The international and European setting

Developments in the world economy

Global economic slump overcome

The world economy probably bottomed out in the winter months. The economic improvement was led by the US economy. Now signs of economic recovery are beginning to mount in the euro area as well. The world economy received a healthy dose of support from economic policy. Central banks in the United States and western Europe, in particular, cut their key interest rates sharply during 2001. In addition, the US government shifted to an extremely expansionary fiscal-policy path. The euro-area economy was supported by allowing automatic stabilisers to work.

IMF forecast

The cyclical upward tendency in most industrial countries and emerging economies is unlikely to result in appreciably higher annual average growth rates for 2002, though. According to the latest forecast by the International Monetary Fund (IMF), however, the United States and Canada, with growth rates of 2.3% and 2.5%, respectively, will be the only two major industrial countries to improve substantially on their previous year's results (1.2% and 1.5%, respectively). The euro area and the United Kingdom, at 1.4% and 2.0%, respectively, will probably have results roughly similar to those in 2001 when their output growth rates went up to 1.5% and 2.2%, respectively. According to the IMF, annual growth rates in the euro area and UK will not be considerably higher until 2003, when each area will achieve just under 3% growth. However, Japan's real gross domestic product (GDP) is expected to continue to go down slightly in 2002.

According to IMF calculations global GDP rose 2.5% in 2001. This meant that a worldwide recession, which is defined by IMF staff as growth below 2.5%, and which had been predicted as late as December, was only just averted. Even so, it was still the worst result since 1993, when growth was 2.2%. This year, global production, according to the April 2002 issue of the World Economic Outlook, will rise by 2.8%, followed by 4.0% in 2003. Real world trade declined slightly in 2001 for the first time since the beginning of this time series after growing by 12½% in 2000. In the wake of the general economic recovery, cross-border trade in goods and services will probably also pick up. For 2002 IMF staff predict a rise of 2½% followed by a 6½% increase in 2003.

IMF forecast for 2002 and 2003 *

Item	2000	2001	2002	2003
Real gross domestic product	Annual percentage change			
Advanced economies 1	+ 3.9	+ 1.2	+ 1.7	+ 3.0
of which				
United States	+ 4.1	+ 1.2	+ 2.3	+ 3.4
Japan	+ 2.2	− 0.4	− 1.0	+ 0.8
Euro area	+ 3.4	+ 1.5	+ 1.4	+ 2.9
Consumer prices 2				
Advanced economies 1	+ 2.3	+ 2.2	+ 1.3	+ 1.8
of which				
United States	+ 3.4	+ 2.8	+ 1.4	+ 2.4
Japan	− 0.8	− 0.7	− 1.1	− 0.5
Euro area	+ 2.4	+ 2.6	+ 1.9	+ 1.6
Unemployment	Number of unemployed persons as a percentage of the labour force			
Advanced economies 1	5.9	6.0	6.4	6.2
of which				
United States	4.0	4.8	5.5	5.3
Japan	4.7	5.0	5.8	5.7
Euro area	8.8	8.3	8.5	8.2

* Source: IMF, World Economic Outlook, April 2002. — **1** Including Taiwan, the Hong Kong Special Administrative Region, and the republics of Korea and Singapore. — **2** Consumer price index; for the euro area, HICP.

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Risks

The large US current account deficit, which recently grew perceptibly once again, poses a considerable risk to the global economic upswing. This is the background behind the increasing trend towards protectionism in the United States, which, if its trading partners take countermeasures, may well present a considerable disruption to global recovery. The worsening Middle East crisis is likewise a danger to the world economy. Beginning with their last low in mid-January 2002, international crude oil prices increased by around 40% up to the beginning of April. Since then, they have occasionally eased slightly, but a renewed setback cannot be ruled out as long as the political turmoil in that region persists.

United States

Buoyed notably by special factors, the US economy was growing surprisingly strongly in seasonally adjusted terms as early as the fourth quarter of 2001, enabling it to make a considerable improvement in its starting position for 2002. In the first quarter of this year the pace of growth actually picked up perceptibly. According to preliminary estimates, total production rose by 1½%, after adjustment for seasonal and working-day variations, compared with both the previous period and the same period a year before. An important factor was that the destocking of inventories was not as pronounced as in autumn 2001.

Growth of real GDP...

... and of important demand components in the first quarter of 2002

By contrast, the seasonally adjusted rise of just over ½% in private final demand was weaker than in the last quarter of 2001, when the extremely attractive financing rates offered by car manufacturers drove up purchases of durable goods. Such purchases subsequently went down by 2%. All in all, though, private consumption rose by 1% thanks to the brisk demand for non-durable consumer goods, putting it at just under 3½% higher than its previous year's level. At the same time, the seasonally adjusted household saving ratio – beginning at a very low level in the last quarter of 2001 – went up by well over 1½ percentage points to 2.1%. The key factor was the seasonally adjusted rise in disposable income by just over 2½% from the previous period owing, above all, to the tax cut which formed part of the tax-reform package passed in mid-2001 and which took effect on 1 January 2002.

Investment in housing construction surpassed the depressed level of the previous quarter by a seasonally adjusted 4%. That was associated not only with the favourable financing rates but also with the unusually mild weather in many parts of the country following the turn of 2001-2002. By contrast, the downward trend in commercial investment which had begun in the spring of 2001 continued, with such investment declining by 1½% from the previous period and 10½% on the year. Seasonally adjusted real exports went up for the first time since summer 2000, by just over 1½%. Imports grew much more strongly, by just over 3½%. The deficit in the real foreign balance therefore reached a new record low.

Weak links in the US economy

The strong US growth in the first quarter must not divert attention from the weak links in the US economy which continue to exist. As the year progresses, they could become increasingly apparent once the influence of the strong stimuli to the inventory cycle begins to recede, as is likely to be the case. (According to information available so far GDP growth is likely to decrease appreciably as early as in the second quarter.) The primary factor deserving of mention here is commercial investment activity, in which no broad improvement is visible just yet. The extreme underutilisation of production capacity in industry, which – despite the fact that the degree of utilisation has been on the rise again since early 2002 – at last report was as low as September 2001 (and June 1983 before that), is probably the main cause. In some sectors of the economy there still seems to be overcapacity which must be reduced since it can no longer be put to economic use. In addition, the massive corporate debt could restrain investment growth.

The force exerted by private consumption must not be overestimated, either. In 2001 consumption weakened relatively little, which means that, in the short run, it can only provide little additional stimuli to the economy, as no major pent-up demand can be expected to exist. In the financial markets, too, recent assessments of further developments in the US economy have been somewhat more muted. This has been reflected in a trend towards falling share prices and a weakening of the dollar against the currencies of important trading partners.

Labour market and prices in the United States

The revival of total output in winter 2001-2002 has not made a dent in the labour market just yet. In the first four months the number of employed persons was 0.3% lower, seasonally adjusted, than in the fourth quarter of 2001, during which it had fallen by 0.4%. The unemployment rate did fall noticeably in January and February, yet shot back up to 6.0% in April, reaching its highest level since August 1994 – most notably owing to the statutory enlargement of the group of people eligible to receive unemployment assistance. Despite the sharp rise in energy prices in March and April, the price climate remained calm throughout. On average over the first four months of 2002 consumer prices were only 1.3% higher than a year earlier; however, core inflation, ie excluding food and energy prices, was 2.5%.

East Asian emerging economies

Because of their close relations with the US in their function as suppliers, the East Asian emerging economies have now overcome the pronounced economic slump into which they had lurched in 2001. The more buoyant demand for IT products played a major role.

Latin America

The Mexican economy, around nine-tenths of whose exports are sent to the United States, has been receiving considerable expansionary stimuli from its northern neighbour. In the rest of Latin America, the cyclical recovery has been making visibly slower progress. This is probably because, on the heels of the economic and financial crisis in Argentina and the political turmoil in other countries, investors have assessed the risks for the region to be greater than had previously been the case. In Argentina, whose economy is clearly in the process of contracting at present, no turn for the better can be expected in the short term.

Central and east European reform countries

In the central and east European reform countries the economy cooled off only relatively little in the past year. The growth rate can be expected to pick up noticeably this year, with the probable rise in demand from western Europe also playing a role.

Japan

In the past few months Japanese enterprises once again recorded increases in foreign orders. In addition, the adjustment of inventories slowed down. The contracting trend gripping the economy as a whole therefore seems to be gradually receding. In the first quarter of 2002, however, domestic final demand remained weak. Private consumption was adversely affected mainly by the worsening of the labour market and income situation. Commercial investment is still on a downward trend because high overcapacity, plummeting profits and sluggish lending by banks have dampened propensity to invest and curtailed scope for borrowing. Public investment likewise continued its decline. Thanks to increased exports, however, industrial production rose for the first time in a long time (+¾%), reducing its year-on-year deficit to -11%. The seasonally adjusted decline in the price level continued in April, following a short interruption in March caused by higher prices for energy. Recently consumer prices were 1.2% lower on the year. The deflationary trend is thus continuing.

United Kingdom

The UK economy hardly grew any further during the 2001-2002 winter. According to initial estimates, the stagnation of real GDP which occurred in autumn 2001 continued in the winter months of 2002. However, the first quarter of 2002 still saw year-on-year growth of 1%. Seasonally adjusted industrial production continued its slide while value added in the services sector grew by ½%.

The UK economy was supported anew by private consumer demand, which – in terms of retail turnover – was a seasonally adjusted 1% higher in the first quarter than in the preceding three-month period and 5½% up on the same period in the previous year. Government expenditure is likely to have risen rather sharply as well. The government budgeted considerably more funds towards improving the public infrastructure. Consumer price inflation picked up in March owing to the higher prices for energy and services. Excluding mortgage interest payments, year-on-year inflation was 2.3% following 2.2% in February.

Macroeconomic trends in the euro area

GDP down in autumn 2001, but ...

In the fourth quarter of 2001, real euro-area GDP, after seasonal adjustment, was down from the preceding period for the first time since early 1993, by ¼%. It was up only ½% from the previous year's result. In the last few winter months, for which no national accounts data are available thus far, the contraction of total production does not seem to have lasted, though. First-quarter industrial production was ½% higher than in the last quarter of 2001, with the year-on-year decline shrinking to 3%. Capacity utilisation in the euro area continued to fall following the turn of 2001-2002.

... industrial production pointed back upwards at beginning of year

Sentiment unchanged as of late

The rather strong improvement in industry confidence that took place between December 2001 and March 2002 did not carry over into April. A look at the individual components of this indicator shows that more favourable production expectations and progress in the adjustment of inventories were recently offset by a more negative assessment of the situation regarding new orders. Consumer confidence even clouded over slightly in April. Households assessed both their financial situation over the next 12 months and the economic trend less favourably on the whole than in March.

Growth gap between the US and the euro area

Owing to the weak starting position at the beginning of this year, annual average growth in the euro area, according to the IMF forecast cited above, will, at 1.4%, be somewhat lower than in 2001. The euro area will therefore probably surrender the growth advantage over the United States which it had gained last year. Throughout the 1996-2001 period US GDP growth averaged 3½% compared with 2½% in the euro area. As regards prosperity, however, it seems advisable to factor the depreciation of the capital stock out of GDP and to incorporate differences in population growth into such a country-by-country comparison. The resultant real per-capita net domestic product, which may serve as a crude measure of income, went up in the United States by an average of 2¼% per year between 1996 and 2001 and thus "only" a little over ¼ percentage point more than in the euro-area countries (for more see the appendix starting on page 34f).

Weak labour market

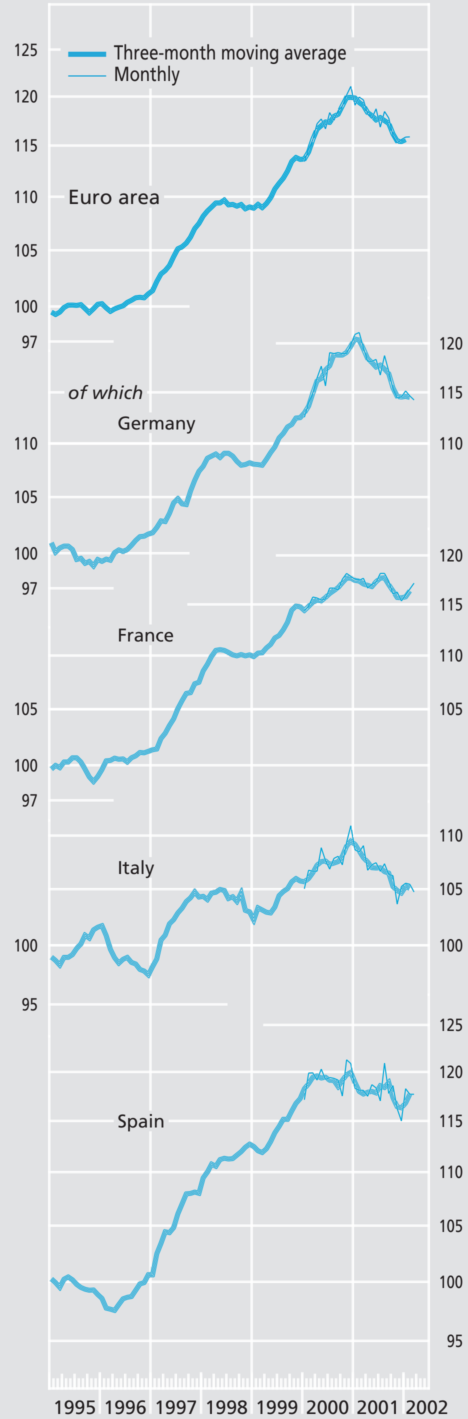
The situation on the euro-area countries' labour markets grew gloomier at the beginning of 2002. Although total employment has probably gone up slightly until the present, this increase is not as large as it was in the same period last year. In the fourth quarter, the latest period for which statistics are available, the annual growth rate was less than 1% for the first time in just over four years. The main reason was that industry and construction already visibly failed to achieve the previous year's employment levels. The shedding of labour in those two sectors is likely to have continued in the first few months of this year as well. The number of unemployed persons has tended to point slightly upwards since April 2001. In March 2002 around 11.5 million persons were unemployed throughout the euro area, or 1¼% more than during the last low reached 11 months beforehand. Since October 2001 seasonally adjusted unemployment has remained unchanged at 8.4%.

Price developments recently more favourable again

Euro-area inflation has recently slowed down. As measured by the Harmonised Index of Consumer Prices (HICP), year-on-year inflation went down to 2.4% in April as against 2.7% in January. At the beginning of the year the harsh winter weather which struck Europe, including the Mediterranean countries, caused food prices to skyrocket. Prices have since then returned to normal. The relief was all the more noticeable in the year-on-year rate because in the spring of 2001 animal diseases and a spate of bad weather had likewise driven food prices upwards. In the area of energy prices a favourable base effect helped to limit the inflationary effect of the latest increases in heating oil and petrol prices caused in particular by the rise in world market prices for crude oil. Spring 2001 also saw considerable increases in energy prices. There were rising inflationary tendencies in the area of industrial goods and services. In the first four months of 2002 consumers had to pay

Industrial output *
in the euro area

1995 = 100, seasonally adjusted; log scale



Sources: Eurostat and national statistics. —
* Excluding construction.

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1.8% more for industrial goods than twelve months previously, and for services the price increase amounted to 3.1%.

Extreme disparity continues to exist in euro area

The regional disparities in inflation rates remained high in the first few months of 2002 as well. Inflation remained well above the euro-area average in Ireland, Greece and the Netherlands. Germany, France, Austria and Luxembourg once again recorded relatively low rates of price increase.

Current account and exchange rates

Foreign trade and the current account

At the beginning of this year, too, euro-area foreign trade was still under the spell of the sluggish world economy which shaped developments up to the end of last year. In the first two months of 2002 the euro area's exports to non-euro-area countries (after seasonal adjustment) just barely reached their previous year's levels. Imports of goods, in fact, were just over 1% lower than in the last two months of the preceding year. On balance, this made the euro area's trade surplus for January and February 2002, at €21½ billion (seasonally adjusted), €1½ billion higher than in the two preceding months. At the same time, though, the deficit in invisible current account transactions rose by roughly the same amount, which caused the overall current account to close in January and February at a surplus of €8 billion, unchanged from the preceding period.

Exchange-rate developments

In the first few months of this year the euro's exchange rate was marked by repeated mood swings in the foreign-exchange markets. However, they did not lead to major shifts in the exchange-rate structure. The euro, having strengthened noticeably following the smooth introduction of euro cash at the beginning of the year, came under renewed pressure soon thereafter. It was forced to surrender much of the ground it had gained previously against the US dollar, whereas it was able to hold its own against the other currencies. Since mid-April, however, the euro has also made visible gains against the US dollar.

US dollar

The euro began the year at just over US$0.90 and then slid to around US$0.86 by the end of January. Other important currencies lost a lot of ground against the US dollar, too. At that time information got out that the US economy was able to return to positive growth figures in the fourth quarter of last year. However, against the background of conflicting signals being issued by individual early-warning indicators and frequently changing assessments of the outlook for the US economy, developments on the foreign-exchange markets changed directions repeatedly in the period thereafter. In the first half of March the US dollar came under pressure following a warning by the Federal Reserve concerning the stubbornly high US current-account deficit. In the second half of March, however, sentiment shifted back in favour of the US dollar following reports that US GDP growth in the fourth quarter of 2001 had been revised upwards and that new statistics on consumer confidence made the US economic situation look unexpectedly bright. It was only in mid-April that the euro-US dollar rate underwent a more sustained correction once the markets came to believe that US economic recovery would be slower than expected, whereas forecasts for the euro area continued to assume that economic growth would recover vigorously during the further course of the year. As of late the euro was quoted at around US$0.91, already somewhat higher than at the beginning of the year.

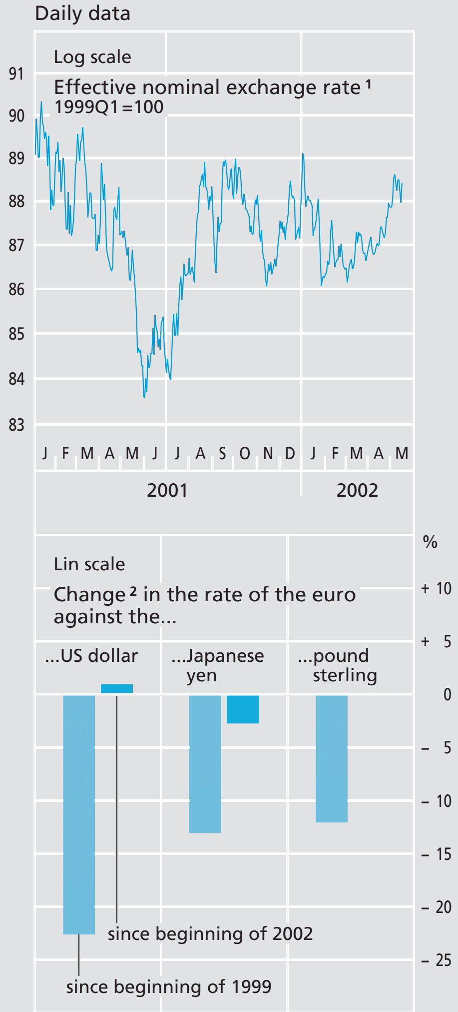
Yen

During the period under review the euro occasionally lost ground against the Japanese yen, too, though it has recently regained some of that ground. The appreciation of the yen (against the US dollar, too), however, stood in contrast to the continued precarious state of Japan's economy. The repatriation of a large volume of funds from abroad by Japanese financial institutions shortly before the end of the Japanese fiscal year is likely to have played a decisive role. However, in the past few weeks the picture shifted back in the euro's favour following reports that Japanese fourth-quarter economic growth was lower than expected. As of late the euro, at just over ¥116, was still just under 3% lower than its rate at the beginning of the year.

Pound sterling

Against the pound sterling, however, the euro remained within a rather tight band of between just under £0.63 and around £0.61 during the entire period under review. Largely in parallel with the development of the euro-US dollar exchange rate, the pound sterling weakened noticeably against the US dollar in January yet was able to recoup its losses in the subsequent period. As this *Report* went to press the euro was quoted at just under £0.63.

Exchange rate of the euro



1 According to ECB calculations, against the currencies of 12 countries. — 2 Appreciation of the euro: +. Latest position: 16 May 2002.

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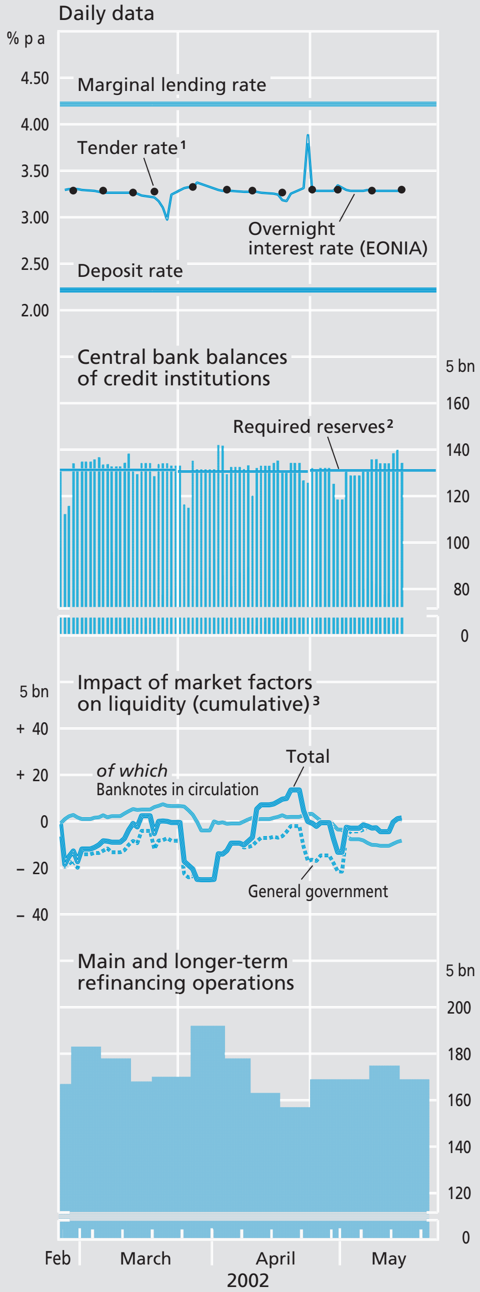
The euro's effective exchange rate

As a weighted average against the currencies of the euro area's 12 most important trading partners, the euro's exchange rate has changed very little since early this year. Given that inflation rates in the industrial countries are quite similar, the exchange rate therefore continues to support the euro-area countries' international competitiveness. However, the advantages to the euro-area economy resulting from this support cannot be expected to

Interest-rate movements and liquidity management in the Eurosystem

Daily data



1 Interest rate for main refinancing operation. — **2** Maintenance periods: 24 Feb to 23 Mar, 24 Mar to 23 Apr and 24 Apr to 23 May 2002. — **3** Banknotes in circulation, net position of general government vis-à-vis the Eurosystem, net foreign reserves of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances.

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last. Future developments will hinge, in particular, on keeping risks on the cost side with regard to wage developments and a renewed rise in world oil prices under control.

Monetary policy and financial markets in the euro area

Eurosystem interest rates unchanged

In the spring months the Governing Council of the ECB continued its "steady-as-she-goes" interest-rate policy, leaving the Eurosystem's key interest rates unchanged. The main refinancing operations have all been conducted as variable-rate tenders with a minimum bid rate of 3.25%. The interest rates for the marginal refinancing facility and the deposit facility have remained unchanged at 4.25% and 2.25%, respectively. The monetary and macroeconomic situation both indicated that interest rates did not need to be changed. The relatively strong monetary growth slowed down since the turn of the year and the weakening of credit growth continued, with the result that monetary developments did not point to any risks to price stability. Although temporary influences caused the decline in the current rate of inflation to be lower than expected, inflationary pressures have been limited even in the context of the second pillar of the ECB's strategy, despite the forthcoming economic recovery. However, future risks still exist with regard to wages and oil prices.

Yield curve on the money market is steeper

Against the backdrop of a stable minimum bid rate for main tenders, the overnight interest rate (Eonia) and the very short-term forward rates have, on the whole, changed very little. By contrast, the longer-term forward rates have, on balance, risen distinctly despite a temporary decline in April. In mid-May they were 30 to 40 basis points higher than in mid-February. Thus the yield curve on the money market has become even steeper. That means that market participants expect the Eurosystem to raise key interest rates over the course of the year.

Liquidity management through main refinancing operations

During the period under review ongoing management of the money market was conducted exclusively through the use of main tenders. January's extremely disparate main tender volumes have since realigned themselves. When gauging these volumes, the Eurosystem particularly had to make sure that the liquidity effects resulting from the sharp fluctuations in general government deposits with the Eurosystem – particularly at the end of February, the beginning of April and the subsequent turn of the month – were offset as soon as possible. It was also necessary to neutralise the inflow of funds caused by the distribution to the Federal Government on 11 April of its share of the Bundesbank's 2001 profit, which amounted to €11.2 billion. Banknotes in circulation, the liquidity effects of which were difficult to forecast in the first few weeks following the introduction of euro cash, no longer presented a major challenge to liquidity management during the period under review. Only at the end of the reserve management periods and, as usual, at the end of each month and quarter did Eonia deviate relatively sharply from the main tender rate. It was particularly at the end of the March-April reserve maintenance period that Eonia rose visibly, and credit institutions

Factors determining bank liquidity *

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

Item	2002 24 Feb to 23 Mar	24 Mar to 23 Apr	24 Feb to 23 Apr
I Provision (+) or absorption (–) of central bank balances by			
1 Change in banknotes in circulation (increase: –)	+ 22.9	– 2.6	+ 20.3
2 Change in general government deposits with the Eurosystem (increase: –)	– 4.6	– 1.7	– 6.3
3 Change in net foreign reserves 1	+ 0.7	+ 8.7	+ 9.4
4 Other factors 2	– 6.6	– 3.5	– 10.1
Total	+ 12.4	+ 0.9	+ 13.3
II Monetary policy operations of the Eurosystem			
1 Open market operations			
a) Main refinancing operations	– 12.7	– 1.9	– 14.6
b) Longer-term refinancing operations	+ 0.0	– 0.0	0.0
c) Other operations	–	–	–
2 Standing facilities			
a) Marginal lending facility	+ 0.0	+ 0.2	+ 0.2
b) Deposit facility (increase: –)	– 0.0	– 0.1	– 0.1
Total	– 12.7	– 1.8	– 14.5
III Change in credit institutions' current accounts (I + II)	– 0.5	– 0.9	– 1.4
IV Change in the minimum reserve requirement (increase: –)	+ 0.5	+ 0.7	+ 1.2
Memo items 3			
Main refinancing operations	114.6	112.7	112.7
Longer-term refinancing operations	60.0	60.0	60.0
Other operations	–	–	–
Marginal lending facility	0.2	0.4	0.4
Deposit facility	0.1	0.2	0.2

* 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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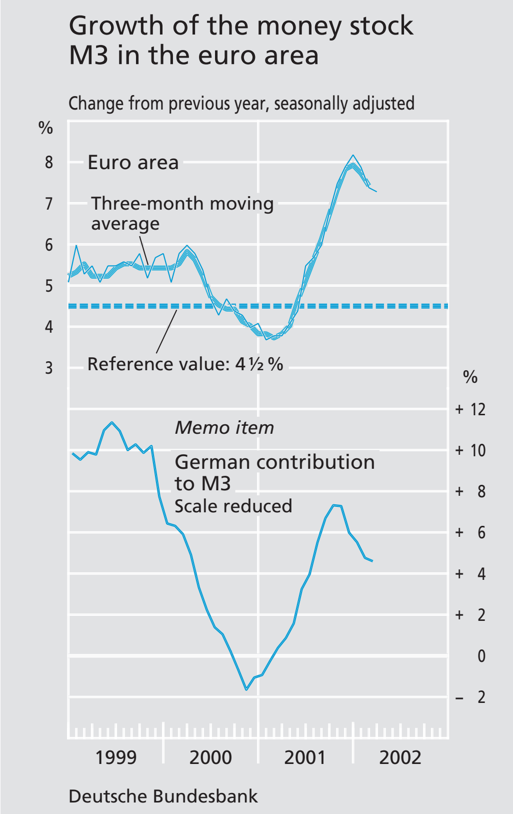


temporarily took major recourse to the marginal lending facility as part of their end-of-period reserve management operations.

Decline in liquidity need

Between February and April, the autonomous factors determining bank liquidity generated, on balance, €13.3 billion of inflows to credit institutions (see adjacent table). This mainly reflected the continuing return flows of banknotes denominated in legacy currencies and the distribution of the Bundesbank's profit. The decline in the minimum reserve requirement by €1.2 billion also had an expansionary effect. The Eurosystem accordingly reduced the volume of its main refinancing operations during the period under review by €14.6 billion to an average of €112.7 billion. On the whole, recourse to the standing facilities remained low.

Recognisable calming of monetary growth

Last year's very strong monetary growth weakened visibly in the first few months of this year. In the first quarter of 2002 the broadly defined M3 monetary aggregate grew at a seasonally adjusted annual rate of only just over 2½%, compared with just under 9½% in the second half of 2001. The growth of the German contribution to M3 was just as muted as that of euro-area M3. Despite the distinct slowdown in growth, M3, at the end of March, was still up 7.3% on the year. The reduction of liquidity holdings in the economy, which had been expanded strongly in connection with the major uncertainty gripping the financial markets in the previous year, is therefore only making slow progress. It is true that this "surplus liquidity" remains unlikely to pose the threat of inflation. However, if it continues to exist even in the face of progressing economic recovery and a deteriorating price outlook in the euro area, this assessment will have to be reviewed.

Components of the money stock

Of the individual components of M3, currency in circulation rose visibly in the first quarter of 2002, though it did not come close to recovering from the beating it took in the run-up to the introduction of euro banknotes and coins. The replenishment of cash holdings probably took place at the expense of overnight deposits, which went down again, seasonally adjusted, in the period under review for the first time since mid-2000. On balance, M1 did increase somewhat in the first quarter of the year; at the end of March its year-on-year rate was 5.8%. Other short-term bank deposits continued to rise sharply in the first quarter. Deposits redeemable at a period of notice of up to three months were in particular demand. Deposits with an agreed maturity of up to two years, too, posted gains, though these gains were not as great as in the preceding quarters. By contrast, negotiable financial instruments went down after adjustment for seasonal variations.

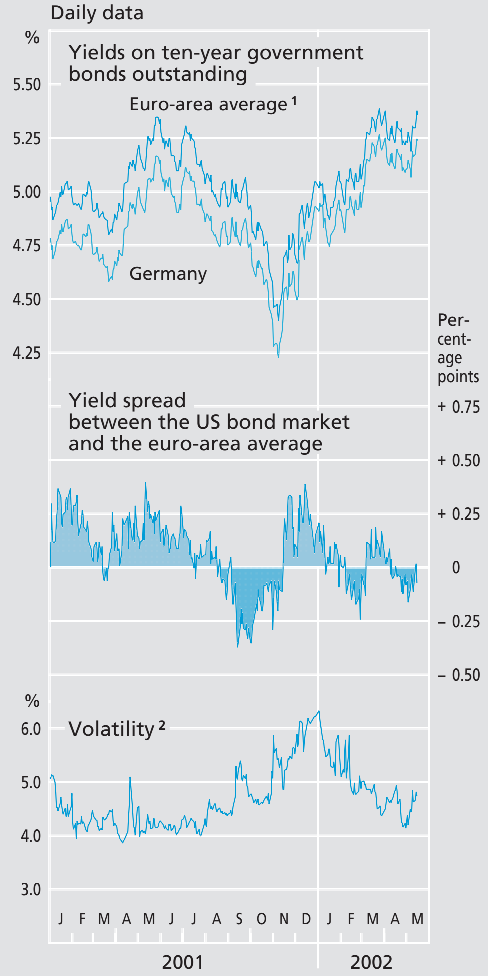
Balance-sheet counterparts

Lending to the private sector continued to weaken during the period under review. At the end of March, lending by MFIs to euro-area enterprises and households were up 5.4% on the year, as against 6.7% at the end of December. The increase in securitised lending to the private sector, at € 3.2 billion, was particularly small, with special circumstances surrounding a German bank having made a contribution. Loans and advances fared somewhat better, rising at a seasonally adjusted annual rate of 5½% between January and March following just under 5% in the fourth quarter of 2001. MFIs' lending to the public sector was clearly increased for seasonal reasons. The longer-term inflow of funds to MFIs in the euro area remained rather muted during the period under report. Excluding capital and reserves, money capital formation was only 3.5% higher at the end of March than a year before. Outflows of funds to non-euro-area countries probably tended to dampen monetary growth in the first quarter of 2002. Following the strong inflows of payments in securities transactions in the second half of 2001, payment flows have since reversed.

Capital market interest rates on the rise

On the euro-area capital markets the rise in interest rates which began in late autumn 2001 continued until the end of March. It was supported in great measure by investors' confidence that the world economy would soon recover, along with slightly increased inflation expectations. Incipient doubts regarding the sustainability of the economic upswing caused yields to fall slightly in April. At the same time, market players' uncertainty about future interest-rate developments on the bond market decreased. In early May, concerns about future price risks and the

Bond-market yields in the euro area



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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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.

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commensurate interest-rate outlook then caused interest rates to rise once again. At last report the yield on ten-year government bonds averaged 5⅓% in the euro area, just under one-third of a percentage point higher than in mid-February.

Spread between money market and capital market rates continues to widen

The yield spread between the capital market and the money market continued to open up slightly during the period under review, from 172 basis points in mid-February to 186 basis points at last report. With short-term money market rates having changed little, the euro-area yield curve has grown steeper, particularly at the short end. This reflects the prospect of a forthcoming cyclical upswing, yet also the somewhat gloomier outlook for prices and the assumption of increased central bank interest rates.

Euro-area interest rates once again ahead of United States

In mid-February yields on ten-year US Treasuries were around ten basis points lower than those on comparable bonds issued by euro-area countries. Afterwards, buoyed by optimistic assessments of the US economy, they picked up somewhat faster than euro-area yields. Consequently the interest-rate disadvantage of ten-year US government bonds was temporarily reduced. In mid-May yields on US Treasuries were once again five basis points lower than on European government bonds owing to the recent, more muted assessment of the outlook for growth.

Risk premiums on non-top-rated corporate bonds

In the euro area the spreads on corporate bonds having a lower credit rating initially continued to slide following a particularly strong increase in autumn, against the background of the expected economic recovery. Given recent renewed scepticism regarding growth expectations, these yield premiums even surpassed their mid-February level, which means that, on balance, assessments regarding the creditworthiness of these enterprises have not improved. The average differential in risk premiums between such corporate bonds and government bonds was 20 basis points higher in mid-May than at the beginning of the period under review.[1]

Sideways movement of share prices

As this *Report* went to press, quotations on euro-area equity markets – measured in terms of the Dow Jones EuroStoxx index – were 2% higher than in mid-February. Initially prices picked up distinctly when market participants, looking at positive early economic indicators, increasingly assumed that a quick and strong recovery of the world economy was in the offing. As the period progressed, quotations receded. On the whole, in mid-May European companies' stock-market quotations were, on average, over one-third lower than their all-time highs of March 2000.

TMT stocks under pressure

In similar fashion to the bond market, price developments on stock markets largely followed those in the US. There, too, investors' confidence in the economy increased, even if some disappointing company reports and earnings forecasts did not necessarily confirm this confidence. The high-tech sector was a striking example. Ultimately share prices in the United States fell slightly. In the euro area, as well, stocks from the technology, media and telecommunications sector (TMT) came under strong pressure following dashed earnings expectations, whereas cycle-dependent stocks from the consumer and capital goods sectors and financial paper were able to hold their own.

Profit estimates stabilised at lower level

The generally expected economic recovery has led to a stabilisation of analysts' forecasts regarding corporate profits. The average annual profits expected for companies listed on the Dow Jones EuroStoxx index,[2] which in February 2002 were nearly 18% lower than a year before, were not scaled back any further. Long-term expectations of profit growth were even raised slightly to annual rates of over 12½%. However, the still very high standard deviation of the forecast values shows that analysts remain uncertain about the future earnings developments of listed companies.

1 Source: Merrill Lynch index of corporate bonds rated BBB.
2 I/B/E/S analyst estimates. Source: Thomson Financial.