

# The international and European setting

## Developments in the global economy

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Whereas industrial production in the G-7 countries and the smaller countries in western Europe picked up noticeably in the third quarter and, at 1%, surpassed the previous year's level for the first time since the beginning of 2001, the global economic outlook has clouded over again during the past few months. A sure sign of this is that business expectations and consumer confidence, which had recovered visibly up to and into the spring period and had indicated a brisk economic recovery, have been inching downwards in most industrial countries since mid-year. Important contributing factors have included high risk premia, sliding share prices on very volatile stock markets up to early October and the speculation-induced rise in oil prices.

*Global recovery  
without  
momentum*

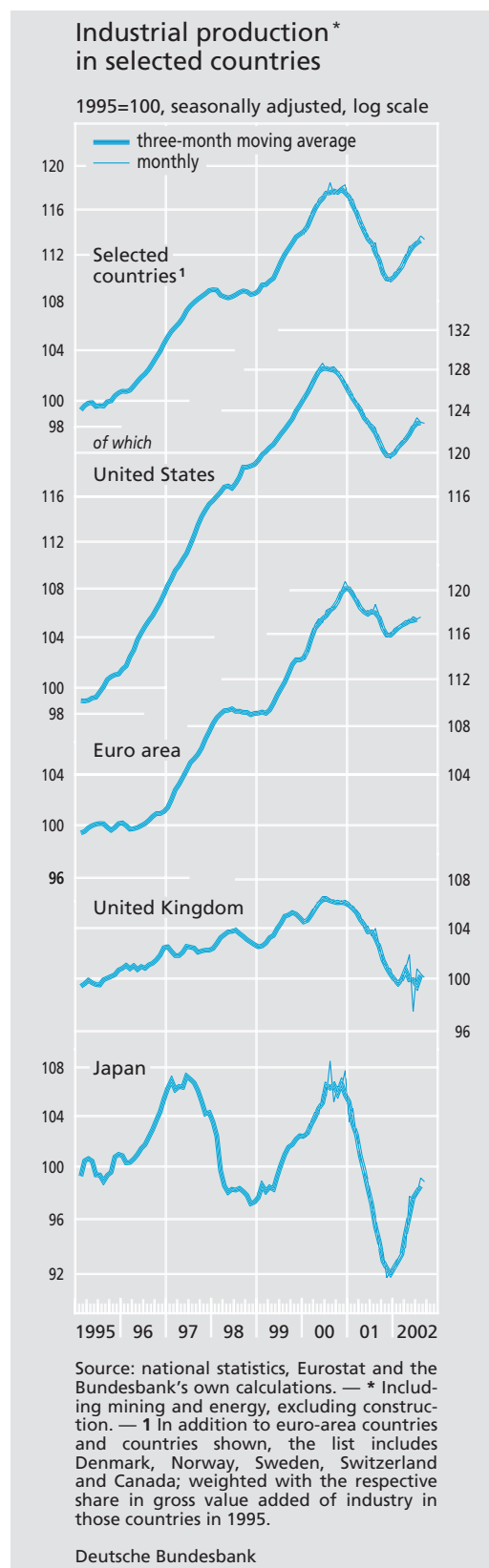
However, barring an escalation of the conflict in the Middle East, the dampening influences are likely to gradually peter out. Oil prices have already declined noticeably in the past few weeks and listed share prices have recovered somewhat from their lows, which means that expansionary forces will probably regain the upper hand in the course of next year. However, the winter of 2002-2003 is likely to see only relatively weak global economic growth, the adverse impact of which is likely to affect the result for 2003 as well. To prop up the US economy, the Federal Reserve once again cut interest rates in early November; at 1.25%, they are now at their lowest level since the 1960s. Euro-area interest rates have remained unchanged at a relatively low level.

IMF forecast

In view of the heightened uncertainty and the drag on the real economy that this is creating, various international organisations and national agencies in industrial countries have recently scaled back their macroeconomic forecasts, especially those for 2003, and in some cases quite considerably. In its latest edition of the World Economic Outlook published in September, the International Monetary Fund (IMF) predicts that global economic growth in 2002 will be 2.8% and, therefore, unchanged from the spring forecast. However, the global outlook for 2003, with growth of +3.7%, is no longer as favourable as six months earlier (+4.0%). Now another revision is on the horizon after the IMF scaled back its forecast for the euro area once again at the end of October. According to the IMF's forecast, global trade will rise by 2.1% and 6.1% in 2002 and 2003 respectively, growing in each case half a percentage point more slowly than had been expected in spring.

The downward revision of the forecast for the USA for 2003, by 0.8 percentage point to 2.6%, was particularly pronounced (although, from the current perspective, even this rate of growth will be difficult to achieve). According to the IMF's end of October forecast, real euro-area GDP is expected to rise by a paltry 2% (compared with 2.3% in September and 2.9% in April). Following two years of negative productivity growth, the Japanese economy is expected to grow by 1.1% in 2003.

The IMF scaled back its forecast for Latin America considerably in view of the sustained financial turbulence in the region. In the cur-



rent year, therefore, Latin America's total economic production will shrink by 0.6% in stark contrast to April predictions which held that growth of 0.7% was probable. Predicted growth in 2003 is now 3.0% as against 3.7% as predicted previously. By contrast, the IMF does not see any need for a tangible correction of the forecasts for the east Asian emerging market economies (including China), which could witness economic growth in excess of 6% in the coming two forecast years. The same applies to the central and east European transition countries (including the Commonwealth of Independent States), whose production will probably rise by 3.9% in 2002 and by 4.5% in 2003. What is particularly noteworthy is that, besides Russia, most of the other members of the Commonwealth of Independent States have entered into a relatively steep growth track.

*Price  
developments  
in industrial  
countries*

Year-on-year consumer price inflation in industrial countries averaged 1.1% over the July-September period compared with 1.0% in the first half of 2002. The fact that the rate of price increase has remained very low is attributable to the continuing decline in prices in Japan. Excluding Japan, consumer prices were 1.7% higher in the third quarter than a year before. According to the IMF forecast, next year inflation pressures in industrial countries will increase slightly on the whole, particularly because the deflationary tendencies in Japan will taper off and prices in the United States will rise more sharply for cyclical reasons.

*United States*

According to initial estimates, real GDP in the United States went up in the third quarter

by  $\frac{3}{4}\%$  after adjustment for seasonal and working-day variations compared with a  $\frac{1}{4}\%$  rise in the spring period. Total economic production increased by 3% on the year. The strongest stimulus by far came from private consumption, which increased by a seasonally adjusted 1% and, in nominal terms, was the sole base of support for GDP growth. Households' rather high demand was based for the most part on special factors and therefore cannot be seen as a sign of a sustained upswing in consumption. One example is the financing campaign by car manufacturers, which at times did much to increase car sales; however, sales figures have since begun to recede. For the next few months, the anticipatory effects triggered by these incentives are likely to lead to a sales dip on car markets. The other factor is that, because of the relatively low level of interest rates, private households have, to a considerable extent, refinanced their existing mortgages with interest rates locked in, which is possible in the United States with only relatively low prepayment penalties. The financial room for manoeuvre thereby gained has, in many cases, been used to increase consumer spending. However, this effect will probably also expire since the volume of mortgages not yet refinanced has already shrunk considerably.

Disposable income did not grow as fast as private consumption, causing the Q3 household saving ratio to fall by one-quarter percentage point to  $3\frac{3}{4}\%$ . Households' debt service, which at last report amounted to just over 14% of disposable income, had returned to its high levels of the mid-1980s. This is likely

to strain further developments in private consumption. In addition, the ability of rising property prices to compensate for the negative wealth effects still being emitted by the stock markets will probably diminish. Consumer confidence, which has already been in decline since June, plummeted in October, reaching its lowest level since 1993. In addition, the outlook on the labour market has not improved. In October, the seasonally adjusted unemployment rate went back up slightly to 5.7%.

In the summer months, industrial investment did not decline further for the first time in two years. It is still unclear, however, whether investment has bottomed out, as the volume of orders for machinery and equipment recently shrank once again by a considerable margin. In the third quarter, spending on new housing virtually stagnated at the high level reached in the spring months. The number of construction permits picked up sharply after mid-year, however, which means that housing construction is likely to once again make a positive contribution to growth in the coming months. Inventories remained largely unchanged in the summer months. The deficit in the real foreign balance rose slightly.

The price climate in the United States remained relatively favourable throughout the period under review. Consumer price inflation was 1.6% in the July-September period, slightly higher than in the first half of the year (1.3%). This mainly reflects abating price pressure owing to declining energy prices in the summer of 2001, however. Core inflation, ie consumer prices excluding energy and food,

continued to decline slightly, going down to 2.3%. The private consumption deflator, which is highly regarded in the United States, was only 1.1% higher in the third quarter than its previous year's level, however.

The agency in Japan responsible for the national accounts announced this summer that it had improved its methods of calculating GDP and its components. These changes are just one reason why GDP figures for the first two quarters of the current year have now been revised upwards. The first estimate for the third quarter signalled growth of  $\frac{3}{4}\%$  after seasonal adjustment. That means that, after bottoming out in the autumn of 2001, total economic production has risen by not less than 2%. Growth exceeded the previous year's level in the summer period for the first time since early 2001 (by  $1\frac{1}{2}\%$ ). Unlike the first half of 2002, in which a key expansionary stimulus was generated by foreign trade and payments, growth was supported exclusively by domestic demand. Private and government consumption rose particularly sharply. Inventory investment contributed one-half percentage point to GDP growth. By contrast, gross fixed capital formation continued to inch downwards. The increase in exports, at a seasonally adjusted  $\frac{1}{2}\%$ , was distinctly weaker than in the past. However, it was offset by a rather large increase in imports, causing a slight decline in the net foreign balance.

*Japan*

Given that the global economic climate has once again clouded over, the outlook for the Japanese economy has likewise taken a turn for the worse. This is indicated by the fact that, in the third quarter, orders for mechan-

ical engineering products declined for the second quarter running. The continuing deflation is also a reflection of the delicate situation in which domestic economic activity finds itself. Over the July-October period, consumer prices were, on average, 0.8% lower than a year before. On the whole, the severe problems besetting the financial sector, in particular, are preventing the Japanese economy from undergoing a lasting and broadly-based revival. It is questionable whether the recently adopted measures to alleviate the strain being placed on banks by non-performing loans will be enough to revive the ailing Japanese financial sector.

United  
Kingdom

According to initial calculations, economic growth in the United Kingdom, after adjustment for seasonal and working-day variations, was  $\frac{3}{4}\%$  in the summer quarter and thus even stronger than in the spring months; the year-on-year growth rate was  $1\frac{3}{4}\%$ . This expansion, which was much stronger than in other industrial countries, was supported by the service sector, which generated  $\frac{3}{4}\%$  more value added after adjustment for price and seasonal variations than in the second quarter of the year. Retail trade and accommodation services fared particularly well. At the least, industry no longer held back total economic growth. The decisive demand stimulus driving the expansion of real GDP came from the increase in private household expenditure. This was supported by a good labour market environment and a moderate rate of price increase of 1.7% in the July-October period (excluding mortgage rates, the rate of consumer price increase was 2.1%). Furthermore, property values, which

rose sharply throughout the period under review, fuelled households' propensity to consume. It is questionable, however, whether the boom in the real-estate market, with property prices rising over 20% in a twelve-month period, is not already a bubble waiting to burst and turn into negative growth, which could put a strain on economic growth in the United Kingdom.

### Macroeconomic trends in the euro area

Real euro-area GDP rose by  $\frac{1}{2}\%$  in the spring months after seasonal adjustment, the same rate as in the winter months. Total economic production increased by  $\frac{3}{4}\%$  on the year. However, growth was supported more strongly by domestic demand than in the past. The main factor was that private consumption, having fallen in real terms in the first quarter of the year, rose by  $\frac{1}{4}\%$  after seasonal adjustment. By contrast, fixed capital formation sagged once again, falling 4% below its last high recorded at the end of 2000. Inventories were depleted further, although the decline was only slightly lower than earlier. Seasonally adjusted exports and imports went back up for the first time since the end of 2000 by  $1\frac{1}{2}\%$  and  $1\frac{1}{4}\%$  respectively. That resulted in a contribution to growth of one-quarter percentage point.

*Moderate GDP  
growth in the  
spring period*

However, the economic recovery in the euro area also lacked force after the middle of the year. In the July-August period, seasonally adjusted industrial production was barely higher than in the second quarter and was still  $\frac{1}{2}\%$  lower than its muted level at the same time in

*No stable  
upswing in the  
summer either*

the previous year. Initial country results for September indicate a decline in the euro area after seasonal adjustment; therefore, industrial production probably increased only slightly in the summer quarter. According to the survey commissioned by the European Commission, capacity utilisation in the manufacturing sector nevertheless rose by one-half percentage point between July and October. However, a closer look reveals that this rise is attributable, *inter alia*, to quite volatile movements in mostly smaller member states. These movements should not be taken at face value.

*Results of EU survey mixed*

In October, seasonally adjusted business confidence in the euro area improved a little after deteriorating in the four preceding months. This result should not be overinterpreted, however, since other key indicators tend to suggest that the economy will run more slowly in the winter. In the quarterly survey, the assessment of incoming orders was distinctly weaker in October than in July. In addition, consumer sentiment in October was at its lowest level since November 2001.

*Little change in the labour market*

Although economic growth tended to be sluggish, the labour market situation remained quite stable. From July to September, the standardised unemployment rate held firm at 8.3% after 8.1% at the beginning of the year and 8.0% in the summer of 2001. Unemployment among women, which was 9.7% in September, hardly rose at all on the year, while the standardised unemployment rate for men, who tend to work in industries which are more sensitive to the business cycle, rose by 0.4% to 7.2%.

General price developments continued to settle down in the summer months. In the third quarter, seasonally adjusted and annualised consumer prices, measured in terms of the Harmonised Index of Consumer Prices (HICP), were up by only 1.7% from the second quarter. Their year-on-year rise decelerated slightly to 2.0%. Lower prices for unprocessed food and energy, in particular, contributed to the more favourable development over the course of the year. Excluding these volatile components, the annual rate of increase was projected at 2.2% in the summer, following 2.5% in the second quarter and 2.6% in the first. Year-on-year core inflation in the third quarter declined to 2.5%, representing only a minute change from 2.6% in the first half of the year. Prices for manufactured goods (excluding sources of energy) rose by only 1.4% on the year, a relatively low rate of increase; this contrasted with a much higher rate of price increase for processed food (+2.9%) and services (+3.3%). According to Eurostat estimates, inflation was 2.2% in October.

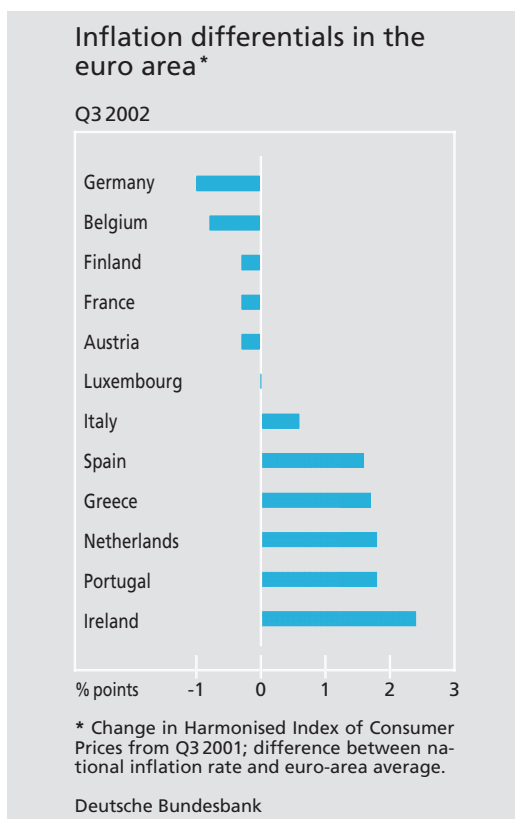
*More favourable price developments in the summer*

Consumer surveys by the European Commission revealed that, despite lower headline inflation rates in the summer months, "perceived" inflation initially continued to rise somewhat, while net inflation expectations declined. "Perceived" inflation has remained at a high level since August.

*"Perceived" inflation remains high*

The regional spread of inflation rates changed only relatively little on the whole during the summer months. The spread between the highest inflation rate (in Ireland) and the lowest rate (in Germany) narrowed from 3.7 to 3.4 percentage points. Measured in terms of

*Diverging inflation rates*



the weighted standard deviation of core inflation rates, which takes account of the countries' varying sizes and, at the same time, cancels out random fluctuations caused by volatile prices, the gap between lower-inflation and higher-inflation countries has widened somewhat again, however, after expanding in the spring months already.

### Euro-area current account and exchange rates

*Foreign trade and current account*

During the summer months, euro-area foreign trade exerted hardly any positive influence on economic growth. In the last three months for which such data are available (June-August 2002), exports remained virtually unchanged from the preceding three-

month period (March-May 2002) after adjustment for seasonal and working-day variations. During the same period, imports increased by about ½%. The euro-area trade surplus therefore declined slightly, reaching a seasonally adjusted €34 billion in the June-August period following €35½ billion in the preceding three-month period.

By contrast, the euro area's seasonally adjusted foreign trade balance in "invisible" current transactions with non-euro-area partners improved. Current transfers by the euro area to non-euro-area countries went down sharply on balance. Net expenditure on factor income was also considerably lower during the June-August period than before, whereas in the case of services the seasonally adjusted net income gain declined. Despite the slightly lower trade surplus, the euro-area current account therefore closed, on balance, with a seasonally adjusted surplus of €15½ billion for the period of June-August 2002 as against €10½ billion for the preceding three-month period.

In the autumn months, the euro held its own remarkably well in an environment plagued by great uncertainty and even continued to stabilise as of late. It held steady against the US dollar, in particular, for several months after having appreciated distinctly up to mid-July. From then until early November, the rates fluctuated within a tight band of around US\$0.03 just below parity between the euro and the US dollar. Such a long phase of relative stability in the US dollar/euro exchange rate is unprecedented. As before, varying reports on the future outlook on each side

*The euro's exchange rate...*

*... against the US dollar, ...*

of the Atlantic played a key role in daily exchange rate fluctuations. However, such changes unleashed dampening balancing forces earlier than usual and these held the exchange rate in a narrow band. Parity with the US dollar represented a line of resistance which was difficult to overcome. The euro had initially reached this line in mid-July but could only stay there for a few days. Unfavourable business indicators for the euro area and heightened general uncertainty in the weeks prior to 11 September 2002 continued to put pressure on the euro in the period that followed; however, the euro did not fall below around US\$0.97.

In mid-September, the euro was given another boost after it became known that in August US industrial production, contrary to the expectations of most market participants, had fallen for the first time this year. However, when it became clear that the budgetary situation in the large euro-area countries, particularly Germany, had deteriorated sharply, the pendulum swung back in the other direction. This countermovement was additionally fuelled by strains caused by the subsequent debate about the Stability and Growth Pact and the imminent increase in the tax burden arising from the coalition agreements. Given that forecasts for the United States were being corrected downwards as well, however, the euro fell by a relatively small margin during this period.

However, new disappointing business indicators for the United States and particularly a sharp cut in interest rates by the US Federal Reserve, which was seen by market partici-

pants as confirmation that the US economy was growing sluggishly, caused the euro to make significant gains against the US dollar in early November, which did not stop at parity. At US\$1.01 as of late, the euro had returned to its previous high for the year as reached in mid-July.

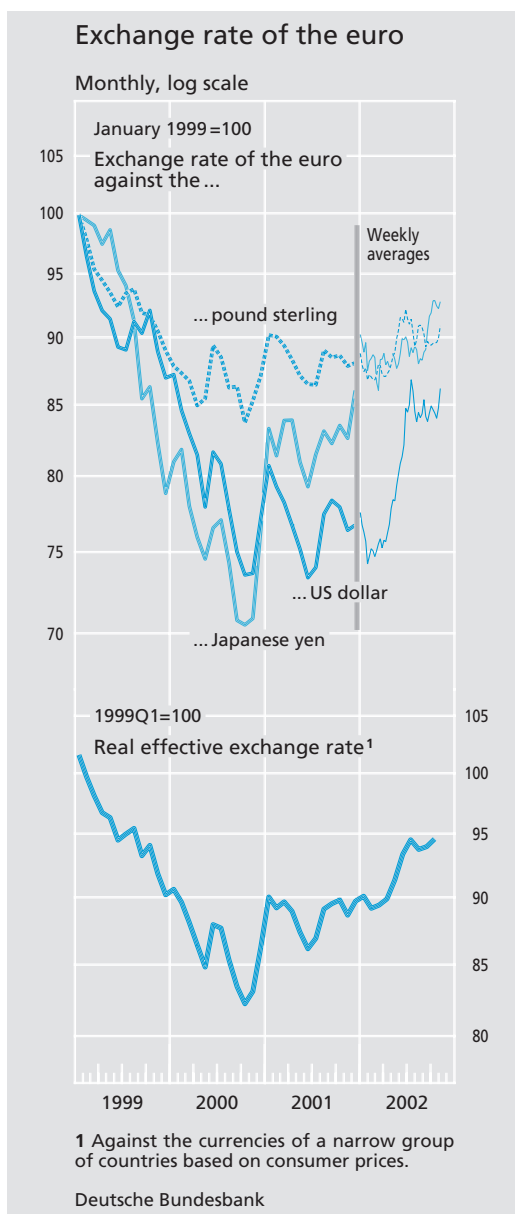
Up until mid-October, the euro made distinct gains against the Japanese yen. It went up from a mid-August level of ¥115 to a recent level of ¥121, a 5% appreciation. The yen was burdened by the fact that prospects for further economic recovery in Japan, which had rested on temporary success in export business, clouded over again in the autumn months. In addition, suggestions that the yen should be actively weakened by having the Bank of Japan sell yen to fight deflation increased depreciation pressure on the yen in mid-September. The decision somewhat later by the Bank of Japan to acquire securities held by credit institutions in order to improve the balance-sheet structure of the ailing banking system had a similar effect, as this strengthened the impression that the Japanese financial system's unresolved structural problems are more stubborn than many had hitherto assumed.

In the autumn months, the pound sterling changed relatively little against the euro. Since late summer, the rate has been moving, much like that of the euro to the US dollar, within a relatively tight band of around £0.63 to the euro. The comparatively robust UK economy has maintained the value of the pound sterling at a relatively high level against the euro.

*... the Japanese  
yen...*

*... and the  
pound sterling*





Effective exchange rate of the euro

In the autumn months up to early November, the euro's external value against the weighted average of the currencies of the euro area's most important trading partners remained practically unchanged just below its peak for the year reached in July. Only following the most recent substantial exchange rate gains achieved by the euro against the US dollar did the effective exchange rate go back up distinctly. As this report went to press, the

euro – in terms of a weighted average – was again quoted at this year's peak as reached in mid-July. However, at its introduction the external value of the euro was 11% higher. Even if differences in the inflation rates of the euro-area countries and the non-euro-area partner countries are taken into account, the outcome is still a real depreciation of 6% compared with early 1999 levels. This means that the competitiveness of euro-area manufacturers on global markets is still being supported by the exchange rate.

### Monetary policy and financial markets in the euro area

The Governing Council of the European Central Bank did not change the Eurosystem's key interest rates in the past few months. The weekly main refinancing operations were all conducted as variable rate tenders with a minimum bid rate of 3.25%, while the interest rates on the marginal refinancing facility and the deposit facility remained at 4.25% and 2.25% respectively. This "steady-as-she-goes" interest policy was consistent with the assessment that risks to monetary stability were balanced. Although monetary growth remained strong, this was mainly a reflection of the considerable uncertainty gripping the financial markets, which meant that the economy's abundance of liquidity did not create any direct threat of inflation. This is also evinced by the fact that the early indicators of business activity and business confidence continued to point to muted economic activity. By applying a steady-handed policy geared towards ensuring monetary stability,

*Eurosystem's interest rates unchanged*

## Money market management and liquidity needs

In the past few months, main refinancing operations remained the sole method of ongoing money market management; recourse to fine-tuning operations was not sought. When gauging the main refinancing operations, the Eurosystem made particularly sure that liquidity effects caused by the strong fluctuations in general government deposits with the Eurosystem – most notably towards the end of the reserve maintenance periods because of tax payments in Italy but also at the end of each month – were offset in the timeliest manner possible. In addition, account had to be taken of the severe withdrawal of funds owing to the continued sharp rise in the volume of banknotes in circulation, which exceeded the previous year's level for the first time in October. Lastly, the reduction in the outstanding volume of longer-term refinancing operations decided by the ECB Governing Council in July had to be taken into account. At the end of July, August and September (for the last time), longer-term refinancing operations of €20 billion each reached maturity and were not completely offset by new transactions worth €15 billion each. On the whole, the Eurosystem's liquidity management has enabled credit institutions to meet their reserve requirements relatively steadily. It was only at the end of the reserve maintenance periods in September and October and, as usual, at the end of the month and quarter that the overnight money rate (Eonia) varied relatively sharply from the main refinancing rate.

Between July and October, the autonomous factors determining bank liquidity withdrew €4 billion net from credit institutions (see adjacent table). The sharp rise in the volume of banknotes in circulation contrasted with an evident decline in general government deposits with the Eurosystem. The minimum reserve requirement fell by €3 billion during the period under review. The Eurosystem met the remaining additional liquidity requirements by increasing the volume of its open market operations by €1 billion net to an average of €191.4 billion. On the whole, recourse to the standing facilities remained slight and was concentrated at the ends of the reserve maintenance periods.

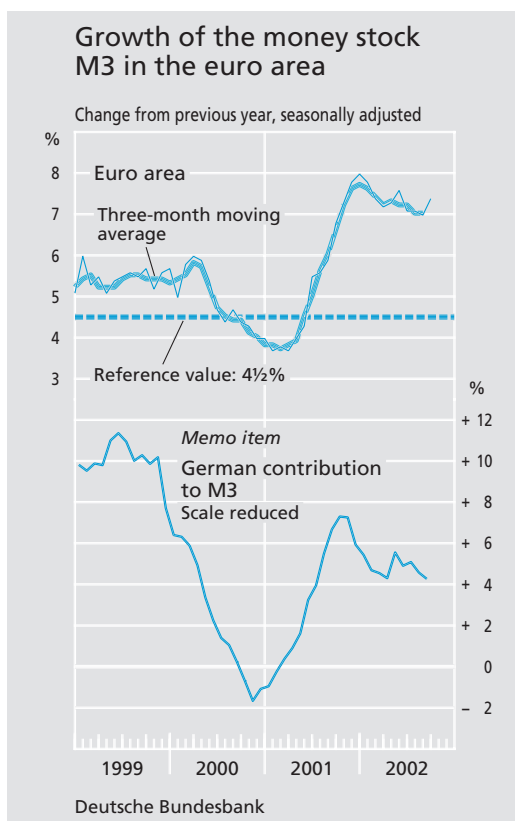
<sup>1</sup> For longer-term trends and the contribution of the Deutsche Bundesbank, see pages 14\* and 15\* of the Statistical Section of the *Monthly Report*. — <sup>2</sup> Including end of quarter valuation adjustments with no impact on li-

## Factors determining bank liquidity <sup>1</sup>

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

Item	2002		
	24 July to 23 Aug	24 Aug to 23 Sep	24 Sep to 23 Oct
I Provision (+) or absorption (–) of central bank balances by			
1 Change in banknotes in circulation (increase: –)	– 9.3	– 0.9	– 5.6
2 Change in general government deposits with the Eurosystem (increase: –)	+ 3.5	+ 1.8	+ 3.5
3 Change in net foreign reserves <sup>2</sup>	– 9.1	+ 2.3	+ 7.7
4 Other factors <sup>3</sup>	+ 9.5	– 0.9	– 6.5
Total	– 5.4	+ 2.3	– 0.9
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	+ 8.8	+ 1.7	+ 5.2
(b) Longer-term refinancing operations	– 4.8	– 4.4	– 5.5
(c) Other operations	–	–	–
2 Standing facilities			
(a) Marginal lending facility	– 0.1	+ 0.0	– 0.0
(b) Deposit facility (increase: –)	+ 0.1	– 0.1	+ 0.1
Total	+ 4.0	– 2.8	– 0.2
III Change in credit institutions' current accounts (I + II)	– 1.5	– 0.3	– 1.3
IV Change in the minimum reserve requirement (increase: –)	+ 1.4	+ 0.3	+ 1.3

quidity. — <sup>3</sup> Including monetary policy operations concluded in stage two and still outstanding in stage three (outright transactions and the issuance of debt certificates).



the Governing Council sought to calm the volatile financial markets and provide reliable general guidance for investors and consumers.

Given that the minimum bid rate on main refinancing operations was stable, the overnight money rates (Eonia) hardly changed apart from fluctuations at the end of the reserve maintenance periods and at the end of the month. However, time deposit rates fell, with rates in the longer-term areas falling much faster than in the short-term areas. This caused the yield curve on the money market to change from a rather flat shape to an inverted shape. Market participants obviously assume that central bank interest rates will fall in the future.

*Inverted yield curve on the money market*

Euro-area M3 growth picked up steam in the summer months. Seasonally adjusted and annualised M3 growth in the third quarter was 10% compared to just under 7½% in the second quarter. This increase was even higher in September. Owing to base effects, however, this acceleration is not at all or only barely visible in the year-on-year rates. By that token, in September 2002, M3 was up 7.4% on the year compared with 7.1% in June. The three-month moving average of annual rates of change even went down slightly from 7.3% for the April-June period to 7.1% in July-September. Portfolio shifts were the main cause of the rise in the money stock. Investors' unease regarding developments in interest rates and stock markets continued to make temporary investment in liquid and secure M3 components appear to be an attractive option.

*Sharp increase in the money stock*

Among the individual components of M3, overnight deposits were once again increased sharply in the third quarter. Two-thirds of this seasonally adjusted increase took place in September when share prices plummeted by around 18%. Euro currency in circulation likewise grew significantly. At the end of September, it was just slightly below its level at the same time in the previous year, which means that the sharp decrease in cash in the last quarter of 2001 has now been almost completely offset. All in all, M1 grew by a seasonally adjusted annual rate of 13% in the July-September period as against 11% in the second quarter. The other short-term bank deposits grew only sluggishly by contrast. Deposits with an agreed maturity of up to two years, in particular, were weak; their

*Components of the money stock*

year-on-year growth rate at the end of September was only just under 1%. Deposits redeemable with a period of notice of up to three months, however, remained in demand. Between July and September, marketable instruments picked up sharply. Money market fund shares/units contributed in large part to this development, as they are especially suited to the short-term investment of funds at market rates. There was also a perceptible increase in repo transactions.

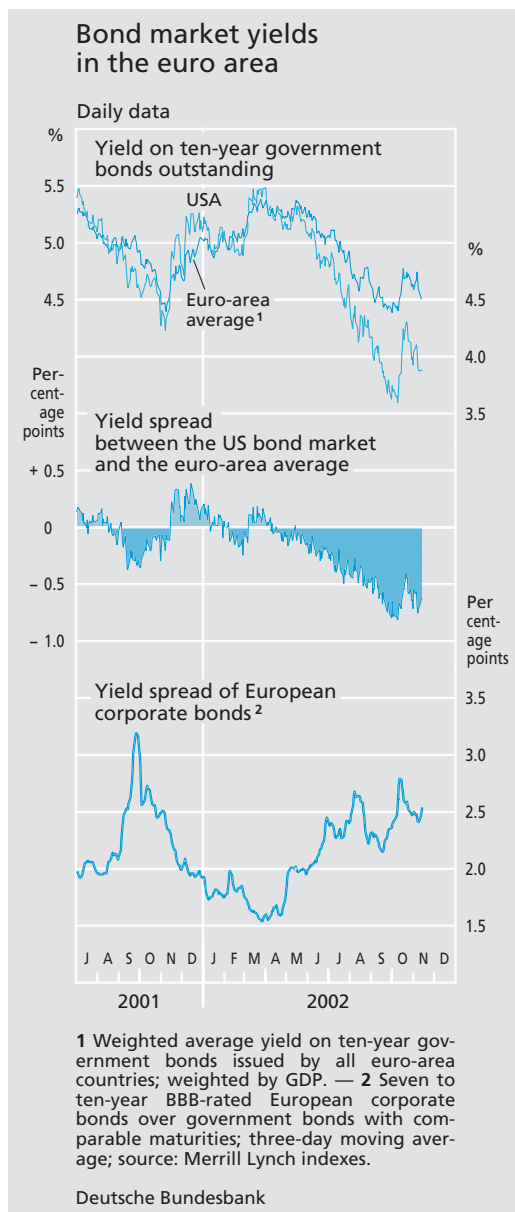
*Balance-sheet  
counterparts*

In the summer months, euro-area MFIs increased their loans to the domestic private sector by a seasonally adjusted and annualised rate of just under 5% compared with just under 6% between April and June. Against the background of muted economic activity in the euro area, which tends to curb the propensity to borrow in spite of the fact that the terms of finance are generally good, the pace of private credit expansion is currently much slower than that of monetary growth. Since MFIs also reduced their securitised lending to euro-area companies by €8 billion during the period under review, the year-on-year increase in total lending to the domestic private sector dropped from 5.4% at the end of June to 5.1% by the end of September. The reduction in lending to euro-area general governments continued in the third quarter. Within this category, only loans were reduced whilst MFIs' holdings of securities issued by domestic public authorities increased. The propensity to deposit funds with euro-area MFIs over the longer term remained muted during the summer months. Excluding capital and reserves, monetary capital was up by 4.5% on the year at the end

of September as against 4.6% at the end of June. The third quarter saw renewed net inflows of funds in payments with non-euro-area countries, although these were smaller than in the preceding quarter. Securities transactions with non-euro-area countries are once again likely to have made a key contribution to this development.

The expectations of market participants regarding economic activity, which have been muted since the summer, also left their mark on the capital market. Long-term capital market rates in the euro area fell by just over one-half percentage point after mid-year. As a consequence of the even steeper fall in interest rates in the United States, the euro area's yield spread initially widened from around one-third of a percentage point in July to three-quarters of a percentage point in the first half of October. Then, within the space of a few days, the yield on ten-year government bonds shot up by one-quarter percentage point in the euro area and even by one-half percentage point in the United States. The reason for this temporary increase is to be found not so much in improved expectations regarding economic activity but rather in portfolio shifts from bonds to shares, which is consistent with the capital gains on the stock markets which took place at the same time. When this report went to press, the average yield on ten-year euro-area government bonds had returned to 4½%. This meant that long-term capital market rates in Europe were just under two-thirds of a percentage point higher than in the United States.

*Capital market  
rates down*



*Hardly any change in inflation expectations*

Market participants' long-term inflation expectations derived from inflation-indexed bonds and from surveys remained largely unchanged during the period under review at between 1½% and 1¾%. The decline in nominal interest rates is, therefore, primarily a reflection of a fall in real interest rates. By mid-September, the expected real interest rate for ten-year bonds had dropped to 2⅔%. The rate had risen again by the time

this report went to press in November, although it remained well below its level of mid-2002.

The decline in interest rates since the summer months was more pronounced in the shorter-term maturities than in the longer-term maturities. As this report went to press, the yield curve of German Federal securities was steeper than in the summer months. This suggests that investors are expecting the economy to improve and interest rates to rise over the medium term, while in the short term they still expect interest rates to decline – as shown by the inverted shape of the yield curve on the money market.

*Yield curve somewhat steeper*

Initially, risk premia on corporate bonds continued to rise in the summer months. After a brief period of calm, the upward trend in yield spreads continued, peaking for 2002 at 280 basis points at the beginning of October. Then, in step with the more favourable stock market developments, they receded somewhat yet remained at a relatively high level. Whereas the increase in risk premia in the spring months was mostly as a result of diminished confidence owing to various accounting scandals, the latest increase is probably a reflection of the deterioration in market participants' expectations regarding economic activity.

*Risk premia on non-top-rated corporate bonds still high*

Against the background of the entrenched crisis of confidence among investors, in the third quarter stock market prices in the euro area continued to nosedive as they had done since April. Between the beginning of July and the beginning of October, the Dow Jones

*Visible losses on stock markets*

EuroStoxx index fell by over 30% to its lowest level since the spring of 1997. Since then, European companies' share prices have recovered somewhat. When this report went to press, they were around one-third lower than their level at the beginning of the year and more than one-half lower than their all-time highs of March 2000.

*Continuing anxiety on stock exchanges*

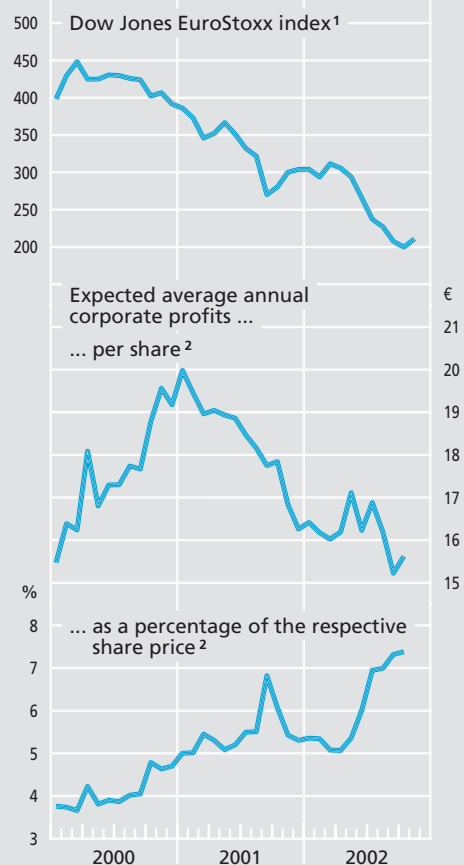
As share prices plummeted, uncertainty regarding further stock price developments, which is expressed in the implied volatility of index options, rose to record heights up to the beginning of October. Since that time, stock price uncertainty has abated slightly but has still been at levels last recorded after the terror attacks of September 2001. Gloomier business prospects and the general collapse of share prices hit financial assets especially hard. The fact that banks' and insurers' profits were put under pressure by reductions in the value of their financial holdings played an important role. This is especially true of institutions which had increased their holdings in listed companies during the bull market phase.

*Crisis of confidence not yet overcome*

Owing to structural weakness on the stock markets<sup>1</sup> and uncertainty regarding further developments in corporate profitability, investors' confidence could not be regained in the third quarter of the year. Most analysts once again downgraded their medium-term growth forecasts for corporate earnings. However, these downward revisions of estimates continue to be based on the expectation that profits will recover perceptibly. Owing to the fact that share prices fell once more during the period under review, the

### Share price developments and profit estimates for European public limited companies

Monthly data



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

Deutsche Bundesbank

price-earnings ratios have now fallen well below their average of the past ten years. The dispersion of analysts' estimates was on the decline in the third quarter yet remained at a relatively high level. According to market experts, therefore, uncertainty remains over further developments in the profitability of listed companies.

*Profit estimates downgraded once again*

<sup>1</sup> See: Deutsche Bundesbank, *Monthly Report*, August 2002, p 21.