

The economic scene in Germany at the turn of the year 1999–2000

The international and European environment

Developments in the global economy

The global environment continued to improve in the later stages of the past year. At the same time the global economic outlook brightened up distinctly; at present it is being assessed more favourably than it has been for a long time. This is all the more remarkable considering that one year ago there were still widespread fears of recession and worries about deflation. For this year the IMF expects global economic growth to accelerate perceptibly, by one-half percentage point, to 3½%, slightly exceeding the annual average growth for the 1990s (just over 3%). That would also lend fresh stimulus to world trade, which would probably have a favourable impact on, in particular, trade flows between the industrial countries and the emerging market economies and countries in transition.

*Sustained
recovery of the
global economy*

It was primarily the continued economic boom in the United States and the rapid recovery in the East Asian emerging economies which contributed to reviving the global economy. In addition, the fact that the forces of growth have been increasingly gaining the upper hand in the euro area, thanks to robust domestic demand and to a rise in exports over the course of 1999, has also been playing a role. Those factors have had a positive effect on most of the central and east European countries in transition. In Latin America, too, a renewed upswing occurred in the second half of 1999 – and thus faster than had generally been expected in the spring.

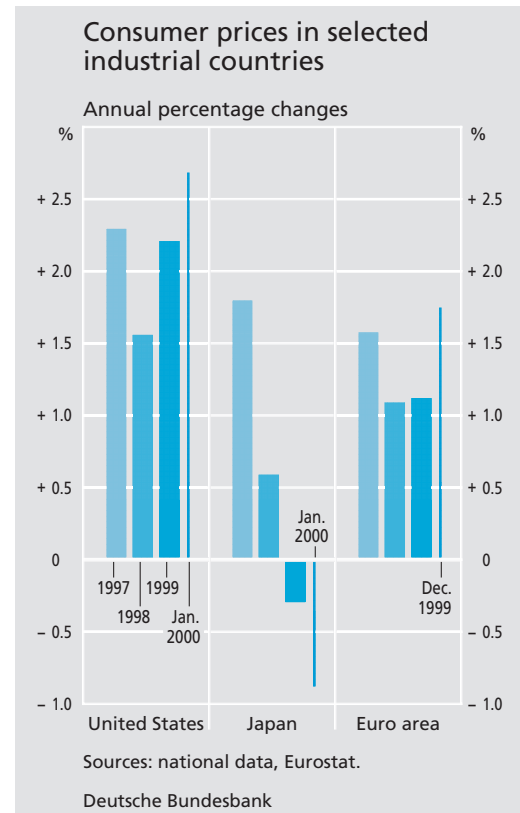
Many signs indicate that the underlying momentum of the global economy is currently

*Upward and
downward risks*

even greater than predicted in the IMF's autumn forecast. At the same time, though, there are a number of risks. First on the list is the very high equity price level in the OECD countries. In the United States, in particular, a drastic drop in equity prices would have a considerably negative impact on overall economic developments since private domestic demand is heavily dependent on assets. In addition, a continued deterioration of the US current account could, with a sliding US dollar, drive prices up. A further risk lies in the continued vulnerability of the Japanese economy. Outside the OECD countries, the upswing in some countries is still fragile. In the East Asian emerging economies, in particular, the visible improvement in the economic situation should not blind observers to the structural problems that continue to plague the banking and corporate sectors. Despite those risks, which must continue to be monitored, the likelihood of a continuation and even an acceleration of the upward trend in the global economy outweighs the risks.

Change in the assessment of the price outlook

As the year 1999 progressed, the assessment of the global price outlook changed perceptibly. A key factor was the drastic rise in oil prices, which, starting from their nadir at the end of 1998, rose by a factor of slightly more than 1½ in dollar terms and more than 2 in euro terms up to February 2000. This caused price pressure at the consumer level to increase worldwide. For the industrial countries, the IMF and the OECD have predicted that inflation will rise this year by one-half percentage point to just under 2%. By contrast, the commodity-exporting countries



have witnessed an improvement in the terms of trade.

Most East Asian emerging economies are back on the path of expansion. This especially applies to South Korea, where the economy grew by 10% in 1999, after having shrunk by 6% the year before. For 2000 the Bank of Korea expects real GDP to grow by 7% and prices to rise by 3%. Singapore and Taiwan also recorded strong economic growth in 1999, at around 5½% in each country; they benefited especially from the worldwide boom in the electronic products sector. At the bottom of the table in East Asia is Indonesia, where overall economic output in the past year is likely to have surpassed the low level of 1998 only slightly.

East Asian emerging economies

Latin America

The financial market turbulence that rocked Latin America at the beginning of 1999, originating in Brazil, had at times a very detrimental impact on overall economic output in the major countries, with the exception of Mexico, which was shielded by the booming US economy. This applies especially to Argentina, whose currency is pegged to the US dollar; following the sharp devaluation of the Brazilian real, Argentina therefore had to cope with considerable losses in bilateral trade with its neighbour. Real GDP in Argentina sank in 1999, unlike in Brazil itself, by an estimated 3 % to 4 %. Thanks to the relatively rapid ebbing of the financial market crisis and owing to the increase in commodity prices, the general outlook for Latin America has again brightened considerably.

Russia

The rise in commodity prices also made a key contribution to the Russian economy's surprisingly rapid recovery from the impact of the financial crisis in the summer of 1998. The sharp devaluation of the rouble at the time led to a considerable substitution of imports by domestic products, particularly in the food industry. As a consequence, overall output went back up perceptibly in 1999. However, there has been little change up to now in the country's structural problems, which are also responsible for the continuous decline in investment recorded since 1991. Those problems include the persistent capital flight, widespread corruption, the overall political situation and the inadequate legal framework.

United States

In the United States, after nearly nine years of an uninterrupted economic boom, there are

no signs that growth will slow down any time soon. According to initial estimates, real GDP grew in the past quarter by a seasonally adjusted 1½ % from the summer quarter's level and surpassed the previous year's level by well over 4 %. Over the entire year it grew by 4 %. Since its cyclical trough at the beginning of 1991, overall economic output has risen by slightly more than one-third, corresponding to an annual growth rate of 3½ %. In autumn 1999 the strongest growth push was provided once again by households' consumption, which, after adjustment for seasonal and price variations, was almost 1½ % higher than in the previous quarter. The exceptionally dynamic consumer demand is expected to have continued following the turn of 1999–2000. The consumer confidence index and retail turnover continued their ascent in January. In addition, the considerable stockbuilding contributed to GDP growth in the fourth quarter of 1999, a trend probably motivated by the computer problems which many were afraid would occur during the roll-over from 1999 to 2000. By contrast, investment by the industrial sector increased only marginally over the year, and housing construction declined once again. In the autumn the real foreign balance slid further into deficit by roughly the same amount as in the previous quarter.

In light of the very brisk domestic demand, the high utilisation of manufacturing capacity and the price stimuli emanating from international commodity markets, inflationary fears are growing in the United States despite the absence at present of clear indicators of a broadly based increase in inflationary pres-

asures. Consumer price inflation did accelerate over the past year by one percentage point to 2.7 % in January 2000, yet that was largely attributable to the rise in energy prices; excluding energy and food products, the inflation rate was 1.9 % of late; in other words, it was even one-half percentage point lower than twelve months earlier.

Japan

In the past year the Japanese economy grew by an estimated ½ %, which was admittedly not nearly enough to make up for the decline in output in 1998 (– 2 ½ %). The rather strong growth in the first half of the year was sustained by public investment and private housing construction, which was boosted for a while by tax incentives. In the summer, real exports shot up, with the braking effect of the yen's appreciation being more than compensated particularly by the surge in import demand in the neighbouring countries. By contrast, a self-sustaining upswing in domestic consumer demand is not yet clearly discernible, as was also confirmed by the Bank of Japan. In the second half of the year overall economic output may have tended to slow down once again. The high burdens on enterprises and employees associated with the economic restructuring process continue to hamper a sustainable revival of the domestic economy. Owing to a decline in households' disposable income, the increase in private consumption over all of 1999 was only possible at the expense of savings, although the saving ratio has still remained relatively high as of late. According to recent surveys, industrial investment has not passed the trough despite enterprises' improved profit situation. In addition, fiscal policy is more and more

being stretched to the limit in its efforts to prop up overall demand. According to OECD estimates, the deficit ratio, at around 8 % of GDP, and the (gross) debt ratio, at 114 %, will both reach a new high this year.

Macroeconomic trends in the euro area

Economic growth in the euro area picked up distinctly after mid-1999. In the third quarter seasonally adjusted real GDP growth was up by just under 1% from its level in the three-month period from April to June, and thus twice as strong as in the two preceding quarters. The year-on-year increase amounted to just over 2 %. The accelerated pace is attributable, for one thing, to domestic demand being more lively than in the spring, which is also true of the individual components, i. e. private and government consumption as well as fixed capital formation. For another, exports grew by a seasonally adjusted rate of 3 % from the previous quarter; this growth notably outpaced that of imports (just under 2 %), resulting in the contribution to growth by euro area foreign trade rising to just under one-half percentage point.

*Stronger
growth in the
second half of
the year*

For the final quarter of 1999, for which no euro area GDP data is available yet, other indicators point to a continuation of the favourable cyclical trend. In the October–November period seasonally adjusted industrial production rose by nearly 1% from its level in the summer quarter and surpassed the corresponding figure for the previous year by 2 ½ %. This went hand in hand with a clear rise in capacity utilisation in the manufactur-

Capacity utilisation in the euro area's manufacturing sector *

Seasonally adjusted data, %

Country	Annual averages (AA) from 1989 to 1998	1999				2000		January 2000 compared with AA from 1989 to 1998 in percentage points
		Total	April	July	October	January		
Euro area	81.9	81.8	81.8	81.6	81.9	83.0	+ 1.1	
of which								
Belgium	79.5	80.9	80.8	81.5	81.5	82.9	+ 3.4	
France	84.4	85.3	84.7	85.5	84.9	86.0	+ 1.6	
Germany	84.5	84.0	83.7	83.6	84.2	85.0	+ 0.5	
Italy	77.2	76.0	76.3	75.9	75.8	77.4	+ 0.2	
Netherlands	84.1	84.0	84.3	83.8	83.9	84.7	+ 0.6	
Spain	77.7	79.7	80.0	79.5	78.5	80.8	+ 3.1	
Memo item								
EU	81.9	81.6	81.5	81.2	81.8	82.8	+ 0.9	

* Source: EU business survey; weighted overall results from data for each country.

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ing sector; in January of this year, according to surveys, it distinctly exceeded its long-time average for the first time since the end of 1998. According to the most recent Commission survey, industrial confidence in monetary union has continued to rise of late. For 1999 as a whole, real GDP is likely to have grown by just over 2 %.

Declining growth differentials within the euro area

In the wake of the buoyant economic recovery in the second half of 1999, growth differentials between the individual euro area countries have shrunk. One reason is that the former economic laggards Germany and Italy, whose exports were particularly hard hit by the international crises, were able to step up the pace of their economic growth noticeably. However, a considerable growth divide still exists between those two countries and a

group of countries with very dynamic economies encompassing Ireland, Finland, Spain, Portugal and the Netherlands.

According to revised Eurostat data, the situation in the euro area labour markets steadily improved in the past few months. In December the standardised unemployment rate, at a seasonally adjusted 9.6 %, was 0.9 percentage point below its comparable level for the previous year. On average, 10 % of the labour force was reported to be looking for work in 1999, whereas this figure had been nearly 11% a year before. A trend towards an improvement can be observed in the major economies of Germany, France and Italy, too. In some smaller countries which at times were at the forefront of labour market devel-

Labour market

opments, the decline in unemployment was not as pronounced as it had been in the past.

*Consumer
prices*

Consumer prices increased at an accelerated pace in the autumn months. The year-on-year increase in the Harmonised Index of Consumer Prices (HICP) widened to 1.7% in December, having stood at 0.8% a year ago. Influenced by rising crude oil prices and the persistent weakness of the euro, petroleum and other fuels, in particular, became more expensive. Excluding energy, food products, beverages and tobacco, prices (at 1.1%) rose at a distinctly slower pace, although even in this relatively narrow definition a certain acceleration in consumer price inflation can be recognised. As an average for 1999, broadly and narrowly defined inflation rates were both 1.1%. The price increase became noticeably more pronounced in those countries that had previously had a below-average rate of inflation. In other countries it even weakened or at least accelerated relatively slowly, with the reduction of indirect taxes in the southern European member states playing a role. In December 1999 Ireland recorded the highest rate of inflation, at 3.9%; the greatest price stability was demonstrated by Germany and France, each with an inflation rate of 1.4%.

**Current account and exchange rate
developments in the euro area**

*Euro area
foreign trade
with third
countries*

Along with the progressing recovery of the world economy from the effects of the crises in east Asia, the situation of the euro area export industry also continued to improve in the

autumn months of the past year. In October–November 1999 deliveries of goods to non-euro-area countries again surpassed their previous year's mark by 10½%; in the first half of the year, by contrast, they had been just over 3½% lower compared with the previous year. Along with the rebound in domestic demand, this has simultaneously led to a distinct rise in imports. In terms of their value, imports from non-euro-area countries were even 14½% higher in October–November than a year before, whereas the value of imports in the first half of 1999 was still 1½% below the comparable 1998 level. However, the increase is largely attributable to higher import prices, too; particularly import prices for crude petroleum jumped sharply over the course of the year, but other imported goods also became more expensive in terms of domestic currency due to the euro's slide. On balance, despite the sharp real rise in exports, the euro area countries' trade surplus, at € 18½ billion in October–November, was somewhat lower than in the corresponding period of the previous year (just under ECU 21 billion).

In the area of "invisible" current account transactions, i.e. transactions in services with other countries plus labour income, investment income and current transfers, during the period under review a deficit of € 12½ billion was generated, which was at the same level as in the previous year. Thus, in the months of October and November 1999 the current account in the euro area showed a surplus of € 6 billion, compared with ECU 8 billion a year before.

*Current
account*



Exchange rate movements

As of late, the euro has once again encountered depreciation pressure. Following a phase of stabilisation, with periods of strengthening near the end of last year and at the beginning of the new year, the euro hit a new all-time low in the past few weeks. As a weighted average against 13 industrialised countries and emerging economies, it was quoted in mid-February at almost 13½%

weaker than when it was introduced at the beginning of 1999.

The spotlight was naturally on the rate of the euro to the US dollar. After grazing the psychological barrier of US\$ 1 to € 1 this past autumn, the euro's rate against the dollar remained in a narrow corridor just above that mark until and into January. However, repeated tendencies towards a more distinct strengthening of the euro lost steam time and again whenever favourable data on the US economy surprised market participants and thus reaffirmed confidence in the performance of the US economy. Against that background, the market tended to attach minor importance to the high American current account deficit; the impressive success in consolidating American government spending apparently represented a stabilising counterweight. In spite of the fact that on this side of the Atlantic, too, the outlook for growth has in the meantime improved distinctly, the US dollar's latest quotation against the euro was just under US\$ 0.99, an appreciation of almost 16% from its level at the beginning of 1999.

US dollar

The Japanese yen, too, remained relatively strong against the euro in the last months of 1999, even though the structural upheavals hampering Japan's prospects for further growth continue to exist in important areas and the economic outlook for the euro area now tends to be more favourable.

Yen

Apparently the exchange rate is more heavily influenced by the large trade surplus with America than by the growth divide vis-à-vis

the euro area. Only temporarily did the yen weaken somewhat, accompanied by renewed interventions by the Japanese central bank. As of late, the exchange rate was ¥ 109 to the euro, just under 18½% lower than at the beginning of 1999 when the euro was introduced.

Pound sterling

In the past few months the pound sterling likewise continued to firm against the euro. This reflects, among other things, the stronger-than-expected growth of the British economy and the increased interest rate differential. Especially over the course of January, the pound sterling rose sharply against the euro and was quoted as of late at around 13½% higher than at the beginning of 1999. At its peak, the pound sterling – measured in terms of the D-Mark – hit the DM 3.25 mark at the beginning of February, its highest level since the end of the eighties.

Adjustment of the drachma's central rate

As opposed to the rate of the euro against the two major world currencies, the dollar and the yen, as well as the pound sterling, the rate of the euro to the EU currencies linked to the euro by the Exchange Rate Mechanism (ERM II), the Danish krone and the Greek drachma, remained virtually unchanged. Although the Greek drachma's central rate was raised by 3.5% on January 15, 2000, thus aligning it more closely to the prevailing market rate and shortening the gap to just over 2%, the drachma's current quotations were hardly affected by this move.

Monetary policy and financial markets in the euro area

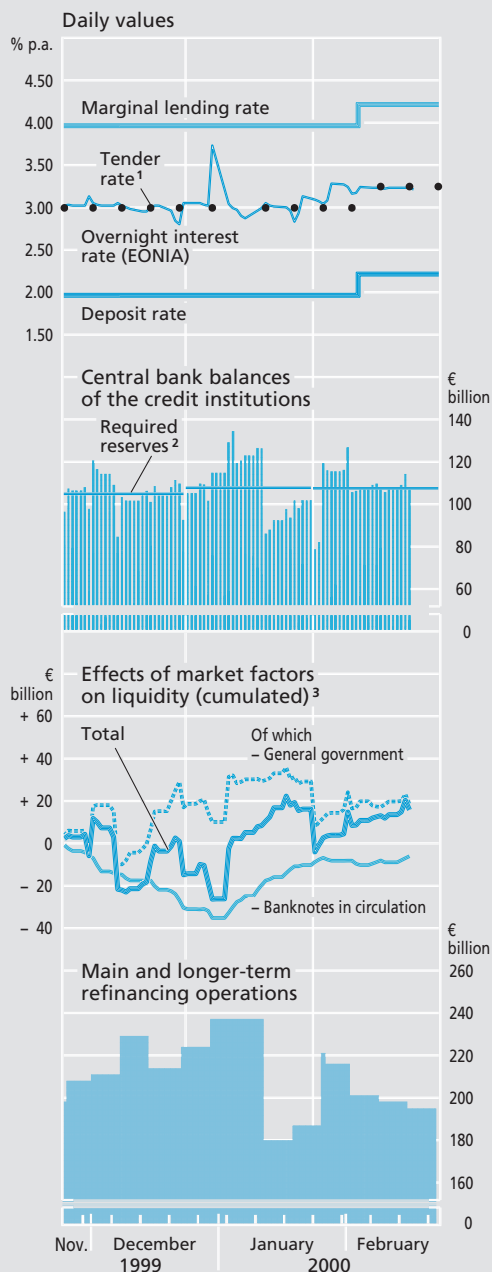
After interest rates were raised on November 4, 1999, the ECB Governing Council initially left central bank rates unchanged. With effect from February 9, the Governing Council then raised the interest rate on main refinancing operations, which continued to be conducted as fixed-rate tenders, from 3.0% to 3.25%, and, with effect from February 4, it raised the interest rates on the marginal lending facility and the deposit facility from 4.0% to 4.25% and from 2.0% to 2.25%, respectively. The increase was necessary because the risks to price stability had risen more sharply than expected as of late. The accelerated economic upswing in the euro area, higher oil prices, and the jump in import prices, as well as the continued abundance of liquidity, all played a role. The interest rate increase is designed to prevent external price trends from spilling over to price and cost developments in the euro area, to safeguard price stability over the medium term, and thus to make a contribution to lastingly strong economic growth.

Central bank rates raised in February

The steady-as-she-goes policy at the turn of the year helped counteract uncertainty on the financial markets relating to the year 2000 problem. In fact, it turned out that those risks were being assessed as being lower and lower. The premiums for uncollateralised liquidity maturing beyond the millennium date change went back down in the last few weeks prior to the roll-over. On December 31 the overnight interest rate was below the marginal lending rate; immediately

Smooth transition to the year 2000

Interest rate movements and liquidity management in the Eurosystem



1 Interest rate for main refinancing operations. — 2 Maintenance periods: November 24 to December 23, 1999, December 24, 1999 to January 23, 2000, and January 24 to February 23, 2000. — 3 Banknotes in circulation, net general government position vis-à-vis the Eurosystem, net foreign currency reserves of the Eurosystem and other factors; provision (+) or absorption (-) of central bank balances.

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thereafter, money market rates returned to normal.

On the whole, though, fixed-term deposit rates have gone up distinctly since the autumn. In addition, the yield curve on the money market has been pointing steeply upwards. This has mainly been a reflection of the fact that market participants were largely expecting the latest interest rate increase by the Eurosystem.

Increase in fixed-term deposit rates

Against the background of initially stable central bank rates and ongoing money market management which continued to be geared towards limiting the daily fluctuations of the credit institutions' central bank balances around the reserve requirement resulting mainly from the persistently high volatility of government deposits with the Eurosystem, the overnight interest rate (EONIA) remained generally close to the main refinancing rate in the past few months. Only at the end of January did the overnight interest rate distinctly outpace the main tender rate, in expectation of the interest rate move by the ECB Governing Council.

Overnight interest rate relatively stable up to the end of January

Since the ECB Governing Council had already indicated in mid-September that it would not conduct a main refinancing operation in the first week of January, the liquidity surplus created at the beginning of the year by high return flows of banknotes, liquidity-providing effects of public sector spending and increased recourse to the marginal lending facility during the turn of the year was absorbed by the collection of fixed-term deposits in a one-week variable-rate quick tender. How-

First fine-tuning operation in January

ever, since the tender result did not reach the absorption volume envisaged and announced by the ECB, the liquidity supply of the banking system could only be restored to normal by sharply cutting the following, first refinancing operation of this year. Furthermore, the allotment profile of the first weeks in January was largely responsible for the extraordinarily tight liquidity situation at the beginning of the latest reserve maintenance period.

*Longer-term
refinancing
operations*

The longer-term refinancing operations which reached maturity in the fourth quarter were stepped up from € 15 billion each to € 25 billion to facilitate the transition to the year 2000. For the main refinancing operations starting at the end of January, the ECB Governing Council decided to reduce the allotment volume to € 20 billion each. On the whole, the Eurosystem's regular open market transactions increased by € 19.3 billion to € 213.5 billion between November and January. This was mainly to offset the absorption of liquidity by the market amounting to, on balance, € 12.8 billion, and financed the rise in the minimum reserve requirement by € 4.3 billion (see adjacent table).

*Credit
institutions'
assistance
measures*

The credit institutions took recourse to the standing facilities primarily at the end of the maintenance periods (particularly to the deposit facility in December) but also at the turn of the year (chiefly the marginal lending facility), with the vast majority of recourse being accounted for in each case by German banks.

Liquidity remains abundant in the euro area. At the end of December the monetary aggregate M3 surpassed last year's level in the en-

Factors determining bank liquidity *

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

Item	1999/2000		
	Nov. 24 to Dec. 23	Dec. 24 to Jan. 23	Nov. 24 to Jan. 23
I. Provision (+) or absorption (-) of central bank balances by			
1. Change in banknotes in circulation (increase: -)	- 11.2	- 8.7	- 19.9
2. Change in general govern- ment deposits with the Eurosystem	- 7.5	+ 18.0	+ 10.5
3. Change in net foreign exchange reserves ¹	- 0.1	+ 10.6	+ 10.5
4. Other factors ²	- 0.2	- 13.7	- 13.9
Total	- 19.0	+ 6.2	- 12.8
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	+ 9.9	- 11.9	- 2.0
b) Longer-term refinan- cing operations	+ 11.3	+ 10.0	+ 21.3
c) Other operations	-	- 3.3	- 3.3
2. Standing facilities			
a) Marginal lending facility	- 0.0	+ 1.6	+ 1.6
b) Deposit facility (increase: -)	- 0.6	+ 0.5	- 0.1
Total	+ 20.5	- 3.1	+ 17.5
III. Change in credit institutions' current accounts (I. + II.)	+ 1.4	+ 3.1	+ 4.6
IV. Change in the minimum reserve requirement (increase: -)	- 1.4	- 2.9	- 4.3
Memo items ³			
Main refinancing operations	150.4	138.5	138.5
Longer-term refinancing operations	65.0	75.0	75.0
Other operations	-	- 3.3	- 3.3
Marginal lending facility	0.3	1.9	1.9
Deposit facility	1.0	0.5	0.5

* For longer-term trends and the contribution of the Deutsche Bundesbank see pages 14* and 15* in the Statistical Section of this Report. — 1 Including end-of-quarter valuation adjustments with no impact on liquidity. — 2 Including monetary policy operations concluded in stage two and still outstanding at the beginning of stage three (outright transactions and the issuance of debt certificates). — 3 Levels on an average of the maintenance period under review or the last maintenance period.

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*Monetary
growth has
remained
above
reference value*

tire euro area by 6.4 %, compared with 6.1 % at the end of September. The three-month moving average of year-on-year growth rates was 6.1 % between October and December, compared with 5.9 % between July and September. It thus remains some 1½ % percentage points above the reference value of 4½ % set by the ECB Governing Council for 1999. When interpreting these figures, though, one must bear in mind that at present this year-on-year comparison reflects current trends only to a limited extent owing to base effects, specifically the weak monetary growth in December 1998. If one excludes these base effects by using shorter-term seasonally adjusted rates of change, the monetary aggregate M3, at an annual rate of 5 %, rose more slowly over the second half of 1999, despite a slight acceleration in the third quarter, than in the first half of the year (8 %). Moreover, the assessment of monetary growth continues to be hampered by statistical uncertainties. In addition, monetary developments in the individual euro area countries still vary, although a certain convergence has been achieved over the course of the past few months. The German contribution to the monetary aggregate M3 grew in the last quarter of 1999 largely in line with the overall monetary aggregate (see page 17 f.).

*Components
of M3*

The individual components of the monetary aggregate saw rather different developments in the fourth quarter of 1999. The marketable instruments contained in M3, especially money market fund certificates and money market paper, grew distinctly more sharply. Currency in circulation also grew perceptibly; however, this rise occurred mainly in Decem-

ber and is, to that extent, probably a reflection of uncertainty involving the year 2000 problem. By contrast, the pace of growth in overnight deposits slowed down in the fourth quarter of 1999; at the end of December 1999 they exceeded last year's level by 10.3 %, following 14.9 % in September. The sluggish growth of sight deposits in the fourth quarter is likely to be linked not only to outflows in cash holding but also to the rise in short-term interest rates, which has promoted shifts to fixed-term forms of investment. On the whole, the monetary aggregate M1, which includes not only currency in circulation but also overnight deposits, remained nearly unchanged in the quarter under review, after adjustment for seasonal variations. In the second half of 1999 M1 rose at a seasonally adjusted annual rate of 4 %, compared with just over 16½ % in the first half of the year. The other shorter-term deposits contained in M3 grew moderately between October and December.

Among the balance-sheet counterparts, lending to the private sector continued to expand strongly in the fourth quarter of 1999. At the end of December 1999 it was 10½ % higher than the year before. Specifically, during the period under review securitised lending by MFIs to the private sector expanded distinctly more strongly, whereas loans grew less strongly than in the previous quarter. The somewhat reduced growth of the latter in the fourth quarter of 1999 of 7 %, measured as a seasonally adjusted annual rate – following 8½ % for the months between July and September – is attributable, on balance, exclusively to the weak growth in December.

*Balance-sheet
counterparts*

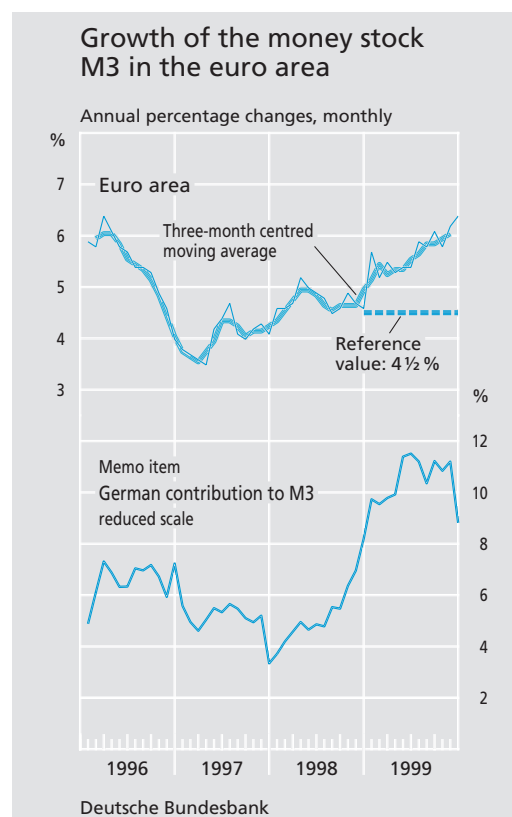
Lending by MFIs to the public sector picked up again in the fourth quarter of 1999 after having been reduced in each of the two preceding quarters. During the period under review monetary capital formation accelerated perceptibly and thus had more of a braking effect on monetary growth than in the preceding quarters. That also applies to payment transactions by resident non-MFIs with counterparties outside the euro area, where a considerable outflow of funds was recorded in the fourth quarter of 1999.

Germany's contribution

In the fourth quarter, the German contribution to the euro area M3 grew largely in line with the overall aggregate, after having increased much more strongly particularly in the first half of the year. The noticeable weakening of German monetary growth was largely attributable to the perceptible decline in money holdings in December owing to large-scale reductions in overnight deposits (see page 25). At the end of December the German contribution to M3 was 8.7 % higher than a year before. This rate is likely to continue to overstate the actual liquidity situation in Germany. One reason is that the sale of money market paper issued by German MFIs in the fourth quarter of 1999, particularly in November, continued its rise. According to balance of payments statistics, once again the vast majority of this paper was purchased by investors residing outside the euro area.¹

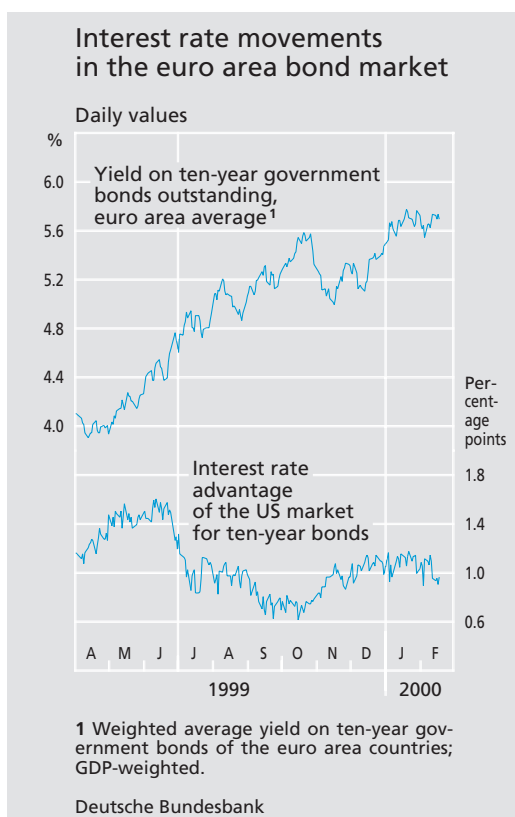
Capital market rates declined shortly before the ECB's interest rate move in November

The capital market rates in the euro area have continued to rise, on balance, since the autumn of 1999. In mid-February 2000 ten-year government bonds of the euro area countries bore an average yield of 5¾ %, or around



one-half percentage point more than at the end of September 1999. Compared with the preceding months, though, the rise in capital market interest rates has tailed off. This slow-down is largely attributable to the fact that, shortly before the interest rate increase by the Eurosystem in early November, yields initially went down by nearly one-half percentage point to 5 %. With the interest rate move becoming more and more evident as October went on, uncertainty began to fade from the capital market; in November the implied volatility of the Bund future, which shows the price fluctuations expected by market partici-

¹ Since the outstanding amount of this paper is reported excluding the holdings of MFIs in the euro area and – owing to statistical difficulties – up to now no distinction has been made between purchasers from the euro area and those from non-euro-area countries, such liabilities of MFIs vis-à-vis investors residing outside the euro area enter into the monetary aggregate M3.



pants on the forward market in the near future, hit its lowest level since early summer.

Interest rates up once again at the turn of the year

Subsequently, long-term interest rates went back up. It was especially the American bond market, where rising inflation fears pushed up yields, that emitted a relatively strong impetus towards increasing interest rates. In the euro area these stimuli were able to take hold, particularly in light of the accelerated growth which was emerging more and more clearly but also given increasing uncertainty regarding price movements. From mid-November 1999 to the end of January 2000 the average yield in the euro area rose by three-quarters of a percentage point to 5¾%. However, euro area yields did not quite keep pace with their counterparts in the United States, which caused the spread be-

tween US and euro area ten-year bond yields to widen to nearly 1¼ percentage points by the end of January.

In connection with the raising of refinancing rates by the Eurosystem at the beginning of February by one-quarter percentage point, capital market rates initially went down once again. Subsequently yields rose slightly, settling in at around 5¾% in mid-February. The euro area capital markets' response to the Eurosystem's interest rate decisions in November and February indicates that inflation expectations on the capital markets have been successfully held in check. At the same time it underscores the fact that market players regard these interest rate moves as suitable measures to forestall increasing price risks.

Decline in yields after interest rate increase in February

In the euro area share prices rose sharply as the end of the year approached. In the fourth quarter of 1999 European shares – measured in terms of the Dow Jones Euro STOXX – rose by more than 30%. The trend was originally dictated for the most part by the prices set on Wall Street. As the year progressed, though, European stock markets increasingly broke away from international trends. The prospect of a strong revival of growth in the euro area, as well as a more optimistic assessment of the will to implement economic policy reform in important euro area countries, contributed to European equity price increases distinctly outpacing those on the US stock markets. That enabled European equity markets to largely make up for the relatively sluggish price developments compared with those of the United States in the first few months of 1999. Equity prices have reached new peaks

Bullish share prices at first, followed by increasing volatility

since the beginning of 2000, but volatility has also been on the rise. This may be linked to renewed flashes of uncertainty regarding further interest rate developments, and it may also be linked to the valuation level that

has now been reached. In mid-February 2000 prices were up by around 5 % compared with their level at the end of 1999 and 37 % compared with their level at the end of September.