

The economic scene in Germany in autumn 2000

The international and European setting

Developments in the world economy

World economic growth maintained its rapid pace in the summer months. In the industrialised countries, business activity continued its upswing throughout the period under review. In addition, developing countries, emerging economies and most of the countries in transition in central and eastern Europe again recorded extremely strong output growth. That led to a faster expansion of world trade. According to the autumn projection of the International Monetary Fund (IMF), published in September, global output in 2000 will rise by just over 4½%, or more sharply than in any year since 1988, thus distinctly outpacing the longer-term trend. Hence the year-on-year expansion in the volume of world trade might even hit 10%, twice the 1999 figure. However, the deterioration in the terms of trade and the concomitant loss of real purchasing power in the oil-consuming countries, as well as the higher price increases, have all conspired to put a damper on global business activity. The price outlook for the world economy in 2001 and 2002 is therefore generally not being assessed quite so positively as in the past. All the same, if internecine struggles for shares of the cake can be avoided, and if reform efforts are continued, the prospects remain good that the world economy will stay on a path of growth.

World economy continues to expand ...

... yet increase in energy prices exerts a dampening effect

Here it must also be borne in mind that the loss of real purchasing power in the oil-importing countries is being accompanied by real income gains on the part of the oil-producing nations, which, with a certain time lag, are likely to lead to heavier demand for

Higher imports by oil-exporting countries

exports from the industrialised countries. The fact that most oil-exporting countries, owing to lower revenues from oil sales, felt compelled to reduce their imports (sometimes drastically) in 1997-8 also plays a role. Correspondingly, the pent-up demand for imports, particularly in the oil-producing countries with large populations (which generally exhibit a high macroeconomic absorption propensity), is probably fairly sizeable.

*Clouds over the
global price
situation*

Since bottoming out early in 1999, US\$-denominated crude oil prices have tripled. Despite the decision of the OPEC countries to expand oil production, the relatively meagre stocks continue to put a strain on the oil market. However, oil prices have remained below the all-time high reached during the second oil-price crisis in 1979-80. That finding applies all the more when seen in real terms, i.e. when the movements of the prices of the exports from oil-consuming countries are taken into consideration. The sharp rise in energy prices caused consumer-price inflation in industrialised countries to reach well over 2% in October, just under one percentage point higher than a year before. Core inflation, which excludes energy and food prices, has also gone up of late, albeit relatively moderately. In the emerging economies and developing countries, as well as the countries in transition, the inflationary impact of the rise in oil prices on the statistics has been mitigated by the fact that increases in the prices of other products have decelerated once again. Previously, the prices of those products had in many cases experienced high double-digit or even triple-digit increases, especially owing to sharp devaluations.

IMF projections for 2000 and 2001

Item	1998	1999	2000	2001
Real gross domestic product	Change from previous year in %			
Advanced economies 1	+ 2.4	+ 3.2	+ 4.2	+ 3.2
of which				
United States	+ 4.4	+ 4.2	+ 5.2	+ 3.2
Japan	- 2.5	+ 0.2	+ 1.4	+ 1.8
Euro area 2	+ 2.7	+ 2.4	+ 3.5	+ 3.4
Consumer prices 3	Change from previous year in %			
Advanced economies 1	+ 1.5	+ 1.4	+ 2.3	+ 2.1
of which				
United States	+ 1.6	+ 2.2	+ 3.2	+ 2.6
Japan	+ 0.6	- 0.3	- 0.2	+ 0.5
Euro area 2	+ 1.1	+ 1.2	+ 2.1	+ 1.7
Unemployment	Number of unemployed as % of the labour force			
Advanced economies 1	6.7	6.3	5.9	5.7
of which				
United States	4.5	4.2	4.1	4.4
Japan	4.1	4.7	5.0	5.3
Euro area	10.8	9.9	9.0	8.3

Source: IMF, World Economic Outlook, September 2000. — 1 Industrial countries plus Israel, Taiwan Province of China, Hong Kong Special Administrative Region, Republic of Korea and Singapore. — 2 Growth forecast revised slightly downwards following Article IV consultations in October 2000; projected consumer price inflation in 2000 and 2001, at 2.3% and 2.1% respectively, has been revised upwards from the outlook in September. — 3 Consumer price index.

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On the whole, the adverse effects on growth and inflation of the most recent rise in oil prices – barring further oil-price surges – will probably turn out to be distinctly weaker than the corresponding welfare losses caused by the oil-price crises in the seventies and early eighties. For one thing, the dependency of the oil-consuming countries on oil – in terms of gross domestic product (GDP) – has gone down markedly since then, for structural reasons. For another, at present the anti-inflation environment is much more favourable than it was back then. The oil-price rises in the seventies and at the beginning of the eighties triggered or exacerbated disputes in the industrialised countries for a share of the macroeconomic pie; this boosted inflation and caused monetary policy makers to tighten the monetary reins. Unlike then, in the in-

*Strain on world
economy less
than in previous
oil-price crises*

dustrialised countries the incidence of second-round effects has so far only been low.

United States

Economic growth in the United States slackened perceptibly in the summer. Real GDP, after adjustment for seasonal and working-day variations, went up by $\frac{3}{4}\%$ after having grown in the preceding two quarters by $1\frac{1}{4}\%$ and $1\frac{1}{2}\%$, respectively. The year-on-year rise in the third quarter was $5\frac{1}{4}\%$, compared with 6% in the spring. The cooling-off of business activity, which had been expected for quite a while, owed something not only to a decline in government consumption but also to plummeting housing investment (which is quite sensitive to changes in interest rates), and to more moderate growth in industrial investment. By contrast, private consumption, which had visibly lost momentum in the spring, picked up again. That, however, was at the expense of the saving ratio, which, at -0.2% of disposable income, hit a new all-time low. In addition, exports, viewed in seasonally adjusted terms, increased more sharply than imports, for the first time in quite a long while. For that reason, the foreign trade deficit rose but relatively slightly, thus imposing hardly any further strain on economic growth.

In addition to the most recent figures from the national accounts, other indicators likewise point to a slowdown in business activity. Capacity utilisation in industry dipped perceptibly following the middle of the year. Moreover, the number of permits for new residential construction continued to fall. Another development that would be consistent with

the advent of a soft landing is the fact that seasonally adjusted labour costs increased more sluggishly in the third quarter (at just under 1%) than in the two preceding quarters. However, owing to the energy price rises, consumer price inflation accelerated to an average of 3.5% in the months from July to October. Core inflation, i.e. consumer prices excluding energy and food prices, has latterly stood at 2.5% .

Japan

In the first half of 2000, aggregate output in Japan rose at a seasonally adjusted annual rate of just over 4% . Growth was bolstered both by strengthening domestic demand and by rising net exports. Following the welcome results of the first half of the year (even though they were influenced by special factors), a weaker expansion is to be expected in the third quarter, for which national accounts figures are not yet available. The underlying trend in business activity, however, remained on the rise throughout. Industrial production in Japan, which has recently shown a steadier course than GDP, rose by just under 2% between July and September, seasonally adjusted, and was thus nearly $5\frac{1}{2}\%$ up on the year. The sharp rise in the orders received in the mechanical engineering industry is likewise a sign that private investment went up perceptibly again in the summer. The indicators of consumer demand among households at the current end, though, convey a mixed picture. The prerequisites for a strengthening of consumption seem to be improving, however, in that the situation on the labour market is stabilising and employees' real incomes are picking up. The loss of households' real purchasing power that accompanied the rise

in oil prices was offset by the fact that the prices of manufactured goods declined again. In October, as in the preceding two months, the consumer price index was 0.8 % below its level of a year before. The recently-announced new economic programme is designed to prevent public investment from declining sharply next year. However, the more favourable overall economic outlook cannot conceal the fact that the Japanese economy is still beset with considerable structural problems. In this context, the fact that the number of cases of insolvency has been tending to rise strongly for over a year is especially worrisome.

*United
Kingdom*

In the United Kingdom, real GDP in the third quarter, according to preliminary estimates, was $\frac{3}{4}$ % up on the previous period, after adjustment for seasonal and working-day variations; it was thus just under 3 % higher than a year before. The pace of growth has slackened somewhat since the spring. The key factor here was the slowdown in momentum in the services sector. Over the past few months, business activity seems to have continued to moderate. In September, industrial output slowed down, after seasonal adjustment, and in the third quarter it grew distinctly less on the whole than in the spring. In addition, capacity utilisation in the manufacturing sector decreased slightly in the summer. However, labour-market conditions continue to be tight. In September–October the seasonally adjusted unemployment rate dropped to 3.6 %, its lowest level since the summer of 1975. Admittedly, the standardised rate was still as high as 5.4 % in the third quarter. In October, consumer prices, excluding mort-

gage lending rates, were 2.0 % up on the year, and thus remained below the official target of 2.5 %. Price pressure was somewhat lower than in autumn 1999. Although energy prices have at times surged sharply in the United Kingdom, too, these rises were accompanied by price reductions for some industrial goods, with the fiercely competitive environment playing a major role. Moreover, the prices of services rose perceptibly more slowly.

Macroeconomic trends in the euro area

Owing to the oil-price-related and exchange-rate-related deterioration in the terms of trade, the international setting for the euro-area economies in the summer was no longer as auspicious as it had been in the preceding quarters. As a consequence, the general business situation, according to surveys, has clouded over slightly in the past few months. The indicator of industrial confidence inched upwards in October, yet it remained below its latest peak of last June. Sentiment among consumers, who are bearing the brunt of the oil-price-related and exchange-rate-related loss of purchasing power, has likewise taken a turn for the worse. In particular, households' restraint has been clearly reflected in purchases of new automobiles.

*Euro area still
on a path of
growth*

Despite the noticeable cooling-off of economic activity, the outlook for growth in the euro-area countries can still be rated good. For one thing, the euro area is likely to benefit more than other industrialised countries from a rise in the oil-exporting countries' imports;

Price movements in the euro area and the United States in 2000

Change from the previous year in %
(differences in percentage points)

Item	1st qtr	2nd qtr	3rd qtr
Consumer prices			
Euro area ¹	+ 2.0	+ 2.0	+ 2.5
United States ²	+ 3.2	+ 3.3	+ 3.5
Difference	- 1.2	- 1.3	- 1.0
Core inflation ³			
Euro area	+ 1.1	+ 1.2	+ 1.3
United States	+ 2.2	+ 2.4	+ 2.6
Difference	- 1.1	- 1.2	- 1.3
Energy prices			
Euro area	+ 13.7	+ 12.3	+ 13.6
United States	+ 19.6	+ 17.0	+ 15.8
Difference	- 5.9	- 4.7	- 2.2
GDP deflator ⁴			
Euro area	+ 1.0	+ 0.9	...
United States	+ 1.7	+ 2.0	+ 2.3
Difference	- 0.7	- 1.1	...

¹ Harmonised Index of Consumer Prices (HICP). — ² CPI. — ³ Consumer prices excluding energy and food products. — ⁴ Comparability limited because of the different methods of deflating nominal GDP used by the United States and the euro-area countries.

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this is suggested by the euro area's competitive price structure and relatively large market share. For another, in the coming year the dampening influences will probably be largely eclipsed by strong fiscal policy stimuli in several euro-area countries, amounting to an estimated ½ % of euro-area GDP. Moreover, the sustained favourable trends in employment are likely to continue to contribute towards stabilising consumer activity. In the first half of this year, the number of employed persons went up by around 2 % against the same period of last year. Accordingly, seasonally adjusted unemployment went down noticeably, from 9.6 % in January to 9.0 % in September. The fact that seasonally adjusted industrial output continued to grow in July and August (more recent data are not yet available) – by just under ½ % compared with

the second quarter, and by nearly 6 % on the year – fits into this picture. In addition, capacity utilisation in the manufacturing sector increased significantly between July and October, reaching its highest level since the beginning of 1991.

The rise in euro-area consumer prices again slowed down somewhat in October. The year-on-year rate of HICP, having reached its highest level in 6½ years in September, at 2.8 %, has latterly decreased to 2.7 %. The key factor here was a drop in the prices of mineral oil products that followed price falls in the international markets. Excluding energy costs and seasonally dependent food prices, which are hardly indicative of underlying inflation trends because of their violent fluctuations due to special factors, inflation stood at 1.5 % in October. That was only slightly more than in the preceding months. Seen in that light, price movements have remained moderate until very recently. Pay rate policy's response to imported price increases will be the factor determining further trends. In Germany, the upturn in negotiated pay rates in 2001 has largely been decided already; with a few qualifications, the same applies to France as well. The moderate trends in negotiated pay rates that are to be observed in the two largest euro-area countries should serve as a model for the other EMU nations.

A comparison with price movements in the United States points to the existence of a pronounced stability differential in favour of the euro area. It amounted to ¾ percentage point in consumer price inflation in October,

Slackening price pressure on the eve of autumn

Stability differential between the euro area and the United States

with the differential in core inflation actually reaching one percentage point. It is true that the US economy's cyclical advantage and its higher degree of macroeconomic capacity utilisation play a part in this; however, that does not completely explain the greater stability success in Europe, to which little attention has hitherto been paid.

Current account and exchange-rate developments in the euro area

Exports to non-euro-area countries

The strong global economic growth and the exchange-rate-related competitive advantage in international trade enjoyed by suppliers from the euro area continued to bolster European exporters' foreign business in the summer months. On balance, the value of exports in the two-month period of July-August (no figures are available yet for September) surpassed the figure for the comparable period of last year by 18½%. It is true that this growth in sales has owed something since the beginning of this year to accelerating price increases, through which, in particular, the rise in energy costs is being passed on at the producer level. However, that is likely to account for "only" four to five percentage points; in actual fact, exports have risen exceptionally fast in real terms, too, on the year.

Imports

By comparison, import price increases play a much greater role; in particular, euro-area crude oil imports exert an impact here. In terms of their value, imports from non-euro-area countries have therefore grown more strongly than exports. During the months under review, their year-on-year rise was

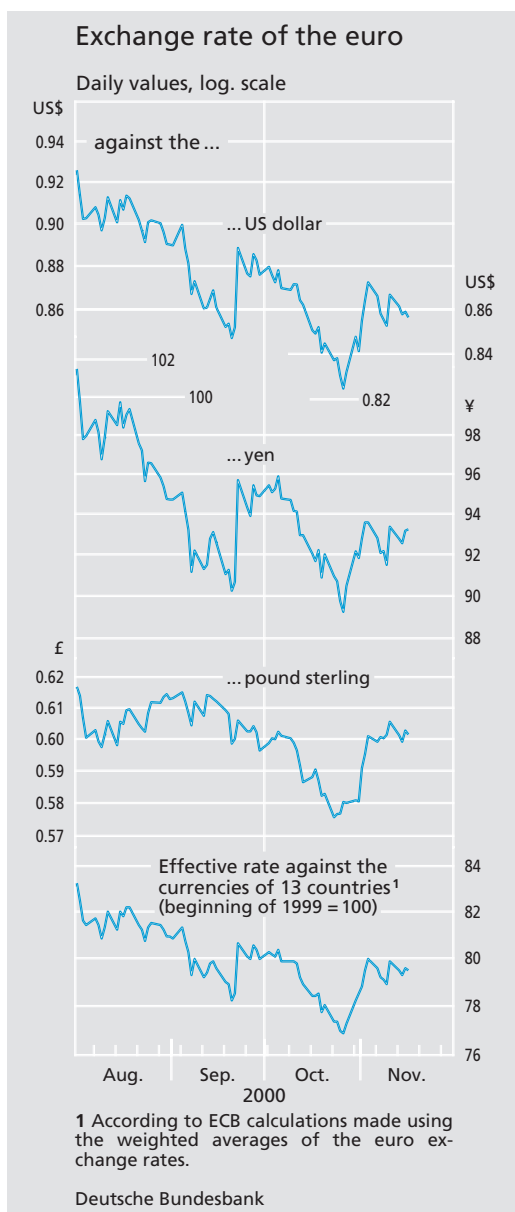
25½%. Despite the favourable exporting conditions, euro-area countries' surplus on merchandise trade went down considerably on the year, from just over € 18 billion to € 13 billion in July-August 2000.

The euro area's "invisible" current account transactions with non-euro-area countries showed a deficit of € 17½ billion in July-August, practically unchanged from the previous year. It is true that the balance of services transactions improved slightly, but the deficits in the balance of factor income and, in particular, in current transfers were higher than a year before. The entire euro-area current account therefore ran a deficit of € 4½ billion in July-August 2000, compared with a slight surplus (€ ½ billion) in the same period of last year.

Current account

The depreciation of the euro has continued in the past few months. Following a temporary period of recovery in the spring, the euro plummeted again in the summer months. As the year progressed, it moved from one all-time low to the next. The sharp decline in the euro's value and the attendant risks to price stability ultimately prompted the European Central Bank, together with the G-7 central banks, to act in concert to support the European currency on September 22; this gave the euro a temporary boost. However, the euro again encountered downward pressure soon afterwards. Only as the end of October approached did the euro appear to have stabilised at a low level. The ECB supported the market stabilisation of the euro in the first few days of November by intervening accordingly in the foreign exchange market.

Exchange-rate movements



US dollar

The persistent weakness of the euro was manifest against all major partner currencies. However, attention is generally focused on the euro's movement against the US dollar. After being quoted at US\$ 0.94 as an average of July, the euro fell to US\$ 0.85 in mid-September. Particularly the somewhat less optimistic assessment of further economic growth in the euro area, according to the findings of ifo institute surveys for the sum-

mer months, and the strains imposed on euro-area countries by the unexpectedly high oil prices, which continued their rise up to and including September, left their mark. The proliferating signs that the US economy was gradually cooling off had no impact, however. In some cases, it was even argued that the impending "soft landing" of the US economy and its stabilising effects on the world economy would tend to benefit the US dollar, if anything. In that environment, the intervention on the foreign exchange market near the end of September was able to support the euro only for a brief period. In the second half of October, the weakness of the European stock exchanges became a further factor putting a strain on the euro. Moreover, the US dollar attracted capital flows as a "safe haven" owing to the crises in the Middle East. As the end of October approached, the euro hit its lowest level ever against the dollar, at US\$ 0.83. Since then, new data concerning a weakening of US economic growth in the third quarter of the year, which were published soon afterwards, have helped to steady the euro somewhat, and the ECB gave more assistance at the beginning of November in the form of further interventions. The euro was last quoted at US\$ 0.85.

Yen

The euro has also depreciated further against the Japanese yen since the summer. After averaging ¥ 101 in July, the euro slipped to ¥ 92 at the end of October, and thus on a scale similar to its slide against the US dollar. At times, the US dollar, too, lost some ground against the yen, because the Japanese economy's growth prospects in September did seem to be a bit more favourable than the

markets had originally assumed. During that time, the appreciation of the yen vis-à-vis the euro was that much stronger. Afterwards, however, the collapse of a major Japanese insurance company redirected the markets' attention to the unresolved structural problems in Japan's economy. Since then, the yen has also gone back down against the US dollar.

Pound sterling

Since the summer, the euro has likewise lost ground against the pound sterling. It had initially held its own, since the possibility of the Bank of England lowering interest rates and the more cautious assessment of the overall economic outlook put a strain on the UK currency well into September. Not until October did the euro depreciate markedly against the pound sterling, its rate moving temporarily into the vicinity of its all-time low of early May.

EMS

Exchange-rate relations in the EMS remained very stable during the summer and autumn months. The Danish rejection at the end of September of the introduction of the euro did not have any discernible impact on the krone rate, either. Supporting foreign exchange market intervention by the Danish central bank and an increase of ½ percentage point in the interest rate probably helped to keep the krone close to its central rate against the euro during that period. The Greek drachma, as expected, continued to approach its euro central rate, which corresponds to the conversion rate once Greece joins the Eurosystem at the beginning of next year.

Effective exchange rate

As a weighted average against the currencies of the 13 most important trading partners of

the euro area, the euro has slipped by nearly 6 % since July, thus being quoted 21 % lower than when it was introduced. In real terms, i. e. after taking due account of the divergent inflation rates in the euro area and in the partner countries involved, the depreciation of the euro during that period was similarly great.

Past experience has shown that the competitive advantages accruing from this to exporters in euro-area countries generally do not last; they are usually quickly absorbed by rising import prices. In particular, though, they cannot offset potential damage to investor confidence and the resultant implications for the supply of capital and the propensity to invest in the euro area. Therefore, for monetary policy makers, there is no alternative to continuing their anti-inflation policy. In the other policy areas, too, it is essential to continue along the path of reform taken so far, and thus to strengthen investors' confidence in the economic future of the euro area.

Monetary policy and the financial markets in the euro area

At the beginning of September and October alike, the Governing Council of the ECB raised central bank interest rates by one-quarter of a percentage point each time. The interest rates on the marginal lending facility and the deposit facility have stood at 5.75 % and 3.75 %, respectively, since October 6. The minimum bid rate for the main refinancing operations of the Eurosystem, which continue to be conducted as variable-rate

Interest-rate increases in September and October

tenders, has been 4.75 % since the operation conducted on October 11. On balance, central bank interest rates are thus $2\frac{1}{4}$ percentage points higher than at their trough in the autumn of last year, when the Governing Council of the ECB began to tighten its monetary policy stance. By its most recent interest-rate moves, it has countered, in a forward-looking manner, the risks to price stability emanating from the continued abundance of liquidity in the euro area, the persistently high oil prices and the low external value of the euro. These moves are intended to help prevent the present upward pressure on prices from having an impact on longer-term inflation expectations – and thus to ensure that confidence in price stability is maintained.

*Rise in money
market rates*

The markets had expected the Governing Council of the ECB to raise official interest rates once more during the period under review. Particularly prior to the interest-rate move at the beginning of September, time deposit rates rose sharply, but fell back somewhat when that move fell short of market expectations. The impact of the October interest-rate increases was initially confined to the shorter-term segments of the money market, whereas longer-term interest rates did not go up again until the later part of October. Since early November, money market rates have been falling across the board. On balance, the yield curve in the money market has flattened distinctly.

*EONIA close to
the refinancing
rate*

In the autumn months, the overnight money market remained relatively tension-free. The marginal allotment rate for main tenders and

the overnight interest rate (EONIA) were for the most part very close to the minimum bid rate; only prior to the latest interest-rate decision did they exceed that rate distinctly – due also to the usual end-of-quarter tensions. In October, by contrast, overnight money was frequently quoted below the minimum bid rate. Accordingly, during that period the bid volume and number of bidders in main tender operations declined perceptibly. That mirrored the ongoing provision of funds by the Eurosystem, aimed at bringing credit institutions' central bank balances close to the required reserves at the beginning of the reserve maintenance period in question, and at avoiding liquidity bottlenecks.

During the past few months, ongoing money market management has been conducted exclusively through the use of regular open-market transactions; no fine-tuning operations were required. When planning its main refinancing operations, the Eurosystem was compelled, above all, to take account of the high volatility of public sector deposits. Moreover, the drain on liquidity owing to the sale of interest income deriving from foreign exchange reserves by the ECB and on account of foreign exchange market intervention in September was offset. After all, it was necessary to take due account of the liquidity effect resulting from the reduction of the outstanding volume of longer-term refinancing operations, which the Governing Council of the ECB decided in June. At the end of August and September, basis tenders of € 20 billion each were due, and were not completely replenished by new tenders of € 15 billion each. Altogether, between August and Octo-

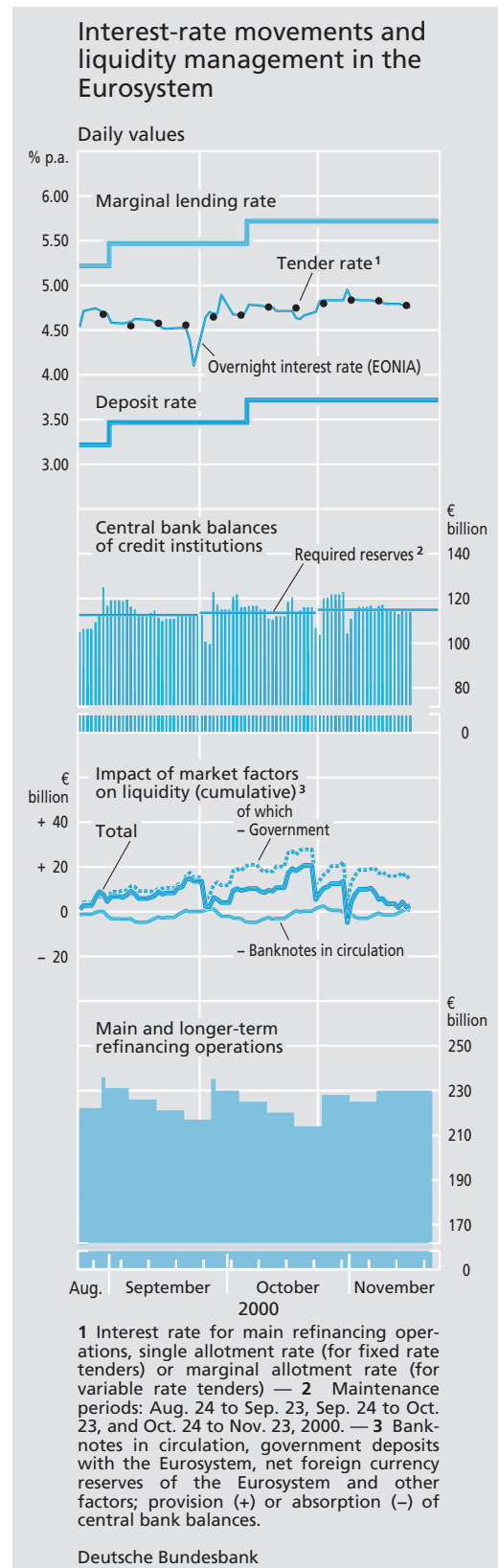
*Liquidity
management
through main
tenders*

ber, the autonomous factors determining bank liquidity deprived credit institutions of € 2.1 billion worth of funds. At the same time, the level of required reserves rose by € 1.8 billion. These changes were accompanied by an increase of € 3.7 billion net in the Eurosystem's open market operations and a slight rise in recourse to the marginal lending facility, which focused on the end of the reserve maintenance periods. The deposit facility was hardly utilised at all.

Monetary growth picked up somewhat in the third quarter

The growth of the money stock M3 accelerated a bit in the third quarter, after having slowed down distinctly in the second. In July and in August, money holdings rose sharply, apparently helped along by enterprises building up their liquidity in connection with the auction of UMTS licences in Germany. In September, when the Federal Government used the accruing funds to redeem debt and to enlarge bank balances which do not count towards the money stock, such holdings rose only weakly. At the end of September, M3 in the entire euro area surpassed its level of a year before by 5.5 %, compared with 5.4 % at the end of June. The three-month moving average of annual growth rates was 5.4 % between July and September; this meant that monetary growth was still roughly one percentage point above the reference value of 4 ½ %, compared with two percentage points in March-April of this year. Over the course of the past six months, however, the money stock M3 has risen perceptibly more slowly, at a seasonally adjusted annual rate of 3 ½ %.

Among the individual components of the money stock M3, cash and sight deposits



Factors determining bank liquidity *

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

Item	2000		
	Aug. 24 to Sep. 23	Sep. 24 to Oct. 23	Aug. 24 to Oct. 23
I. Provision (+) or absorption (-) of central bank balances by			
1. Change in banknotes in circulation (increase: -)	+ 4.4	+ 0.3	+ 4.7
2. Change in government de- posits with the Eurosystem	- 7.8	+ 9.2	+ 1.4
3. Change in net foreign exchange reserves ¹	- 0.4	+ 14.7	+ 14.3
4. Other factors ²	- 1.2	- 21.3	- 22.5
Total	- 5.0	+ 2.9	- 2.1
II. Monetary policy operations of the Eurosystem			
1. Open market operations			
a) Main refinancing operations	+ 10.0	+ 3.4	+ 13.4
b) Longer-term refinan- cing operations	- 4.3	- 5.4	- 9.7
c) Other operations	-	-	-
2. Standing facilities			
a) Marginal lending facility	+ 0.2	+ 0.2	+ 0.4
b) Deposit facility (increase: -)	+ 0.1	- 0.0	+ 0.1
Total	+ 6.0	- 1.8	+ 4.2
III. Change in credit institutions' current accounts (I. + II.)	+ 0.9	+ 1.1	+ 2.0
IV. Change in the minimum reserve requirement (increase: -)	- 0.8	- 1.0	- 1.8
Memo items ³			
Main refinancing operations	173.1	176.5	176.5
Longer-term refinancing operations	51.1	45.7	45.7
Other operations	-	-	-
Marginal lending facility	0.3	0.5	0.5
Deposit facility	0.2	0.2	0.2

* 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 initiated in Stage Two and outstanding at the beginning of Stage Three (outright transactions and the issuance of debt certificates). — ³ Levels as an average of the maintenance period under review or the last maintenance period.

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were replenished again, seasonally adjusted, in the third quarter, after having been slightly reduced in the second. At the end of September the money stock M1 was 6.6% higher than a year before; at the end of March that rate had been as high as 10.0%. Deposits with an agreed maturity of up to two years went up sharply in the third quarter. They benefited in particular from the further rise in shorter-term interest rates and the flattening of the yield curve. Marketable financial instruments likewise recorded heavier sales in the third quarter than in the second, after adjustment for seasonal variations. Especially money market paper and money market fund certificates were in demand again. By contrast, the reduction in deposits with an agreed maturity of up to three months continued unabated in the quarter under review.

As for quite a long time past, in the third quarter monetary growth was mainly fuelled by persistently strong lending to the private sector. At the end of September, MFIs' lending to households and enterprises was 10.8% up on the year, compared with 9.9% at the end of June. Securitised lending as well as loans to the private sector grew more strongly. Loans, seasonally adjusted, rose between July and September at an annual rate of just under 10 ½%, compared with 8 ½% in the months between April and June. This seems to have owed something to the credit-financed raising of funds for purchases of UMTS licences. By contrast, lending to the public sector in the euro area was distinctly reduced in the third quarter; this applied not only to securitised lending, but also to loans. In some cases, UTMS sales proceeds were

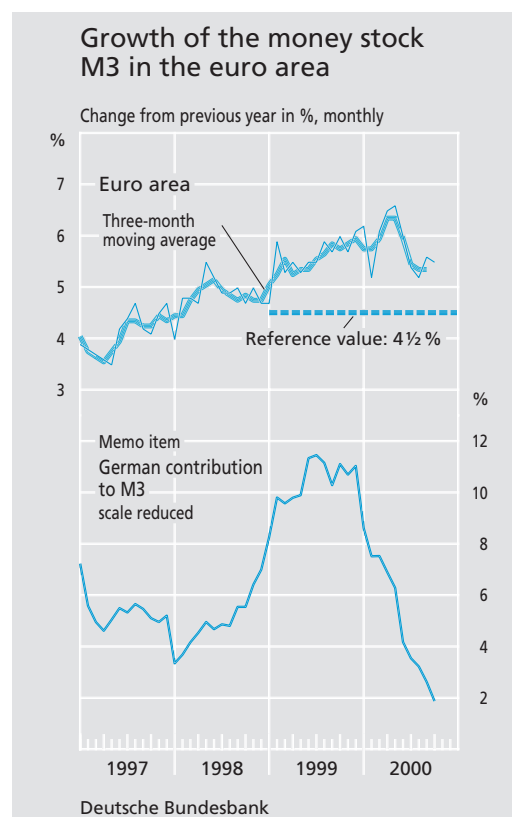
*Components of
the money
stock M3*

*Balance-sheet
counterparts*

probably used to that end. However, since the bulk of UTMS proceeds has been earmarked for the repayment of equalisation claims at the beginning of 2001, such proceeds were for the most part lodged temporarily in the money market. An associated – and monetary-growth-dampening – increase in the Federal Government’s deposits with MFIs in the euro area was accompanied, however, by almost equally large withdrawals of deposits by other euro-area central governments. The relatively sharp expansion of monetary capital formation had a noticeably moderating effect on the expansion of the monetary aggregates. At end-September they were 7.3 % up on the year. Outflows of funds totalling € 35.3 billion in resident non-MFIs’ payments with non-euro-area countries had a similar effect; in the same period of last year, they were much lower, at € 13.2 billion.

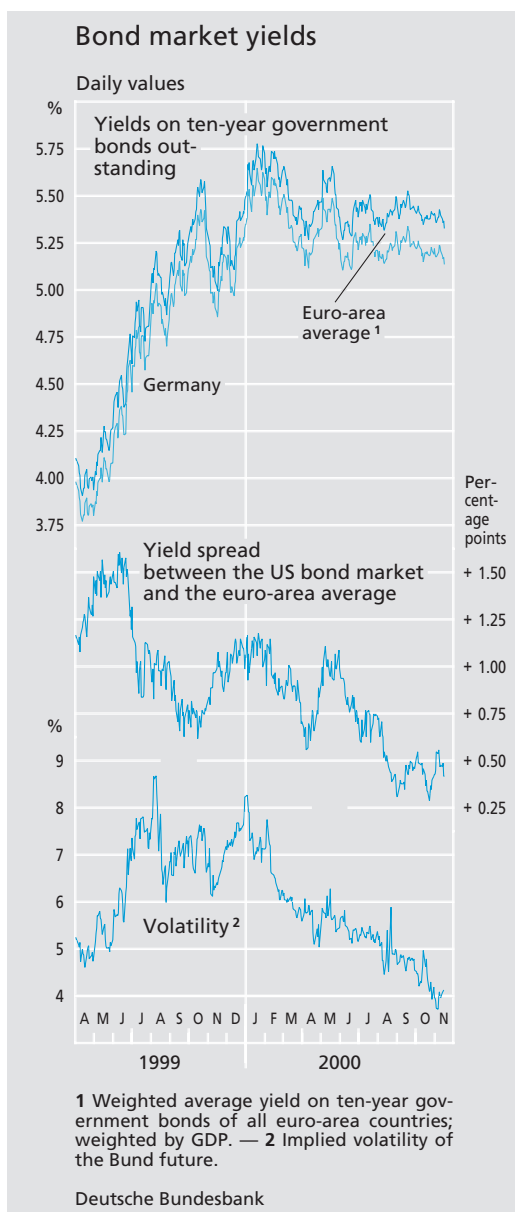
Germany’s contribution

The German contribution to the money stock M3 in the euro area, having gone down in the second quarter, rose slightly, after seasonal adjustment, during the period under review. At the end of September it exceeded its September 1999 level by 1.9%. Since, according to the figures of the balance of payments statistics, investors outside the euro area purchased German money market paper again in the third quarter, in all likelihood that rate overstates the liquidity expansion.¹ In the past few months, not only interest-rate increases but also heavy outflows of funds abroad, which most likely owe much to large purchases of foreign securities by residents, have contributed to the sluggish pace of monetary growth in Germany. Unlike at the euro-area level, the auctioning-off of UTMS



licences in Germany probably did not have a major impact on the development of the German contribution to M3. The funds to finance the purchases of UTMS licences were mostly raised abroad, and only to a very limited extent in Germany, with the result that in August the German contribution was hardly distorted upwards. In September the Federal Government did reduce its borrowing from German credit institutions. Moreover, it perceptibly enlarged its deposits in the German MFI sector, which do not count towards the money stock M3. At the same time, in that month a considerable volume of funds

¹ Since the outstanding amount of such paper is reported exclusive of the holdings of domestic MFIs 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 to entities residing outside the euro area go into the monetary aggregate M3.



flowed in from abroad on balance (particularly from other euro-area countries), in connection with the purchase of UMTS licences. Furthermore, lending by domestic MFIs to the private sector in the euro area increased. Overall, the upshot was major fluctuations in the balance-sheet counterparts, rather than in the German contribution to M3.

Long-term capital market rates in the euro area have hardly changed over the last few months. When this Report went to press in mid-November, the average yield on ten-year government bonds in the euro-area countries, at just over 5½%, had returned to the level of mid-August 2000, following a slight temporary increase in September. The consistently low level of capital market rates suggest that the Eurosystem has succeeded in stabilising the long-term inflation expectations of market players at a low level, despite rising consumer prices. Following the interest-rate moves at the beginning of September and October, the gap between capital market rates and money market rates has continued to narrow. The interest-rate differential was halved between July and October and, in November, was around 30 bp. Uncertainty about future interest-rate movements on the capital market has also continued to diminish. For instance, the implied volatility of the Bund future, which measures the scale of the price fluctuations expected by market players in the futures market in the short run, decreased again up to mid-November.

Capital market rates moving sideways

In the long-term segment, the US yield spread is continuing to dwindle. Both the yields on ten-year US government bonds outstanding and the fixed rates on ten-year interest-rate swaps² fell between early August and mid-November, by one-quarter and one-third of a percentage point, respectively. The yield spread between the US and the euro area

US yield spread narrows further

² In interest-rate swaps, the parties to the contract exchange future interest rate payments, i.e. fixed coupons against variable interest rates pegged to a money market rate.

with respect to swaps thus narrowed from 1 1/3 percentage points to just over 1 percentage point. The yield spread between ten-year US Treasury bonds and comparable paper from euro-area countries decreased to less than 1/2 percentage point. The reasons for the drop in US interest rates included expectations of further buy-backs of bonds in connection with the upward revision in July of estimates of future budget surpluses and the calming of interest-rate movements in the markets following the FOMC meeting at the end of August. Altogether, however, the decline in long-term interest rates in the United States was mainly driven by heightened expectations of the US economy having a "soft landing", which many market players regarded as an essential prerequisite for containing price pressures.

In the euro-area stock markets, following mostly sideways movements in the summer

months, September saw a downward movement. In terms of the Dow Jones Euro STOXX broad index, European equity price quotations in mid-November were 14 % below their peak in March. That caused European share-price levels to fall slightly below their end-1999 level. This pattern, however, masks strongly diverging sectoral share-price trends. Whereas the prices of the shares of traditional business sectors tended to move sideways until August, with few fluctuations, and have dropped comparatively little since September, the fall in European high-tech equity prices persisted throughout the third quarter, in parallel to the US tech-heavy NASDAQ. These mostly highly volatile stocks from the sectors of technology, media and communications have forfeited 47 % of their value since peaking in the spring, thus running at some 27 % below their level at the end of 1999.

*Downward
trend in the
European stock
markets*