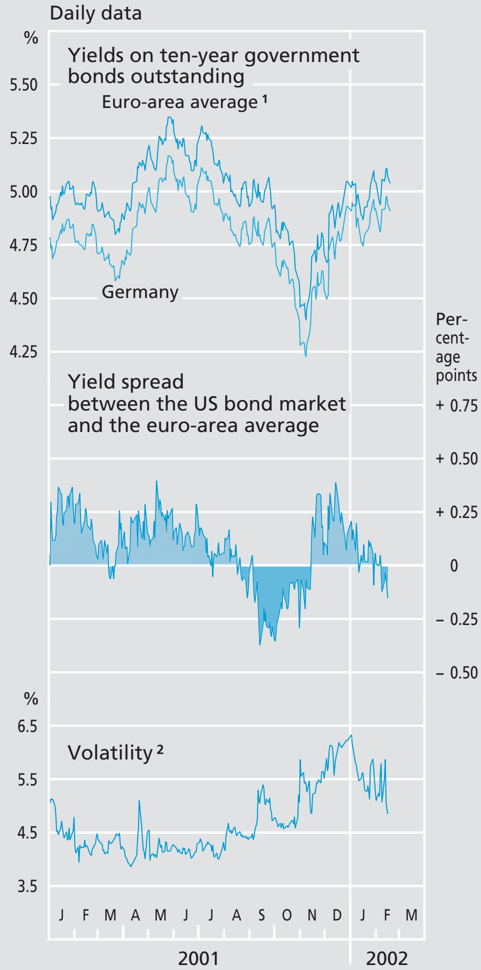
Balance-sheet counterparts

As the end of the year approached, lending to the private sector continued to weaken. Lending by MFIs to individuals and enterprises was up 6.7% from its previous year's level at the end of December, as against 7.1% at the end of September. The major reason was that loans to the private sector suffered a renewed setback owing to the sluggishness of the euro-area economy. Between October and December direct lending rose, on an annual basis, by just over 4½% compared with a 5½% rise in the July-September period. In the fourth quarter, MFI loans to the public sector were increased only within the scope which is usual for the season. By contrast, extensive inflows of funds from outside the euro area, particularly through portfolio investment, continued to promote monetary expansion in the last quarter of 2001. The

Bond-market yields in the euro area

Daily data



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

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low propensity of domestic investors to purchase longer-term monetary assets had a similar effect. Excluding capital and reserves, monetary capital held at MFIs increased by a mere 3.5% last year.

German contribution

Germany's seasonally adjusted contribution to euro-area M3 went back down after seasonal adjustment in the last quarter of 2001 following strong growth during the earlier course of the year. The other components of the money stock did not rise enough to match the major reduction in the volume of currency in circulation. Although overnight deposits did increase rather sharply, as did negotiable financial instruments (thanks to vibrant demand for domestic money market fund shares/units), the other short-term deposits stagnated, on the whole. Over the course of the entire year, the German contribution to M3 rose by 6.1%.

Capital market rates up

Long-term capital market rates in the euro area have been on the rise since late autumn, largely following the trend set by US interest rates. On a euro-area average, yields on ten-year government bonds were slightly over 5% in mid-February, over ¼ percentage point higher than in mid-November (4¾%). The rise in yields on the European bond market was supported mainly by the expectation that the economic outlook, having become dismal following the terrorist attacks in the USA, would soon brighten up. At the same time, market participants' inflation expectations – gleaned from expert surveys and inflation-indexed bonds – remained moderate.

Spread between money market and capital market rates continues to widen

The yield spread between the capital market and the money market widened during the period under review from 134 basis points to 169 basis points as this report went to press. As a result of the ECB cut in interest rates on 8 November 2001 and higher capital market yields, this spread has widened noticeably in the euro area. Even if expectations of a cyclical turnaround in the financial markets have increased, uncertainty surrounding the start of economic recovery and its extent, and thus the future development of bond prices, has remained relatively high. This has been reflected in a noticeable increase in the implied volatility of options in the forward contracts of long-term (German) Federal bonds. As of late, though, this volatility has receded slightly.

US rates ahead of euro-area yield curve for most of the time

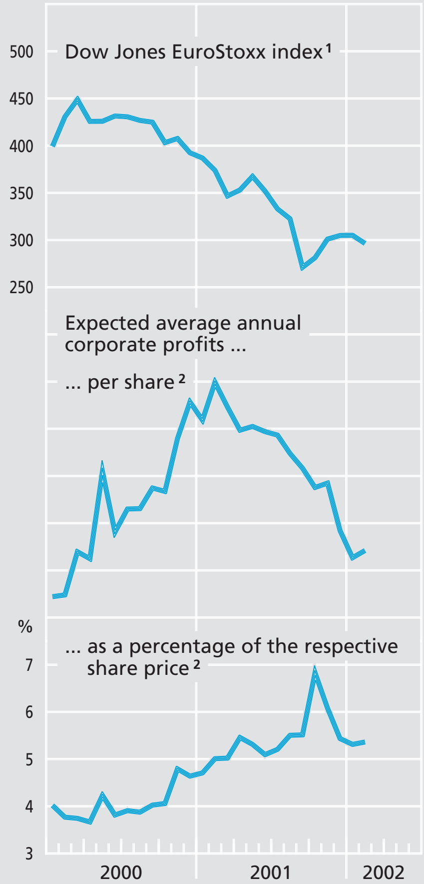
At the beginning of November 2001 yields on ten-year euro-area government bonds, at less than 4½%, hit their lowest level for the year; comparable US Treasuries actually hit 4¼%. Since then, they have largely developed in the same direction. After the US Federal Reserve lowered interest rates on 11 December, US yields rose slightly amid hopes that the US economy would soon recover. European government bond yields, though, did not fully match that move, causing the slight interest-rate disadvantage of US bonds to turn into an interest-rate advantage on the part of US Treasuries of up to ⅓ percentage point. Recently, however, European government bonds have again generated slightly higher yields (12 basis points) than US paper.

Falling risk premiums for non-top-rated corporate bonds

Risk premiums for corporate bonds with a low credit rating,[2] having gone up sharply in September 2001, gradually receded again in the winter months. This process was temporarily interrupted, however, by mounting concerns surrounding the accounting practices of large multinationals, in particular. Recently, the differential in risk premiums between such bonds and (German) Federal bonds, at just over 1¾ percentage points, was around half a percentage point lower than mid-November.

Share price developments and profit estimates for European public limited companies

Monthly data



1 End of 1991 = 100; Source: Deutsche Börse AG. — 2 Based on I/B/E/S analyst estimates for the Dow Jones EuroStoxx index. Source: Thomson Financial.

Deutsche Bundesbank

Share prices stabilised

The general price level in the euro-area equity markets changed little on the whole over the past few months, even though relatively slight fluctuations did occur. As this report was going to press in mid-February, the Dow Jones EuroStoxx index was somewhat lower than in mid-November (-3%). Although that enabled prices to maintain the distinct gains

2 Corporate debt securities rated BBB by Standard & Poor's.

achieved since the end of September, it was nowhere near enough to recoup the losses which had occurred even before the slump provoked by the 11 September terrorist attacks. Instead, the above-mentioned broad index for the euro area fell by a total of around 20% throughout 2001. In mid-February European companies' stock market quotations were over one-third lower than their all-time highs of March 2000.

Decline in share price uncertainty

During the entire period under review, European stock exchanges were largely aligned with the US stock market, where quotations likewise tended to move sideways in view of concerns about corporate balance sheets, on the one hand, and the increasingly entrenched expectations of economic recovery, on the other. The stabilisation of stock prices was accompanied by a slight decrease in market participants' uncertainty regarding further share price movements. The implied volatility of options on the Dow Jones EuroStoxx index fell clearly below the very high levels that had been reached following the September slump; however, it remained visibly above the average level in the first half of 2001.

Profit estimates scaled back further

Share price developments in euro-area equity markets were supported only to a certain degree by the fundamentals during the period under review. The general value continues to be below that of the past few years. However, the average annual profits expected by analysts for companies listed on the Dow Jones EuroStoxx index[3] have once again been scaled back noticeably for the winter months. The greater variation among analysts' expectations also reveals increased uncertainty surrounding the continued profit outlook for listed companies. In addition, experts expect distinctly more sluggish corporate profit growth not only over the next few months but also over the longer term. Forecast annual growth for the next three to five years has sunk from 17½% at the beginning of 2001 to just under 12½%.

3 Based on I/B/E/S analyst estimates. Source: Thomson Financial.