The international and European setting

Developments in the global economy

Improved situation and brighter outlook

The forces holding back economic growth in winter 2002-2003, especially in the industrial countries, weakened in the spring months. According to country information available so far, aggregate output in the advanced economies probably rose somewhat more sharply than in the two preceding periods. The conditions for world economic recovery have improved noticeably over the past few months. There are now increasing signs that global growth will pick up in the second half of 2003.

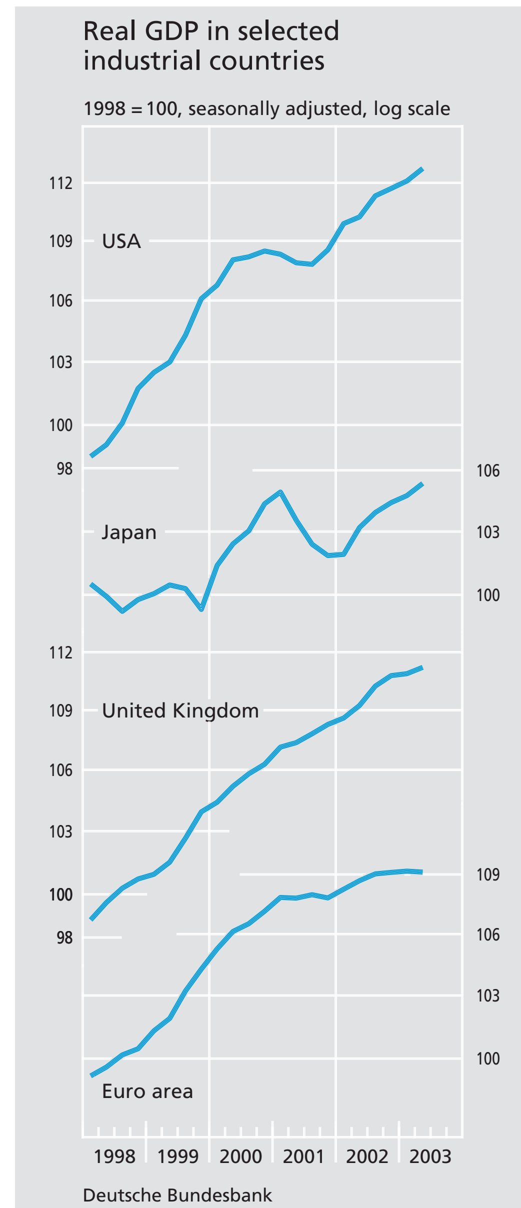
Fewer strains on world economy

There was a high level of uncertainty leading up to the Iraq war, which was reflected primarily in a sharp rise in oil prices and renewed falls in share prices. This uncertainty began to recede soon after military action had started when it became apparent that it would end quickly. As early as mid-March, international oil prices began to fall distinctly. They initially held firm within the OPEC corridor of between US$22 and US$28. Since early July, though, they have been at the upper margin of the corridor or even slightly above it. Since their most recent low in early March, share prices have been moving clearly upwards and – in terms of the S&P 500 – had returned to their end-June 2002 level by the end of the period under review. The SARS epidemic, which, for a time, had sharply dented output and demand in the most severely affected East Asian countries, has since abated. The situation in Latin America likewise appears to become somewhat less tense, even if the potential for a setback remains high, especially since the revival of capital flows is associated

in large part with the very low interest rates in the industrial countries.

Macro policy with new stimuli

The widespread expectation of a marked revival of the global economy in the coming months rests not least on expansionist economic policies in the industrial nations. Further cuts in interest rates were made in the euro area in early June, in the USA in late June, and in the UK in mid-July. The tax relief package adopted in the USA in late May is likely to provide additional stimuli. The envisaged relief will amount to $350 billion over a ten-year period, with a large part being front-loaded in 2004 and 2005. As early as the summer quarter of 2003 the US Internal Revenue Service will commence sending tax refunds to households. This, together with the reduction in the income tax rate which is already in effect, will increase disposable income in the second quarter and will, in all probability, give a perceptible boost to private consumption. Public finances in the euro area are still supporting demand through the operation of the automatic stabilisers.



Calm price climate

In this connection, the calming of the global price climate, to which falling energy prices made a major contribution, has had a positive impact. This has tended to strengthen consumers' purchasing power. In the group of industrial countries as a whole, consumer price inflation was 1.6% in June, compared with 2.2% in the first quarter of 2003. This time a year ago, at 1.1%, it was even lower, however. Nevertheless, deflation in Japan, which was accelerating again somewhat at the end of the period under review, has dragged down the average inflation rate of the industrial countries perceptibly. Excluding Japan, the rate of price increase in June was 2.1%. Given the continuing calm price trend and the recent budding hopes for the economy, the at times strongly accentuated concerns about deflation have largely receded.

Progress in the financial and corporate sectors

Account should be taken not only of those macroeconomic changes but also of the fact that profitability and financing in the banking

and insurance sectors of most industrial countries have improved recently. In addition, many manufacturing enterprises have used these difficult times as an opportunity for restructuring and consolidation in the real and financial sectors. The elimination from the market of borderline firms, the reorganisation of business areas, the modernisation of product ranges and the review of value-added chains are important elements of a new basis for economic development. Those factors contrast, however, with low capacity utilisation, high unemployment and the fact that investor confidence has not yet completely stabilised, all of which are inhibiting economic growth.

USA once again the economic engine

The brightening of the economic outlook in the industrial countries is not yet broadly based across regions but rather focused on the United States. In the USA, most preliminary economic indicators are now pointing upwards. The sharp rise in orders for machinery and equipment, in particular, is seen by many as a harbinger of more buoyant investment activity. Admittedly, this is not consistent with the disappointing outcome of the end-July consumer survey commissioned by the Conference Board; nevertheless, since other consumer signals were quite positive, not too much importance should be placed on these results. Seasonally adjusted retail trade turnover in July was up by 1½% on the month; this represented a year-on-year increase of 5¼%. In its latest forecast, at any rate, the US Federal Reserve Board assumes that real GDP in the fourth quarter of 2003 will be up by 2½% to 2¾% on the year and that the relevant year-on-year figure will be 3¾% to 4¾% at the end of 2004.

External imbalances as a risk

One difficulty in the development of the international economy is that, once again, the USA will probably be the sole engine of global economic growth, with some support from East Asian emerging markets and from the central and east European transition countries, most of which are showing sound growth. Such a global economic situation would appear to be quite prone to disruption and hardly sustainable in the long run. If the US economy's sizeable lead in growth were to be maintained over a relatively long period of time, external imbalances in the global economy would be increased further and the risk of abrupt exchange rate changes would tend to be heightened. The continuing threat of terrorism and new geopolitical tensions, especially in the Middle East, pose additional risks to a global upswing.

US economy

According to initial calculations, real gross domestic product (GDP) in the USA rose in spring by just over ½% from the previous period after adjustment for seasonal and working-day variations, compared with just under ½% in each of the two preceding quarters; this translates to a year-on-year rise of 2¼%. This fairly moderate acceleration in the growth rate, however, is being supported by a distinctly faster pace of growth in US domestic economic activity. Private final demand rose by a seasonally adjusted 1%, more than twice as fast as in the first quarter. Expansion was driven once again by commercial investment, which went up by a seasonally adjusted 1¾% (after having declined in winter),

thus showing a year-on-year increase for the first time since early 2001. In addition, real spending on new housing again picked up perceptibly. Considerably increased purchases of personal and household goods caused private consumption to rise more quickly than before. Besides private final demand, government expenditure on consumption and investment was also increased considerably – in connection with the Iraq war and the subsequent stationing of troops – by a seasonally adjusted 1¾%. Domestically, however, only some of the additional private and government final demand in the second quarter had a direct impact on output. Inventories were depleted, resulting in a nominal negative growth contribution of ¼ percentage point. Also, imports grew by no less than 2¼% after seasonal adjustment. Since, in addition, exports were on the decline, the gap in real net exports widened again.

Japan

In Japan, seasonally adjusted aggregate second-quarter output went up by just over ½% after having risen by only ¼% in the winter months. Especially owing to a relatively sharp expansion in the second half of 2002, overall output was up by over 2% on the year. GDP growth was driven mainly by domestic private demand. Private consumption, up by ¼% at constant prices and after adjustment for seasonal variations, did show a relatively small increase on the quarter. Nevertheless, it should be noted that Japanese travel expenditure abroad was curtailed drastically in spring owing to uncertainty caused by the Iraq war and the outbreak of SARS in neighbouring countries. This was also reflected in lower imports of services and made a major contribution to the overall decline in real imports. Domestic households' consumption expenditure, by contrast, rose quite sharply – not least owing to special factors which, to some extent, have obscured the underlying cyclical trend.

The size of the contribution to growth made by commercial investment, which again rose sharply in spring by a seasonally adjusted 1¼%, was similar to that made by private consumption. Commercial investment thus went up by no less than 7% on the year. Among other factors, Japanese enterprises' improved performance, higher sales expectations and possibly also the recovery of share prices may have played a part in this. According to the latest survey of companies by the Bank of Japan, the "Tankan Report",[1] the revival of investment will continue in the months to come; business sentiment has improved perceptibly. Real exports likewise grew quite sharply, at a seasonally adjusted 1%. Aggregate economic growth was curbed by the continuing slide in housing investment and further cut-backs in government expenditure.

Even though the Japanese economy has shown six consecutive quarters of growth, it would be premature to speak of a self-sustaining upswing. The problems that continue to plague the corporate and financial sectors and the high level of government debt continue to be acute weaknesses. In addition, the deflationary tendencies have not yet been

1 The Bank of Japan's "Tankan Report" is published quarterly and is based on a comprehensive survey of Japanese enterprises.

surmounted. Consumer price deflation, which – on a year-on-year basis – had come to a virtual standstill in March-April, has since accelerated again, reaching 0.5% in June-July. Excluding energy and food, prices fell by an average of 0.3% in spring.

United Kingdom

According to initial estimates, UK economic growth in spring remained subdued, amounting to ¼% after adjustment for seasonal and working-day variations. This works out to a year-on-year rate of 1¾% as against 2% in the first quarter. Viewed from the value-added side, on which the initial estimate is based, the relatively weak second-quarter GDP growth is due in large part to the stagnation of industrial output. In addition, the services sector, having been the linchpin of the UK economy in 2002, remained on the flatter growth path on which it had embarked at the start of 2003. However, retail trade value added is likely to have risen disproportionately strongly, as second-quarter turnover went up by no less than 1½% in seasonally adjusted terms. This translates to a rise of 4½% on the year. This shows quite clearly that, if nothing else, consumption in the United Kingdom is still intact.

The continuing favourable situation on the labour market, which is reflected in a relatively low standardised unemployment rate of 5% and persistent growth in employment, are major factors in this development. What has to be taken into consideration, however, is that a large percentage of the net jobs created in the past 12 months are in the public sector, especially in health care. Consumer price inflation has ebbed noticeably since early spring. In terms of the Harmonised Index of Consumer Prices (HICP) – which the UK government intends to use as a basis for setting its inflation targets in future – inflation was 1.3% in July, compared with 1.6% in March.

Macroeconomic trends in the euro area

Overall output in the second quarter

The euro area's economic slump continued in the spring months. According to Eurostat's "flash estimate", real GDP was stagnating in seasonally adjusted terms, which means that there had been virtually no growth since summer 2002: output was up by only just under ½% on the year.

Industrial output

In the April-May period seasonally adjusted industrial output was ½% below its first-quarter level and down by ½% on the year. Initial country results show that industrial output may have grown again somewhat during the course of June, yet for the second quarter as a whole, euro-area industrial output appears to be down. Production of capital goods fell particularly noticeably in April-May. One contributory factor is likely to have been the decline in orders from non-euro-area countries, which is due not only to the still-hesitant revival of world trade but also, in large part, to the preceding sharp appreciation of the euro against the US dollar. Another factor is that, in seasonally adjusted terms, just under 1½% fewer cars were registered in the euro area in the April-June period than in the preceding three-month period and a good 3% fewer than 12 months earlier.

EU survey

The renewed decline in capacity utilisation in manufacturing is consistent with the picture of subdued industrial activity in the euro area during the spring months. Capacity utilisation in this sector in July was again almost as low as in early 1997, when industry was caught in an interim cyclical trough. The outcome of the monthly survey of industry conducted on behalf of the European Commission was also disappointing. The confidence indicator went down further in July after having held firm at a low level in June. Not too much importance should be placed on this finding, however, especially as the data for the three large member states are difficult to interpret. Italy's "production expectations" subsegment is shown to have deteriorated very strongly, but this is not substantiated by other industry survey data. According to the EU Survey, in France and Germany the confidence indicator fell in July in seasonally adjusted terms, whereas the matching national results in these two countries – admittedly using different statistical methods – signal a slight improvement in sentiment.

According to the latest EU survey, consumer confidence continued to recover slightly in July: the balance of ups and downs returned to its January 2003 level. The easing of geopolitical uncertainty and the attendant increasingly optimistic assessment of the economic outlook over the coming 12 months were probably the main factors in this development.

Labour market

Seasonally adjusted unemployment in the euro area continued to rise in spring, albeit more slowly than in the preceding months. The number of unemployed persons rose by 200,000 from the first quarter of 2003, when the figure had gone up by 270,000. A total of 12.42 million members of the labour force were without work in the second quarter, corresponding to a rate of 8.9% following an average rate of 8.7% in the January-March period. A year earlier, the standardised unemployment rate had been 8.3%.

Consumer prices

Consumer prices, measured in terms of the Harmonised Index of Consumer Prices (HICP), calmed down noticeably by mid-year. Second-quarter inflation, at 2.0% on the year, was only slightly above the Eurosystem price norm. The rate of price increase had been distinctly higher in the winter months, at 2.3%. Households' cost of living went up by 0.2% in spring in seasonally adjusted terms (and 0.9% on the year). This was the weakest rise in approximately four years. The nearly 3% decline in energy prices was the main reason for this. However, prices for unprocessed food hardly rose after seasonal adjustment, either. Excluding these two volatile components, the extent of the increase in HICP inflation was similar to that in the preceding quarters, ie 0.5%. The year-on-year HICP rate excluding energy and unprocessed food was virtually unchanged at around 2% in spring. Processed food, drinks and tobacco (+3.4%) rose more sharply than average – mainly because of higher taxes on tobacco in some member states – as did services (+2.6%), whereas the rate of price increase for other household goods remained quite moderate, at less than 1%. According to provisional Eurostat estimates, the overall calm price climate persisted in July; despite a re-

Euro-area consumer prices

Annual percentage change

Item	2002				2003	
	Q1	Q2	Q3	Q4	Q1	Q2
Food, drinks and tobacco	4.9	2.9	2.3	2.3	2.0	2.6
Unprocessed	7.0	2.5	1.4	1.7	0.2	1.6
Processed	3.5	3.2	2.9	2.7	3.2	3.4
Energy	– 2.1	– 2.3	– 0.7	2.9	7.0	1.5
Industrial goods (excluding energy)	1.7	1.6	1.3	1.2	0.7	0.9
Services	3.1	3.1	3.3	3.1	2.7	2.6
Harmonised Index of Consumer Prices (HICP)	2.5	2.1	2.1	2.3	2.3	2.0
Memo item Excluding unprocessed foods and energy	2.6	2.6	2.5	2.3	2.0	2.1

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newed slight rise in crude oil prices, the annual rate of inflation fell slightly to 1.9%.

Current account and exchange rates

Foreign trade and current account

In spring 2003 euro-area exports were affected by the subdued economic growth of important trading partners and the appreciation of the euro. Between March and May (up to which statistics are available), seasonally adjusted exports of goods went down by nearly 2½% from the preceding three-month period. Imports were also down in a three-month comparison, falling slightly behind the previous period's level (-1%). That caused the euro area's total trade surplus for the period from March to May to drop to €25 billion from as much as €28½ billion in the preceding three-month period.

At the same time, the seasonally adjusted deficit on invisible current transactions increased. This was due to higher net expenditure in current transfers to non-euro-area partner countries and to a lower surplus on services. By contrast, the deficit on factor income remained nearly unchanged. Thus, on balance the euro area's seasonally adjusted current account surplus in the March-May period fell by over €6½ billion from the preceding three-month period to €3 billion.

Exchange rate movements

The first few months of this year saw the euro surge anew, culminating at the end of May in new all-time highs against other key currencies. However, during the period under

review the euro was forced to surrender some of its previous gains. As usual, the markets' attention was focused on the euro's rate against the US dollar.

US dollar

In May 2003 the euro was trading at over US$1.19, its highest level since the launch of monetary union. Thereafter, it initially fluctuated within a rather tight band between US$1.17 and US$1.19. These fluctuations primarily reflected shifting market views of the US economic outlook. Positive reports on consumer and business confidence in the USA alongside new data indicating that the weakness of the US labour market would initially persist presented a mixed picture of the state of the US economy and failed to provide any guiding stimuli to the exchange rate.

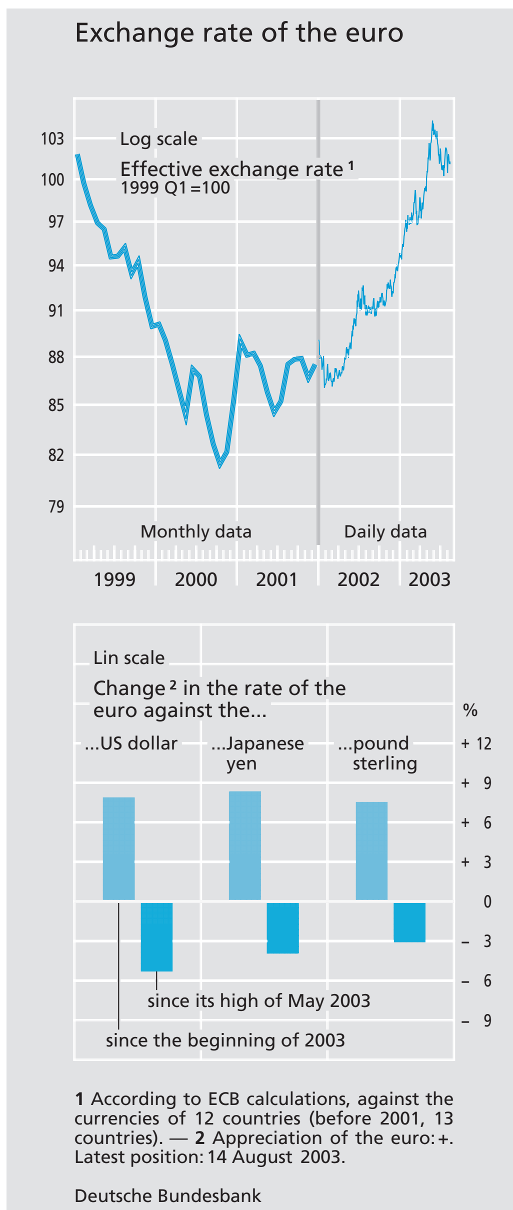
The interest rate cut by the European Central Bank in early June had generally been expected on the foreign exchange markets and failed to make a discernible impact on subsequent exchange rate movements. After the US Federal Reserve cut interest rates at the end of June, the euro lost ground perceptibly against the US dollar, falling to US$1.11 by mid-July. This move, coupled with the Fed's optimistic assessment of the economy, led to an upward revision in market expectations regarding future developments in the US economy. By contrast, the growth outlook for the euro area was increasingly being revised downwards in the light of the exchange-rate-related reduction in competitiveness. Furthermore, the euro area's yield spread over the USA in the long-term segment diminished and even went into reverse at the end of the period under review. The euro, after its clear surge of appreciation in the spring months, may have been hurt by profit-taking on the foreign exchange markets. As this report went to press, the euro was being quoted at US$1.13, or around 8% higher than at the beginning of the year.

Yen

At the end of May this year the euro also hit a new high against the yen, trading at ¥140 and initially staying just below that level. In early July, however, the euro encountered heavy selling pressure against the yen, falling below the ¥132 mark by mid-month. The euro began to weaken against the yen once the Bank of Japan's Tankan survey, which is widely read around the world, reported a surprisingly clear improvement in the Japanese business climate. The yen then continued to stabilise following the publication of positive data on the Japanese economic situation. As this report went to press, the euro was trading at just under ¥135, or around 8½% higher than at the beginning of the year.

Pound sterling

The euro hit a new high against the pound sterling at the end of May, too, rising to £0.72. During June, however, the pound sterling regained just under 4½% of its value against the euro. The recent recovery of the pound sterling should also be seen against the background of the publication of new UK economic data which came out better than expected despite moderate growth. By contrast, the outcome of the British Treasury's economic tests, which indicated that it was not advisable at the present time for the UK to join monetary union, had been anticipated by market participants and therefore had no discernible impact on exchange rate move-



1 According to ECB calculations, against the currencies of 12 countries (before 2001, 13 countries). — 2 Appreciation of the euro: +. Latest position: 14 August 2003.

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ments. After the Bank of England cut interest rates in mid-July, citing the unfavourable business outlook for the UK economy, the euro was able to regain some of the ground it had lost earlier, albeit with some fluctuations. As this report went to press the euro was trading at £0.70 and was thus around 7½% above its value at the beginning of the year.

Effective exchange rate of the euro

As a weighted average against the currencies of the euro area's 12 most important trading partners, at the end of May the euro hit its highest level since the launch of monetary union. Even though the euro relinquished some of its gains in mid-year, its effective exchange rate was, at the end of the period under review, still 6½% higher than at the beginning of the year. In terms of its long-term average and taking into account the diverging inflation rates in the euro area and the key partner countries, European industry's price competitiveness may still be classified as neutral.

Monetary policy and financial markets in the euro area

Renewed interest rate cut in June ...

During the second quarter, as in the two quarters before it, there were mounting signs that the risks to euro-area price stability would be lower than initially expected. At its meeting in early June the Governing Council of the ECB therefore decided to reduce the key ECB interest rates by a further ½ percentage point. Since 6 June 2003, the interest rates on the marginal lending facility and the deposit facility have been 3% and 1% respectively; since 11 June 2003, all main refinancing operations have been conducted as variable rate tenders with a minimum bid rate of 2%.

... owing to subsiding inflationary risks

The weak economic growth in the euro area, which showed no signs of picking up in the second quarter despite the rapid end to the Iraq war, was one indication that price pressures were easing. In addition, the euro's ap-

preciation put a damper on euro-area inflation. The Eurosystem staff's macroeconomic projections therefore indicate a perceptible decline in the inflation rate this year and next. Even though the money stock increased sharply again in the second quarter, the monetary side does not appear to signal any direct threat of inflation at present, either. Persistently moderate growth in lending in the euro area and as well as the inflows of funds in portfolio transactions with non-residents suggest that the rapid growth in liquidity holdings is still primarily due to prudent investment and is not an indication that the private sector is about to step up its spending activity. The low interest rates, however, may have likewise promoted the holding of money.

Interest rates in the money market

Even in the run-up to the interest rate cut in early June, forward rates had, in some cases, been distinctly lower than the relevant spot rates. The interest rate move therefore came as no surprise to many market players. The size of the interest rate cut had also been widely expected. Prudent bidding practices, especially towards the end of the half-year (when liquidity is always at a premium), initially prevented a sharper fall in money market interest rates following the interest rate cut in early June. Well into July, the marginal rate on main refinancing operations (MROs) was ten or more basis points above the minimum bid rate. Accordingly, the Eonia was clearly above the rate of 2% desired by monetary policymakers. It was only the generous provision of liquidity in the 23 July tender operation that perceptibly closed the gap between the marginal allotment rate and the minimum bid rate, causing the overnight rate to come distinctly close to the 2% mark. At the same time, the money market was characterised by major uncertainty, which was reflected in violent swings in interest rates.

Money stock grew sharply

Euro-area M3 grew sharply between April and June, its pace of expansion being even faster than in the preceding quarter. The seasonally adjusted, annualised growth rate increased from 7½% at the end of March to 9% at the end of June. The three-month moving average of the annual rates of growth in the April-June period, at 8.5%, was higher than the rate for the January-March period (7.8%). On the whole, the persistently high level of uncertainty on the financial markets is likely to have encouraged the holding of cash balances. It is true that, as the second quarter progressed, share prices rose sharply, yet uncertainty about bond market price movements increased perceptibly as well. Hopes of an economic recovery in the euro area failed to materialise in the first half of 2003, leading investors to continue to hold their money primarily in the form of secure and liquid bank deposits.

Components of the money stock

Of the components of the monetary aggregate M3, overnight deposits again rose sharply in the second quarter, although the pace of expansion eased slightly. Between April and June, sight deposits rose at a seasonally adjusted and annualised rate of 8½% compared with 9½% in the first quarter of 2003. Currency in circulation likewise grew less sharply in the second quarter than in the first. Cash holdings, however, continued to increase at a rapid rate. On the whole, the money stock M1 grew somewhat faster than

Money market management and liquidity needs

Main refinancing operations (MROs) were the main method of ongoing money market management in the Eurosystem during the past three reserve maintenance periods. One liquidity-absorbing fine-tuning operation was conducted.

The 7 May and 9 July MROs were conducted as split operations, each consisting of a one-week tender and a two-week tender. In both cases the size of the remaining MROs was rebalanced.

Following relatively large recourse to the marginal lending facility on two consecutive days at the end of the April-May reserve maintenance periods, on 23 May the Eurosystem launched a fine-tuning mechanism by accepting fixed-term deposits with a maturity of three days, which served to withdraw €3.9 billion from the market. This ensured that the reserve maintenance period ended with credit institutions holding a normal €600 million in excess of reserve requirements.

Strong expectations of interest rate reductions led to underbidding in the MRO settled on 4 June. The credit institutions' resultant large reserve deficits were balanced out by a matching increase in the allotment amount in the subsequent MRO.

The Governing Council cut the key ECB interest rates on 5 June. In the following weeks, the Eonia initially remained entrenched well above the new minimum bid rate of 2.0 %. By "flooding" the market with €33 billion worth of net liquidity in the 23 July MRO, it was possible to bring the Eonia distinctly closer to the minimum bid rate. Owing to this measure, however, the June-July maintenance period ended with recourse of €5.3 billion to the deposit facility.

Between April and July, the autonomous factors determining bank liquidity withdrew €23.9 billion net from credit institutions (see adjacent table). As in the preceding reserve maintenance periods, what drove this development was not only the decline in net foreign assets but also the strong demand for banknotes. The low opportunity costs of holding cash and non-euro-area residents' stronger demand for euro banknotes are key factors that explain this development. As in the spring, the "Other factors" were net suppliers of liquidity. The minimum reserve requirement went up by €1.6 billion during the period under review.

To cover the increased need for liquidity, the Eurosystem expanded its open market operations in the last three reserve maintenance periods by a total of €25.3 billion to an average of €249.7 billion.

Factors determining bank liquidity [1]

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

Item	2003		
	24 Apr to 23 May	24 May to 23 Jun	24 Jun to 23 Jul
I Provision (+) or absorption (–) of central bank balances by			
1 Change in banknotes in circulation (increase: –)	– 7.7	– 7.0	– 9.5
2 Change in general government deposits with the Eurosystem (increase: –)	+ 9.5	– 10.0	+ 0.2
3 Change in net foreign reserves [2]	– 4.3	– 1.8	– 10.9
4 Other factors [3]	+ 5.0	+ 2.3	+ 10.3
Total	+ 2.5	– 16.5	– 9.9
II Monetary policy operations of the Eurosystem			
1 Open market operations			
(a) Main refinancing operations	– 2.3	+ 17.6	+ 10.0
(b) Longer-term refinancing operations	– 0.0	+ 0.0	+ 0.0
(c) Other operations	– 0.1	– 0.1	+ 0.2
2 Standing facilities			
(a) Marginal lending facility	+ 0.3	– 0.0	+ 0.0
(b) Deposit facility (increase: –)	+ 0.0	– 0.1	+ 0.0
Total	– 2.1	+ 17.4	+ 10.2
III Change in credit institutions' current accounts (I + II)	+ 0.3	+ 1.0	+ 0.3
IV Change in the minimum reserve requirement (increase: –)	– 0.4	– 0.8	– 0.4

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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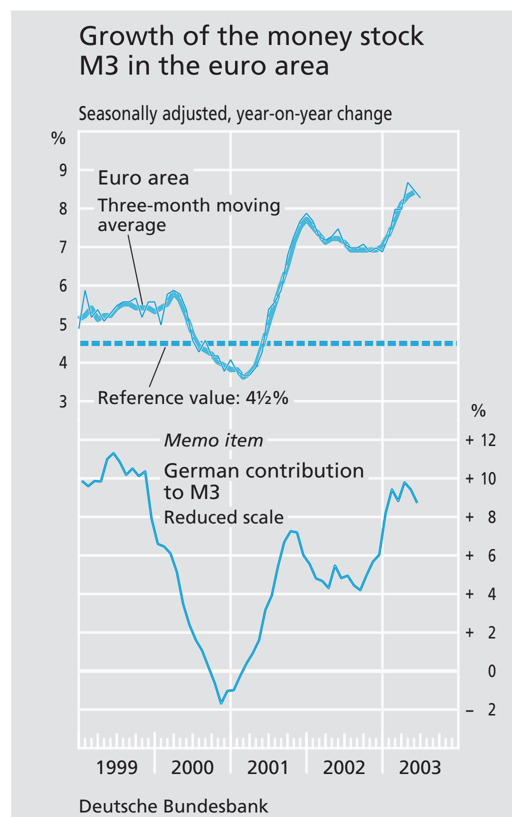
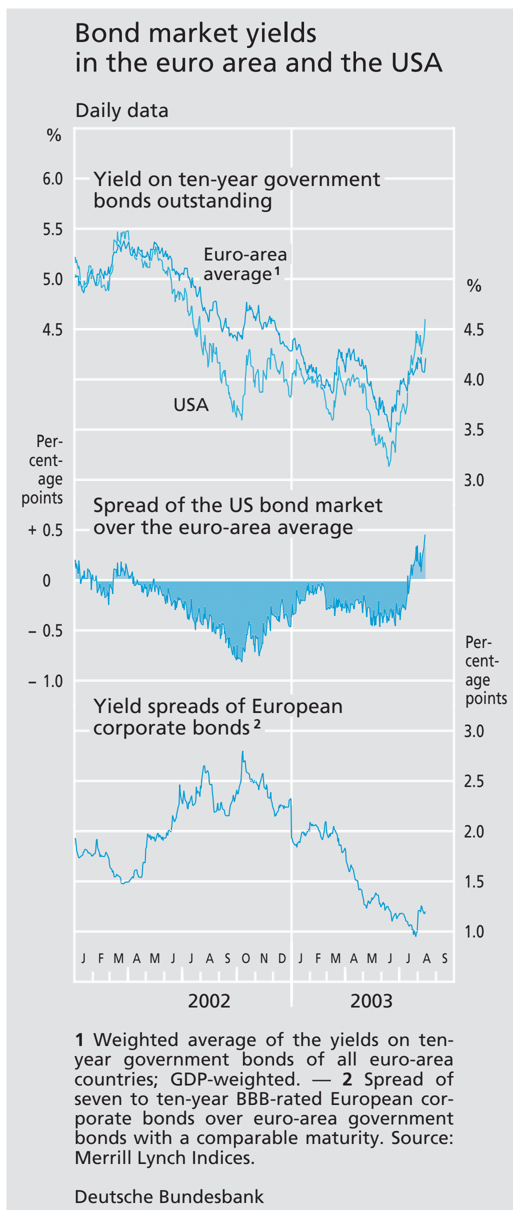
the M3 aggregate. During the period under review, as in the preceding quarter, the other short-term bank deposits (excluding overnight deposits) grew strongly. Falling interest rates and uncertain bond market price developments have evidently enhanced the attractiveness of these instruments. It was particularly deposits redeemable with a period of notice of up to three months which showed strong growth. At the end of the period under review they were 10.5% up on the year. However, deposits with an agreed maturity of up to two years were, in fact, reduced over the past 12 months. Between April and June, marketable instruments picked up noticeably. Before adjustment for seasonal effects, only money market fund shares/units were in demand, whereas repo transactions, money market paper and short-term bank debt securities were reduced.



Balance sheet counterparts

As regards the balance sheet counterparts, euro-area monetary growth in the second quarter of 2003 was boosted particularly by strong inflows of funds from non-euro-area countries to domestic non-banks. The net external position of the MFI sector, which reflects non-banks' payment transactions with non-euro-area countries, went up by €93.4 billion during the period under review, a development to which securities transactions with non-euro-area countries are again likely to have contributed.

By contrast, loans to the domestic private sector again grew distinctly more slowly than M3 in the second quarter in seasonally adjusted terms. In this context, it was primarily the sluggish economy which curbed the demand for loans. At a seasonally adjusted and annualised rate of 5%, the growth of unsecuritised lending during the period under review was still somewhat higher than in the preceding quarter (just over 4½%). This means that euro-area lending has probably now stabilised, not least owing to falling interest rates. Moreover, MFIs have also perceptibly increased their holdings of securities issued by domestic enterprises. There were net portfolio additions of shares and other equities along with fixed-interest securities. This contrasted with the previous quarter when banks had been divesting themselves of these instruments. Securitised lending to the public sector in the euro area likewise rose distinctly in the second quarter (by €36.7 billion). That contrasted with an €8.7 billion reduction in unsecuritised loans to the public sector. Over-



1 Weighted average of the yields on ten-year government bonds of all euro-area countries; GDP-weighted. — 2 Spread of seven to ten-year BBB-rated European corporate bonds over euro-area government bonds with a comparable maturity. Source: Merrill Lynch Indices.

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all lending to the public sector in the euro area thus rose by €28.0 billion, following an €11.5 billion reduction between April and June 2002.

The propensity to deposit funds with euro-area MFIs over the longer term likewise picked up during the period under review and thus tended to dampen monetary growth. Excluding capital and reserves, monetary capital formation in the euro area grew at a rate of 5.4% over the past 12 months compared with 5.0% at the end of March. With net sales of €40.3 billion, banks were able to place a distinctly larger number of longer-term bank debt securities with non-MFIs than in the same period of 2002 (+€29.3 billion). This contrasted, however, with somewhat smaller growth in deposits with an agreed maturity of over two years and deposits with an agreed maturity of over three months. Their growth between April and June 2003 was €2.7 billion as against €3.2 billion a year earlier.

Capital market rates affected by uncertain outlook for the economy and prices

During the period under review, the euro area's capital markets felt the effects of sharply falling interest rates followed by their rapid rise. Up to mid-June the average yield on ten-year government bonds in the euro area fell below 3½%, an all-time low. Since then, however, they have risen by nearly ¾ percentage point. They thus replicated, albeit in a less marked fashion, the movements of interest rates on US government bonds. At 3.14% in mid-June, yields on ten-year US Treasury bonds hit their lowest level since the late 1950s. The ensuing 1⅓ percentage point rise in interest rates resulted in a ⅓ percentage point yield premium for US government bonds over corresponding euro-area bonds in mid-August. The decline in interest rates on US and European government bonds up to mid-June may have been driven in part by worries of potential deflation risks, which had been additionally fuelled by statements made by Federal Reserve Board members following their meeting on 6 May 2003. This concern, however, was evidently only partially reflected

in the findings of the survey on inflation expectations. The surveyed year-on-year inflation forecasts went down by no more than around ¼ percentage point between May and July (see adjacent chart). The temporary disconnect between the bond market and expectations regarding inflation and economic growth – the factors that have a major impact in determining nominal interest rate movements – was at least partly corrected by the upswing in interest rates which began in mid-June. The fact that growth and inflation expectations for the euro area were lower than those for the USA indicates that, even at its all-time low in mid-June, the interest rate level in the euro area diverged less from the fundamentals than did interest rates in the USA, where the debate on deflationary tendencies had originated (see adjacent chart and chart on page 18). The average expected real rate of interest on ten-year bonds for the euro area went down somewhat from its April level to around 2% in July.

Price uncertainty remains high

Persistent risks with regard to the scale of the economic recovery have, in addition, caused prices to continue to fluctuate sharply. Market players' uncertainty about the future movements of bond prices, expressed in terms of the implied volatility of options on forward contracts for long-term Federal bonds, have held steady at a high level since interest rates began to rise in June.

Yield curve reflects brighter economic outlook

From early April the yield curve of German Federal securities (the benchmark for the euro area) was shifting downwards initially across all maturities. The inverse slope at the short end, which had already begun to take shape prior to the ECB's interest rate move on 5 June 2003, remained inverse in the ensuing period. Thus, in mid-June the yields on short-term Federal securities were nearly 30 basis points below the three-month Euribor. However, they then rose – in reaction to the brighter economic outlook – and, as this report went to press, were more than 1⁄10 percentage point above the three-month funds rate. The increasingly steeper slope of the

Inflation and growth expectations in a one-year horizon

Source: Consensus Forecast survey results for the current year and the coming year; Bundesbank calculations.

Deutsche Bundesbank

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

Deutsche Bundesbank

yield curve caused by the rise in the interest rates on longer-term Federal securities since mid-June is also a sign of improved expectations for the economy. On balance, the spread between money market rates and long-term capital market rates in the euro area had risen from 1½ percentage points in early April to 2 percentage points at the end of the period under review.

Market risk premia on non-top-rated corporate bonds remain low

The financing conditions on the market for corporate bonds have remained favourable despite the general increase in interest rates. This is also revealed by the fact that the already exceptionally low risk premia on European corporate bonds continued their slide during the period under review. In the euro area, the yield on seven to ten-year BBB-rated corporate bonds – the lowest investment-grade rating – was, in mid-August, just under 1¼ percentage points higher than that on government bonds with the same maturity; at the end of July this risk premium had even fallen below the 1 percentage point mark. This contrasts with the persistent credit risk. The wave of insolvencies gripping European enterprises has not ebbed this year, either. Bond prices were high probably on account of investors' great interest in adding a larger volume of riskier yet higher-yielding bonds to their portfolios. On the supply side, the high level of net issuing of European corporate bonds indicates that companies seeking capital made use of the favourable financing conditions on the capital markets.

European share prices recovered vigorously

Euro-area equity markets made considerable gains during the period under review. Between early April and mid-June the Dow Jones EuroStoxx index picked up by nearly one-fifth and has remained steady since then. This means that share prices have reached their highest level since early December 2002. Even so, they are less than half as high as their all-time highs of March 2000. The rise in share prices was accompanied by diminishing uncertainty among investors regarding future share price movements, since the implied volatility of index options receded perceptibly.

Investors' risk aversion seems to have lessened as well. This, along with the high level of liquidity on the market, may have fostered the positive developments on the stock exchanges.

Rising prices despite falling profit estimates

The rise in European share prices is all the more remarkable in the light of downgraded estimates of corporate profitability. Between April and July, equity analysts reduced their forecasts for average longer-term earnings growth of the companies listed in the Dow Jones EuroStoxx index by more than 1 percentage point to 9.2%. In addition, on average they reviced down their 12-month earnings expectations for these shares by a small margin from April. Given the rise in share prices, the price-earnings ratio of European shares, based on expected annual profits, has gone up from 13.3 to 14.6.