Highlights of Recent Trends in Financial Markets

I. Overview

Financial markets continue to reflect a positive outlook…

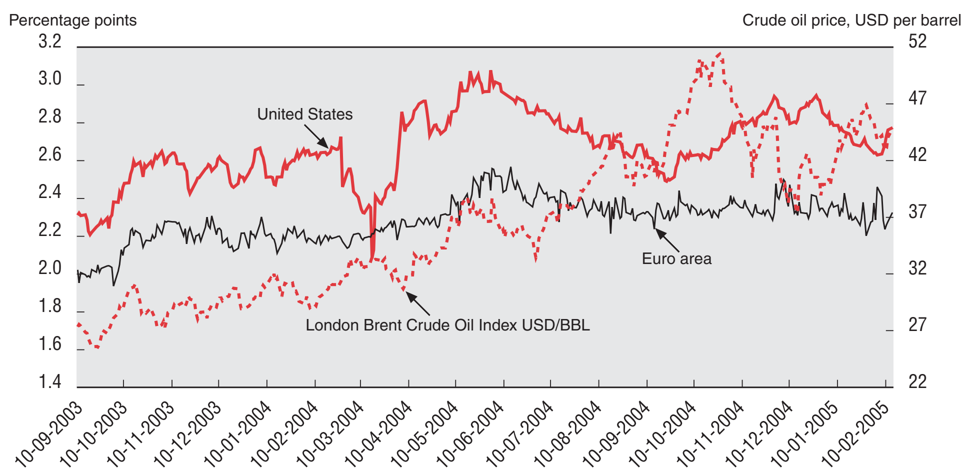
Over the past few months, major equity markets generally have continued their upward trend, while interest rates at the long end of the maturity spectrum have declined. Meanwhile, credit spreads for both investment grade and sub-investment grade borrowers continue to be compressed and volatility appears to have diminished in most market segments.

… as some of the downside risks have dissipated…

OECD economic growth was relatively strong on the whole in 2004 and, despite geopolitical uncertainty and volatility in commodities (especially oil), only a moderate slowing is projected for this year, although this broadly positive outlook masks regional differences. Some of the downside risks which had previously clouded the outlook have not materialised. Increases in oil prices had been a major concern of investors during the first half of last year, and the US dollar's decline was closely watched over the second half. Recently, the dollar has strengthened again, and oil prices have come down since their highs in October 2004. Even though rather volatile, they have since remained below these record levels. Furthermore, while first-round effects have been absent or benign (Figure 1), central banks have issued notes of caution about possibly more pronounced second round effects, and these not only fed into investors' expectations of sooner-than-expected increases in policy rates and slower growth, but also enhanced their confidence that inflation will be contained.

© OECD 2005

Figure 1. **Implied inflation expectations and crude oil price**



Note: Daily data until 14 February 2005. Implied inflation expectations ("breakeven inflation") are differences in yields between 10-year government benchmark bonds and inflation indexed bonds (Merrill Lynch government inflation-linked bond indices).
Source: Thomson Financial Datastream.

… and the outlook remains positive also for emerging markets.

In emerging market economies, the macroeconomic situation remains generally positive and most of these countries continue to enjoy very favourable access to financial markets, as reflected in the narrow spreads on emerging market bonds. Among the major regions of emerging economies, Latin American stock markets were the best performers. At the end of December, a number of Asian countries were hit by a tsunami, which caused major human losses and had disastrous effects on some of their shore infrastructures. Thus far, however, this disaster has not had a major impact on the economic outlook of the countries concerned. Elsewhere, China's economy continues at a brisk rate of growth, although recent policy measures have begun to moderate the pace.

© OECD 2005

II. Equity markets

Equity markets have overcome previous soft spots, underpinned by a positive outlook.

Over the past few months, major equity markets have more than recuperated losses suffered during the first half of 2004, making that year an overall positive one for investors (Figure 2). Meanwhile, volatility, as implied in options prices (implied volatility) and in terms of share price variations (historical volatility), has remained low or, as in the euro area, declined further over the past few months (Figure 3). Price-earnings ratios of broad market indices are still below their long-run averages (1990 to date) in all major economies (Table 1), and are in many cases in line with "pre-stock market bubble" averages (from 1990-94). The uptrend in equity prices reflects in part some easing in geopolitical uncertainties, favourable news regarding growth in major economies and an improved outlook for corporate earnings, as well as declines in oil prices from their record highs.

Overall performance in 2004 has been remarkable ,...

Even though performance of broad equity indices was less strong than in 2003 (when recovery from the post-2000 downturn set in briskly in the second quarter), last year's increase was nonetheless quite strong by historical standards. In 2004, broad market indices returned over 12 per cent in the United States, around 10 per cent in the euro area, and more than 7 per cent in Japan. The performance of the broad equity market in the United Kingdom, which grew eight per cent in 2004, was only slightly below the gains recorded in the two biggest euro area countries, Germany and France, where broad markets expanded slightly above that pace. Markets in Italy performed even better, growing almost 15 per cent in 2004, and performance was particularly strong in some smaller euro area countries, such as Belgium and Austria, where equity markets recorded price increases of more than 36 and 46 per cent, respectively.

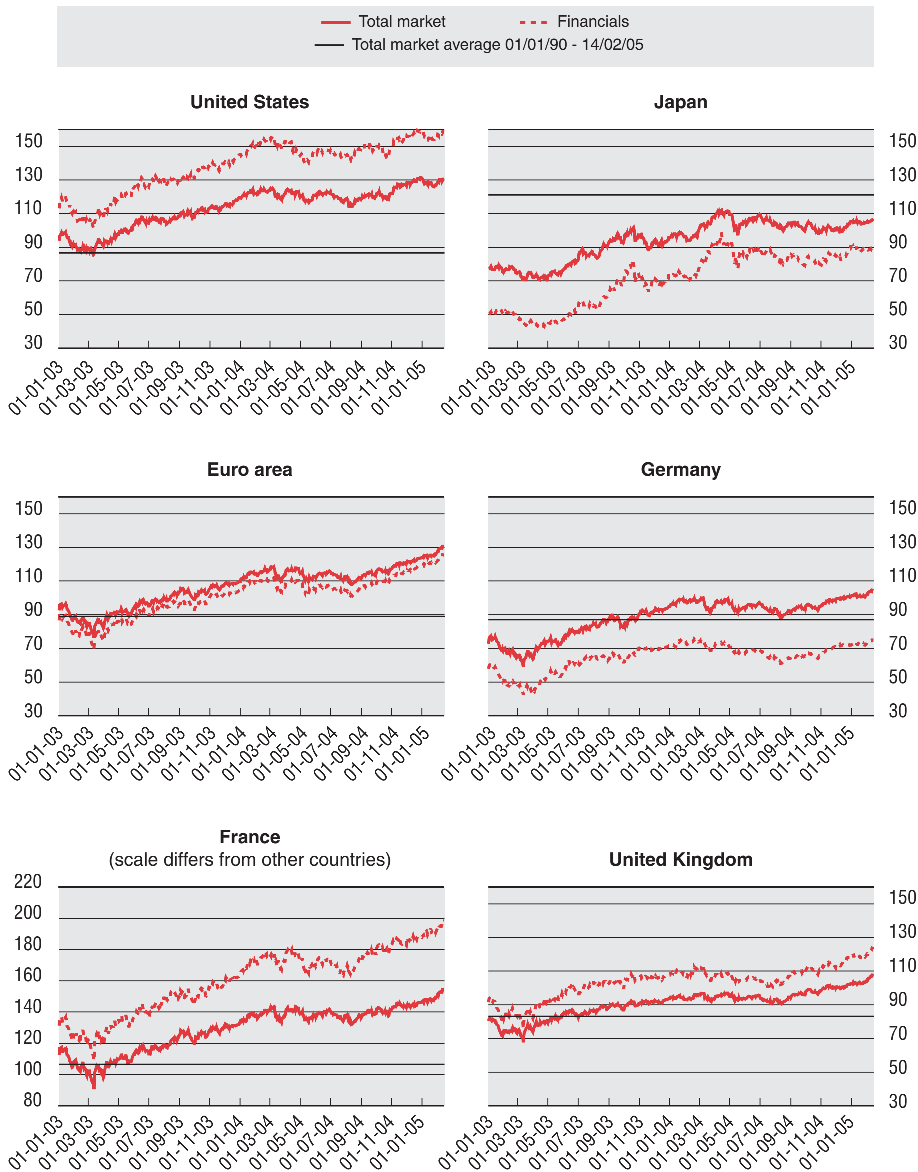
... mainly owing to solid increases over the past months.

Most of the past year's improvement in equity markets was concentrated in the latter months of the year. For example, in the United States and the euro area, broad equity indices rose at annual rates of more than 26 and 29 per cent, respectively, over the months from October until January, and at roughly half that rate in Japan, the United Kingdom

© OECD 2005

Figure 2. **Major stock markets**

Total market and financial sector equity price indices, 1 Jan. 1998 = 100

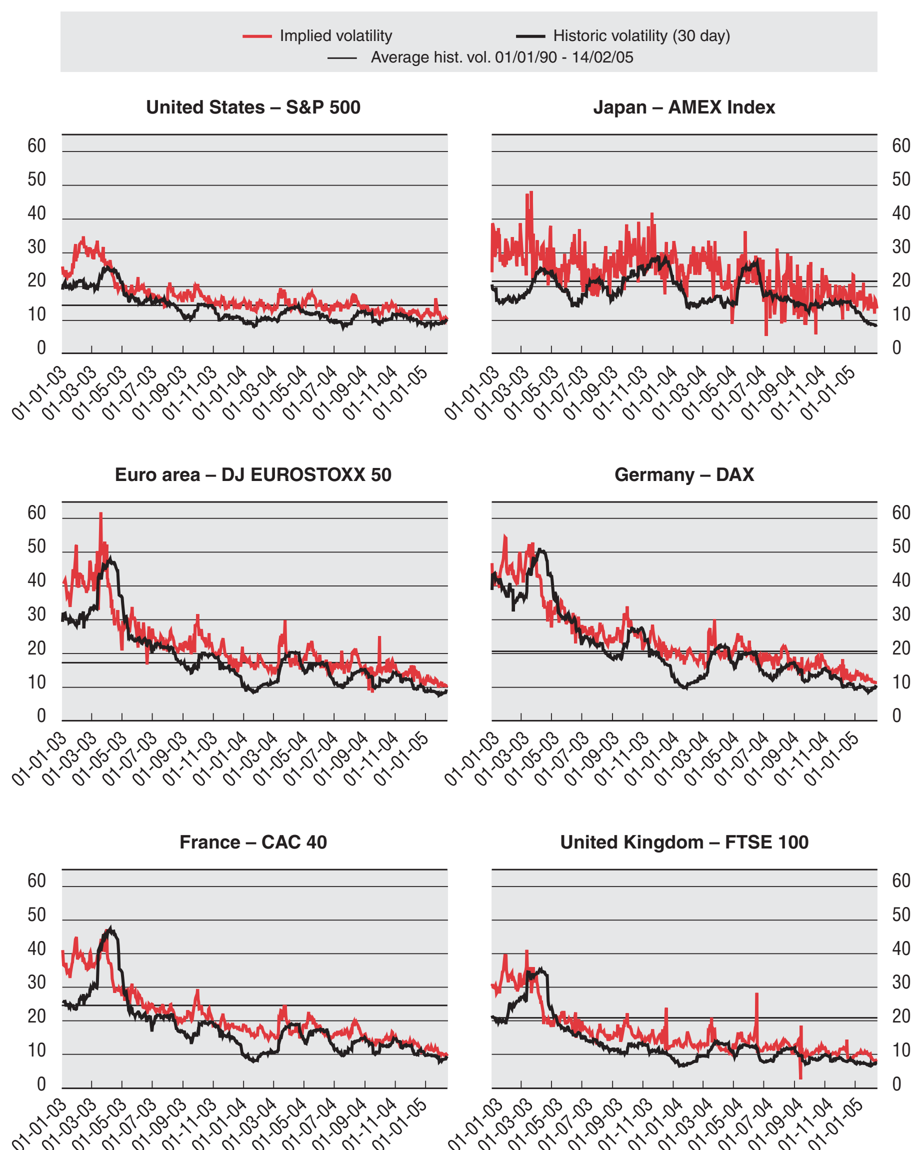


Note: Datastream indices. Daily data until 14 February 2005.

Source: Thomson Financial Datastream.

© OECD 2005

Figure 3. **Stock markets: implied and historic volatilities**



Note: Daily data until 14 February 2005. Historic volatilities are monthly volatilities calculated from daily data. Implied volatility can be interpreted as market expectation of risk (future volatility) and is derived from at-the-money call option prices (interpolated) using the Black-Scholes formula. The Cox-Rubinstein binomial method is used for American style options.

Source: Thomson Financial Datastream.

© OECD 2005

Table 1. **Overall and sectoral stock market performance in major economies**

	United States	Japan	Euro area	Germany	France	Italy	United Kingdom	Canada
	Broad stock market indices							
	WILSHIRE 5000	NIKKEI 225	DJ EURO STOXX	DAX 30	CAC 40	MILAN MIBTEL	FTSE 100	S&P/TSX COMP.
Ann. ret. Dec. 03-Dec. 04	12.3%	7.4%	10.5%	8.8%	8.7%	14.5%	8.0%	13.5%
Ann. ret. Oct. 04-Jan. 05	26.4%	13.8%	29.5%	30.7%	18.2%	48.6%	16.0%	14.0%
P/E Jan. 05[b]	19.9	27.3	14.2	12.1	13.3	16.9	15.1	17.7
P/E avg. Jan.90-Jan. 05[b]	21.5	51.1	16.5	17.7	15.2	19.4	17.5	19.2
P/E avg. 90-94[b]	17.6	48.7	14.2	17.4	12.5	17.8	15.4	19.2
	Telecom, Media, IT[a]							
Ann. ret. Dec. 03-Dec. 04	4.6%	–2.5%	7.7%	6.9%	2.9%	16.6%	3.6%	9.3%
Ann. ret. Oct. 04-Jan. 05	18.8%	5.9%	37.0%	12.9%	39.2%	92.7%	24.9%	12.0%
P/E Jan. 05	28.7	30.6	18.9	15.7	16.2	20.3	16.7	26.6
P/E avg. Jan.90-Jan. 05	29.5	66.6	22.2	33.8	19.8	21.2	25.2	29.0
P/E avg. 90-94	21.2	49.7	14.3	28.6	13.0	13.6	14.8	27.1
	Financials[a]							
Ann. ret. Dec. 03-Dec. 04	11.1%	23.2%	13.8%	2.2%	16.0%	8.9%	9.0%	16.8%
Ann. ret. Oct. 04-Jan. 05	22.9%	40.5%	42.3%	47.2%	23.5%	43.5%	30.1%	13.5%
P/E Jan. 05	14.9	23.3	13.3	10.3	12.6	16.7	13.5	14.9
P/E avg. Jan.90-Jan. 05	15.5	67.2	16.2	20.6	12.3	21.0	17.1	13.4
P/E avg. 90-94	12.5	61.1	14.8	22.1	11.2	18.6	18.4	12.7
	of which: *Banks*[a]							
Ann. ret. Dec. 03-Dec. 04	8.7%	26.8%	15.3%	3.8%	14.4%	5.7%	5.6%	12.1%
Ann. ret. Oct. 04-Jan. 05	13.0%	54.6%	41.5%	47.0%	17.9%	38.9%	18.0%	7.3%
P/E Jan. 05	14.9	22.1	13.4	11.9	11.0	15.2	11.8	13.6
P/E avg. Jan.90-Jan. 05	14.3	104.5	13.3	13.8	10.7	16.3	14.5	12.7
P/E avg. 90-94	11.3	64.4	10.6	13.4	9.5	11.0	14.5	12.5
	Insurance companies[a]							
Ann. ret. Dec. 03-Dec. 04	6.8%	12.9%	10.0%	–2.4%	12.2%	17.9%	–4.7%	18.2%
Ann. ret. Oct. 04-Jan. 05	26.7%	14.1%	42.4%	52.1%	37.5%	37.8%	27.1%	65.5%
P/E Jan. 05	15.0	21.8	10.4	7.6	14.4	17.9	12.5	18.1
P/E avg. Jan.90-Jan. 05	18.8	47.7	22.1	35.3	13.7	31.0	25.1	13.5
P/E avg. 90-94	13.9	49.3	24.7	47.7	11.4	33.6	29.2	12.2
	of which: *Life insurance companies*[a]							
Ann. ret. Dec. 03-Dec. 04	19.8%	43.4%	3.3%	25.6%	35.9%	1.1%	18.9%	24.9%
Ann. ret. Oct. 04-Jan. 05	39.0%	5.1%	50.3%	22.2%	11.0%	47.9%	54.9%	12.6%
	Non-life insurance companies[a]							
Ann. ret. Dec. 03-Dec. 04	12.6%	12.9%	12.2%	–10.1%	. .	25.6%	0.0%	27.3%
Ann. ret. Oct. 04-Jan. 05	36.7%	14.1%	46.0%	0.5%	. .	52.0%	44.1%	74.2%

© OECD 2005

Table 1. **Overall and sectoral stock market performance in major economies** (*cont.*)

	United States	Japan	Euro area	Germany	France	Italy	United Kingdom	Canada
	Reinsurance companies[a]							
Ann. ret. Dec. 03-Dec. 04	–0.4%	. .	–2.7%	–3.1%	4.2%	. .	–20.1%	. .
Ann. ret. Oct. 04-Jan. 05	25.4%	. .	76.0%	75.1%	98.4%	. .	–25.3%	. .

Note: Calculations based on monthly averages. Annualised returns ("Ann. ret.") are annualised percentage changes of the indices over the period indicated. Earnings per share, the denominators of the price-earnings ratios, are based on the latest annualised rate reflecting the last financial year or derived from an aggregation of interim period earnings. For France, the current earnings per share are a forecast provided by local sources. For the United Kingdom, the earnings are calculated by a rolling 12 months method of analysis based on interim, final and annual accounts.
a) Datastream indices.
b) From Datastream Total Market Indices.
Source: Thomson Financial Datastream.

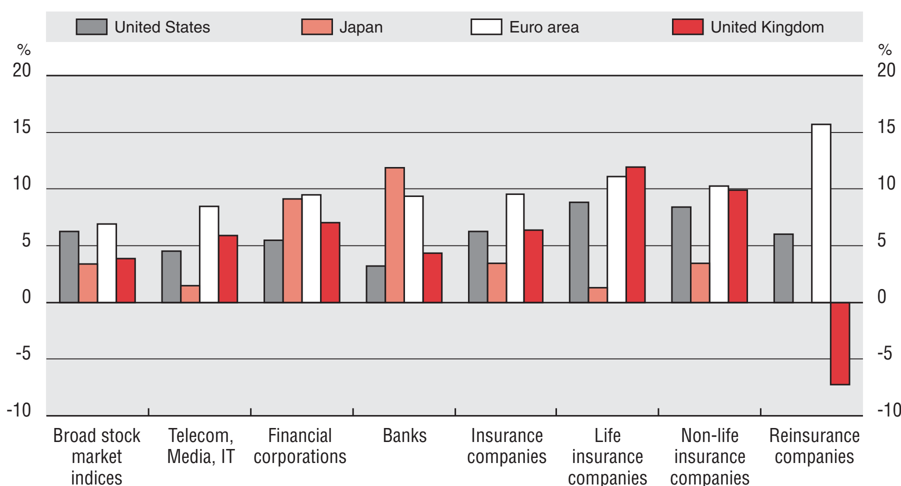
and Canada (Table 1). In the United States, gains in equity prices have been underpinned by positive earnings surprises, as most of the firms in the S&P 500 index announced fourth-quarter earnings higher than forecast. In the euro area, recent economic news (among those, increases in business and consumer confidence in Germany) has also supported the upward trend in stock markets.

Technology sectors performed under par in many economies, ...

Looking at sectoral indices in major economies, some of the differences in and main drivers of stock market growth become apparent. The Telecom, Media and IT sectors (TMT) have picked up strongly in recent months, and in some cases have regained some of the ground lost early in the year (Table 1 and Figure 4). Performance of the sector was particularly weak in the United States and in Japan. In the former, the increase in the TMT index in the past year was less than half that of the broad market index, while in Japan the index fell 2.5 per cent from end of 2003 to end of 2004 (December averages). In the euro area and Canada, the TMT sectors fared better, but their gains of 7.7 and 9.3 per cent respectively were still below the overall market averages in 2004 (10.5 and 13.5 per cent). In Italy, by contrast, growth in the TMT index was not only above that of TMT indices in other G-7 economies, but was also stronger than the overall equity market growth in Italy and elsewhere.

© OECD 2005

Figure 4. **Recent sectoral stock market performance in major economies**
Percentage changes from October 2004 until January 2005



Note: Calculations based on monthly averages. Indices as specified in Table 1.
Source: Thomson Financial Datastream.

... but financial sectors did better, owing to banking sector performance in particular in Japan...

The financial sectors performed generally well in all major equity markets. Over the past three months (October until January) and for the past year as a whole (December 2003 to December 2004), financial sector indices in Japan, the euro area, the United Kingdom and Canada increased more than the respective broad market indices. The performance was particularly remarkable in Japan, where the financial sector sub-index showed an annualised return above 40 per cent from October until January, and more than 20 per cent over 2004 as a whole. This strong growth owed mainly to the developments in the banking sector. The Japanese banking sector index grew over 50 per cent on an annualised basis from October until January, and more the 25 per cent for 2004 as a whole. This certainly reflects the improvement in the health of the Japanese banking system, which has reduced its exposure to non-performing loans.

... as well as in the euro area, but less so in the United States.

Banks also performed strongly in the euro area, with the banking sector index outpacing broad market indices over the past three months (October until January) and for 2004 as a whole. The improvement in the euro area banking sector

© OECD 2005

index was underpinned by strong growth of the banking index in France over the whole period of observation, and for the more recent period, in Germany and Italy. In Germany, recent profit reports of some major banks have boosted this index, with an increase of almost 50 per cent on an annualised basis over the past few months, compared with growth of less than four per cent during 2004 as a whole. In the United States, banking sector indices grew well below broad stock market indices as well as the broad financial sector index.

Also the insurance sector performed strongly, remarkably so in Canada…

The relative contribution of the insurance sector to the broad financial sector indices differed across the major markets. Looking across some major markets, over the past few months (October until January) the insurance sector index grew strongest in Canada, with annualised growth of over 65 per cent during that period, which was far above the growth of insurance indices of its G7 peers, and far above Canada's broad stock market growth (14 per cent annualised from October until January). In the United States and Japan, the insurance indices expanded at about the same pace as the respective broad market indices in that period (October until January).

… as well as in the euro area, with a strong performance of the reinsurance sector in Germany and France,…

The performance of the insurance sector index during that period was also strong in the euro area, with growth above that of the broad market. In Germany, where the non-life insurance index performed badly during the past few months (and fell 10 per cent over the whole year 2004), the insurance sector's generally good performance in the period from October to January owed a lot to the strong growth in the reinsurance subsector (75 per cent annualised in that period). Some positive signs of the sector's performance in Germany are coming from the fact that many insurance companies (as well as other financial groups) have begun to sell off shareholdings that have burdened their balance sheets. In France, the reinsurance sector outperformed the respective indices of other major economies over the past few months, growing at an almost 100 per cent annualised rate from October until January.

© OECD 2005

... but the UK reinsurance sector dropped.

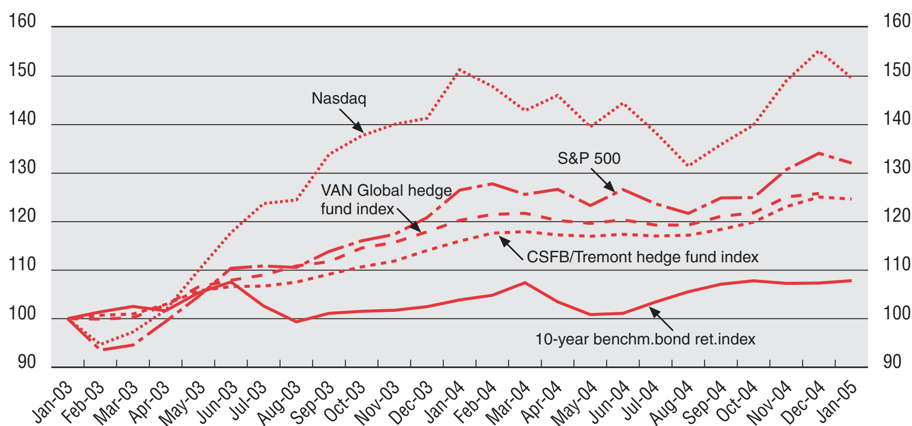
In the United Kingdom, the almost five per cent drop of the insurance sector in the course of 2004 was mainly related to the sharp fall in the reinsurance index of more than 20 per cent. More recently, the sector as a whole recovered and grew above market, at an annualised rate of more than 27 per cent from October until January. Also the UK reinsurance sub-index strengthened again in January, even though it is still far from reaching its levels of a year ago.

Hedge funds continue to be attractive investment alternatives.

With traditional stock markets rebounding, the hedge fund sector was outperformed by traditional stock market investments in 2003 and 2004 (Figure 5). For example, the S&P 500 index grew over 20 and eleven per cent in 2003 and 2004, respectively, while the Van Hedge fund index returned around 18 and seven per cent in the respective periods. But hedge funds outperformed US benchmark bonds, and the sector realised large inflows for the year, including increased allocations by institutional investors.[1] In the United States, for example, while 23 per cent of institutional investors used hedge funds in 2003, preliminary data

Figure 5. **Relative Hedge Fund Performance**

Return indices, Jan 2003 = 100



Source: Credit Suisse First Boston/Tremont Index LLC; Van Hedge Fund Advisors International, LLC; Thomson Financial Datastream.

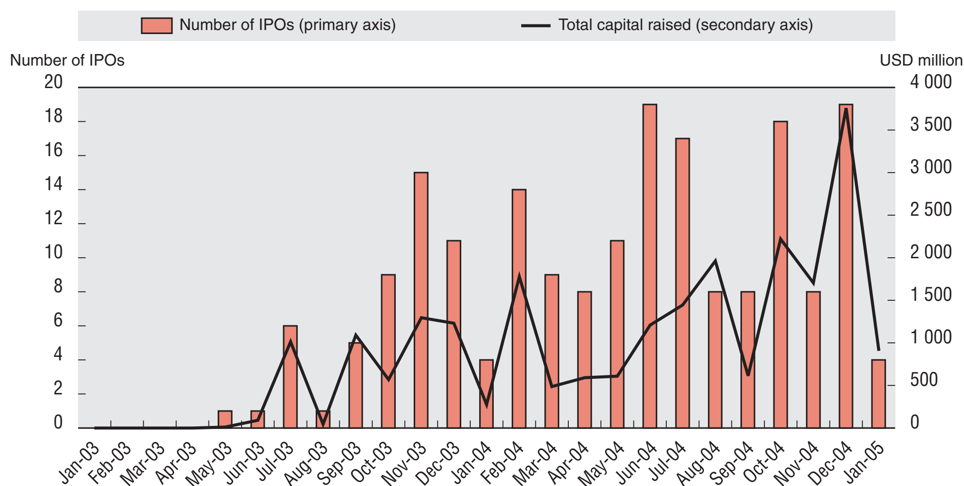
© OECD 2005

for 2004 suggest that usage has reached 28 per cent. In Japan, comparable figures for 2004 reached 40 per cent, more than double the 18 per cent share recorded in 2003. Among European institutions, the proportion using hedge funds rose from 23 per cent in 2003 to 32 per cent last year. In terms of current strategies, hedge funds are now playing a dominant role in trading distressed debt of US companies, and hedge funds also are accounting for a third of all trading in futures, junk bonds and credit derivatives.

A positive market sentiment has been reflected in IPO and M&A increases …

The overall positive equity market sentiment has been reflected in increases in the number of initial public offerings (IPOs). In the United States, where IPO activity had come to a standstill in the first quarter of 2003, the number of IPOs increased steadily over the last year, with the value of capital raised at a record of just under 4 billion USD in December (Figure 6). As well, mergers and acquisitions (M&As) rebounded in 2004, with the highest value of M&As worldwide since the equity market downturn in 2000, and the wave continued also in January.

Figure 6. **Initial Public Offerings (IPOs) in the United States**



Note: Underwritten Initial Public Offerings (IPOs) for US non-financial firms, excluding leveraged buyouts and spinoffs (as marked by SDC), with an offer price of USD 1 or more.
Source: US Federal Reserve.

© OECD 2005

… as well as in an increase in private equity deals.

At the same time, global private-equity investment (buy-outs and venture capital financing) has been rising from its low of less than 100 billion USD in 2001 to a record level of 300 billion USD in 2004.[2] The lion's share of those deals took place in Europe (150 billion USD), even though the increases had been more spectacular in the United States, where deals about doubled from 2003 to 2004, attaining the range of 100 billion USD. In Europe, the most significant increases in the volume of private equity deals in 2004 took place in United Kingdom, France and Germany, reaching about 45 billion euro in the United Kingdom, and about half that value in France and Germany. In the latter, where deals had been lower than in the other countries, the 2004 volume was more than double the volume in 2003. The value of these deals (27 billion euro) accounted for about 40 per cent of all German M&As in that year.

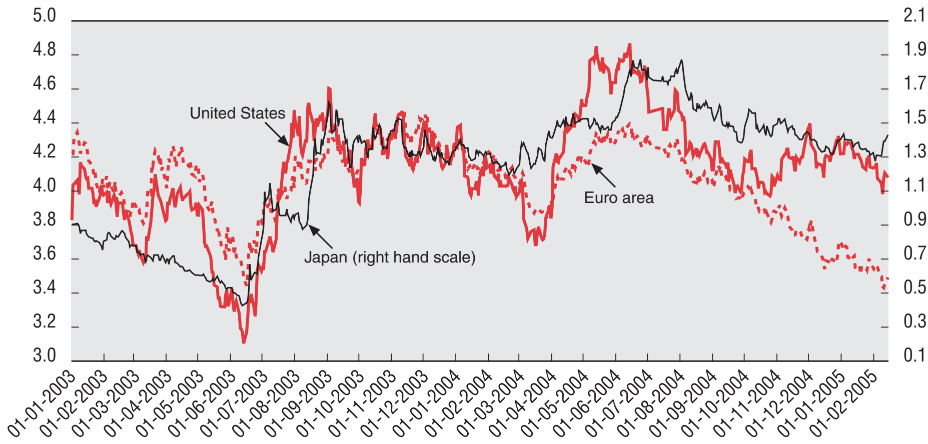
III. Bond markets and interest rates

With diminished growth and inflation expectations, benchmark bond yields have declined…

In fixed-income markets, where fears of oil-price driven inflation may have previously held up yields, rates in most sectors have since declined. In the euro area yields have dropped further to new record lows around 3.5 per cent (Figure 7) and are now about 50 basis points below US yields, partly reflecting growth differentials between the two economies. US yields have not fallen much further below the 4 per cent mark they had reached at the end of September (and again at the end of October), but they have since fluctuated in a range of roughly 4 to 4.4 per cent – more widely than the euro area counterpart. To some extent, the recent drop in bond yields may reflect reduced concerns about longer-term inflationary effects of oil prices. In Japan, some disappointment about growth prospects may have contributed to the recent drop in bond yields, which fell from around 1.9 per cent in early August to around 1.3 per cent more recently. With increases in short term rates, yield curves have become flatter (Figure 8).

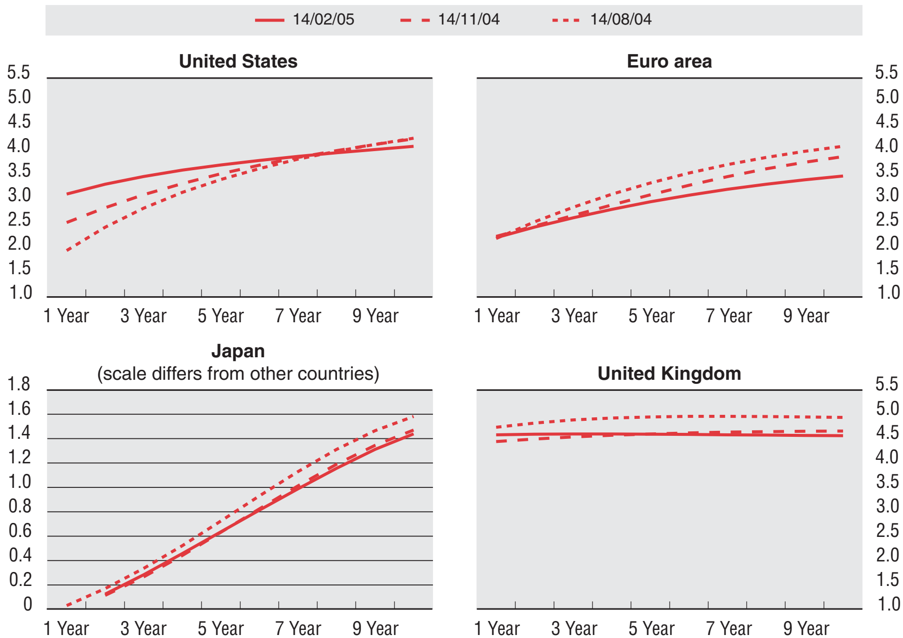
© OECD 2005

Figure 7. **10-year government benchmark bond yields**



Note: Daily data until 14 February 2005.
Source: Thomson Financial Datastream.

Figure 8. **Yield curves**



Note: Monthly averages of daily data.
Source: Thomson Financial Datastream.

© OECD 2005

... also at the very long end, where demand especially from pension funds is becoming more significant...

In some cases, yields have declined despite relatively high issuance. Thirty-year German government bonds' yields, the euro area benchmark, fell to a low of 3.90 per cent early in February. In the United Kingdom, recent movements in bond yields resulted in an inversion at the long end of the yield curve, as thirty-year yields fell to around 4.36 per cent early in February, while 10-year yields dipped more slightly to 4.50 per cent. The inversion of the yield curve in the United Kingdom partly reflects continued strong demand for long maturities, in particular from pension funds. Yields on 30-year Treasury bonds also dropped in the United States. The strong demand for this long-term paper, as market observers noted, was related to speculation that new long-dated paper would be issued to fund the social security reforms planned by the Bush administration.[3] The issuance of that paper had been suspended late in 2001 when the budget was in surplus. In response to investors' requests, the US Treasury had introduced 20-year inflation-protected securities (Tips) in 2004, selling 19 billion USD worth of paper. However, the US Treasury has not been favourable towards the idea of reintroducing the 30-year bond.

... and will have to be matched by supply.

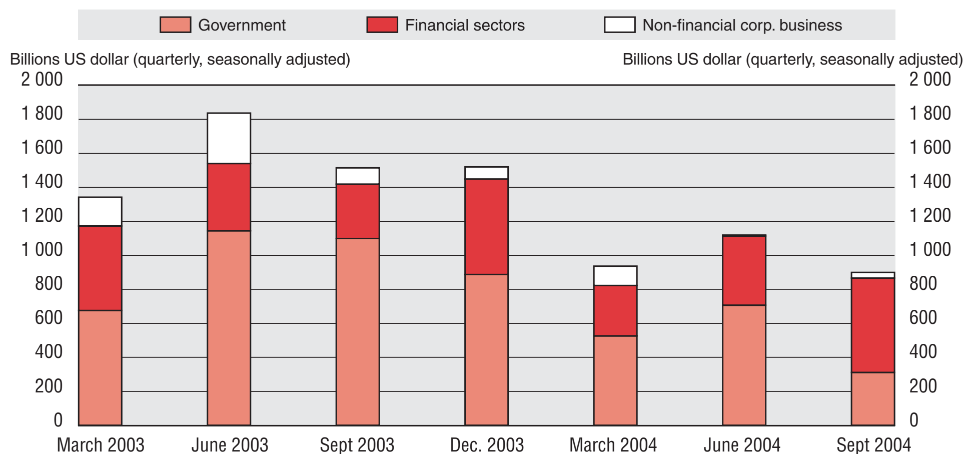
Governments on the other side of the Atlantic, in contrast, seem to be more open to investors' demands for longer maturity paper, in particular to needs of pension funds to match their long-dated liabilities against comparable maturity assets. For example, the French Treasury announced at the end of January that it was considering issuing a new 50-year bond. In the United Kingdom, the UK Debt Management Office is proposing to increase the amount of 30-year debt. In Italy, the success of the 30-year index-linked bonds issued last year is leading the government to increase the size of the issue, and there is general interest for index-linked paper across Europe.

Bond issuance has declined lately in the United States,...

Looking at bond issuance across sectors, the issuance of government bonds in the United States declined in 2004 as compared to the previous year, with a low in the third quarter (most recent available) of 311 billion USD (Figure 9). This decrease in public issuance was partially compensated by issuance of financial corporations, which had a relatively strong third quarter, with a net issuance of 555 billion USD.

© OECD 2005

Figure 9. **Net issuance of US bonds**
In billions of US dollars



Note: Government includes Treasury, Municipal and Agency Securities.
Source: US Federal Reserve Board, Flow of Funds Accounts of the United States.

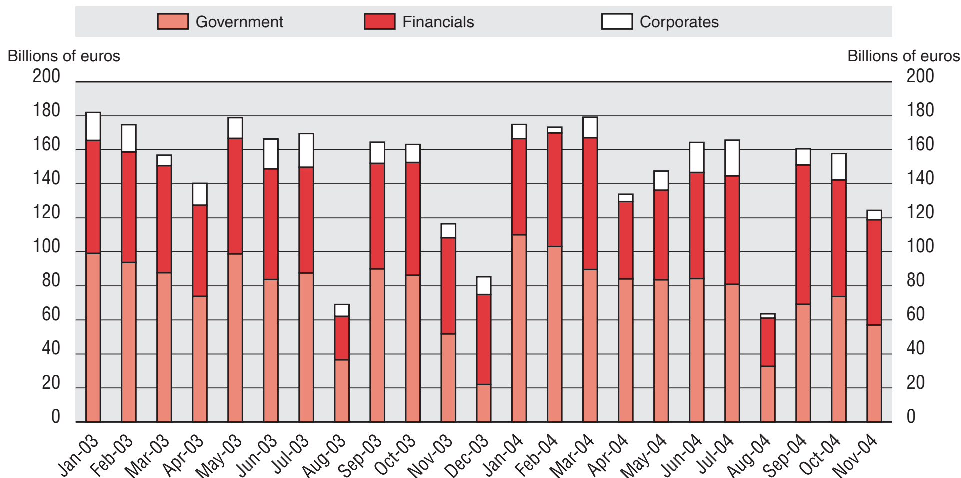
But issuance by non-financial corporations' shrank to almost insignificant levels, at about 5 billion USD in the second quarter and 34 billion in the third quarter.

... but was somewhat stronger in the euro-denominated market.

Issuance of euro-denominated bonds was stronger, although with a slightly declining trend over last year (until November; Figure 10). This trend mainly reflected lower government issuance. Issuance by financial corporations continued at a relatively strong pace, but bond issuance by non-financial corporations has been rather lacklustre. However, it picked up somewhat during the second half of 2004 and its share in total issuance rose to around 10 per cent. Furthermore, while in October the share of triple-A rated issues and floating-rate notes had increased, reflecting developments in the asset-backed securities segment, in November the share of non-rated issues increased, against the backdrop of the reduced share of central government bonds and increased share of Pfandbriefe and covered bonds.

© OECD 2005

Figure 10. **Euro-denominated bond markets: volumes issued by type of issuer**
In billions of euros



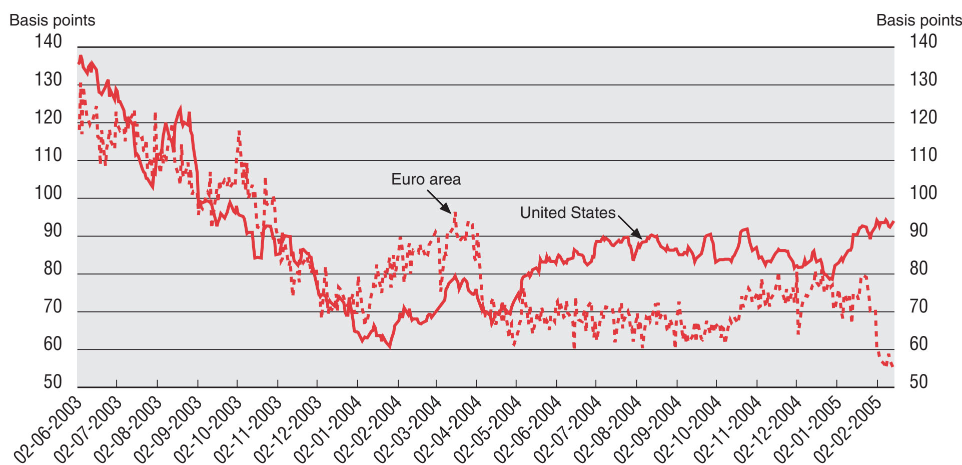
Note: Issues of a maturity of 1 year or more. "Government" comprises bonds of agencies, central governments, municipals, regions, cities, and supra-nationals. "Financial" comprises asset-backed securities, financials' bonds, and Pfandbriefe. The latter includes Pfandbrief-style paper issued in EU-countries, like for instance French Obligations foncières, Spanish Cedulas hipotecarias, etc.
Source: European Commission (DG ECFIN).

Corporate spreads remained low or dropped further…

Given the relatively low issuance of corporate bonds, corporate spreads remained narrow both in the United States and in the euro area (Figure 11). While spreads between BAA and benchmark yields were further compressed in the third quarter for US bonds, spreads generally remain well above their historical lows reached in early 2004. By contrast, spreads in the euro area recently dropped below the historically compressed levels around which they had hovered in the third quarter last year, but this compression was due to a rise in the 5-year benchmark yield rather than a decline in the BAA yield.

© OECD 2005

Figure 11. **Investment-grade corporate bond spreads**



Note: Daily data until 14 February 2005. Aggregate corporate BAA bond yields (Lehman indices) minus government benchmark bond yields. In order to match the respective average maturities of the BAA indices, 10-year benchmark bonds are used for the United States and 5-year benchmark bonds for Europe.
Source: Thomson Financial Datastream.

… but high-yield spreads have recently risen somewhat from their lows.

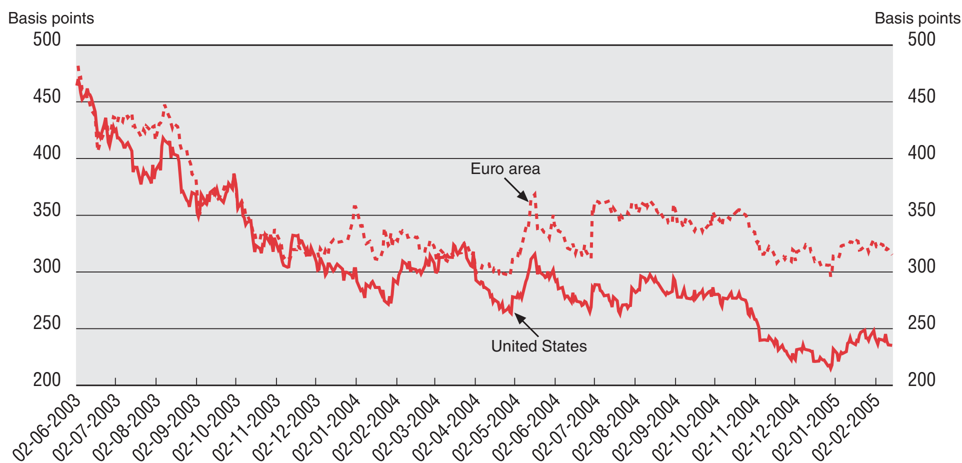
Spreads between high-yield and BAA bonds' yields also remained at low levels, but with slightly different dynamics than investment-grade corporate spreads (Figure 12). In the United States these high yield spreads rose slightly during the first quarter from their January lows to converge with euro area spreads which had remained steady after some volatility at the turn of the year. But US spreads have stayed below euro areas spreads since then. They broadly moved sideways in both economies in the second quarter – albeit on a volatile path – and moved further downwards in the last quarter of 2004. More recently, through January and early February, these spreads rose slightly on both sides of the Atlantic.

Improved credit quality, but also ample liquidity are keeping bond spreads low.

The fact that corporate defaults declined in 2004 and that credit quality improved in general also helps in part to explain why corporate and high yield spreads have remained narrow. Excess liquidity may also play an important role in spread compression, facilitating the "search for yield" and decline in risk aversion. However, there are some signs that liquidity is diminishing, also as monetary policy

© OECD 2005

Figure 12. **High-yield bond spreads**



Note: Daily data until 14 February 2005. Aggregate corporate high-yield bond yields minus aggregate corporate BAA bond yields (Lehman indices).
Source: Thomson Financial Datastream.

actions, in particular by the Fed, have helped to withdraw liquidity. Judged by two measures, excess money and an aggregate overnight rate, there are indications that global liquidity is at high levels but has somewhat declined recently (Figure 13).

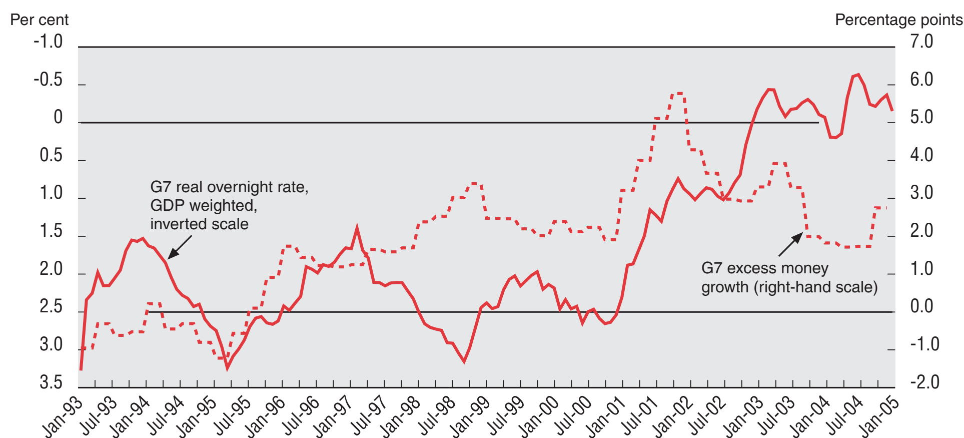
Monetary tightening is underway in the United States.

Further tightening of liquidity conditions are in fact expected by the markets, assessing implied forward interest rates and interest rate futures (Figure 14). So far, the US Federal Reserve has increased the Federal Funds rate target in successive steps since last June, from the historical low of 1 per cent to 2.5 per cent. In line with the decline of the dollar, which eased monetary conditions, markets revised upwards their expectations for short-term rate increases in coming months (Figure 15, panel (a), for June 2005 futures). Expectations at the long end were more volatile (panel (b), also for June 2005 contracts), and apparently changed according to incoming macroeconomic news which had investors reassess the growth and inflation outlook.

© OECD 2005

Figure 13. **Proxies for global liquidity developments**

G7 real overnight rate, GDP weighted, inverted scale, and actual money growth minus potential real GDP growth, in percentage points



Note: The global liquidity indicator based on real interest rate developments follows Borio and White (2004), "Whither monetary and financial stability? The implications of evolving policy regimes", BIS Working Paper No. 147. The measure shows a weighted average of real overnight rates in G7 countries; for France and Germany, the Euro Overnight Index Average (EONIA) is used from 1999 onwards. The weights are based on USD GDP, and real rates are calculated by deducting three-month moving averages of year-on-year CPI changes from nominal overnight rates, including projected CPI changes in cases where most recent data have not yet been available. The other indicator focuses on G7 excess money growth (again as GDP-weighted average). Actual nominal money growth aggregates; potential real GDP growth is corrected for trend velocity growth, *i.e.* it is a residual money growth measure derived from the quantity equation assuming zero inflation. Trend velocity growth is based on average velocity growth 1980-2002 in the respective economies, except for the euro area, where it is based on the mid-value of the range for velocity growth as assumed by the European Central Bank in deriving the quantitative reference value for monetary growth (0.75).

Source: Thomson Financial Datastream; OECD, Main Economic Indicators and Economic Outlook Database; European Central Bank.

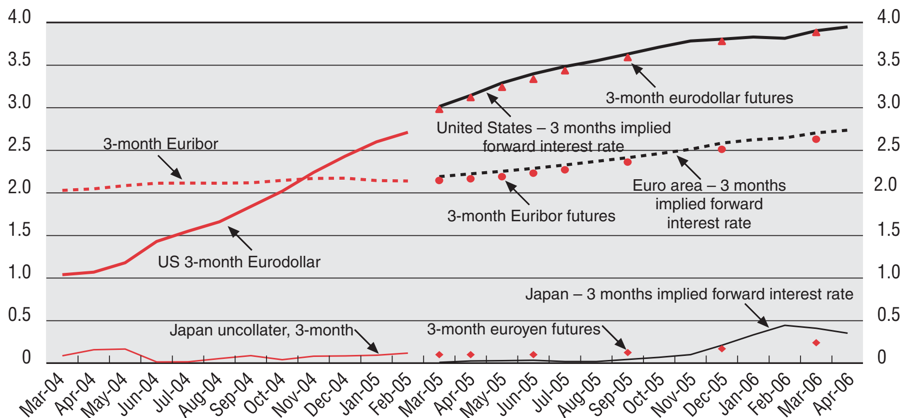
Policy rates have remained unchanged in the euro area.

In the euro area, expectations about long-term interest rates showed a pronounced downward trend, following the slowing growth outlook for the region. So far, the ECB has not raised policy rates as some investors had expected earlier, and left the main refinancing rate at its level of 2 per cent, unchanged since 6 June 2003. With the rise of the euro against the dollar and therefore tightening monetary conditions in the euro area, investors have further postponed expectations of interest rate increases. Currently, markets do not expect short-term interest rates increases during the first half of the year.

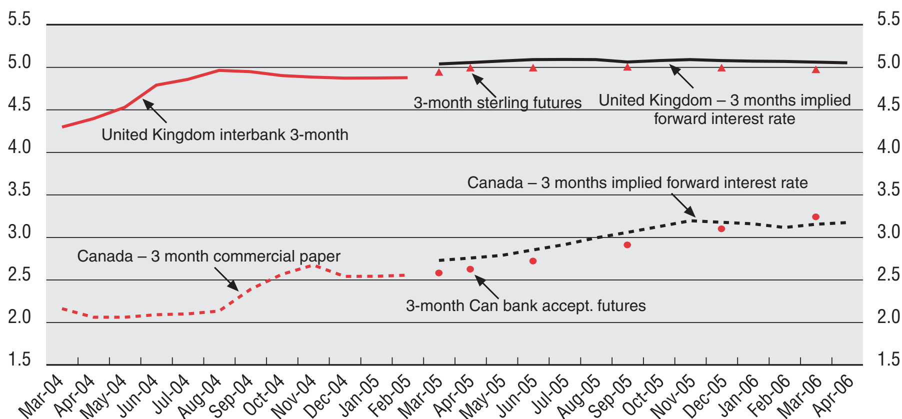
© OECD 2005

Figure 14. **Implied forward and futures short-term interest rates**

(a) United States, euro area and Japan



(b) United Kingdom and Canada



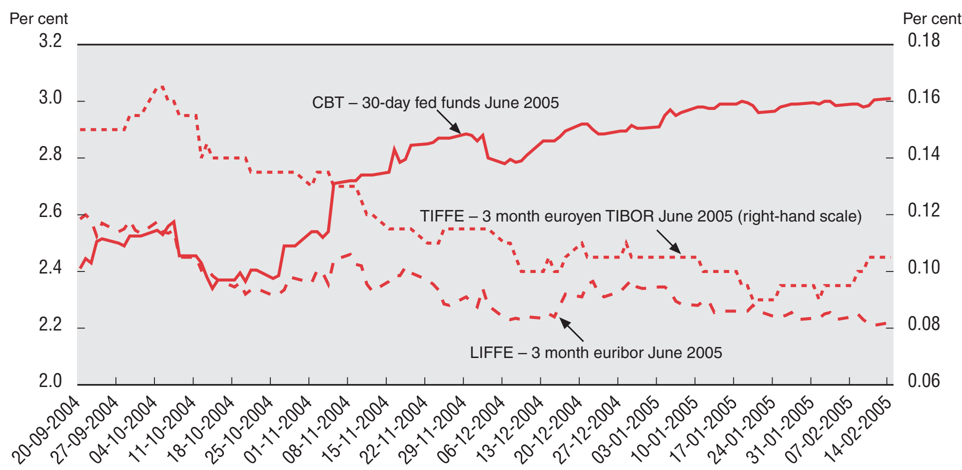
Note: Data as of 15 February 2005. Actual rates: United States: 3-months eurodollar middle rate; euro area: Euribor 3 month offered rate; Japan: uncollater. 3-month middle rate; United Kingdom: Interbank 3-month offered rate; Canada: commercial paper 3-month middle rate; monthly averages. Implied forward rates are derived from zero-bond yield curves. Eurodollar futures: 3-month (CME); Euribor futures: 3-months (LIFFE); United Kingdom: 3-month sterling futures (LIFFE); Canada 90-day bank acceptance futures (ME).

Source: Thomson Financial Datastream, OECD.

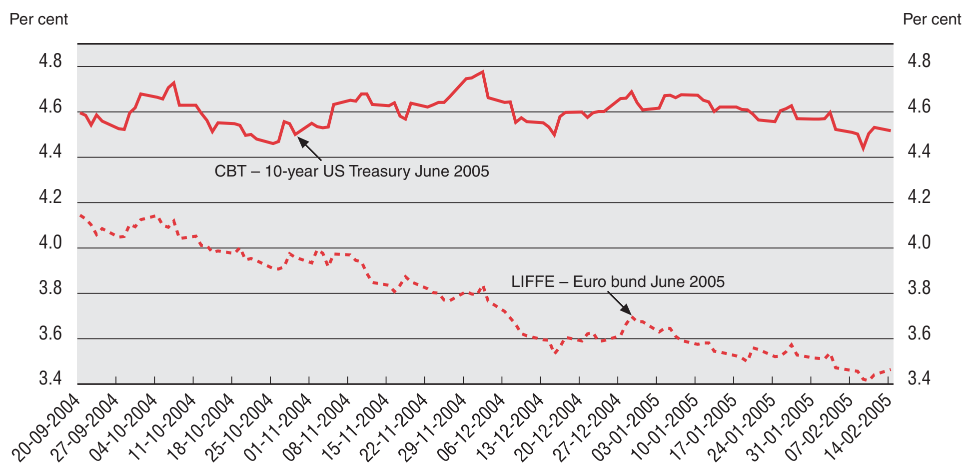
© OECD 2005

Figure 15. **Changes in interest rate expectations in major markets**

(a) Short-term interest rate futures, June 2005 contracts



(b) Long-term interest rate futures, June 2005 contracts



Note: Data as of 14 February 2005.
Source: Thomson Financial Datastream, OECD.

© OECD 2005

The BoJ has continued an expansionary policy, but has faced some limits.

Even though short-term interest rates in Japan move very little (close to zero, their use as a policy instrument has been suspended), the downward trend in interest rate futures over the past year may also reflect the downward revisions to growth. These revisions were effected after GDP figures had disappointed investors in mid-2004. With somewhat better results at the end of the year, interest rate futures have moved sideways since. Early in February, there was some speculation about a possible tightening of monetary policy, when discount bill offers from financial institutions fell short of the Bank of Japan's buying target.[4]

In the United Kingdom and in Canada, the tightening cycles have been halted.

In the United Kingdom, the Bank of England has not further tightened policy rates after a series of quarter point increases stopped on 5 August last year, given that inflationary pressures from oil prices and house price increases have abated. The repo rate now stands at 4.75 per cent, and markets do not expect any further increases in the near future, as suggested by implied forward rates and futures (Figure 14, panel (b)). Also in Canada, there was no further tightening since two quarter point increases in September and October last year. However, while the Bank of Canada's target for the overnight rate stands now at 2.5 per cent, markets expect some further tightening in the second half of this year.

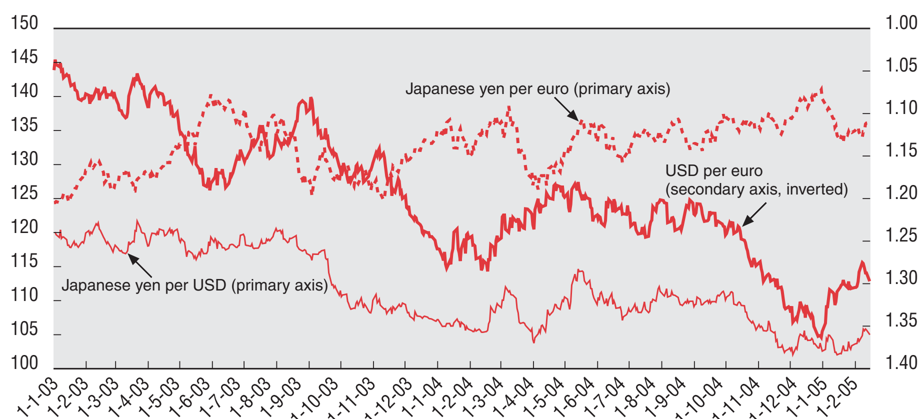
IV. Foreign exchange markets

The dollar declined further, but regained terrain since the beginning of the year…

The further decline of the US dollar in 2004 has been one of the developments frequently cited in the trade press. Such a decline did not come unexpectedly, as global imbalances led many investors to believe that the dollar was too highly priced. The high US current account deficit, driven by weaker demand from the slower growing economies abroad and strong demand of US households, have all been structural factors putting pressure on the currency. Over the past year, the dollar lost 8.2 per cent of its value against the euro, 4.4 per cent against the yen, and it gained 7.9 per cent against the British pound (beginning of January to end of December, weekly data). More recently, the dollar gained ground in January and early February, reaching a three-month high against the euro (Figure 16).

© OECD 2005

Figure 16. **Major exchange rates**



Note: Daily data until 14 February 2005.
Source: Thomson Financial Datastream.

… while the euro showed more flexibility than the yen during the adjustment.

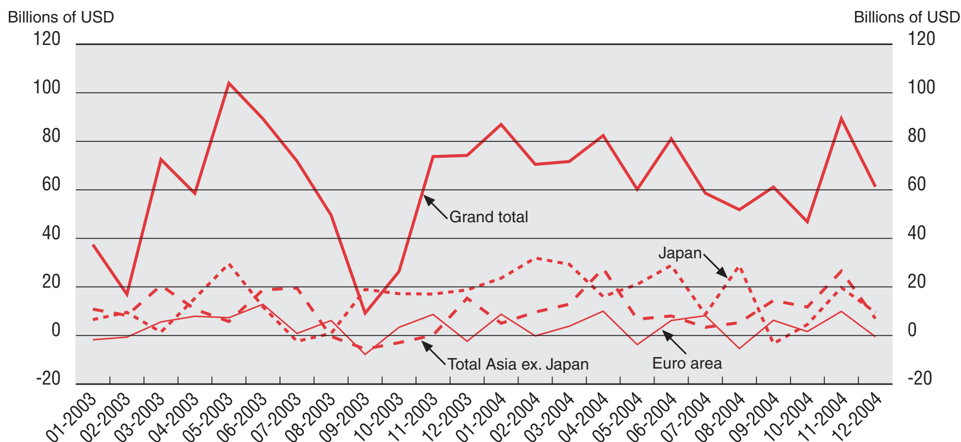
During the recent rebound of the dollar (end of December until the first week of February), the US currency gained 5.4 per cent against the euro, 1.4 per cent against the yen, and lost 1.7 per cent against the pound; the yen lost 3.5 per cent against the euro. The recent strengthening has been related to news and information which enhanced investors' confidence in the US currency. The announcement of the US administration's plans to cut the fiscal deficit,[5] positive data on capital inflows released in January, and higher than expected non-farm payrolls compensated for the news of a record fourth quarter trade deficit. Furthermore, remarks by the Fed chairman early in February helped to assuage concerns over the US trade deficit.[6]

Concerns about global imbalances have been assuaged by data on US capital inflows.

News about net portfolio flows into the United States have been important drivers of the dollar exchange rate over the past year, as investors were concerned that Asian central banks and oil exporters would diversify their portfolios out of the dollar into other currencies. However, while total inflows have fluctuated (Figure 17), they amounted to 820 billion USD in 2004 which is more than adequate to finance the US current account deficit of roughly 650 billion USD. The contribution in demand for US securities was

© OECD 2005

Figure 17. **Net portfolio flows into US by region**
Billions of US dollars



Note: Net portfolio flows are net purchases of assets by foreigners from US Residents (gross purchases – gross sales).
Source: US Treasury, Treasury International Capital (TIC) Reporting System.

strongest from Japan, by far the biggest holder of US assets, and stronger than the contribution of all other Asian countries together. Inflows from the euro area, which were relatively high in November (but still only half the inflows from Japan in that month) turned slightly negative in December. While US government bonds generally make up the greatest share in capital inflows, corporate bonds recently gained more importance (Figure 18). In September and December, when the foreign investment in government bonds had fallen from the previous months' levels, corporate bonds contributed most to the inflows.

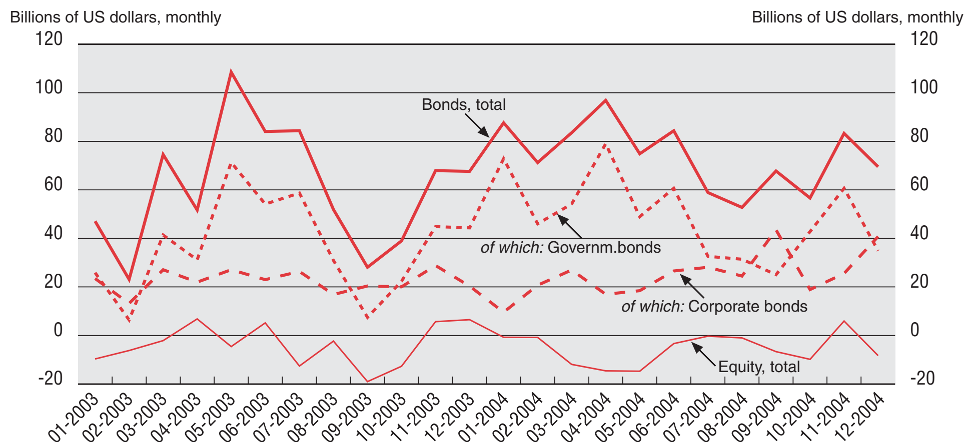
V. Emerging economies

Emerging markets spreads remain low and emerging stock markets continued to rise, given positive economic fundamentals...

Emerging markets continued to attract foreign capital. As an indication of investors' confidence in those markets, yield spreads of emerging market bond indices (EMBI) over US government paper were further compressed over the past months, reaching new historical lows late in January (Figure 19). However, the Latin American (and thus the total) emerging market spread picked up suddenly, by almost

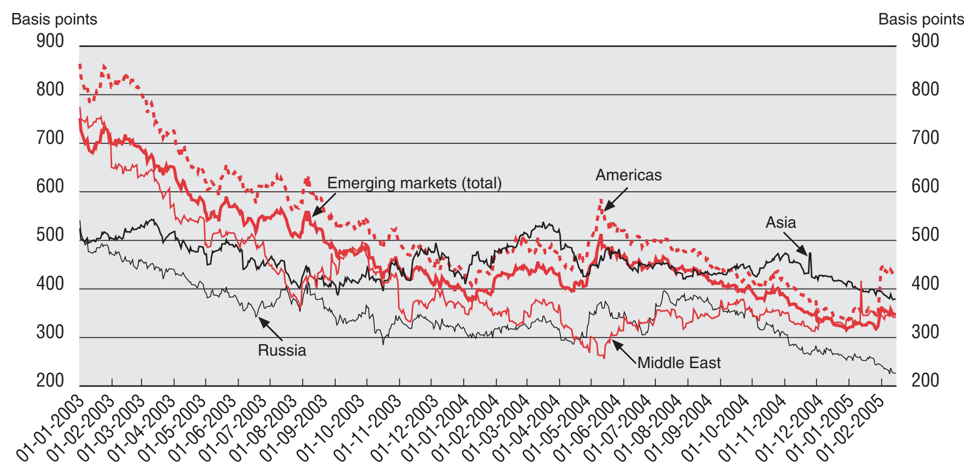
© OECD 2005

Figure 18. **Net portfolio flows into US by category**
Billions of US dollars



Note: Net portfolio flows are net purchases of assets by foreigners from US Residents (gross purchases – gross sales). Bonds comprise US and foreign bonds; equity comprises US and foreign equity.
Source: US Treasury, Treasury International Capital (TIC) Reporting System.

Figure 19. **Emerging market bond spreads**



Note: Daily data until 14 February 2005. Lehman indices, redemption yields minus 5-year US government bond index yield.
Source: Thomson Financial Datastream.

© OECD 2005

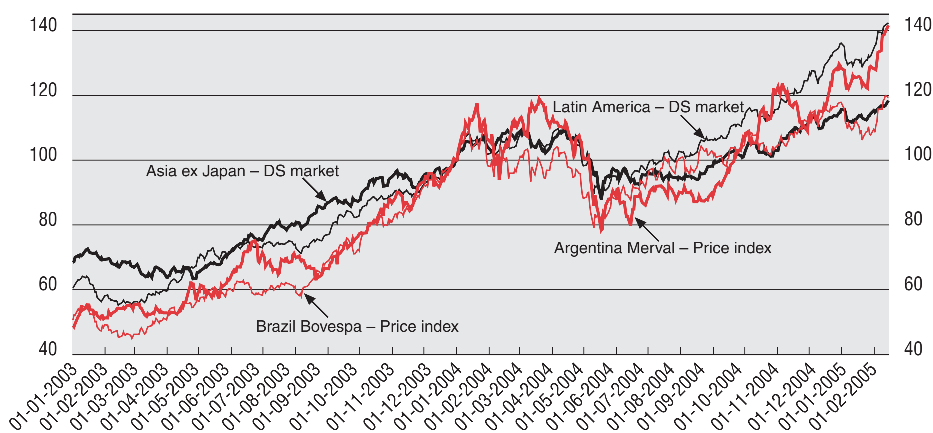
100 basis points at the end of January, but have since slightly declined. While ample liquidity and the search for yield have played a role in bringing down emerging market spreads, there are also fundamentals in place which support investors' confidence in emerging markets. Taking advantage of the favourable financing conditions, emerging market issuance has further increased. Issuers were also able to lengthen the maturities of their issues and widen the variety of currencies, including their own, which will help to reduce the exposure to exchange rate shocks.[7] Fuelled by positive prospects, stock markets in all major emerging economies have continued their upward trend since they rebounded from their lows of May last year (Figure 20).

... in Latin America,...

Among the emerging markets group, stock markets have performed most strongly in Latin America, underpinned by strong growth in the region, which is estimated to have averaged 5.8 per cent for 2004 as a whole, and is expected to attain 4.1 per cent this year (Consensus Forecasts). Macroeconomic policies have stabilised the Latin American economies, and high commodity prices have helped to boost export income. But given countries' external debt levels and their high dependency on exports, they remain vulnerable

Figure 20. **Stock market performance in selected emerging economies**

Equity price indices, 1-Jan.-04 = 100



Note: Daily data until 14 February 2005.
Source: Thomson Financial Datastream.

© OECD 2005

to external shocks.[8] In Argentina, creditors have not yet agreed to the government's debt rescheduling proposal, the outcome of which may be a crucial signal for the region as a whole. In Brazil, macroeconomic reforms continue to put the economy back on a long-term growth path.

... Asia, in particular China,...

At a somewhat slower pace than Latin America, emerging Asia is estimated to have grown at a 4.4 per cent rate last year, and expansion is forecast at 2.9 per cent this year. While Asian bond yield spreads have stayed above the total emerging market index yields since last August, they have declined in concert with other emerging market spreads. The tsunami disaster at the end of last year, which caused major human losses and severely hit the coastline infrastructures of some major Asian economies, apparently did not have any significant effects on the spreads, reflecting the fact that wider economic effects of the disaster are expected to remain small and not affect the positive economic outlook for the region as a whole. China has remained the major driver of growth for the Asian region, even though the government has taken measures to cool down the overheating economy.

... and in Russia, where the central bank recently switched to a dual-currency basket.

Russian bonds showed the strongest decline in yield spreads over the last months. This sign of confidence is corroborated by the higher than expected growth figures that were released early in February. According to these data, Russia's economy grew 7.1 per cent last year, also profiting from the high oil prices. Furthermore, the Russian central bank has, as of February, switched to a dual-currency basket, loosely pegging the rouble against the euro and the dollar, rather than just the dollar as done under the previous currency policy. The announcement of the new policy immediately strengthened the rouble against the dollar, and is expected to reduce the high volatility of the rouble to currencies of other Russian trading partners, including the euro. Initially, the weight of the euro in the basket will be only ten per cent – thus much less than the current 65 per cent euro area trade share – but this share is announced to increase to an appropriate level. Thus, it remains to be seen how reserves will actually be affected, and what the composition of currencies in the basket will finally be. Currently, the share of the euro in the official reserves is estimated at 25-30 per cent.

© OECD 2005

Notes

1. According to a recently released study by Greenwich Associates.
2. For this and the following, data are from Dealogic and Thomson Financial.
3. See Financial Times, February 1st, 2005, "Atlantic divide over long bonds".
4. The Bank of Japan conducts money market operations aimed at keeping its target for excess liquidity between 30 000 billion and 35 000 billion yen. Tightening of monetary policy would imply a lowering of that target.
5. President Bush announced substantial deficit cutting plans in a speech on 7 February 2005, bringing the US fiscal imbalance from currently 3.5 per cent of GDP to 1.7 per cent by 2008.
6. "Current account", Remarks by Chairman Alan Greenspan at *Advancing Enterprise* 2005 *Conference*, London, England, February 4, 2005.
7. For details see Bank for International Settlements (2004), "The International Debt Securities Market", BIS *Quarterly Review* (December).
8. A higher exposure to competition from Asian exporters, in particular from China, can be expected with the phasing out of the Multi-Fiber Agreement this year, abandoning quotas on textile exports which had been set by this agreement for the past 30 years.

© OECD 2005