The international and European setting

Developments in the global economy

Global recovery slowed down in autumn

The recovery of the world economy slowed down noticeably in autumn 2002; in industrial countries it even ground to a halt. This picture of the economic situation has changed little since the turn of 2002-03. Manufacturing output (excluding construction) in the G7 countries and the smaller west European countries fell by a seasonally adjusted ½% between October and December; however, at +2%, it was still distinctly higher than a year before. On average over the past year, industrial production was down by 1% on the year; it has declined by 4% since 2000. The growing threat of a war in the Middle East which, along with the unrest in Venezuela, has led to a steep rise in oil prices, above all placed a great strain on the world economy in autumn. The after-effects of the stock market slide increased the strains. In addition, the debt financing conditions were less favourable for companies in industrial countries than the low money market rates and low interest rates on government bonds would suggest, especially owing to the rather high risk premia. All of these factors are ultimately rooted in a pronounced lack of confidence, which is having a retarding influence on the economy.

No improvement following turn of 2002-03

The global economy's starting position at the beginning of 2003 tended to be unfavourable. Even though the business expectations of companies in several industrial countries recently brightened somewhat, consumer confidence continued to decline. Growing uncertainty on the financial markets regarding the potential economic consequences of a war put an additional strain on share prices worldwide in the past few weeks. In all likelihood the current economic slump will be overcome only once the existing major confidence deficits have been eliminated and the risk premia on the markets have receded. A reduction in geopolitical tensions is essential.

War scenarios are incalculable

It is not possible to estimate adequately the potential impact which an escalation of hostilities in the Middle East would have on the world economy. The consequential costs to the economy ultimately hinge on too many variables. These costs will depend *inter alia* on the length and intensity of a potential military conflict.[1] If the military conflict were to be short and followed by peace in the region, the oil price might go back down rapidly, and confidence among investors and consumers would improve. However, a protracted conflict would probably lead to stubbornly high oil prices and cause an additional setback to the world economy.

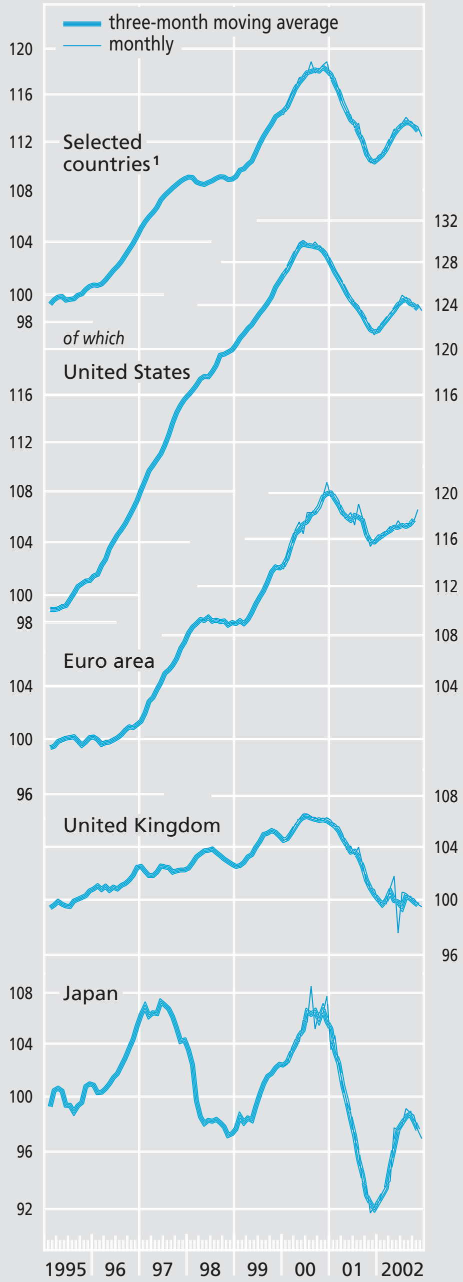
South-East Asia

The South-East Asian emerging market economies have so far been largely able to disassociate themselves from the unsatisfactory economic developments experienced in the industrial countries in autumn 2002 because their domestic economies were mostly robust. Exporters in this region continue to be heavily dependent on the US economy, espe-

1 For the United States alone, the costs of war, which include not only military expenditure but also expenditure on reconstruction, the real income effect of higher oil prices and the strain on the economy are – accumulated over several years – estimated at around US$100 billion if the war were to progress in the USA's favour. If the war were not to progress in the USA's favour, however, overall costs could amount to over US$1.9 trillion. See William D Nordhaus, The Economic Consequences of a War with Iraq, NBER Working Paper No 9361, December 2002.

Industrial production* in selected countries

1995=100, seasonally adjusted, log scale



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

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cially the US demand for IT products, although China seems more and more to be asserting its position as the economic driving force in South-East Asia. Chinese economic growth in 2002 is estimated to have averaged 8%, a somewhat faster pace than in 2001. However, it is debatable whether this pace can be maintained. Consumer prices in China are likely to have fallen by ¾% last year. At the same time, there was particular pressure on companies' profit margins which, along with banks' increased risk awareness, has been curtailing industrial investment lending. Indonesia suffered a severe economic setback due to the terrorist attack on Bali. The concomitant uncertainty could also ripple over to Indonesia's neighbours, especially Malaysia and the Philippines.

Latin America

The situation in Latin America remained tense in the past few months but has not deteriorated further since the summer months. The political unrest in Venezuela plunged the economy into a severe crisis. However, more positive signals from Argentina and Brazil offset the Venezuelan situation. The Argentinean economy appeared to bottom out in summer 2002. Industrial production stabilised at a low level. Real GDP, however, is still estimated to have fallen by more than one-tenth on average in 2002. Since 1999, the fall has been nearly one-fifth. A lasting upswing is only likely to occur once the domestic political situation has become secure, the banking system is back on its feet and an agreement has been reached with national and international private creditors. The financial market turbulence in Brazil, which had erupted in the period leading up to the presidential elections in October 2002, eased noticeably as of late. One key reason is that the newly elected president has declared his willingness to continue the stabilisation policy agreed by the previous government with the IMF. The premia on Brazilian government bonds in comparison with US government bonds fell from 2,451 basis points at the end of September to 1,374 basis points in mid-February. In the second half of 2002, total economic production picked up surprisingly sharply.

Central and eastern Europe

The central and east European EU accession countries recently received only weak stimuli from abroad owing to the renewed economic slump in the industrial countries. Domestic demand, however, continued its upward trend for the most part. In 2002, there was considerable disparity in growth among the countries in this category, ranging from ¾% in Poland to 5% in Lithuania as well as in Latvia according to the European Commission's November 2002 estimates. After a relatively weak start at the beginning of 2002, the Russian economy resumed stronger growth as the year progressed. The economy was supported mainly by private consumption. This was reflected by the fact that imports picked up sharply and the current account surplus declined noticeably despite a rise in the export value of oil and gas. Real GDP, having increased by 4% on the year, is likely to have expanded more slowly than in the three preceding years.

US economy

According to initial estimates, in the last quarter of 2002 the US economy grew by only ¼% on the previous period after adjustment for seasonal and working-day variations. This is the weakest result since summer 2001, when total economic production had even fallen slightly in the aggregate. However, production actually increased considerably (by 2½%) on average for 2002. The more sluggish pace of private consumption was a particularly noteworthy factor in last quarter's slowdown. This was caused by a distinct decline in car purchases which, in turn, was attributable mainly to the anticipatory effects triggered by the financing campaign of car manufacturers last summer. Exports proved to be an additional restraint on growth; in the fourth quarter, they were down by just under ½% on the previous period, while imports continued to rise. Private gross fixed capital formation, which grew by ¾%, formed a certain counterweight. Industrial investment rose for the first time since the third quarter of 2000 and housing investment continued its upward trend. Government expenditure on consumption and investment increased substantially.

The economic climate remained subdued after the turn of the year as well. In January, consumer confidence ebbed to its lowest level since November 1993. The expectations component was particularly low, undoubtedly in conjunction with the looming threat of war. The absence of a drastic improvement in the labour market was an additional factor. The geopolitical risks are probably putting a strain on investment activity too. US exporters' price competitiveness, however, has improved noticeably in the past few months owing to the depreciation of the US dollar on foreign exchange markets. Conversely, however, higher import prices might cause consumer price inflation to rise in the coming months. In December, annual consumer price inflation rose to 2.4% owing to a base effect; core inflation, however, fell slightly to 1.9%.

The US government's economic stimulus package

The US government recently presented a new economic stimulus and growth package to the US Congress for ratification. This package will provide US$674 billion worth of relief over the next ten years, more than half of which is accounted for by the abolition of the dividend tax. Another major feature is that measures adopted as part of the 2001 income tax reform and scheduled to take effect gradually over the next few years will be moved forward. In addition, federal unemployment benefits are to be extended. If the economic stimulus package passes Congress without any major changes, the tax burden on the private sector for 2003 could be reduced by about US$102 billion. The direct demand stimulus – which, however, would not come to bear until the second half of the year – would amount to an estimated US$50 billion to US$80 billion, or 0.5% to 0.8% of GDP. The relief would be even greater in the election year 2004. Account needs to be taken not only of the short-term economic stimuli but also of the growth-promoting effects of the package, which arise mainly from the abolition of the tax on dividends. This increases investors' yields on their invested capital. At the same time, it eliminates the existing distortions in allocation caused by the favourable tax treatment enjoyed by internal finance relative to external finance. However, the fact that the US government budget is, as a result, likely to slide further into deficit than already expected in the next few years should be assessed critically.

Japan

The Japanese economy, which had seen strong growth in summer at a projected seasonally adjusted and annualised rate of 3½%, lost steam in the last quarter of 2002; however, real GDP was still ½% higher than in the third quarter. (By contrast, in autumn, industrial production fell by a seasonally adjusted 1% on the previous period.) The key factor in the overall economic slowdown was the reduction in domestic driving forces. Falling household income caused by reduced wage and salary payments and the persistently bleak employment situation impaired consumer confidence. In the fourth quarter, the volume of incoming orders for mechanical engineering products remained at the low level of the preceding period. There was no evidence of an end to the slump in the construction sector either. By contrast, exports grew quite strongly, even taking into account the backlog effects in trade with the United States, where dockworkers' strikes had intermittently disrupted export shipping. The relevant contribution to growth was one-half percentage point higher than in the previous quarter. The outlook for exporters, however, has recently clouded over somewhat, particularly because of the sluggishness of the US economy. Consumer price deflation has visibly slowed down. Its average level for the period between November and January was "only" -0.4% on the year, compared with -1.5% in the January-February 2002 period. The consumer price index fell by 1% on average for 2002 and was thus 2½% lower than its record high of 1998. A vicious circle of deflation has not yet materialised in Japan.

United Kingdom

According to initial estimates, fourth-quarter real GDP in the UK rose by almost ½% after adjustment for seasonal and working-day variations, ie considerably more slowly than in summer (+1%). It was up by 2¼% on the year. Total growth for 2002 amounted to 1¾%. One reason for the slowdown in growth was that real value added in the manufacturing sector, having risen slightly in the third quarter, went back down after seasonal adjustment. Another reason is that growth in parts of the services sector weakened. However, value added in the retail trade, buoyed by the unabated propensity of UK households to consume, showed renewed strong growth. Turnover in the period between October and December was 1½% higher than in the preceding quarter and was up 3½% on the year. Private consumption in the United Kingdom is being supported both by considerable increases in the value of residential property and by the favourable labour market situation. In autumn, consumer prices (excluding mortgage rates) were 2.6% higher than a year earlier compared with 2.0% in the summer quarter. However, measured in terms of the harmonised price index, which was up 1.5% in the fourth quarter, inflation in the United Kingdom was clearly below the euro-area average.

Macroeconomic trends in the euro area

Real euro-area GDP rose by a seasonally adjusted ¼% in the third quarter, ie at nearly

The economy in the second half of 2002

the same pace as in spring. It was up by 1% on the year. Net exports, which also include intra-euro-area exports and imports, gave a somewhat greater boost to growth than domestic demand did. Private consumption increased more strongly than in the past at a seasonally adjusted rate of ½% and, for the first time since the end of 2000, fixed capital formation did not decline. Unlike in the two preceding quarters, however, these factors were offset by a negative growth contribution on the part of inventory investment.

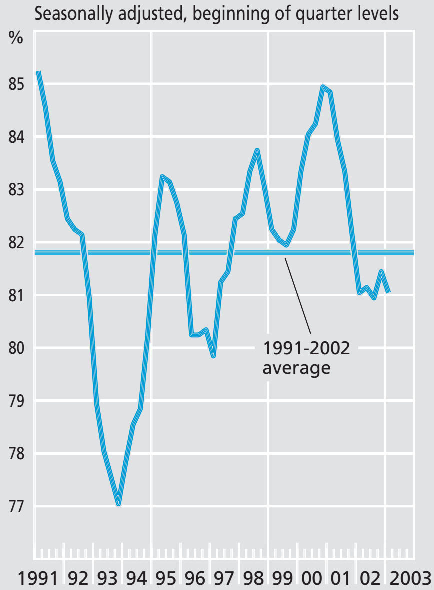
In the last quarter of the year, euro-area GDP – based on the national estimates available to date – is expected to have grown somewhat more weakly than in summer. In the October-November period, industrial production, although distinctly higher than in the summer quarter after seasonal adjustment (+¾%), is not likely to have maintained this trend in December owing, among other things, to a larger number of extra days taken off in conjunction with public holidays to create long weekends. This is also indicated by the decline in capacity utilisation in the manufacturing sector between October and January; it is now almost as low as in mid-2002. In addition, adverse weather conditions hampered construction work in the northern euro-area countries more than usual.

Results of the EU survey

The overall low level of economic growth in autumn 2002 seems to have continued following the turn of 2002-03. According to the monthly survey on behalf of the European Commission, industrial confidence sank in January after having brightened somewhat in December. The main reason was a decline in

Capacity utilisation in the manufacturing sector of the euro area

Seasonally adjusted, beginning of quarter levels



Source: European Commission business surveys.

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production expectations in nearly all euro-area countries. Consumer sentiment deteriorated in January for the fourth time in succession. The number of negative responses was thus higher than at any time since spring 1997.

Unemployment

The unemployment level, which has been persistently on the rise for around one-and-a-half years, rose somewhat more sharply in autumn 2002. In the fourth quarter, an average of 11.78 million people (after seasonal adjustment) were without work according to Eurostat's standardised definition. This was around 640,000 persons more than a year before. The unemployment rate was 8.5%. The average for 2002 was 8.2% as against 8.0% in 2001.

Consumer prices

In terms of the Harmonised Index of Consumer Prices (HICP), consumer prices were up by a seasonally adjusted +0.5% in the last quarter of 2002. This increase was somewhat stronger than in the summer quarter; the year-on-year difference increased to 2.3%. Inflation pressures were greatest on the volatile components. If these components are excluded, the rate of price increase was the same as in the previous period. The year-on-year rise in core inflation decreased slightly from 2.5% to 2.3%. Consumer goods prices rose by an average of 2.2% over the past year. The rate of inflation was thus somewhat lower than in the two preceding years. At 2.5%, the rate of inflation excluding unprocessed foods and energy was clearly higher than the comparable figures for 2000 and 2001. The lowest rate of price increase within the euro area last year was recorded by Germany (+1.4%). This compares with inflation rates of up to 2.0% in Belgium, Austria, France, Finland and Luxembourg. Italy's inflation rate was 2.6% and in the other countries inflation was well over 3%; in Ireland it even hit 4.7%. In January 2003, year-on-year consumer price inflation – according to Eurostat estimates – went down to 2.1%.

Euro-area current account and exchange rates

Foreign trade and current account

The somewhat muted trend which had already characterised euro-area exports to non-euro-area countries throughout the whole of 2002 continued in autumn. Positive external stimuli to the euro-area economy were thus largely non-existent. Between September and November 2002, the last three months for which information is available, goods exports to non-euro-area countries were down by ½% on the preceding three-month period after adjustment for seasonal variations. Total goods imports in the period between September and November just barely reached the preceding period's levels. On balance, the euro area's trade surplus receded slightly to just over €33 billion following €34 billion in the preceding three-month period.

By contrast, "invisible" current account transactions recorded slightly lower net expenditure in the period under review than in the previous period after adjustment for seasonal variations. Developments in the services sector were the key factor: in the period between September and November, the surplus on services rose to €6 billion following €2 billion in the preceding period. This positive contribution by services to the current account was not completely offset by larger net current transfers to non-residents – with net expenditure for cross-border factor income remaining virtually unchanged. This means that, after adjustment for seasonal influences, the euro-area current account closed with a surplus of €18 billion for the period from September to November, a somewhat larger surplus than in the preceding three-month period (June-August: just under €17 billion).

Exchange rate developments

After a relatively calm autumn on the foreign exchange markets last year, the euro appreciated distinctly at the turn of 2002-03. The euro rose so sharply against various currencies that new three-year highs were reached repeatedly. Geopolitical tensions propelled the euro's exchange rate against the US dollar into an even more prominent position than usual.

US dollar

After the US Federal Reserve had cut interest rates sharply which, against the background of disappointing figures for the US economy, was seen as proof of the US economy's weakness, the euro appreciated distinctly in the first half of November 2002. During this period, it once again surpassed parity with the US dollar and, in mid-November, was trading at US$1.01, its level of last July. In the second half of November, however, the euro was initially forced to relinquish its gains after US GDP growth in the third quarter of 2002 was revised upwards and new statistics on consumer confidence made the US economic situation look somewhat brighter.

At the beginning of December, the euro began to appreciate considerably and sustainably against the US dollar once it became known that the US unemployment rate had reached an eight-year high of 6% in the preceding month and that the US fiscal deficit will probably rise by a large margin in the coming years. This has also brought the question of the sustainability of the large US current account deficit more to the fore, giving a further boost to the euro's exchange rate against the US dollar. The interest rate cut by the European Central Bank in early December had been expected by most market participants and thus had no discernible impact on further exchange rate movements. Afterwards, market sentiment turned further against the US dollar given the growing threat of a war with Iraq and increasing uncertainty about the development of the US budget deficit as well as the considerable fiscal burden caused by the announced economic stimulus package. The euro was trading at almost US$1.08 as this report went to press. It was thus around 8% higher than in November last year but still lower than at the beginning of monetary union.

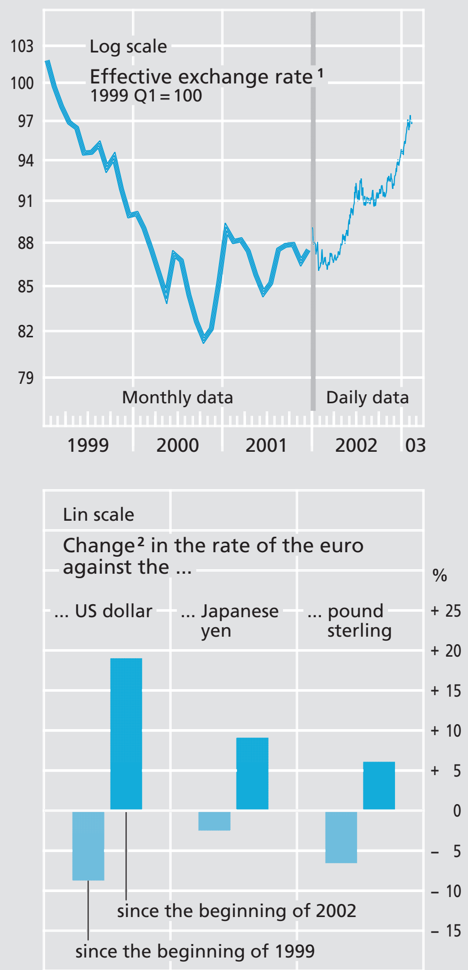
Yen

In the past three months, the euro appreciated noticeably against the Japanese yen too following distinct gains in September 2002. After trading at just under ¥122 at the beginning of November last year, the euro rose to just over ¥130 by the time this report went to press, thus appreciating at a slightly slower pace than against the US dollar. Indications by the Bank of Japan of rising uncertainty about the sustainability of the Japanese economic recovery were just one factor which placed a strain on the yen. The downgrading of a few Japanese financial institutions' credit ratings reinforced existing doubts on the market that the urgently needed structural reforms are being implemented quickly and uncompromisingly. Official comments that the yen was clearly overvalued gave market participants the impression that foreign exchange market intervention could be expected. This is likely to have heightened the downward pressure on the yen.

Pound sterling

During the period under review, the euro clearly rose against the pound sterling as well. In the past few years already, the close ties between the UK and US economies caused both currencies to develop largely in parallel. Whereas the relatively robust UK

Exchange rate of the euro



1 According to ECB calculations, against the currencies of 12 countries (before 2001, 13 countries). — 2 Appreciation of the euro: +. Latest position: 13 February 2003.

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economy had maintained the value of the pound sterling against the euro at a relatively high level well into the autumn months of last year, the pound was hit by increasing signs of a weakening economy in the period under review. As this report went to press, the euro was trading at £0.66, ie just over 4½% higher than in early November last year.

Effective exchange rate of the euro

During the period under review, the euro rose by around 5% against the weighted average of the currencies of the euro area's 12 most important trading partners, ie a slightly lower appreciation than against the US dollar alone. As of late, the euro's effective exchange rate was thus 9% higher than at the beginning of 2002. The rise in the euro's value over the past few weeks, however, is less a reflection of the euro area's economic strength than the result of the aforementioned negative factors burdening the other currencies. It must be noted, moreover, that capital flows (direct investment and securities transactions taken together) have changed direction; since spring 2002, the euro area has been a net capital importer. Evidently the euro has become more important as an international investment and reserve currency. The euro's recent considerable appreciation has undoubtedly tended to impair the price competitiveness of euro-area suppliers, especially as the exchange rate shifts took place very quickly. However, euro-area companies, in terms of exchange rates, are still in a somewhat better position than at the beginning of monetary union. In terms of the weighted average of the currencies of the euro area's most important trading partners, the euro is (in real terms) currently around 1% lower than at the beginning of 1999.

Monetary policy and financial markets in the euro area

Interest rate move in December

After having left the Eurosystem's interest rates unchanged over the autumn months, the Governing Council of the ECB, at its

Money market management and liquidity needs

Around the turn of the year, the Eurosystem's provision of funds was based on the marked fluctuations in general government deposits with the Eurosystem – especially towards the end of the reserve maintenance periods and at the end of each month – as well as on the extensive calendar-related changes in the volume of banknotes in circulation. Ongoing money market management was not restricted to main refinancing operations; in December, a fine-tuning operation was conducted as well. On 4 December, just before the Eurosystem cut its interest rates as had generally been expected, the bidding volume for main refinancing operations remained, surprisingly, only just below the credit institutions' short-term liquidity needs, whereas on 18 December, main refinancing operations were marked by unexpected and considerable underbidding. This prompted the Eurosystem to conduct, on 18 December, a liquidity-providing six-day quick variable-rate tender to fill the unplanned liquidity gap. Nevertheless, at the end of the reserve maintenance period, the marginal lending facility was greatly utilised owing *inter alia* to unexpectedly heavy liquidity withdrawals from the market. In January, however, the reserve maintenance period closed with increased recourse to the deposit facility following what tended to be abundant allotment in the last main refinancing operation of the period.

Between October and January, funds in the amount of €27 billion net were withdrawn from credit institutions owing to the autonomous factors determining liquidity (see adjacent table). This is mainly a reflection of the especially sharp rise in the volume of banknotes in circulation over the Christmas period. Moreover, the minimum reserve requirement increased by €3.2 billion during the period under review. In order to cover the heightened liquidity needs, the Eurosystem increased the outstanding volume of open market operations by €29.9 billion to an average of €221.3 billion.

Factors determining bank liquidity [1]

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

Item	2002		
	24 Oct to 23 Nov	24 Nov to 23 Dec	24 Dec to 23 Jan
I Provision (+) or absorption (–) of central bank balances by			
1 Change in volume of banknotes in circulation (increase: –)	– 4.8	– 16.7	– 3.2
2 Change in general government deposits with the Eurosystem (increase: –)	+ 2.8	– 8.9	+ 8.0
3 Change in net foreign reserves [2]	+ 2.1	– 0.6	– 10.6
4 Other factors [3]	– 0.4	+ 3.1	+ 2.2
Total	– 0.3	– 23.1	– 3.6
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	+ 1.4	+ 20.6	+ 8.2
(b) Longer-term refinancing operations	– 0.3	+ 0.0	± 0.0
(c) Other operations	–	+ 2.0	– 2.0
2 Standing facilities			
(a) Marginal lending facility	+ 0.0	+ 1.0	– 0.6
(b) Deposit facility (increase: –)	+ 0.0	– 0.1	– 0.1
Total	+ 1.1	+ 23.5	+ 5.5
III Change in credit institutions' current accounts (I + II)	+ 1.0	+ 0.2	+ 2.1
IV Change in the minimum reserve requirement (increase: –)	– 1.0	– 0.1	– 2.1

1 For longer-term trends and the contribution of the Deutsche Bundesbank, see pages 14* and 15* of the Statistical Section of the *Monthly Report*. — **2** Including end of quarter valuation adjustments with no impact on liquidity. — **3** Including monetary policy operations concluded in stage two and still outstanding in stage three (outright transactions and the issuance of debt certificates).

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meeting in early December, lowered each of the key interest rates by half a percentage point. On 6 December 2002, the interest rates on the marginal lending facility and the deposit facility were lowered to 3.75% and 1.75% respectively; since 11 December 2002, all main refinancing operations have been conducted as variable rate tenders with a minimum bid rate of 2.75%. The receding threat of inflation towards the end of the year provided room for this interest rate cut. Although M3 had grown quite strongly up until then, this continued to reflect investors' pronounced preference for safe and liquid assets. The sluggish pace of longer-term monetary capital formation with banks and the slowdown in credit growth in the euro area, as well as the slumping economy, are all points in favour of this assessment. The ample supply of liquidity in the economy is unlikely to generate any immediate inflationary risks in the foreseeable future. In addition, the rise in the euro's external value forms a counterweight to the higher oil prices.

Tension on the money market in December

The interest rate cut by the ECB in early December had been expected by the money market. This was reflected in corresponding discounts on forward rates relative to short-term money market rates. In the second half of December, the overnight money rate (Eonia) became increasingly volatile. Underbidding in the main refinancing operation settled in mid-December contributed to this. The ECB countered the concomitant rise in interest rates with a fine-tuning operation without completely preventing the interest rate fluctuation. At the end of 2002, the usual end-of-year liquidity bottlenecks once again triggered a noticeable increase in the overnight money rate. In January, Eonia approached the marginal allotment rate for main refinancing operations, although it slid briefly at the end of the maintenance period. Time deposit rates have also continued to fall since the interest rate cut, especially in the longer-term segment, causing the yield curve on the money market to remain inverted. Market participants are evidently expecting a further reduction in central bank rates.

Money stock up sharply

Following strong euro-area M3 growth up to late summer of last year, monetary growth between October and December weakened perceptibly compared with the preceding quarter although it remained high. In the fourth quarter, M3 rose at a seasonally adjusted and annualised rate of 6½% following 9½% in the third quarter. This growth, however, varied considerably over the quarter. After expanding sharply in November, it grew only moderately in December. All in all, however, the three-month moving average of the annual growth rates of M3 changed little, falling from 7.1% between July and September to 6.9% between October and December. In the light of the major uncertainty concerning further economic developments both in and outside the euro area as well as the medium-term outlook for interest rates and securities prices on financial markets, investors continued to prefer safe and liquid assets. Given the low capital market rates and the renewed setback suffered by the stock markets in January as well as the uncertainty concerning a possible war with Iraq, the situation is likely to have changed little up to the present time.

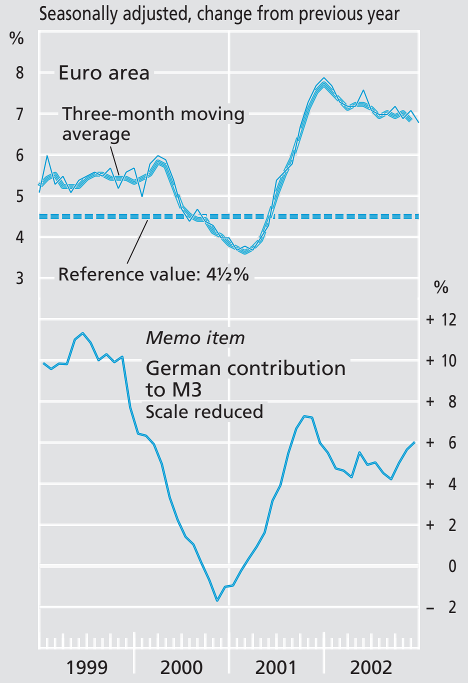
Components of the money stock

Of the individual components of the money stock M3, overnight deposits, in particular, went up in the fourth quarter. However, a sharp rise in November was countered by meagre increases in October and in December. The sluggish increase in December could also be explained in connection with the sharp rise in the volume of euro currency in circulation in that month; after seasonal adjustment, euro currency in circulation resumed its stronger expansion in the fourth quarter. All in all, M1 grew strongly again in the autumn months. By contrast, the expansion of other short-term bank deposits was only muted in the period under review. The performance of deposits with an agreed maturity of up to two years dampened monetary growth; in the past 12 months, they were even reduced slightly. Between October and December, marketable instruments likewise rose only moderately after having increased sharply in the preceding quarter. Money market fund shares were once again in demand; unlike in earlier years, however, the number of such shares in circulation even increased in the fourth quarter. This contrasted with a reduction in repo transactions, money market paper and short-term bank debt securities.

Balance-sheet counterparts

Euro-area MFIs increased their loans to the domestic private sector by only a relatively small margin in the fourth quarter. These rose at a seasonally adjusted and annual rate of 3% during the period under review, which was again weaker than a quarter earlier (just under 4½%). The muted economic activity in the euro area, in particular, may have curbed the demand for credit. Heightened uncertainty surrounding the economic outlook may have reinforced individuals' reluctance to borrow. Even if credit growth in the euro area continues to show great disparity, in most participating countries a clear decline in credit growth may be observed. Only if securitised lending to domestic enterprises is included is the slump much less pronounced. The year-on-year change in total lending to the domestic private sector fell from 5.0% at the end of September to 4.7% at the end of December.

Growth of the money stock M3 in the euro area



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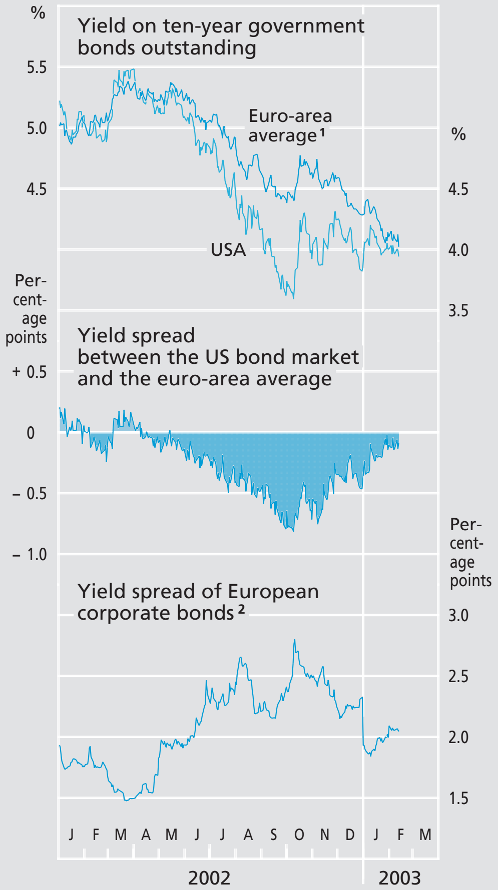
In the fourth quarter, loans and securitised lending to the public sector in the euro area increased in the aggregate. The decline in securitised lending to domestic general government which is typical of the season contrasted with the increase in loans which is typical in the fourth quarter.

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 Seven to ten-year BBB-rated European corporate bonds over government bonds with comparable maturities; source: Merrill Lynch indices.

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Monetary capital formation at euro-area MFIs was weaker in the period under review than at the same time a year earlier. The increase in the amount of funds invested in deposits with a maturity of more than two years was offset mainly by a clear decline in sales of longer-term bank debt securities. In addition, the year-on-year increase in capital and reserves was more muted. Moreover, payment transactions with non-euro-area countries had an expansionary impact on monetary growth during the period under review. Inflows of funds were considerable, causing the net external asset position vis-à-vis non-euro-area countries to rise by €82.4 billion following rises of €30.5 billion in the third quarter and €43.6 billion in the fourth quarter of 2001.

Fall in capital market rates

The fall in long-term interest rates, which has characterised bond market movements since the early summer of 2002, continued throughout the period under review. This is consistent with market players' expectations, which have undergone a downward correction in several stages since summer. The downward slide of interest rates was interrupted only briefly in mid-October 2002 when yields on the euro-area capital market shot up by nearly 40 basis points within just a few days. However, this was caused not by a fundamental re-evaluation of the euro area's economic situation but by portfolio shifts from bonds to stocks, for which at times more optimistic assessments prevailed after various positive company reports had temporarily boosted market expectations. This newly-found optimism was short-lived, however. In the second half of October, long-term interest rates remained relatively steady at around 4¾% but then receded. At the turn of the year, the decline in interest rates accelerated. As this report went to press in mid-February, the average yield on ten-year euro-area government bonds was just over 4%. Since last summer, capital market rates have fallen by nearly one-and-a-half percentage points.

Interest rate advantage over United States diminished

The euro-area capital market has noticeably detached itself from the "standards" set by the US market. At all events, in contrast to the euro area, there was no clear interest rate trend in the United States. Yields on ten-year US Treasuries rose more sharply in mid-October than their euro-area counterparts but then plummeted back to their original level more quickly. Since early October, long-term US interest rates have hovered around the 4% mark. The euro area's interest rate advantage has therefore decreased from around three-quarters of a percentage point to minuscule values.

Yield curve moved downwards

The decline in interest rates during the period under review was more pronounced in the bond market's shorter-term segment than in the other maturity segments. This has further accentuated the inverted shape of the short end of the yield curve which was already visible in autumn.

Lower real interest rates

The decline in nominal euro capital market rates was also reflected in a corresponding reduction in real interest rates whereas market players' long-term inflation expectations, calculated from inflation-indexed bonds and surveys, have hardly changed. The real yield on ten-year German Federal bonds, calculated on the basis of inflation forecasts, fell to 2½% by January. Such low levels were last reached at the turn of 1998-99.

Declining stock price uncertainty and risk premia on corporate bonds

Since mid-October 2002, the tense situation which existed in the corporate bond market segment has become noticeably more relaxed. The risk premia on these instruments have clearly declined since then, yet are still higher than in early summer of last year. The debt securities of enterprises with a low credit rating have particularly benefited from this trend. The risk premium on BBB-rated corporate bonds, for instance, has gone down from its peak for the year of 280 basis points reached in mid-October to around 200 basis points.

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

Interim peak on stock markets…

During the period under review, the decline in stock prices on European stock markets initially continued. Then, as mentioned earlier, in mid-October the trend was temporarily reversed, which benefited, in particular, technology stocks, the prices of which had earlier plunged especially precipitously. This turnaround in sentiment on the stock market was, however, ultimately not fuelled by improvements in the market fundamentals. Analysts' estimates of current and expected future profits have hardly changed since October 2002. Subsequently, the situation on the stock market has therefore been marked by pronounced restraint and uncertainty among investors.

… only briefly interrupts nosedive of stock prices

Only the telecommunications sector was at times able to escape the broad collapse of stock prices in December, whereas technology stocks surrendered a major share of their price gains. In January, stock prices continued to nosedive, which meant that as this report went to press the EuroStoxx index was only somewhat higher than its low of early October and nearly 60% below its high of March 2000.