Report of the Deutsche Bundesbank

for the Year 1985

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Members on April 1, 1986

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Note: In order to expedite publication of the English version of this Report, the following sections contained in the German original have been omitted:

Part A	Bank supervision, domestic and external monetary and foreign exchange policy regulations of the Deutsche Bundesbank
Part C	Fund for the Purchase of Equalisation Claims
Appendices to Parts B and C	Nos. 1, 3, 4 and 5

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Part A: General part

The currency and the economy in 1985

I. Economic developments and central bank policy

In 1985 the Deutsche Bundesbank conducted its monetary policy against the background of an economic upswing in the Federal Republic of Germany which was by and large free of distortions. The expansion of the money stock in accordance with the target was associated with a marked decline in the interest rate level, a further curbing of the pace of price rises and finally also a strengthening of the exchange rate of the Deutsche Mark. But it was not merely the performance in the monetary sector of the economy, which is the Bundesbank's primary sphere of operation, that was satisfactory; with respect to the non-monetary objectives of economic policy as well, significant successes were achieved in 1985. The increase in the real gross national product was largely in line with the medium-term growth potential. In 1985 the present upswing was thus accompanied for the first time by a strong expansion of employment, although this has not yet had the desired effect of reducing unemployment. However, the chances for such a development are improving, given the good prospects of the upward trend in economic activity continuing in 1986. 1

Towards the end of 1985, goods production in Germany reached a level that was nearly 10% higher than at the trough of the cycle in autumn 1982; since then the economy has been growing at an annual rate of roughly 3%. Calculated on a per capita basis, this represents an annual growth rate of some 3½%. As regards the improvement in its standard of living, therefore, Germany is one of the league-leaders among the western industrial countries. During 1985 real GNP went up by only 2½%; this departure from the 3% trend is due to the production losses suffered during the exceptionally severe winter of 1984-85.

Among the forces fuelling economic activity, domestic demand assumed increasing importance during the year under review while foreign demand, which had previously imparted the main stimulus, lost momentum. In particular, capital spending by enterprises gathered pace on account of the favourable outlook for sales and earnings. Another significant factor was that, following the decline in market interest rates, financing conditions improved further and financial assets became less and less attractive in competition with fixed capital formation.

Conditions on the labour market were determined by contrasting tendencies. On the one hand, enterprises in many industries started to recruit labour again and short-time working was reduced to a very low level. Between the end of 1984 and the end of 1985 the number of wage and salary earners in employment grew by about 200,000. Inclusive of the reduction in short-time working, this was a rise in employment such as has not been witnessed since 1979-80. On the other hand, the inflow of job-seekers to the labour market continued, from the ranks both of young school-leavers and of those who had not previously been employed, especially women. As a result of the steep increase in the supply of labour, the number of unemployed persons did not decline; the unemployment rate in 1985 was a good 9% of the dependent and just over 8% of the total labour force.

Given the functions assigned to the Bundesbank, it should be especially emphasised that the third year of the economic upswing passed without inflationary tensions. At the consumer level, in particular, the observed price rises were very limited. Taking the average of 1985, the cost of living index was 2.2% higher than a year before; at the end of 1985 the year-on-year increase was only 1.8%, and in March 1986 consumer prices were virtually no higher than a year earlier. The slowdown in price rises in 1985 was mainly attributable to domestic factors, especially the moderate growth in wages and salaries. Only in the latter part of last year and more particularly at the beginning of 1986 was the slowdown due primarily to the cheapening of imports. It remains to be seen whether this factor will retain its influence.

Key data on overall economic developments

Period	Gross national product 1	Employed persons 2		Unemploy-ment rate 3	Consumer prices; 4 annual increase	Balance on current account
	Annual change					
	in %		in thousands	in %	in %	in DM billion
1970 to 1973 5	+ 4.2	+ 0.5	+ 140	0.8	+ 5.3	+ 5.3
1974 to 1979 5	+ 2.3	− 0.5	− 150	3.5	+ 4.6	+ 10.5
1980 to 1985 5	+ 1.2	− 0.3	− 90	6.6	+ 4.1	+ 6.5
1974	+ 0.2	− 1.3	− 360	2.2	+ 6.9	+ 26.6
1975	− 1.4	− 2.8	− 760	4.0	+ 5.9	+ 10.0
1976	+ 5.6	− 0.8	− 220	4.0	+ 4.4	+ 9.9
1977	+ 2.7	− 0.2	− 40	3.9	+ 3.6	+ 9.5
1978	+ 3.3	+ 0.6	+ 150	3.8	+ 2.7	+ 18.0
1979	+ 4.0	+ 1.4	+ 350	3.3	+ 4.2	− 11.0
1980	+ 1.5	+ 1.1	+ 280	3.3	+ 5.4	− 28.5
1981	+ 0.0	− 0.7	− 180	4.8	+ 6.3	− 11.7
1982	− 1.0	− 1.7	− 440	6.7	+ 5.3	+ 9.9
1983 p	+ 1.5	− 1.5	− 380	8.1	+ 3.3	+ 10.6
1984 p	+ 3.0	+ 0.1	+ 20	8.1	+ 2.4	+ 19.9
1985 p	+ 2.4	+ 0.7	+ 180	8.2	+ 2.2	+ 38.8

1 At 1980 prices. — **2** Persons employed in Germany, annual averages, absolute figures rounded. — **3** Unemployed persons as % of the total labour force. — **4** Cost of living index for all households. — **5** Annual averages. — **p** Columns 1 to 3 provisional. BBk

In 1985 German products maintained their strong position in international competition despite the appreciation of the Deutsche Mark in the course of the year. The massive current account surplus of almost DM 39 billion may, however, somewhat overstate the strength of the basic external position since the decline in import prices owing to exchange rate movements pushed up the current account balance further in the short run. This connection has re-emerged very recently in the wake of the fall in oil prices. A downward adjustment of the surplus position is to be expected, however, as soon as real foreign trade flows start to respond more markedly to the price changes that have occurred.

The economic performance in 1985 was bolstered by financial and monetary policy alike, whose common objective it was and is to safeguard the underlying economic conditions for a long-term upswing at stable prices, and as far as possible without disruptions. This was the aim both of the public authorities' consolidation policy, which was continued in 1985, and of the central bank's monetary policy, which remained geared to stability and continuity. The Bundesbank's intention in 1985 was to allow the money supply to expand within the target corridor fixed for the purpose — i. e. a growth of central bank money by 3 to 5%; as in the two preceding years, the central bank money stock increased during the year by 4½%. The monetary expansion was gauged in such a way that it allowed virtually non-inflationary and adequate economic growth. From the outset the Bundesbank took due account of the fact that, in view of the increase in investment activity and a growing supply of labour, production potential has expanded in recent years. At the same time it endeavoured to keep the inflation risks as low as possible on the monetary side and to safeguard the progress made towards stability.

An interest rate and liquidity policy which the Bundesbank oriented towards continuity was consistent with the envisaged pace of monetary growth. The Bundesbank allowed downward trends in interest rates emanating from the market to take their course, and encouraged them, especially when favourable domestic and external fundamentals appeared to guarantee that the interest rate reduction would be largely free from setbacks. In keeping with price, exchange rate and international interest rate movements, and assisted by the drop in public sector borrowing requirements, the Bundesbank's monetary policy — designed as it is to build up confidence — has contributed in the last fifteen months to a decline in the long-term interest rate from an average of nearly 8% in 1984 and roughly 7% last year to less than 6% so far in 1986. Thus in the financial sector a sound basis has been created for a continuation of the economic expansion, which is now mainly due to the strong rise in (real) domestic demand. The preconditions for a favourable economic performance in Germany in 1986 in terms of our prime policy goals — stable prices, steady economic growth, a further increase in employment and thus ultimately a decline in unemployment as well — seem to be assured. Although no definite headway towards better external equilibrium is likely to be made this year (in particular, Germany's current account surplus will probably again turn out to be larger rather than smaller, as one would normally expect in the fourth year of an upswing), this must be put down to the special global economic circumstances, deriving above all from the sharp drop in oil prices. There is, however, a good deal to suggest that, via the strengthening of domestic demand, an adjustment process has been initiated which will gradually be reflected in a reduction in the surplus on current account as well.

1. The economy of the Federal Republic of Germany in the cyclical upswing

1985: expansion in output and employment at a time of increasing domestic demand

1985 was generally a successful year for the economy of the Federal Republic of Germany. In the third year of the upswing, economic activity increased strongly once more, with clearly beneficial effects on employment. Cyclical stimuli increasingly shifted from foreign demand to domestic demand in the course of last year. It is true that foreign orders for industrial goods remained fairly lively overall; on an annual average for 1985 they were 11% above the previous year's level. However, following the steep rise from the middle of 1983 to the beginning of 1985, foreign demand in the further course of the year did not increase appreciably any further. Domestic demand for industrial products gained considerable impetus in the course of 1985. With a plus of just over 6% on an annual average it did, however, rise less than foreign demand.

Sustained rise in investment activity

The driving force behind domestic demand was enterprises' investment activity, in particular. The capital goods sector (excluding manufacture of vehicles) received just under 9% more domestic orders on an annual average for 1985 than in the preceding year. Demand for office machines and EDP equipment, which last year was about 22% higher than in 1984, was one of the leaders here. The renewed demand push had to do not least with the fact that more and more applications are being found for the high-technology products of this economic sector. In many cases they are incorporated in other products (as, for example, in electronically controlled machine tools) and thus make a decisive contribution to their success on the market. Enterprises in mechanical engineering and electrical engineering, in particular, have moved to the forefront of the innovation process by offering capital goods which have been "refined" by the use of microelectronics. Domestic demand experienced by producers of commercial vehicles also went up noticeably. In the first two months of the year, domestic demand for capital goods continued strong. In total, the signals will have been set for sustained and lively investment activity this year, too. This was already shown in the results of the Ifo Investment Survey of autumn last year: at that time, enterprises in manufacturing industry were planning on expanding their capital spending by 10% in 1986. Overall capital expenditure on machinery and equipment exceeded the previous year's level by about 12% in 1985, the figure for 1984, however, having been relatively low owing to the labour disputes in the metal-working industry. In the manufacturing sector and mining, in particular, capital expenditure rose strongly in 1985. It also increased sharply in the transportation sector and at the Federal Post Of-

Key economic variables in the Federal Republic of Germany

Item	Unit	1982	1983	1984	1985	1982	1983	1984	1985
						Change from previous year in %			
Aggregate demand									
Private consumption	DM billion	918.1	958.5	990.3	1,027.3	+ 3.4	+ 4.4	+ 3.3	+ 3.7
Public consumption	DM billion	326.2	336.5	350.5	365.7	+ 2.5	+ 3.2	+ 4.1	+ 4.3
Fixed capital formation	DM billion	326.9	344.1	354.6	359.3	− 2.5	+ 5.3	+ 3.0	+ 1.3
Machinery and equipment	DM billion	124.9	135.6	137.6	153.9	− 2.2	+ 8.6	+ 1.5	+ 11.9
Construction	DM billion	202.0	208.5	217.0	205.4	− 2.7	+ 3.2	+ 4.1	− 5.3
Increase in stocks	DM billion	−11.5	−2.0	11.2	14.2	.	.	.	.
Domestic expenditure	DM billion	1,559.6	1,637.2	1,706.6	1,766.5	+ 1.9	+ 5.0	+ 4.2	+ 3.5
External surplus **1**	DM billion	+ 37.5	+ 36.9	+ 50.3	+ 71.4	.	.	.	.
Exports	DM billion	517.5	526.4	588.3	647.4	+ 7.3	+ 1.7	+ 11.8	+ 10.0
Imports	DM billion	480.1	489.5	538.0	576.0	+ 2.8	+ 2.0	+ 9.9	+ 7.1
Gross national product at current prices	DM billion	1,597.1	1,674.1	1,756.9	1,837.9	+ 3.4	+ 4.8	+ 4.9	+ 4.6
Memorandum items									
Orders received by the manufacturing sector	1980 = 100	103.4	107.9	118.2	127.7	− 1.0	+ 4.4	+ 9.6	+ 8.0
Domestic orders	1980 = 100	98.3	103.1	109.5	116.3	− 0.5	+ 4.9	+ 6.2	+ 6.2
Foreign orders	1980 = 100	114.4	118.3	137.1	152.4	− 1.9	+ 3.4	+ 15.9	+ 11.1
Orders received by the construction industry	1980 = 100	85.9	94.4	88.9	87.4	+ 0.6	+ 10.0	− 5.8	− 1.7
Distribution of income									
Wage and salary income	DM billion	902.5	920.7	952.7	989.3	+ 2.2	+ 2.0	+ 3.5	+ 3.8
do. as a percentage of national income	%	73.8	71.9	70.8	70.0	.	.	.	.
Entrepreneurial and property income	DM billion	321.0	360.0	393.6	424.9	+ 5.5	+ 12.1	+ 9.3	+ 8.0
Memorandum items									
Gross income of producing enterprises	DM billion	232.7	270.6	300.9	328.2	+ 4.3	+ 16.3	+ 11.2	+ 9.1
do. as a percentage of national income	%	19.0	21.1	22.4	23.2	.	.	.	.
National income	DM billion	1,223.5	1,280.7	1,346.3	1,414.2	+ 3.1	+ 4.7	+ 5.1	+ 5.0
Production									
Gross national product at 1980 prices	DM billion	1,471.0	1,493.5	1,538.9	1,576.0	− 1.0	+ 1.5	+ 3.0	+ 2.4
Productivity **2**	1980 = 100	102.9	106.4	109.7	112.3	+ 1.1	+ 3.4	+ 3.1	+ 2.4
Output in the producing sector (excluding construction) **3**	1980 = 100	95.5	96.4	99.6	104.5	− 2.8	+ 0.9	+ 3.3	+ 4.9
Construction output **3**	1980 = 100	88.5	89.0	89.5	83.7	− 4.4	+ 0.6	+ 0.6	− 6.5
Employment									
Employed persons	Millions	25.7	25.3	25.4	25.5	− 1.7	− 1.5	+ 0.1	+ 0.7
Wage and salary earners	Millions	22.4	22.1	22.1	22.2	− 1.9	− 1.7	+ 0.1	+ 0.8
Memorandum item									
Total number of man-hours worked	1980 = 100	96.3	94.5	94.5	94.5	− 2.0	− 1.8	− 0.1	+ 0.0
Unemployed persons	Thousands	1,833.3	2,258.2	2,265.6	2,304.0	+ 44.2	+ 23.2	+ 0.3	+ 1.7
do. as a percentage of									
the total labour force	%	6.7	8.1	8.1	8.2	.	.	.	.
the dependent labour force	%	7.5	9.1	9.1	9.3	.	.	.	.
Prices									
GNP deflator	1980 = 100	108.6	112.1	114.2	116.6	+ 4.4	+ 3.2	+ 1.9	+ 2.1
Memorandum item									
Unit labour costs in the economy as a whole **4**	1980 = 100	108.1	108.8	109.3	110.8	+ 3.5	+ 0.7	+ 0.4	+ 1.3
Cost of living index for all households	1980 = 100	111.9	115.6	118.4	121.0	+ 5.3	+ 3.3	+ 2.4	+ 2.2
Producer prices of industrial products	1980 = 100	114.1	115.8	119.2	121.8	+ 5.8	+ 1.5	+ 2.9	+ 2.2
Overall construction price level	1980 = 100	108.1	109.9	112.5	113.5	+ 2.7	+ 1.7	+ 2.4	+ 0.9
Index of import prices	1980 = 100	116.2	115.8	122.8	124.6	+ 2.3	− 0.3	+ 6.0	+ 1.5

1 Balance of transactions in goods and services with other countries (including the GDR). — **2** Gross national product at 1980 prices per man-hour worked; calculated by the Bundesbank. — **3** Results for kinds of activity units. — **4** Index of gross wages and salaries per employee divided by index of real GNP per employed person. — The figures from the national accounts from 1983 onwards are provisional.

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fice. Spending will probably have gone up further in the services sector, too, while the distributive trades probably invested somewhat less than in 1984.

Growing inclination towards capacity extension

Extension of capacity gained considerable importance in enterprises' fixed capital formation in 1985. An extension of plant was often unavoidable because not a few firms were already working at the limits of their production capability last year. In addition, many enterprises were concerned to counteract the aging of their fixed assets — a delayed consequence of the low level of investment in the early eighties. At the same time, many technical innovations were incorporated in the production process, and this made a big contribution to securing domestic suppliers' competitiveness on German and foreign markets.

Increased stock-building

In 1985 enterprises invested considerable funds in stocks. On as yet provisional data of the Federal Statistical Office, total stock levels in the economy last year rose by a good DM 14 billion, i. e. by DM 3 billion more than in 1984. Levels of primary products, in particular, will have increased in connection with the rise in production. An indication of this is, inter alia, that imports of such products went up by volume in the course of 1985 by over 4 %, i. e. more than overall production. Industry and the distributive trades also built up their stocks of finished goods considerably, to meet increasing final demand.

Improved earnings strengthen investment propensity

A decisive factor in the high propensity to invest was that some major underlying conditions improved further for enterprises last year. Business earnings went up strongly again, and earnings and sales perspectives were judged as being favourable. The gross income of producing enterprises, which provides a rough indicator of earnings trends in current business, rose by about 9 % in 1985, somewhat less than a year before. Its share in national income increased to just over 23 %, which corresponds roughly to the level of 1973, before the first oil crisis; admittedly, the average level of the sixties of 31½ % was not nearly regained.

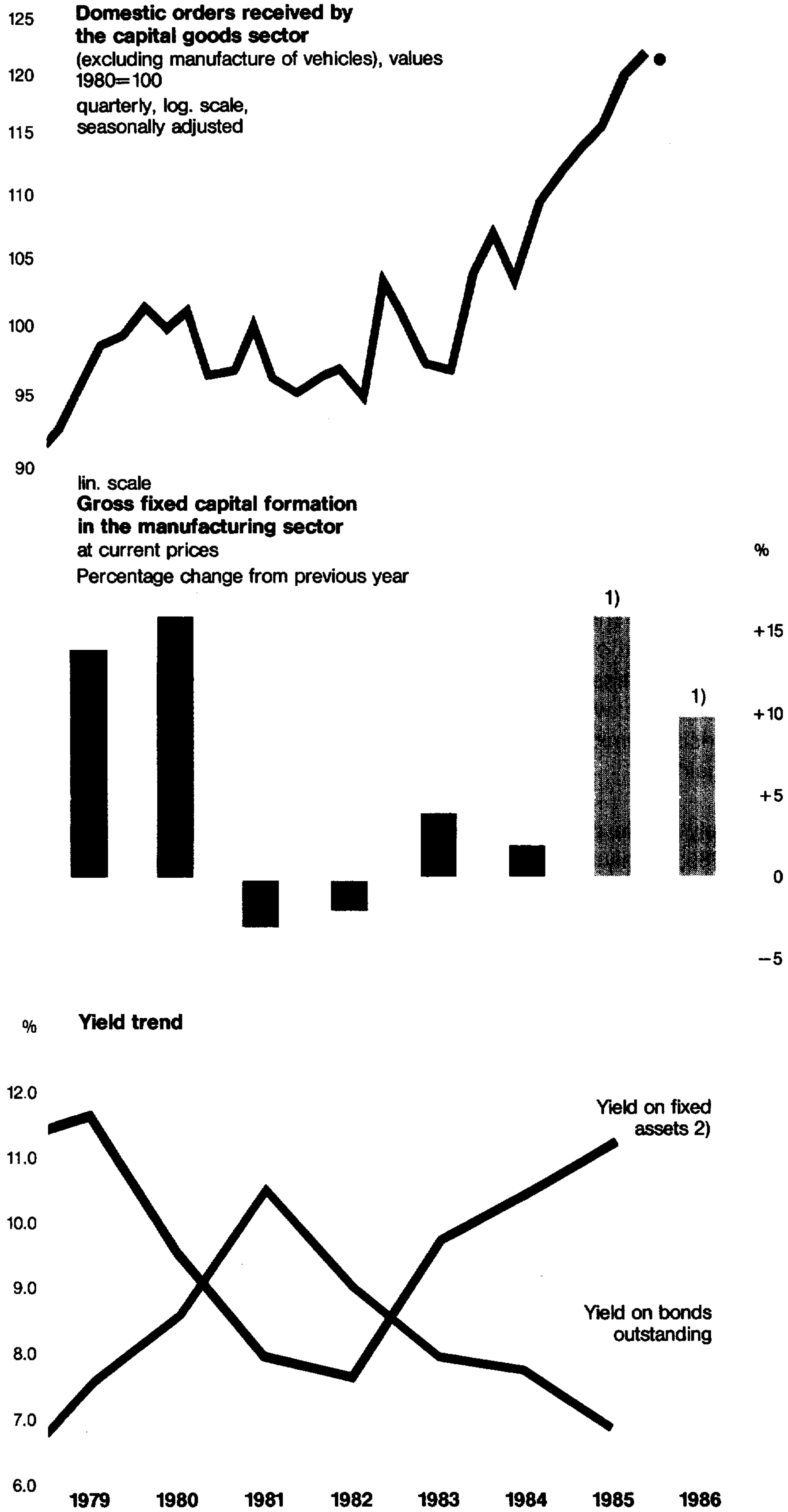
Moderate rise in labour costs

With largely stable prices, earnings margins improved primarily from the cost side in 1985, mainly because the rise in labour costs remained moderate overall. Calculated per man-hour worked, wages and salaries went up in 1985 by a good 3½ %. This figure takes account of the fact that in spring 1985 the reductions in weekly working hours with no loss of pay agreed on in the wage round 1984 went into force in important sectors of the economy. The cost effects of these reductions in working hours were limited in many firms, inter alia, because use was made of the possibilities under collective agreements for flexible handling of the reduction in working time; surveys revealed that about 70 % of the enterprises questioned managed not to reduce the running times of their machines and plants in spite of the shortened working hours. In some cases these times were lengthened. Overall staff costs in 1985 increased by about 4 %; this was 1 percentage point less than the rise in total turnover.

Cost relief from the import side only in the course of 1985

On an annual average for 1985 expenditure on imported goods did increase again strongly. But after the exchange rate of the Deutsche Mark against the US dollar had passed its peak in March last year, prices for imported goods fell. The negative price effects of the preceding Deutsche Mark depreciation were now quickly made good as the decline in the dollar rate soon coincided with falling dollar prices for internationally traded raw materials. Whereas total expenditure on imports by German business in the first half of last year exceeded its level of the previous year by almost 9½ %, it was only about 5 % higher on a year-on-year basis in the second half of 1985. However, the rise in total expenditure on imported goods remained somewhat below that in total sales at home and abroad. Thus both domestic factors and, in the final analysis, external ones strengthened enterprises' earning capacity.

Demand for capital goods



1) Investment plans of enterprises in Aug./Sep. 1985 according to the Ifo Investment Survey.- 2) Gross income of producing enterprises (less imputed entrepreneur's remuneration) as a percentage of net fixed assets at replacement prices; estimated by the Bundesbank.- ● =January/February.

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Improved return on fixed capital employed

In 1985 (on provisional calculations) the profitability of capital used in enterprises — calculated as "return on fixed assets"[1] — was about 11½%, almost 1 percentage point higher than in 1984. Since its low in the years 1981-82, the return on fixed assets has thus risen by 3½ percentage points. In this period, however, the long-term interest rate, as measured by the yield on bonds outstanding, decreased from 10½% in 1981 to 7% in 1985; as at the time this Report went to press it fell to less than 6%. This "scissors movement" shows that the yield on fixed assets now again contains a premium for the risk that experience shows is associated over the long term with enterprises' capital formation. The implementation of new investment projects is additionally facilitated by enterprises overall — no doubt with big differences in individual cases — being in a good financing position, in particular with regard to ample internal resources from their "cash flow". All in all, the positive relationship between earning power and investment propensity was completely confirmed last year.

Continuing series of enterprise start-ups and high level of insolvencies at the same time

The cyclical upswing and the improvement in underlying economic conditions was associated with a noticeable strengthening of confidence in future economic trends. Not the most minor indication of this was that last year the series of enterprise start-ups which had already been evident in previous years continued. A peak was reached in 1985 with over 36,000 entries of new firms in the Commercial Register. Many firms started up in the services sector and in the crafts field especially, and in many cases they were supported by public funds. Last year also saw the establishment of the savings promotion scheme for enterprise start-ups. However, the risk of insolvency for enterprises — caused, among other things, by ongoing structural change — remained very high last year. About 13,700 firms, 13½% more than a year before, saw themselves forced in 1985 to file bankruptcy or composition proceedings. Among these were relatively many enterprises in the services sector, the distributive trades and the construction industry, which has been having to reduce capacity for a long time now under the pressure of structural change. Private limited companies featured strongly among the firms which had become insolvent. Just under 7,000 of them were involved. In earlier years, too, enterprises of this legal form showed themselves to be relatively susceptible to insolvency; it remains to be seen whether this will improve with the increase in minimum capital requirements.

Private consumption providing increasing support for domestic economic activity

Households' consumer demand developed last year, against a background of increasing employment and positive income expectations, into a further important element of domestic economic activity. Households put up their consumption expenditure in 1985 by 3½%. This constituted a price-adjusted rise of a good 1½%; it was — promoted by the moderate rise in consumer prices — the strongest real increase in consumption for six years. Consumers spent relatively generously when buying everyday requisites and services especially. There was lively demand for textiles, clothing and shoes. Budgets for holiday trips abroad were stocked up again appreciably for the first time for a fairly long while. By contrast, hardly any more was spent overall in 1985 than in 1984 on consumer durables, but special influences were at work here. Ultimate demand for passenger cars in the first months of the year was initially depressed by uncertainty about the technical and tax provisions for low-pollutant vehicles. Only after the end of the discussion on the catalytic converter did pent-up demand start to be released. However, over the year as a whole, new registrations of passenger cars for private purposes did not quite reach the level of the previous year.

Increased rise in income from higher employment

The scope given households by incomes widened somewhat more strongly in 1985 than in the preceding year. Total gross wages and salaries grew last year by 3½% (after 3% in 1984). Average negotiated monthly earnings were indeed

1 Enterprises' gross income (less imputed entrepreneur's remuneration) relative to net fixed capital at replacement prices.

raised in 1985 by only about the same amount as in the previous year (a good 2½%); but owing to the reductions in working hours agreed in 1985 in major sectors of the economy, hourly earnings rose somewhat more strongly. At the same time, employment increased sharply, firstly as a result of the sustained reduction in short-time working and then because staff levels were raised. Almost a quarter of the rise in total gross wages and salaries in 1985 was accounted for by higher employment. Last year, as already in 1984, current transfers by public cash offices in the form of pensions and maintenance payments went up only slightly. By contrast, households' other income will have risen fairly strongly, inter alia because there were more private withdrawals by self-employed persons in view of the improved earnings situation in the economy. In total, 1985 saw households with about 3½% higher incomes than in the preceding year.

Massive strengthening of purchasing power in 1986 from tax reductions and decline in energy prices

At the start of 1986 the purchasing power of many sections in the population was strengthened from two directions. For one thing, the first stage of tax reductions went into force, and this provided an estimated DM 11 billion in relief. For another, consumers profited, as a result of the downward slide of oil prices starting at the end of 1985, from lower petrol and heating oil prices, and this gave them additional scope for other consumption expenditure and increased saving. If prices for mineral oil products and other sources of energy remain at a noticeably lower level over the year, this could expand households' real purchasing power into an order of magnitude which would in fact exceed the above-mentioned relief flowing from the first stage of the tax reform. The preconditions for consumption to strengthen further this year thus appear favourable on the income side.

Saving ratio unaltered over the year

Last year, as in 1984, households used about 13% of their disposable income for saving. Over the course of the year private saving was, however, subject to considerable fluctuations. There was a relatively strong build-up in private financial assets and only little borrowing in the first months of last year in connection with an initial sluggish consumption trend and, in particular, the restraint — caused by the catalytic converter debate — which consumers showed in purchasing new passenger cars. In the spring and summer months, when consumer demand rose strongly and pent-up demand in the automobile business was released, saving slackened. However, towards the end of the year a relatively large amount of the special payments falling due at this time appears not to have been used for consumption expenditure for the time being but flowed instead into saving.

Construction demand stays at its low level owing to the sustained weakness of housing construction

1985 was a difficult year for the construction industry. At the start of the year, demand for construction work had fallen to a low. In construction, orders did indeed increase, seasonally adjusted, in spring and summer last year; in the later course of the year, however, the upward trend did not continue. Over the year, orders placed with construction were about 1½% below the level of the preceding year. A decisive factor here was the sustained weakness of housing construction. Although orders placed in this sector in 1985 temporarily increased in the later course of the year after a very hesitant start, the year as a whole saw them remaining considerably (22½%) below the already strongly depressed level of the previous year. The demand for construction of apartment houses, in particular, was very weak, because in many regions there had been an oversupply of rented dwellings for a fairly long time. In many cases, there is no profit to be gained from publicly assisted housing, and this is to be expected even less in unassisted housing construction which is burdened with the full capital costs. In the past, investors were able to count on a strong appreciation in the value of completed rented dwellings, which was seen as being a compensation for the lack of profitability in their construction. For some years now, however, housing construction prices have risen only relatively little, and the prices for existing buildings have been tending to decline. In addition, tax advantages for the so-called "Bauherrenmodell" construction schemes were restricted as from April 1985. It is now obvious that — not least because housing construction was overpromoted in the past — there is an oversupply of dwellings which cannot be marketed at cost-covering prices given existing rents and incomes; at the same time, the sale of existing rented dwellings is thus made more difficult. Demand for one and two-family houses has not decreased quite as strongly as that for apartment houses. The former has received a certain amount of support from the good conditions on the construction market — short construction times, almost stagnating construction prices and, particularly in the second half of the year, low interest rates for mortgage loans. But as measured by building permits granted, it too remained considerably below the level of the preceding year in 1985. In total, about 312,000 new dwellings were completed last year, a good 86,000 fewer than in 1984. As things are at present, the construction industry will probably have to adjust to the fact that the number of new dwellings each year will tend to stagnate in the medium term or sink further. New promotional measures for housing construction would in the final analysis only delay the adjustment process.

Increase in orders in industrial and public construction

Other than was the case in housing construction, there was a marked cyclical recovery in public and industrial construction in 1985. In total, industrial investors placed almost 7 % more construction orders last year than in the preceding year, with the demand for industrial buildings following, on the whole, the general expansion in investment activity. In some cases, the rise in depreciation rates for industrial buildings will have had a positive effect last year already. In public construction, orders received in 1985 also increased strongly (by about 5½ % against the previous year), with the local authorities again being the most important clients. Their financial situation had already improved so much in 1984 that, overall, they attained surpluses. The local authorities were thus able, given their favourable position, to undertake more new construction projects, focusing on urban renewal, waste disposal and environmental protection. In road construction, too, noticeably more new projects were started after the winter months.

Strong expansion in overall production and raised utilisation of production potential

Production followed the demand trend with no time-lag. Real gross national product rose on an annual average for 1985 by 2.4 %. This meant that the growth target cited in the Annual Economic Report of the Federal Government for 1985 was reached, although overall production at the start of last year was considerably hampered by the extremely cold winter. Looking at the situation over the whole course of the upswing to date, i. e. from the fourth quarter of 1982 to the fourth quarter of 1985, real gross national product has risen at an annual rate of about 3 %. It should also be taken into account here that Germany's resident population has been falling for a fairly long time now. Real gross national product over this period increased by about 3½ % per capita per annum. Germany is thus among the leading western industrial countries as far as economic growth is concerned. Overall production in 1985 grew more strongly than production potential, the increase in which can be put at just over 2 %. The utilisation of the economy's real resources — calculated according to the potential concept of the Deutsche Bundesbank — has thus gone up further; in 1985 it was 95 %, compared with 94½ % in 1984 and 94 % in 1982, before the start of the upswing. In 1986 economic growth, from the present perspective, could in fact be stronger than in the course of the upswing to date as savings on energy expenditure related to the most recent fall in import prices for crude oil and mineral oil products will probably generate additional growth stimuli. The utilisation of the production potential — growth of which in 1986 is estimated at about 2½ % — would thus increase further.

Sustained expansion of production and improved utilisation of fixed capacity in the producing sector

In the producing sector (excluding construction) enterprises produced 5½ % more in 1985 than in 1984, after approximate adjustment for working-day variations, output in 1984 having gone up by about 3½ %. This expansion in production entailed in many industrial sectors a markedly better, and in some areas towards the end of the year in fact a full, utilisation of fixed assets; in the manufacturing sector (excluding the chemical industry and the food, drink and tobacco industry) fixed capacity utilisation in December — on Ifo Institute data — almost reached the level of December 1979, the cyclical high in the second half of the seventies.

Capital goods sector the focus of the upswing

Apart from construction, all main areas of the producing sector participated in the expansion in output in 1985. The capital goods sector boosted its production particularly strongly — by just over 10 %. It profited from the generally good investment climate in Germany and important partner countries. Thus the electrical engineering industry produced over 12 % more and mechanical engineering 7 % more than in the preceding year. The automobile industry was also very successful last year, its annual production exceeding 4 million passenger and estate cars for the first time. In manufacture of road vehicles as a whole, output in 1985 was 11½ % over the level of the previous year, in which production had, however, been detrimentally influenced by the labour disputes in the metal-working industry. In the basic and producer goods sector and in the consumer goods sector output went up in 1985 by about 1 % against a year earlier. After approximate adjustment for working-day variations, output in construction, by contrast, remained roughly 6 % below the level of the preceding year in 1985. On the average of the first two months of 1986, industrial production (excluding construction) stayed just under the level it had reached in the previous autumn, seasonally adjusted. Construction output suffered heavily in the same period, on account of the cold spell in February.

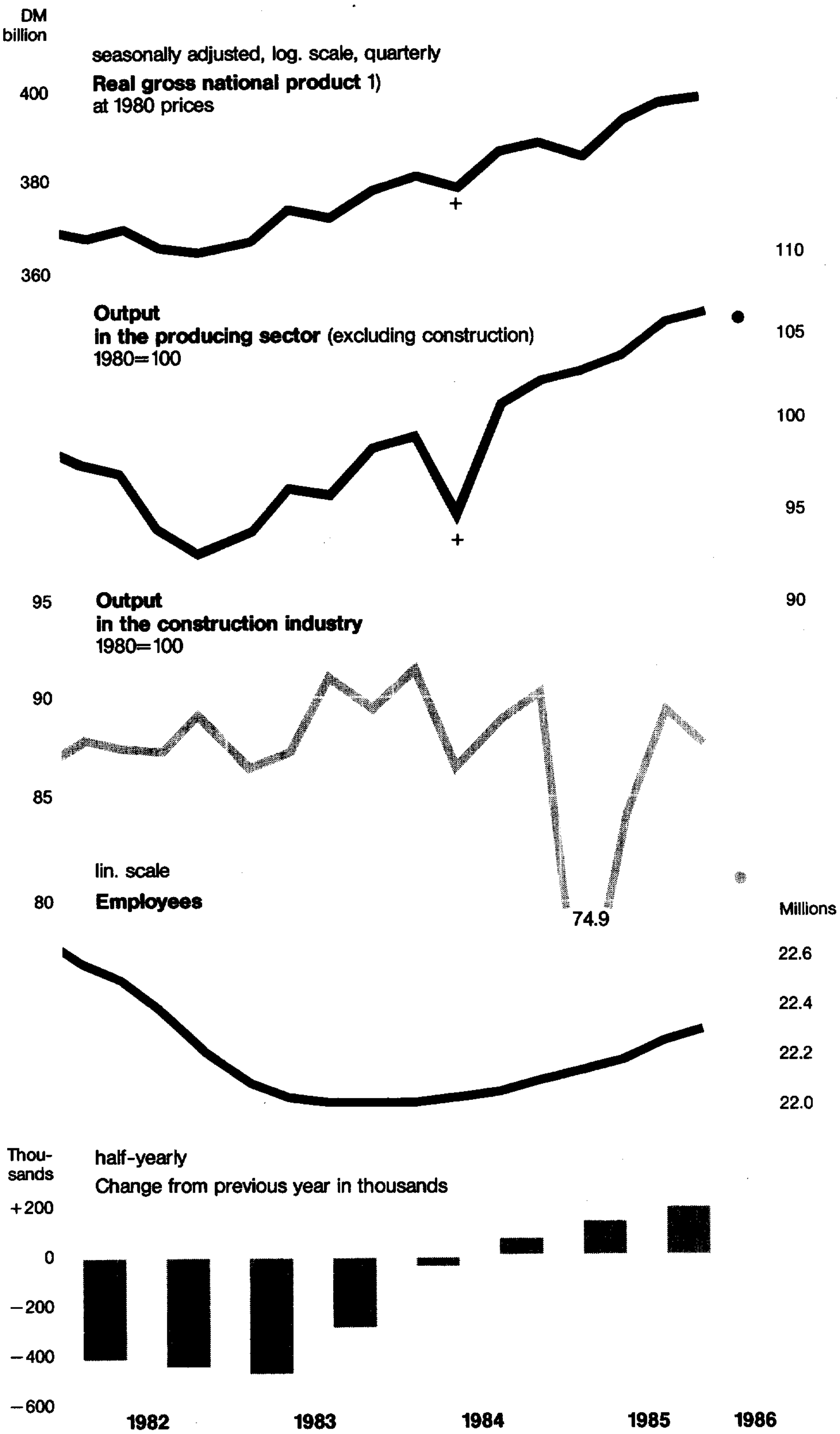
Labour market increasingly influenced by the upswing

Last year the labour market came more and more under the influence of the upswing. The number of employees increased strongly in the course of the year; in the last quarter of 1985 it was about 200,000 up on the year and just under 300,000 higher than around the turn of 1983-84, which was the cyclical low on the employment graph. Leaving aside seasonal influences, short-time working played a very insignificant role at the end of 1985; the return of about 1 million short-time workers to normal working hours since the start of 1983 is equivalent to an additional rise in the number of full-time employed in this period of about 300,000. In mid-March 1986, only about 295,000 short-time workers were registered at the labour exchanges, and of these 160,000 were in construction. In broad areas of the economy, internal personnel reserves have probably been largely exhausted by now, so that improved market chances can only be realised if additional staff is hired.

Employment increase in the manufacturing sector

In the manufacturing sector this was already the case in many instances in 1985. Enterprises in the capital goods sector especially, where demand and output developed particularly dynamically, raised their staff levels considerably in the course of last year. In some regions and sectors it became increasingly difficult to find suitable specialist labour. This was true in some cases for the construction industry, too, although there have been capacity reductions for some time here and for this reason alone personnel separations have been predominating. Relatively many older employees in this area made use in 1985 of the possibility for employees who were at least 58 years old to take early retirement, as provided for under wage agreements; to December last year, about 32,000 applications for early retirement were lodged from employees in construction. In the economy as a whole, about 48,000 employees had made use of the early retirement scheme by the end of 1985, but the preconditions for the Federal Labour Office being able to grant allowances — inter alia, someone who had previously been unemployed had to fill the job — were met in

Output and employment



1) Also adjusted for working-day variations.- + Affected by labour disputes.- ● =Jan./Feb.

BBk

barely 25,000 cases. In other sectors of the economy, for example in various services fields, in the wholesale trade and the public sector, employee numbers rose strongly in 1985 in some cases; in particular, many women interested in part-time work have probably found a job in these sectors. Overall, the increase in employees in the tertiary sector was in fact noticeably larger than in the producing sector.

Economic growth has become more labour-intensive over the long term

For some time the structural trend towards a services society and the fact that real value added per employee in the services sector is growing relatively slowly in comparison with other economic sectors both have tended to have the same effect. Economic growth in Germany has thus become more labour-intensive over the long term, an experience which is true for other countries as well, incidentally, especially for the USA. Regression calculations for Germany have shown that on an average for the years since 1983 — including the likely results for 1986 — total man-hours worked have increased when the economy grows by more than 2½ % per year. From 1973 to 1982 this rate had been 3½ % and from 1961 to 1972 in fact a good 5 %. In view of the fact that regular working hours have been tending to decrease for some time, this means that an increase in the number of employees starts at a point below the growth rates mentioned in each case. This also implies, however, that in the long term there is no fixed relation between growth in gross national product and employment; the trend towards a services society, on the one hand, and an appropriately depressed trend in real wages in the last few years, on the other, have, on the contrary, continuously brought forward the point as from which a rise in gross national product is associated with an increase in employment.

Continuingly high unemployment owing to demographic trends . . .

The number of unemployed reacted relatively little to the strong rise in employment. Seasonally adjusted, it was still 2.29 million at the end of March 1986; it has fallen by only about 30,000 since its high in spring 1985. Of late it has been equivalent to 9.2 % of the dependent or 8.1 % of the total labour force. Several factors have contributed to unemployment figures not having fallen more strongly in spite of increasing recruitments. The rise in the labour force which has been observable for a long time has continued undiminished of late. Some of the rise is due to young people from the high birth-rate years up to the end of the sixties starting working life. It is particularly gratifying that in the vocational training year 1984-85 by far the majority of applicants succeeded in finding an apprenticeship. At just under 700,000 newly concluded apprenticeship contracts, the vocational training year just ended saw the very high level of the previous year virtually being reached again. At the same time, the trend towards growing participation of women in the labour force continued. Among women registered at the labour exchanges as unemployed, at any rate, the proportion of those who had not been in the labour force before rose in the last few years to just under 30 % in 1985.

. . . and differentiated structure of supply and demand on the labour market

Moreover, great structural differences between supply and demand for labour still stood in the way of a more rapid reduction in unemployment. Enterprises were primarily looking for labour with vocational or tertiary education. The unemployment rate among these persons was between 4 and 6 % of the dependent labour force already in autumn 1984 (more recent data are not available), this being markedly lower than the overall average at the time (8.6 %). For those without completed vocational training it was, on the other hand, much more difficult to find a job; almost a fifth of this less qualified section of the labour force was registered as unemployed at the same time. In addition, there were problems of the regional distribution of labour supply and demand. Whereas in some regions (Baden-Württemberg, Hesse, Bavaria) the unemployment rates in 1985 on an annual average remained below the level of the previous year and, at between 5½ and 8 % of the dependent labour force, were noticeably below the Federal average (9.3 %), rates have risen further in those

Conditions on the labour market

Item	1982	1983	1984	1985	1984	1985
	in thousands, annual averages				Change from previous year in thousands	
Employment						
Employed **p**	25,709	25,331	25,352	25,531	+ 21	+ 179
of whom						
Wage and salary earners **p**	22,436	22,057	22,070	22,237	+ 13	+ 167
German citizens	20,649	20,363	20,461	°) 20,474	+ 98	°) + 200
Foreigners	1,787	1,694	1,609	°) 1,562	− 85	°) − 65
Unemployed	1,833	2,258	2,266	2,304	+ 8	+ 38
Short-time workers	606	675	384	235	− 291	− 149
Vacancies	105	76	88	110	+ 12	+ 22
Structure of unemployment	in thousands, at end-September				% of total	
Unemployed, total	1,819	2,134	2,143	2,151	100	100
by sex						
Male	982	1,145	1,155	1,132	53.9	52.6
Female	836	989	988	1,019	46.1	47.4
by vocational qualification						
qualified **1**	706	895	925	883	43.2	41.1
unqualified **2**	1,113	1,239	1,218	1,268	56.8	58.9
by length of time unemployed **3**						
less than 6 months	1,052	1,079	1,061	1,039	49.5	48.3
6 months to less than 1 year	440	524	464	446	21.7	20.7
1 year and more	327	532	617	666	28.8	31.0
by age						
up to 24 years	551	623	582	564	27.2	26.2
25 to 44 years	813	961	959	951	44.8	44.2
45 to 64 years	455	549	601	636	28.0	29.6
by nationality						
German citizens	1,566	1,850	1,896	1,907	88.5	88.7
Foreigners	253	284	247	244	11.5	11.3

1 Skilled workers and salary earners of equivalent status. — **2** Unskilled workers and salary earners of equivalent status. — **3** Calculation method changed by the Federal Labour Office. — ° 1st half-year 1985. — **p** As from 1983 provisional. BBk

areas of north and western Germany which are less favoured structurally and cyclically — to values between 11% (Schleswig-Holstein, North Rhine-Westphalia) and 15% (Bremen).

Progress in monetary stability through domestic and external influences

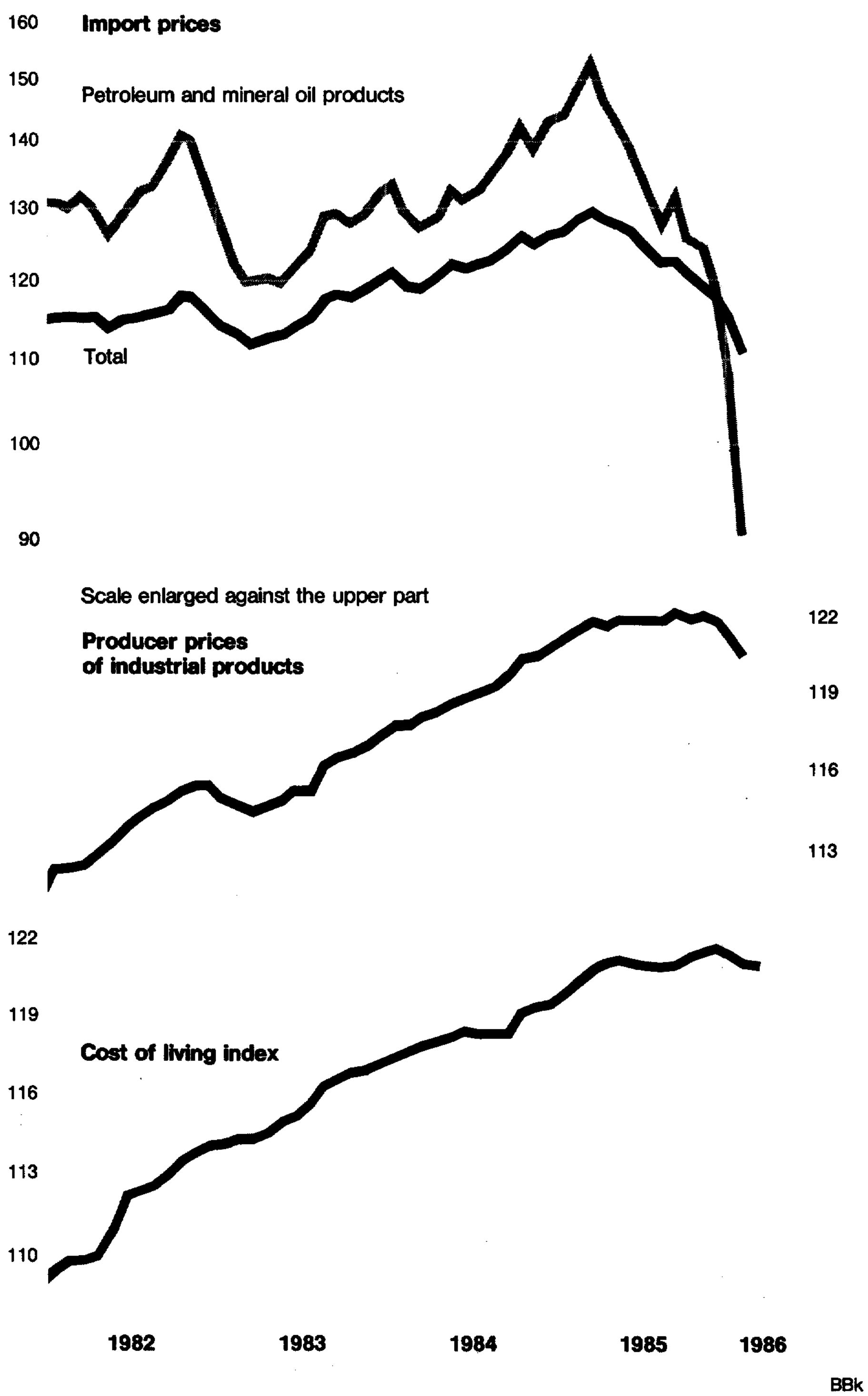
The economic upswing remained untroubled by inflationary tensions in its third year, too. The upward price pressure declined further in 1985 at all levels. It was domestic influences especially, particularly the moderate rise in wages, which worked in this direction. In the course of the year there were external factors in addition. Thus in February last year the dollar rate came down from the high it had been at for many years. The value of the US dollar fell from its peak at the time of DM 3.47 by almost a third (to DM 2.46) to the end of 1985. In addition, oil prices, calculated in US dollars, slumped on the international markets towards the end of the year. Dollar quotations of other important raw materials did indeed increase appreciably towards the end of last year, seasonally adjusted; in total, German importers' buying prices for imported primary products have nevertheless declined of late.

At the beginning of 1986 sustained pressure on import prices from a declining dollar rate and further oil price reductions

In the first few months of 1986 the US dollar rate continued to go down sharply. At the end of March it was quoted on the foreign exchange markets at DM 2.32. At the same time, the fall in oil prices intensified. The cause for this was a considerable rise in the quantity of crude oil on offer, which has to do with disputes within the OPEC price and quantity cartel and was not least designed to force the oil-producing countries to reach new agreements. The oversupply was reflected, inter alia, in the increasing importance of "net-back" contracts, under which, while retaining a formally unchanged "official" selling price, the actual price for crude oil is calculated on the basis of the selling price of processed

Prices

1980=100, seasonally adjusted, log. scale



mineral oil products. Freely traded North Sea oil from the Brent field, the price of which can serve as an indicator of price trends on the oil markets, cost only US$ 11.50 per barrel at the end of March this year; in US dollars its price has thus fallen to two-fifths of its previous year's level and in Deutsche Mark to nearly one-third. Some oil-producing countries within OPEC also cut their official selling prices strongly for the first time in three years, and the spot market prices for mineral oil products sank by March this year to their lowest level since 1978. Since the middle of last year the Deutsche Mark import prices for finished industrial products have also been declining. As from autumn 1985, capital goods have for the first time in eight years been imported at lower prices than in the preceding year. In February (more recent data are not available) there was a year-on-year fall in import prices of about 14½ % in total.

Stable industrial producer prices and small rise in construction prices

In addition to the already mentioned generally moderate "home-made" cost rise, price-depressing influences from abroad contributed to the price increase at home coming to a halt in the course of 1985. Industrial producer prices hardly showed any rise. In the first two months of 1986 they have in fact moderated noticeably, seasonally adjusted. In February, including mineral oil products, they were almost 1 % lower, but excluding mineral oil products still 1 % higher than a year before. Average construction prices rose by barely 1 % in 1985.

Price stability at the consumer level almost reached in 1985

At the consumer level Germany came very close to the goal of price stability last year. On an annual average the consumer price level went up by 2.2 %. One has to go back to the sixties to find lower annual average consumer price rises. In 1981 the inflation rate caused, among other things, by the follow-up effects of the second oil price crisis of 1979-80, had averaged 6.3 %. Since then it has fallen year after year. Seasonally adjusted, households' cost of living in the first months of 1986 has in fact declined under the influence of the most recent sharp price reductions for petrol and light heating oil. In March this year the level of consumer prices was hardly any higher than a year earlier. Food has been less expensive of late than a year before. By contrast, the rise in the prices of industrial goods outside the energy sector and those of many services and housing rentals has continued, but here, too, only at fairly low rates until recently. As far as approaching the stability goal is concerned, Germany has remained one of the leaders among the major industrial countries. Admittedly, the favourable results at the consumer level are partly due to factors which compensate for what is after all a moderate increase in the cost of domestic value added, measured by the deflator of the gross national product. The GNP deflator rose by 2½ % towards the end of 1985. This increase would have been decisive for prices of end-products if the price falls for imported goods had not occurred in the course of last year. In the short or long term this downward tendency will not continue and will then not be available to compensate for domestic price rises. In addition, the oversupply of many agricultural products in the European Community is currently depressing the prices of foodstuffs. Whether this price stabilisation effect will prove to be a sustained one is also uncertain. Ensuring monetary stability in Germany thus remains a task which, in spite of the good results for 1985, still requires ongoing efforts on the part of all those involved in the economic process.

2. Further progress in the consolidation of the public budgets

Further reduction of the public sector deficit in 1985

The basis for sustained economic growth without inflationary pressures was strengthened in 1985 through the continuation by financial policy of the consolidation course adopted in the autumn of 1981. Mainly because of the restraint which was again exercised in overall spending, the deficit in the budgets of the central, regional and local authorities was reduced by DM 8 billion in 1985, against the preceding year, to a total of DM 38 billion. Especially the budget situation of the Federal Government improved, and the deficits in the Länder Governments' budgets declined slightly, too. The local authorities, taken as a whole, were however no longer under pressure to consolidate further, after they had recorded a small surplus in 1984. The social security funds on aggregate achieved a surplus in 1985, for the first time after having been in deficit for two years. The main reason for this was that the finances of the pension insurance funds took a turn for the better under the impact of the consolidation measures and the economic upswing. Equilibrium between expenditure and receipts has, however, not yet been reached by the health insurance institutions, despite increases in contribution rates. In sum, the deficit of the public authori-

Finances of the public authorities*

Item	1982	1983	1984 pe	1985 pe	1982	1983	1984 pe	1985 pe
	DM billion				Change from previous year in %			
A. Expenditure, receipts and balances								
Central, regional and local authorities								
Expenditure								
Personnel expenditure	178.9	183.9	186.7	193.5	+ 2.8	+ 2.8	+ 1.5	+ 3.5
Other operating expenditure	85.4	89.0	92.8	97	+ 4.6	+ 4.1	+ 4.3	+ 5
Transfers	160.5	158.2	160.7	165	+ 3.6	− 1.5	+ 1.6	+ 2.5
Interest	45.2	51.4	53.6	56	+23.1	+13.8	+ 4.2	+ 5
Fixed capital expenditure	54.3	50.4	49.6	51.5	− 8.4	− 7.1	− 1.6	+ 4
Financial aid **1**	38.5	37.7	40.7	40	+ 6.2	− 2.1	+ 7.8	− 2
Total expenditure **2**	562.8	570.5	583.6	603	+ 3.7	+ 1.4	+ 2.3	+ 3.5
of which								
Federal Government	246.6	248.7	253.9	259	+ 5.0	+ 0.9	+ 2.1	+ 2
Länder Governments	224.2	228.3	234.9	243.5	+ 3.5	+ 1.8	+ 2.9	+ 3.5
Local authorities	153.0	151.7	153.8	162.5	+ 0.6	− 0.9	+ 1.4	+ 5.5
Receipts								
Tax revenue	378.7	396.6	414.7	437	+ 2.3	+ 4.7	+ 4.6	+ 5.5
Other receipts	115.4	119.8	123.5	129	+17.8	+ 3.8	+ 3.1	+ 4
Total receipts **2**	492.8	515.2	537.6	565	+ 5.6	+ 4.5	+ 4.3	+ 5
of which								
Federal Government	208.9	216.8	225.2	236	+ 6.1	+ 3.8	+ 3.9	+ 5
Länder Governments	199.6	206.9	216.7	227.5	+ 4.8	+ 3.6	+ 4.7	+ 5
Local authorities	145.8	150.3	155.2	163	+ 2.7	+ 3.1	+ 3.3	+ 5
Surplus (+) or deficit (−)	− 70.0	− 55.3	− 45.9	− 38	.	.	.	.
of which								
Federal Government	− 37.7	− 31.9	− 28.6	− 23	.	.	.	.
Länder Governments	− 24.6	− 21.4	− 18.2	− 16	.	.	.	.
Local authorities	− 7.3	− 1.3	+ 1.5	+ 1	.	.	.	.
Social security funds								
Expenditure	310.4	316.9	331.1	341.5	+ 5.9	+ 2.1	+ 4.5	+ 3
Receipts	315.2	315.7	328.2	344	+ 5.4	+ 0.2	+ 4.0	+ 5
Surplus (+) or deficit (−)	+ 4.8	− 1.2	− 2.8	+ 3	.	.	.	.
Public authorities, total								
Expenditure	828.7	848.4	876.0	904	+ 4.4	+ 2.4	+ 3.3	+ 3
Receipts	763.6	791.9	827.2	869	+ 5.5	+ 3.7	+ 4.5	+ 5
Deficit (−)	− 65.2	− 56.4	− 48.8	− 35	.	.	.	.
	Level at end of year in DM billion				Change from previous year in DM billion			
B. Indebtedness of the central, regional and local authorities								
Borrowers' note loans	449.4	474.5	490.0	498.5	+40.1	+25.1	+15.5	+ 8.5
Securities	142.4	175.7	205.1	243	+31.6	+33.3	+29.4	+38
Other debt	23.0	21.5	22.4	19	− 2.5	− 1.5	+ 0.9	− 3.5
Total indebtedness	614.8	671.7	717.5	760.5	+69.2	+56.9	+45.8	+43
of which								
Federal Government	309.1	341.4	367.3	392.5	+36.0	+32.4	+25.9	+25
Länder Governments	190.6	212.0	230.6	247.5	+25.5	+21.4	+18.5	+16.5
Local authorities	101.8	104.1	104.8	105.5	+ 6.7	+ 2.3	+ 0.7	+ 1

* Including hospitals keeping commercial accounts and other special accounts. Receipts and expenditure are shown here under the period for which they are intended, in accordance with budgetary practice. — **1** Expenditure on investment grants and loans to third parties, plus the acquisition of participations. — **2** This aggregate — unlike the figures below for the Federal and Länder Governments and local authorities — does not include transfers between the various levels of government (apart from differences in clearing transactions). — **pe** Partly estimated.
Discrepancies in the totals are due to rounding.

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ties decreased by DM 14 billion to DM 35 billion in 1985, i.e. to roughly half the amount of 1981.

Renewed decline in the government spending ratio

In 1985 the public authorities (central, regional and local authorities plus social security funds) spent a good 3% more than a year previously. The rise in expenditure thus once again fell short of the growth of the nominal gross national product (4½%). The government spending ratio (i.e. the ratio of government expenditure to the gross national product) therefore declined further; at 49¼% it was just over 2½ percentage points below its all-time peak in 1982.[1] The central, regional and local authorities enlarged their expenditure by 3½% last year. Although they did not fully utilise the expenditure appropriations of the original budgets, their spending rose slightly more than was consistent with the limitation to 3% recommended by the Financial Planning Council; in the preceding two years they had remained below that mark (with growth rates of 1½% and 2½%). The local authorities' spending went up particularly sharply (+5½%), after their deficits had been run down, but Länder Government expenditure, too, rose at a faster pace than a year before (+3½%); by contrast, Federal Government spending grew only by 2%, as it had done in 1984.

Capital spending higher again . . .

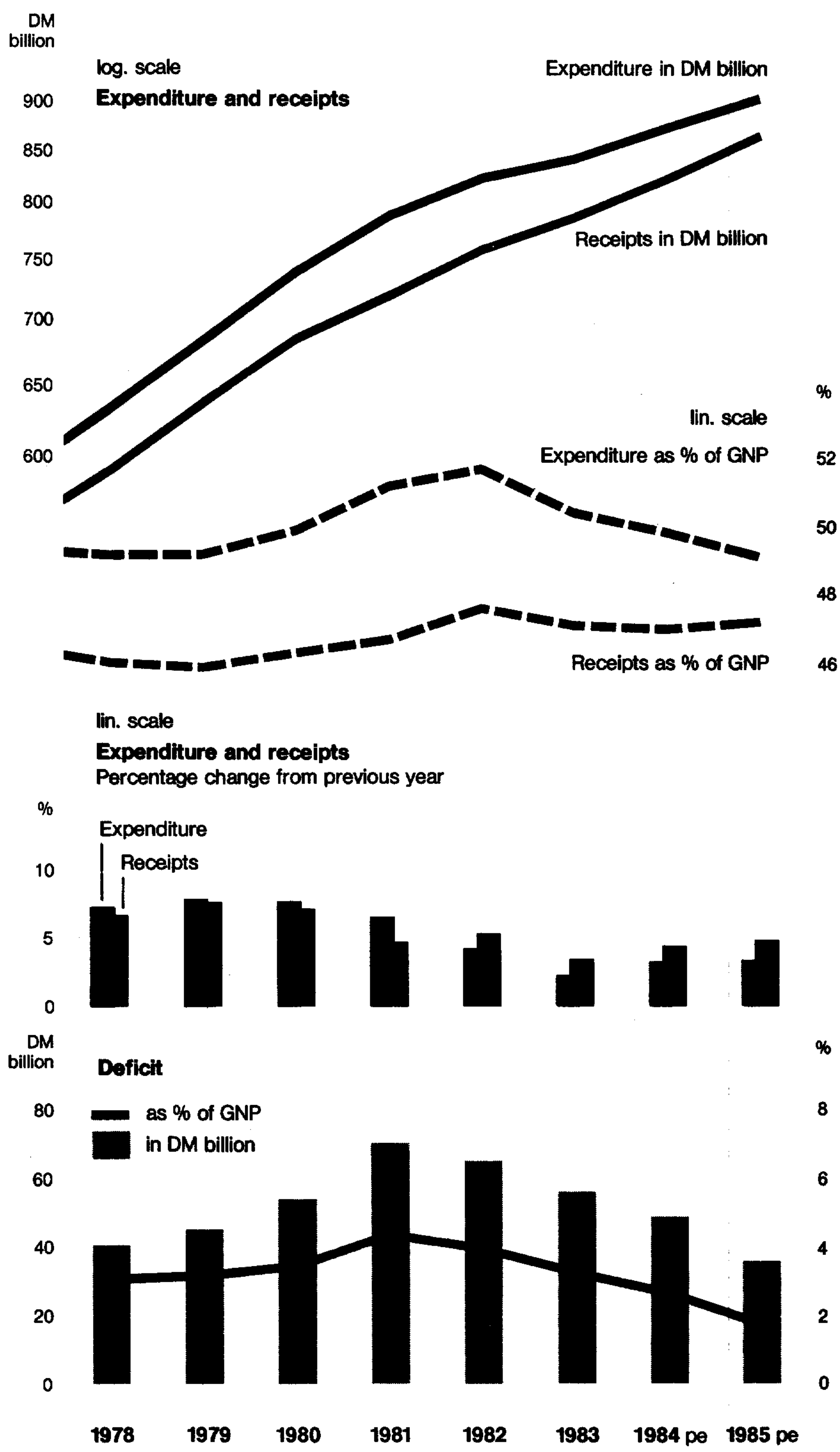
In 1985 the central, regional and local authorities not only reduced their deficits and the government spending ratio further; they also took a first step towards restructuring expenditure in favour of capital formation. The central, regional and local authorities' capital spending, for instance, went up in 1985, for the first time after several years of decline; its growth, at 4%, was slightly sharper than that of overall expenditure. The prime reason for this was that the local authorities, the principal public investors, had more financial scope for capital formation. The "qualitative" consolidation aimed at in the longer run is best served by capital projects which foster economic growth and improve the environment.

. . . but sharper increase in consumption expenditure as well

Some of the consumption expenditure of the central, regional and local authorities also rose more rapidly. This applies at all events to the two biggest spending items, personnel expenditure and social security transfers. Personnel expenditure grew by just over 3½% and hence over twice as much as a year before, mainly because wages and salaries in the public service were raised more than in 1984, when pay increases had been postponed. In addition, more new staff was apparently recruited in some cases. Current transfers by the central, regional and local authorities to households likewise rose more steeply than in 1984 (by 2½%); whereas further expenditure cuts came into force at that time, the sharp raising of the rates of social assistance in the middle of the year now had the opposite effect. Besides, the number of recipients of social assistance has presumably increased further. The rise in other operating expenditure, which had already been fairly sharp in 1984, continued (+5%), one of the main factors apparently being the pent-up demand for measures for the upkeep of buildings. Lastly, interest payments still went up by 5%, although their growth rate slackened in comparison with earlier years as a result of the smaller borrowing requirements of the central, regional and local authorities and the lower level of interest rates. The proportion of interest expenditure in the central, regional and local authorities' total spending now stands at 9½%, against not quite 6% in 1980 and 3½% in 1970.

1 The government spending ratio was calculated here on the basis of expenditure as defined in the financial statistics. In the definition of the national accounts the government spending ratio is slightly lower (mainly because loans granted out of budget funds are counted there as financial transactions rather than expenditure), but the decline was roughly the same. The fact that the government spending ratio reached its peak in 1982, despite the start of restraint in expenditure, and not in 1981, is ascribable to the sluggish pace of economic activity and the resulting low growth of the nominal gross national product in 1982.

Finances of the public authorities*



* Central, regional and local authorities and social security funds.- pe Partly estimated.

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Weaker growth of social security expenditure

The growth rate of the social security funds' expenditure slowed down to 3% last year, after 4½% in the preceding year. The pension insurance funds spent only 2½% more; this was partly due to the fact that in mid-1985, simultaneously with the regular pension adjustment, pensioners' own contribution to their health insurance was raised from 3% to 4½% of their pension, and the share to be borne by the pension insurance funds was lowered accordingly. The expenditure of the Federal Labour Office was hardly above the previous year's level; higher disbursements on vocational assistance and measures to create jobs were accompanied by a decrease in payments of short-time working benefits, in particular. But the statutory health insurance institutions did not succeed in adequately curbing the cost rises; their expenditure still grew by nearly 5 %.

Strong rise in receipts in the wake of the economic upswing

The public authorities' endeavours to reduce their budget deficits further in 1985 were assisted by the fact that receipts grew more strongly again (+5 %) in the wake of the economic upswing. As a result, the overall revenue ratio (the relationship between revenue from taxes and social security contributions, on the one hand, and the nominal gross national product, on the other) also admittedly rose slightly in 1985. At just under 40 % last year, it was, however, no higher than at the beginning of the eighties.

Sharp increase in income tax revenue

In 1985 tax revenue increased relatively sharply, i. e. by 5½ %, as a result of the favourable economic trend. The overall tax ratio rose by 0.2 percentage point against 1984 to 23.8 %, mainly owing to the progressive income tax scale; unlike the ratio of social security contributions, it was, however, still lower than at the beginning of this decade. Revenue from the major direct taxes, and notably from corporation tax, increased particularly sharply. Corporation tax yielded 21 % more in 1985, primarily because of the further improvement in corporate profitability. Revenue from assessed income tax also increased, for the first time since the beginning of the eighties; it constitutes the balance of several elements, some positive and some negative. On the one hand, advance payments were increased further in 1985, mainly in view of the substantial rise in self-employed persons' income. On the other hand, larger sums had to be refunded to employees liable to assessment, either because they had paid too much wage tax, or in connection with tax-reducing factors such as depreciation under section 7b of the Income Tax Act; these refunds lower the net receipts of assessed income tax. In the event, the yield of assessed income tax, which de facto is calculated residually, went up by 8½ % in 1985. The revenue from wage tax (which is deducted at source from wages and salaries and civil servants' pensions) was likewise 8½ % above the preceding year's level. This owed something to the rise in the number of employees and the substantial reduction in short-time working. The growth of profits caused trade tax receipts to increase vigorously, too (+8½ %).

Slight decline in the turnover tax yield

By contrast, the yield of turnover tax actually declined slightly (by ½ %), despite the upturn in economic activity. One of the reasons for this was the fact that the higher VAT input tax rate granted to farmers since mid-1984 (i. e. a subsidy lowering tax receipts) had for the first time taken effect over a full year in 1985. Besides, turnover liable to tax rose relatively sluggishly in comparison with the nominal gross national product. After all, precisely those elements of the national product which contributed most to its growth in 1985 — i. e. exports and entrepreneurial capital formation — are tax-exempt, whereas investment in housing construction, which is subject to value-added tax, was on the decline because of the adjustment problems in that sector.

An especially important factor in the field of non-tax receipts was that the amount which the Bundesbank transferred to the Federal Government out of its profit, at almost DM 13 billion, was actually a little larger than in 1984.

Further rise in the burden of social security contributions

The volume of contributions received by the social security funds likewise grew vigorously again last year (+5 %). As a proportion of gross wage and salary income, the burden of social security contributions rose by 0.3 percentage point to 28.5 % last year; in 1985 it was thus almost 2½ percentage points higher than at the beginning of the eighties (in 1970 the ratio had been only 21½%). Its renewed increase last year is mainly attributable to the fact that the health insurance institutions raised their contribution rates by roughly ½ percentage point on average.

Consolidation policy promoted the sustained upswing in economic activity

Although the economic upswing has now entered its fourth year and is being fuelled increasingly by domestic demand, some eminent observers abroad, pointing to the massive current account surpluses, have been calling for the abandonment of the present financial policy stance in the Federal Republic of Germany. In actual fact, however, the consolidation policy has done more to pave the way for the upswing in the German economy than to obstruct it. As the government deficits and the large share in GNP of public expenditure predominantly serving consumption purposes were gradually reduced, the basic conditions for economic activity improved and confidence in the further course of economic policy strengthened. The curtailment of government demand for credit assisted the process of lowering interest rates and facilitated the financing of private capital formation; in this way it helped to make fixed capital expenditure in enterprises more attractive relative to investment in financial assets. In addition to these favourable effects for the economy as a whole, consolidation of the budgets was also in the interests of the central, regional and local authorities themselves: for it curbed the growth of their interest burden, which is increasingly narrowing the scope for the fulfilment of the government's functions proper. Moreover, the public sector benefited indirectly, through higher receipts, from the upswing in the private sector.

Consolidation is continued

The consolidation policy of the Federal Government and the Financial Planning Council is designed to lower the deficit, reduce the government spending ratio (relative to GNP) and create room for tax cuts. This goal has not been reached so far: the level of the central, regional and local authorities' debt, for instance, is still rising by about 5% a year and the share of the interest burden borne by the public authorities is increasing further. At 2% of the nominal gross national product in 1985, the public sector deficit is still larger than it was on an average between the middle of the sixties and the middle of the seventies, i.e. before the period of massive deficits started. In the light of growth policy requirements, moreover, there is much to be said for not merely limiting the deficit of the public authorities (and hence the use of monetary capital formation for government purposes) to the proportions customary in the past, but actually reducing it still further, because the underlying situation has meanwhile changed: before grave structural weaknesses in the economy and employment problems emerged in the middle of the seventies, the financial policy makers had focused their attention primarily on smoothing out cyclical fluctuations. Today, by contrast, the financial policy makers are primarily concerned with helping to safeguard favourable conditions for private capital formation (which creates long-term jobs) in order to reduce unemployment. It should be kept in mind in this context that the decline in the government spending ratio achieved in the past three years is still small relative to the preceding rise, and that the burden of levies remains heavy; furthermore, no progress has been made in lowering the subsidies.

The consolidation strategy now includes tax cuts as well

At the beginning of 1986 consolidation policy entered a second phase: while in preceding years the main emphasis of financial policy had of necessity been on reducing the massive public sector deficits, as described above, the progress achieved in this field now makes it possible, in keeping with the longer-term strategy, to embark not only on the further gradual lowering of the deficits but also on a reduction of the tax burden, as had been envisaged in principle from the outset. It is important at the same time to ensure that a further raising of the contribution rates to the social security funds is avoided as far as possible. The alleviation of the tax burden (like a decrease in recourse to the credit markets by the government) results in greater room for manoeuvre for the private sector. Incidentally, the fact that some of the financial scope which the government has gained by showing restraint in its spending is now being used for tax cuts weakens the force of the misgivings harboured in some quarters to the effect that the government is behaving restrictively.

First stage of the tax cuts comes into force at the beginning of 1986

Extensive tax cuts were approved last year, and the first stage of them came into force at the beginning of 1986. In the context of wage tax and income tax, the basic allowance and children's allowance were raised, and the marginal tax rates in the progressive zone of the tax scale were lowered slightly. Private consumption will benefit most from this. The second stage of the tax relief, in which the marginal rates in the progressive zone of the tax scale will be reduced more drastically, follows in 1988. As a result of these tax measures, which will cause receipts to fall by an estimated DM 11 billion in 1986, the central, regional and local authorities will in all probability have to accept a pause in the reduction of their budget deficits in the current year. It is planned, however, that the tax cuts of 1986 and 1988 should not jeopardise the medium-term trend towards a further decline in the deficits.

Risks to the successful continuation of the consolidation policy

Success in reducing the deficits further over the longer term admittedly hinges on the central, regional and local authorities exercising strict restraint in their expenditure. The Financial Planning Council accordingly repeated its recommendation to limit the growth of spending to 3% a year in the medium term and thus to keep it distinctly below the expected rate of increase of the nominal gross national product. But now that the central, regional and local authorities narrowly failed to observe this limit in 1985, as stated above, some risks are also looming for the future: income increases of roughly 4%, such as are embodied in the pay settlements for the public service in 1986, mean that the rise in personnel expenditure will exceed the above-mentioned mark in the current year even without the recruitment of any additional staff. Transfers, too, will grow by more than 3% in 1986 owing to various increases in benefits; judging by the longer-term underlying trend, they are likely to more or less follow the movement of wage and salary income in the economy as a whole, unless the usual adjustments are dispensed with or legislation is amended. A stronger expansion of consumption expenditure cannot, however, be reconciled with a spending limit of 3% if at the same time public capital formation is to be accorded a larger share in the budget volume. Risks to the budget exist also in respect of Community requirements. The limit envisaged for all central, regional and local authorities appears to be in special jeopardy at the municipal level, as was already the case in 1985. Particularly in view of the high proportion of personnel expenditure in their budgets, the Länder Governments will in all probability also find it difficult to limit the growth of their expenditure to 3%. The Federal Government cannot ensure the attainment of this target on its own.

Sustained slow growth of expenditure a precondition for a fundamental tax reform

Scope for the fundamental tax reform now projected for the beginning of the nineties (and centering on a further lowering of the income tax scale) can be created in the budgets of the central, regional and local authorities only if the growth of expenditure is lastingly kept within narrow limits. While the proposals on the content of this reform are assuming more and more concrete shape in the public debate on the issue, it is less clear how they can be fitted into the financial framework. The calculations made in various quarters show at all events that the financial latitude for such a reform can be lost very rapidly if expenditure growth overshoots the envisaged limit.

Record of economic policy measures

	I. Domestic and external monetary policy
1985	
January 31	The Bundesbank raises the lombard rate from 5½% to 6% with effect from February 1. By offering more securities repurchase agreements at low interest rates the Bundesbank subsequently makes it easier for the banks to run down their lombard debt. At the same time the banks are offered, until further notice, Federal Treasury bills with very short maturities (normally 3 days), initially at a rate of 5½%, as a temporary investment facility to preclude an undesirable fall in the day-to-day money rate.
April 11	The Bundesbank approves the annual accounts for 1984; DM 12.9 billion of its net profit is to be transferred to the Federal Government. It has been agreed with the Federal cabinet that — as in the previous year — the profit is to be transferred in instalments: DM 5 billion is to be disbursed at once and the remainder is to be paid in four monthly instalments, each of DM 2 billion, between May and August.
April 12	Through the "Statement by the Deutsche Bundesbank on issues of foreign Deutsche Mark bonds" the range of banks allowed to lead-manage foreign Deutsche Mark bond issues is extended with effect from May 1 to include foreign-owned domestic banks of independent legal status. This statement replaces the "Gentlemen's agreement" last concluded in January 1980 with the leading German banks in the field of foreign Deutsche Mark bond issues. At the same time the German market is opened to a number of different types of bonds which are now well-established internationally (such as floating rate notes and zero bonds).
July 4	Following its regular review of the monetary target for 1985 the Bundesbank decides to retain the envisaged target range of 3% to 5% for the growth of the central bank money stock (from the fourth quarter of 1984 to the fourth quarter of 1985).
July 18	With effect from August 1 the Bundesbank raises the banks' rediscount quotas by about DM 3 billion, thus enabling them to consolidate part of the basic amount of shorter-term debt accumulated in the course of securities repurchase agreements.
July 20	In the eighth realignment of exchange rates in the European Monetary System the central rates of the Italian lira against the other currencies participating in the exchange rate mechanism are refixed. The realignment results in a uniform 7.8% devaluation of the lira against the partner currencies.
August 15	With effect from August 16 the discount rate is lowered from 4½% to 4% and the lombard rate from 6% to 5½%. The Bundesbank, using a "confirmatory approach", thus follows the falls in interest rates which have occurred in the money market. In addition, the cut in the discount rate reestablishes a larger gap between that rate and the money market rates; this facilitates the Bundesbank's strategy of continuing to manage the money market flexibly through securities repurchase agreements.
September 22	The Finance Ministers and Central Bank Governors of the five most important industrial countries discuss in New York economic trends and the economic policies pursued in their respective countries. Among other things they advocate a further orderly appreciation of the major currencies against the US dollar and agree to cooperate more closely with one another to this end.
December 19	The Bundesbank announces the 1986 monetary target. The envisaged 3½% to 5½% expansion of the central bank money stock (between the fourth quarter of 1985 and the fourth quarter of 1986) is gauged in such a way as to permit strong real growth of the economy from the monetary angle while safeguarding the virtual price stability already achieved. In addition, the Bundesbank announces a revision of the minimum reserve regulations. The object of the revision is, in particular, to alter the pattern of reserve ratios and to authorise the issue of bonds denominated in Deutsche Mark which have the characteristics of certificates of deposit. At the same time shorter-term bank bonds with maturities of less than two years will in future be subject to minimum reserve requirements. The change in the minimum reserve regulations will reduce the banks' required reserves by some DM 8 billion.
1986	
March 6	With effect from March 7 the discount rate is lowered from 4% to 3½%. With this decision the Bundesbank takes due account of the tendency towards relaxation in German financial markets. At the same time it decides to reduce the banks' rediscount quotas by DM 5 billion with effect from May 1. This will offset the greater part of the release of liquidity resulting from the changes in the reserve ratios and in the Bundesbank's "Minimum Reserves Order" approved with effect from that date.
April 6	The central rates in the EMS are realigned. The Deutsche Mark and the Netherlands guilder are revalued by 3%, the Belgian franc, the Luxembourg franc and the Danish krone by 1%, and the French franc is devalued by 3%.

II. Economic and financial policy

1985

January 30 — In its 1985 Annual Economic Report the Federal cabinet ascribes the upswing inter alia to the reorientation of economic policy towards market principles, which it had initiated. It also emphasises the fact that the degree of price stability already achieved helps to guarantee future economic growth. For 1985 the Federal cabinet considers an increase of 2½ % or more in the real gross national product and a decline in the unemployment rate to below 8 % of the total labour force on an annual average to be within reach. In its opinion the average annual rise in consumer prices could be limited to about 2 %.

March 21 — The Environment Ministers of the European Communities agree on the introduction of cars with low-pollutant emissions in the EEC. Requirements and time limits are graduated according to engine capacity.

April 19 — The Bundestag approves the Act to Strengthen the Financial Basis of the Statutory Pension Insurance Funds. The contribution rate to the pension insurance funds is raised from 18.7 % to 19.2 % from June 1, 1985, while the contribution rate to the Federal Labour Office is lowered from 4.4 % to 4.1 %.

April 26 — The Bundestag approves the Act to Promote Employment, which comes into force on May 1, 1985. For the period until 1990 it provides for the possibility of concluding employment contracts limited to a maximum of 18 months. Besides, the maximum duration of the hiring out of labour is extended from three to six months.

May 24 — The Bundestag approves the 1986-88 Tax Reduction Act. It will relieve the burden of wage and income tax by a total of over DM 19 billion in two stages in 1986 and 1988.

June 19 — The Financial Planning Council recommends that the current course of financial policy should be adhered to in the medium term, i. e. that annual new borrowing should be reduced further and that the growth of expenditure should be limited to 3 % a year. Any financial scope gained thereby should be used to stabilise and increase capital formation by the public sector, notably the local authorities.

June 23 — In a Special Report, the German Council of Economic Experts points out that the driving forces behind the upswing have not weakened and will presumably remain operative in 1986 as well.

July 1 — The Act on Tax Relief for Passenger Cars with Low-Pollutant Emissions comes into force. Passenger cars whose pollutant emissions are below the limits set by the EEC are granted, for a limited period, a tax exemption or tax reduction which is graduated according to engine capacity. Motor vehicle tax on all passenger cars not eligible for such a tax reduction is raised as from January 1, 1986.

July 1 — The Federal cabinet approves the draft Federal budget for 1986 and the financial plan for the period from 1985 to 1989. The budget volume in 1986 amounts to DM 264 billion and the financial deficit, at almost DM 25.5 billion, is put at as high a level as in 1985. In the medium term expenditure is to grow by just under 3 % a year; on account of the Tax Reduction Act, the deficit will remain at about the same level until 1988 and will not decline (to DM 23.5 billion) until 1989. In addition, the Federal cabinet approves various measures to strengthen the capacity of the business community to invest and to facilitate adjustment processes in the construction industry.

November 22 — In its Report for 1985-86 the German Council of Economic Experts notes that the upswing is developing on a sound basis. It has been fuelled by buoyant exports and by investment in machinery and equipment. Private consumption, too, has gradually gathered pace in the course of 1985. This, however, has been accompanied by a sharp decline in the demand for new housing. As the labour force has grown further, unemployment has not been reduced despite a perceptible increase in employment. For 1986 the Council anticipates a continuation of the economic upswing: the real gross national product is expected to go up by 3 % on an annual average and the number of employees by 300,000.

November 29 — The Bundestag approves the 1986 Federal budget, with an expenditure volume of DM 263.5 billion (+ 2.2 % over the adjusted amount envisaged for 1985) and a financial deficit of DM 24 billion.

1986

January 1 — Numerous measures of tax, family and social policy come into force, in particular

- the first stage of the Tax Reduction Act, comprising inter alia the raising of the basic tax allowance, the children's allowance and the education allowances and, in a first step, the lowering of the tax scale in the progressive zone. Taxpayers liable to little or no income tax are granted, in addition to children's benefits, a monthly sum of up to DM 46 per child;
- the lowering, for 1986, of the contribution rate to the Federal Labour Office by 0.1 percentage point to 4.0 % and the extension of the period for the payment of unemployment benefits to elderly jobless persons;
- the raising of housing allowances;
- the introduction of an education allowance.

January 30 — In its 1986 Annual Economic Report the Federal cabinet points out that the economic upswing perceptibly gained momentum in 1985, and that the German economy has therefore come significantly closer to the attainment of the objectives of the Economic Stability and Growth Act. For 1986 the Federal cabinet expects an average annual growth of approximately 3 % in the real gross national product and a rise of about 300,000 in the number of employed persons. On an annual average, a distinct reduction in the unemployment rate (to some 7½ % of the total labour force) and a limitation of the rise in consumer prices to between 1½ % and 2 % are to be expected.

3. External position strengthened considerably

Sharp improvement in Germany's current account

The economic upswing and the external position in the Federal Republic of Germany were closely correlated in 1985. Firstly, the growing surpluses on the current account of the German balance of payments undoubtedly did much to buttress the cyclical uptrend. Secondly, economic developments in Germany, which in many respects were positive, gave non-residents considerably more confidence in the Deutsche Mark, so that there was a strong inflow of foreign capital and a strengthening in the upward tendency of the Deutsche Mark. The consolidation of Germany's external position was and continues to be rooted in the improved competitiveness of German enterprises. In statistical terms, this is seen not least in the surplus of close on DM 39 billion on the current account of the German balance of payments in 1985 which was nearly twice as large as in 1984 (DM 20 billion). This figure is in marked contrast to the deficits in the period between 1979 and 1981, when the deficit, in 1980, had risen to a record level of DM 28.5 billion. The foreign trade result, in particular, improved sharply in 1985. Exports of goods rose appreciably more strongly in value, at 10%, than imports of goods (+7%), so that the trade surplus – on an f.o.b./f.o.b. basis[1] – went up from DM 67 billion to DM 86 billion.

Increased competitiveness of German exporters

Whereas at the beginning of the eighties German enterprises had lost some of their international competitiveness, especially in high-technology products, German industry has clearly concentrated in recent years on the "right" products and the most ready markets. The particular strength of German business lay in the quality of the products, the after-sales service, prompt deliveries, the willingness to comply with customers' individual requests and an increasing range of goods on offer. Furthermore, because of the large degree of cost and price stability in Germany and the at times lower external value of the Deutsche Mark, products made in Germany, which for a long time were considered to be relatively expensive, also became attractive from the price point of view. Hence the market share of German goods went up again; while the volume of world trade (excluding oil) increased by approximately 4% in 1985, Germany's exports rose by 6% in volume. Of course, this figure is also partly attributable to temporary trends which, like the downward tendency of the Deutsche Mark, had already ceased by 1985 and have been reversed in the meantime. Processes of adjustment thus got under way in 1985 though of course their full effects on the level of the current account surpluses have not yet been felt owing to the sharp oil price reduction which took place at the beginning of 1986.

Export business weakens during 1985

In export business, in particular, there was a marked change during the year. After the previous strong growth German exporters witnessed a decline in orders received from abroad, which was mainly a reflection of similar trends in world trade. In the course of 1985 foreign orders barely remained at the high level reached in the first quarter. To begin with, of course, this made little difference to actual export deliveries, since a large backlog of orders continued to make an impact. Germany's exports, which are largely accounted for by capital goods that take a fairly long time to produce, went on rising strongly, at any rate until the late summer of 1985; the downturn did not occur until afterwards, although it did not appreciably impair the gratifying performance in 1985.

After-effects on exports of the sharp fluctuations of the dollar rate

The sharp exchange rate fluctuations also had a delayed effect on export opportunities. Although the dollar boom had already ended by the spring of 1985, German exports to the United States increased sharply for a long time; in the first three quarters of 1985 they were 25% up on a year earlier. In the fourth

1 Both exports and imports are recorded here at their value at the border of the exporting country (f.o.b. value), in accordance with international balance of payments practice. The transport and insurance costs payable on imports are included in services transactions. In accordance with the official foreign trade statistics, which record imports at their value at the German border (c.i.f. value), the export surplus is correspondingly smaller (1985: DM 73 billion compared with DM 54 billion in 1984).

quarter, however, exports to the United States were only 3% above the level of the corresponding period of the previous year; this would seem to be ascribable to the correction of the Deutsche Mark/dollar rate and the weakening of the US economy. The fall in the dollar rate, which continued in the first three months of 1986 (at the end of March the US dollar was quoted at DM 2.32), can probably be seen largely as a "normalisation". Hardly any enterprises would seem to have reckoned on a long-term overvaluation of the dollar when making their longer-term export plans. Of course, given the current exchange rate level, the "windfall profits" from the excessively high exchange rate have dried up, and considerable efforts must be made if the market shares gained in the dollar area are to be maintained. Enterprises which have only recently forged ahead on this market will probably find it particularly difficult to consolidate their success.

Exports favoured by the real depreciation of the Deutsche Mark in the EMS

The competitiveness of German suppliers has changed only little against most of the countries of western Europe, the major market for German exports. After a period of three years, in which the central rates in the European Monetary System (EMS) remained constant (apart from the isolated devaluation of the Italian lira in the summer of 1985), there was a realignment of parities at the beginning of April this year. The resulting revaluation of the Deutsche Mark against the EMS currencies — as measured by the central rates it comes to a good 3% on a weighted average — is hardly likely to adversely affect the competitive position of German exporters, as prices and costs in most EMS countries have risen more sharply than in Germany since the last realignment of exchange rates in the spring of 1983. As overall demand in the EMS countries increased for cyclical reasons, German exports to this region went up by 8½% in value in 1985. There was a rise of 13½% in exports to the other industrial countries of western Europe, in which conditions of growth and competition for German exporters were similar; exports to the Scandinavian countries and to Austria and Switzerland took the lead. However, in western Europe — as in the dollar area — Germany cannot permanently rely on the supportive effect of the exchange rate trend. Instead, it will have to hold its own on the traditional markets, even if circumstances are less favourable.

Exchange-rate-induced fall in import prices

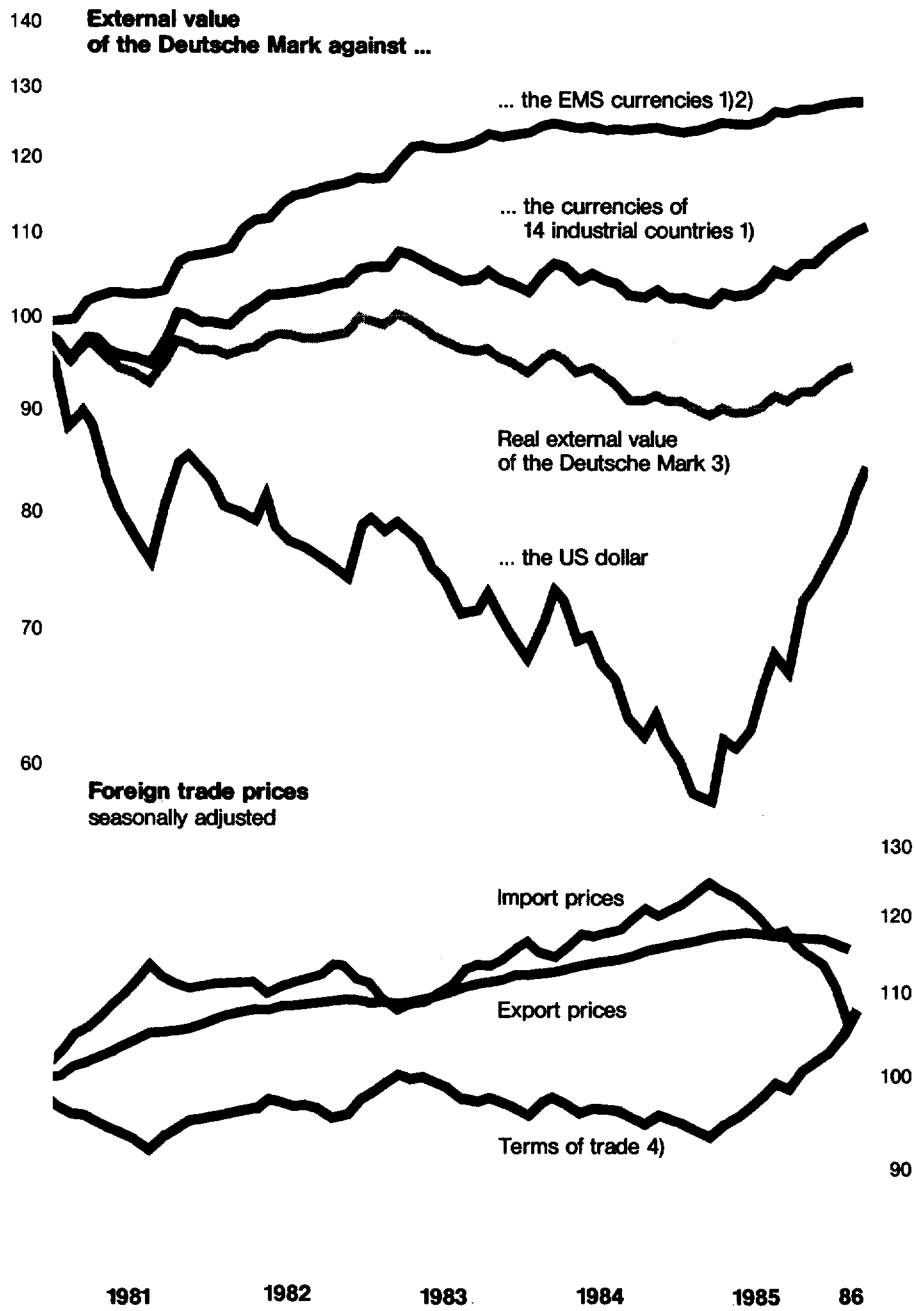
Specific conditions in 1985 did not only bring about an increase in exports, on an annual average. The trade surplus was also markedly influenced by the trend of import prices. After the dollar boom and the resulting rise in import prices until the spring of 1985, this trend corrected itself in the ensuing months of the year, so that in December import unit values were 5½% down on a year earlier. The exchange-rate-induced price falls directly affected the value of imports while, as is customary, quantitative reactions can only be expected gradually. Hence two factors stemming from the latest exchange rate trend and occurring at the same time had a cumulative effect on the foreign trade figure for 1985: firstly, the sudden rise in foreign orders, which is having a somewhat longer-term effect, as a result of the previous weakness of the Deutsche Mark, and, secondly, the swift decline in import prices after the correction of the dollar rate. It is obvious that these trends cannot be extrapolated into the future, since the stabilisation of the current exchange rate relations will gradually lead to a curbing of real export growth and a sharp expansion in the volume of imports, while the specific effect of changes in foreign trade prices on the value of exports and imports will not be repeated.

Sharp growth in imports of goods

Imports rose sharply in 1985; they went up by a total of close on 7% in value and a good 4% in volume. Imports thus increased considerably more strongly than Germany's real gross national product, with the actual momentum tending to be understated since, with the fall in the prices of energy and raw materials, some importers exercised restraint in their purchases from abroad, hoping to buy later at more favourable terms. However, such restraint with regard to im-

External value of the Deutsche Mark and foreign trade prices

4th qtr 1980=100; log. scale; monthly



1) Weighted external value of the Deutsche Mark.- 2) Excluding the pound sterling and the Greek drachma.- 3) Weighted external value against the currencies of 14 industrial countries after adjustment for discrepancies in inflation rates (measured by consumer prices).- 4) On the basis of price indices; an increase in the terms of trade shows that import prices rose less sharply than export prices.

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ports cannot continue indefinitely since the increase in production in Germany requires a continuous supply of primary products. The strength of the underlying trend in imports is seen most clearly in the fact that imports of finished goods — which, after all, account for over half of Germany's total imports — went up by 9% in nominal terms and 4½% in real terms. The western European partner countries have benefited most from this, as the value of Germany's purchases from them went up by a total of 9½% in 1985. Demand in Germany stimulated economic activity appreciably in these countries. In all probability this trend will have an even more significant effect in 1986, especially since a number of domestic enterprises have already reached a high degree of capacity utilisation.

Rising trend of deficits on services and transfer payments in the longer run

Moreover, in 1985 Germany's large deficits on services and transfer payments rose again slightly, in contrast to the two previous years, from DM 45.5 billion to DM 46.5 billion on an f.o.b./f.o.b. basis, i.e. including transport and insurance costs payable on imports. This owed something to the fact that the surplus on investment income account fell by DM 2 billion to DM 5 billion. Nevertheless invisible current transactions in 1985 have not returned to the trend prevailing up to 1982 when the deficits had at times increased rapidly from year to year. However, a number of special factors prevented a stronger growth in the deficit. In 1985 the pension and maintenance payments to non-residents went down to the "normal" level of DM 8 billion, after rising to DM 9 billion in the preceding year as a result of the social security contributions refunded under the "Act to Promote the Willingness of Foreigners Working in Germany to Return to their Home Countries". Furthermore, the dollar rate, which, taking the average of the year, was DM 2.94 per dollar and thus still slightly above the annual average of 1984 (DM 2.85) in spite of the correction that occurred during the year, led to fairly large receipts in services transactions. This was one of the main reasons for the rise in the Deutsche Mark equivalent of dollars exchanged by US troops stationed in Germany. In addition, an increasing number of tourists from the United States visited Germany, so that there was a sharp expansion in receipts from foreign travel. The services account will cease to benefit from these positive effects after the decline in the dollar rate. In 1985 the deficit on foreign travel rose for the first time since 1982 (by DM 1 billion to DM 25.5 billion). In view of the high priority given to holiday trips in households' budgets, the expected improvement in real income will be reflected in additional expenditure abroad in the near future. Moreover, Germany's net contributions to the European Communities will presumably continue to increase strongly in the transfer payments account. In sum, the German deficits on invisible current transactions will probably rise again, as has normally been the case in the past.

Oil price reduction temporarily interrupts self-correction of large current account surpluses

In foreign trade and in services and transfer payments forces are thus already at work which point to a reduction in the large current account surpluses in the longer term. However, because of the sharp decline in oil prices since the beginning of 1986, these trends will not initially be evident in the overall current account. For this reason — and because of the decline in the dollar rate — the surpluses on current transactions rose sharply in January and February 1986. The tendencies to correct these large surpluses which are already established in the non-oil sector will not prevail until the oil price level has stabilised. In contrast to previous years, when Germany's additional surpluses were mainly generated in trade with the western industrial countries, the improvement on current account is now chiefly reflected in transactions with the oil-exporting countries. These initially considerable regional shifts in the current account structure, which generally apply between all oil-importing countries on the one hand and the oil-exporting countries on the other and are mainly due to the collapse of the OPEC cartel, of course make large demands on the international financial system. Low-population oil countries are in a position to liquidate financial reserves; however, the financial problems of the high-population oil countries, which up to now have been considerable in some cases because of their external indebtedness, are increasing.

Major items of the balance of payments

DM billion

Item	1978	1979	1980	1981	1982	1983	1984	1985
A. Current account								
1. Foreign trade								
Exports (f.o.b.) 1	284.9	314.5	350.3	396.9	427.7	432.3	488.2	537.2
Imports (f.o.b.) 1	235.8	282.7	331.4	357.3	365.2	378.5	421.4	451.1
Balance	+ 49.2	+ 31.8	+ 18.9	+ 39.6	+ 62.6	+ 53.8	+ 66.8	+ 86.0
2. Supplementary trade items 2 and merchanting trade	+ 1.7	+ 0.0	− 0.6	+ 0.6	+ 1.5	+ 3.5	− 1.5	− 0.7
Balance of trade	+ 50.9	+ 31.8	+ 18.3	+ 40.2	+ 64.1	+ 57.2	+ 65.3	+ 85.4
3. Services								
Receipts	71.9	78.0	89.7	106.9	118.5	120.6	132.2	141.0
Expenditure	88.4	101.3	114.0	134.5	147.2	142.4	146.6	156.7
Balance	− 16.5	− 23.3	− 24.2	− 27.6	− 28.7	− 21.8	− 14.4	− 15.7
4. Transfer payments	− 16.4	− 19.6	− 22.6	− 24.3	− 25.5	− 24.9	− 31.0	− 30.8
of which								
Remittances of foreign workers	− 6.3	− 7.0	− 7.5	− 7.7	− 7.7	− 7.7	− 8.3	− 7.8
Transfers to the European Communities (net)	− 1.9	− 4.0	− 4.4	− 6.5	− 7.5	− 6.1	− 7.4	− 8.2
Balance on current account	+ 18.0	− 11.0	− 28.5	− 11.7	+ 9.9	+ 10.6	+ 19.9	+ 38.8
B. Capital account								
1. Long-term capital transactions								
(a) German investment abroad (increase: −)	− 23.5	− 20.3	− 28.4	− 27.4	− 29.1	− 36.5	− 42.0	− 58.4
Direct investment	− 7.2	− 8.2	− 7.6	− 9.3	− 6.8	− 8.1	− 9.4	− 10.8
Foreign securities	− 4.2	− 3.0	− 7.7	− 6.0	− 11.4	− 10.4	− 15.7	− 31.3
Advances and loans to non-residents	− 11.1	− 7.8	− 11.1	− 9.6	− 8.7	− 14.7	− 14.3	− 13.4
Other investment abroad	− 1.0	− 1.3	− 2.0	− 2.5	− 2.3	− 3.3	− 2.6	− 2.9
(b) Foreign investment in Germany (increase: +)	+ 20.7	+ 32.5	+ 33.9	+ 35.3	+ 14.2	+ 29.5	+ 26.3	+ 52.1
Direct investment	+ 3.3	+ 3.2	+ 0.8	+ 0.8	+ 2.0	+ 4.6	+ 3.2	+ 2.9
Domestic securities and official domestic borrowers' notes	+ 2.6	+ 6.2	+ 23.4	+ 23.3	+ 12.2	+ 25.5	+ 21.7	+ 40.1
Securities	+ 3.2	+ 5.9	+ 0.9	+ 1.0	+ 2.8	+ 13.6	+ 17.5	+ 42.1
Borrowers' notes	− 0.6	+ 0.3	+ 22.6	+ 22.3	+ 9.4	+ 11.9	+ 4.3	− 2.0
Advances and loans to residents 3	+ 15.0	+ 23.2	+ 9.9	+ 11.2	+ 0.1	− 0.4	+ 1.4	+ 9.1
Other investment in Germany	− 0.1	− 0.0	− 0.2	− 0.0	− 0.1	− 0.2	− 0.0	− 0.1
Balance of long-term capital transactions	− 2.8	+ 12.2	+ 5.5	+ 7.9	− 14.9	− 7.0	− 15.7	− 6.3
2. Short-term capital transactions (net capital exports: −)								
(a) Enterprises and individuals	− 2.9	− 5.3	+ 7.6	+ 8.2	+ 1.5	− 7.2	− 14.7	− 13.0
Financial credits	+ 1.0	− 3.7	+ 13.3	+ 13.0	+ 3.6	− 1.0	− 5.5	− 9.7
Trade credits	− 3.9	− 1.7	− 5.7	− 4.8	− 2.1	− 6.3	− 9.1	− 3.3
(b) Official	+ 1.2	− 0.3	− 0.4	+ 2.8	+ 0.7	− 3.3	− 1.8	+ 0.2
(c) Banks	+ 10.1	+ 4.1	− 8.9	− 10.3	+ 8.1	+ 1.8	+ 0.1	− 27.7
Assets	− 2.2	− 1.7	− 7.1	− 11.2	+ 4.3	+ 5.3	− 17.8	− 33.4
Liabilities	+ 12.3	+ 5.8	− 1.8	+ 0.9	+ 3.8	− 3.6	+ 17.8	+ 5.7
Balance of short-term capital transactions	+ 8.4	− 1.5	− 1.6	+ 0.7	+ 10.3	− 8.7	− 16.4	− 40.5
Balance on capital account	+ 5.6	+ 10.7	+ 3.9	+ 8.5	− 4.6	− 15.8	− 32.0	− 46.8
C. Balance of unclassifiable transactions (balancing item)	− 3.8	− 4.6	− 3.3	+ 0.9	− 2.2	+ 1.1	+ 9.1	+ 9.8
D. Balancing item for the external position of the Bundesbank 4	− 7.6	− 2.3	+ 2.2	+ 3.6	− 0.4	+ 2.4	+ 2.1	− 3.1
E. Change in the net external assets of the Bundesbank (increase: +) (A plus B plus C plus D)	+ 12.2	− 7.3	− 25.7	+ 1.3	+ 2.7	− 1.6	− 1.0	− 1.3

1 Special trade. — 2 Mainly warehouse transactions for account of residents and deduction of goods returned and of commission processing. — 3 Excluding official domestic borrowers' notes. — 4 Counterpart of changes in the Bundesbank's external position which are not caused by external current and capital transactions: mainly the allocation of IMF special drawing rights and changes in the Deutsche Mark value of the external position of the Bundesbank owing to valuation adjustments; as from 1982 also the differences between the transaction values and the changes in the external position shown in the Weekly Return at balance sheet rates.
Discrepancies in the totals are due to rounding.

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Reversal in the exchange rate trend brings increased purchases by non-residents on the German bond market

A sharp upturn in long-term external capital movements was discernible in 1985. The inflows of foreign capital into Germany, in particular, have risen especially sharply, more so than outflows of funds which grew at the same time. Germany's net exports of long-term capital thus declined and at times gave way to net capital imports which were one of the major factors responsible for the correction of the exchange rates. The increase in international competitiveness, the economic upswing and the accompanying rise in enterprises' earnings, coupled with the large degree of price stability, seem to have strengthened confidence in the German economy and hence in the Deutsche Mark. In spite of the interest rates in Germany, which by international standards were relatively low, Deutsche Mark assets became increasingly attractive to international investors, owing to the expectation that the Deutsche Mark would appreciate in the longer term, particularly vis-à-vis the dollar.

Foreign purchases also stimulated by the further opening of the German capital market

In addition, the measures taken since the autumn of 1984 to open the German bond market further and to integrate it internationally increased the propensity of non-residents to invest in Germany (see page 50). In sum, around DM 31 billion in foreign funds flowed onto the German bond market in 1985; roughly three-quarters of this amount was invested in public bonds which non-residents prefer. Foreign purchasers thus moved up to join the banks as the major group of purchasers on the German bond market, as is described in more detail elsewhere in this Report. Here Germany offers non-residents investment opportunities in a currency which is stable in the long term and can be used internationally without restrictions. Moreover, by international standards the interest paid on these assets is not subject to extreme fluctuations. While the changes in the yields on German bonds have been temporarily considerable, they have in fact been noticeably smaller than those of, for example, US bonds. Of course, the increasing integration of the German capital market in the international financial markets is inevitably associated with risks for Germany since, in so far as the inflows of capital are based on expectations of an appreciation of the Deutsche Mark, they will again decline as these expectations dwindle. The German capital market thus has an element of instability which, however, can be matched by a stabilising factor in the form of a renewed rise in purchases of bonds by domestic non-banks. In the period of large capital inflows domestic investors abstained temporarily from purchasing German bonds since they preferred for a time foreign currency bonds issued by non-residents (see page 46). Obviously, the exchange rate expectation for the Deutsche Mark was a less important consideration for residents' investment decisions, while the interest rate level was a significant factor.

Large inflows of long-term funds on the share market and through the banks' borrowing abroad

Foreign purchases on the German share market (excluding participations) also increased noticeably in 1985; here, foreign purchases reached the record level of close on DM 11 billion. German shares, which by international standards were still valued at a relatively low level at the beginning of 1985, were very attractive to foreign investors both because of the exchange rate trend and the boom on the German stock exchange, especially since numerous new issues were launched on the market. Apart from securities transactions, long-term foreign funds were primarily imported in 1985 through borrowing by banks whose long-term external liabilities rose sharply again for the first time (by a good DM 10 billion), after having declined or stagnated in the years before. The inflows of funds, most of which the banks channelled back into long-term lending to non-residents, reflect above all the issuing activity of the foreign financing companies of German banks; these subsidiaries took up more funds on the international bond markets which they passed on to their German parent banks in the form of long-term deposits. Hence these capital imports are also at least partly attributable to securities transactions. However, in contrast to highly liquid and fungible instruments, non-residents, at close on DM 3 billion, invested relatively few funds in German participations or branches. All in all, long-term capital imports nevertheless attained a record level in 1985; at around DM 52 billion, they were twice as large as a year earlier (DM 26 billion).

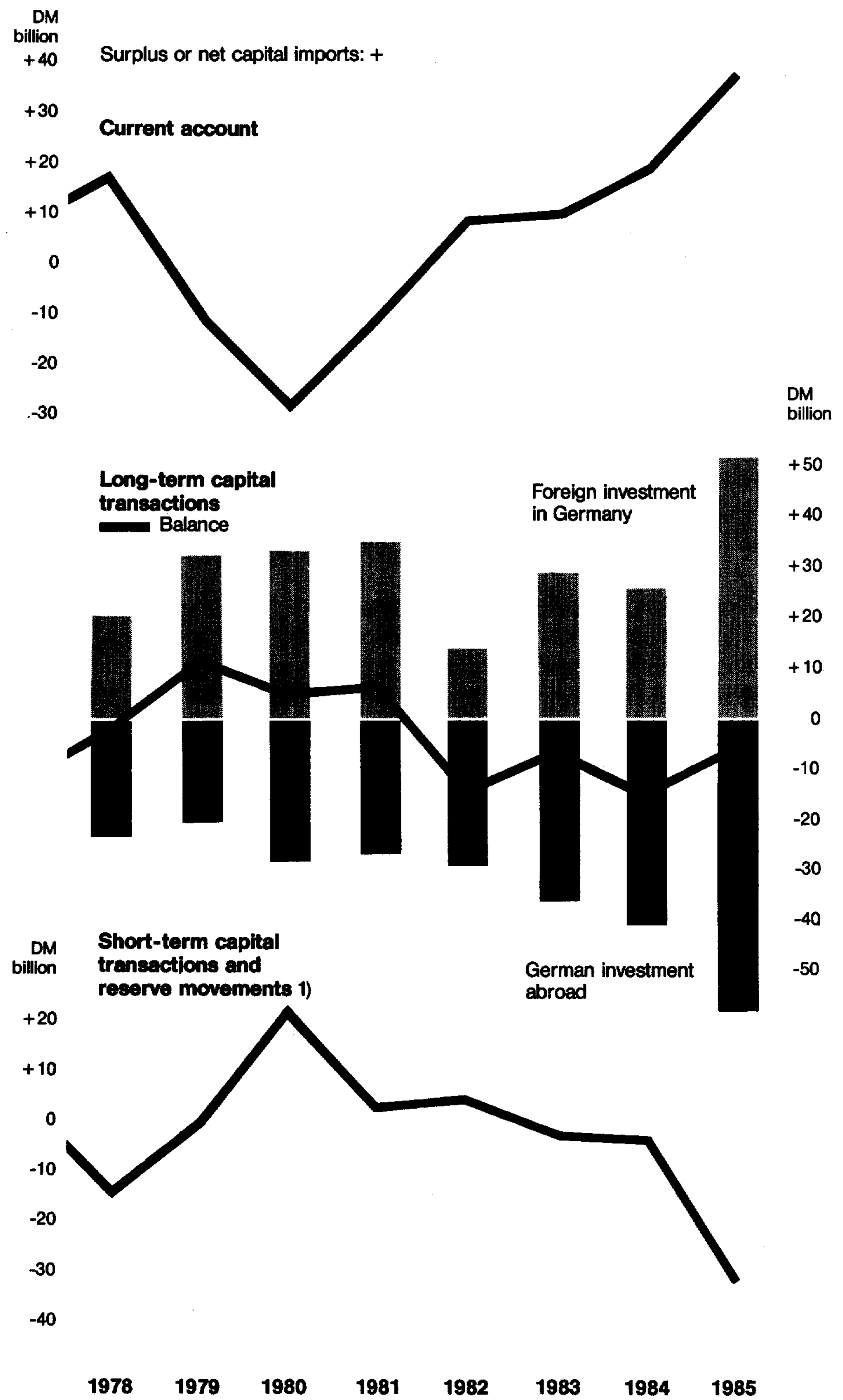
Surge in capital exports mainly through increased purchases of foreign currency bonds by residents

In 1985 there was also a remarkable expansion of financial flows on the capital exports side. In spite of the upward trend of the Deutsche Mark and the debt problems of several countries, which were again becoming more acute, there were outflows of DM 58 billion through German investments abroad. Long-term capital exports were thus DM 16 billion, or over one-third, up on the previous year. As the exchange rate trend of the Deutsche Mark shows, this outflow of funds did not really impose a burden on the balance of payments, since it only partly offset the inflow of funds from the large surplus on current account and long-term capital imports. In capital exports, too, securities transactions clearly predominated in 1985, at a good DM 31 billion, which is not surprising in view of the international advance of financing through securities and the concentration of capital flows on the industrial countries. German investors purchased, in particular, high-yielding foreign currency bonds of non-resident issuers for a record sum of DM 20 billion. Of all purchases of bonds by domestic non-banks almost half were accounted for by such foreign currency paper (see page 46), and here an increasing diversification of issue currencies to the detriment of the US dollar, the most important issue currency in the past, was discernible in the course of the year. While at first sight the large exports of capital through purchases of foreign currency bonds contrast with the concurrent inflow of foreign funds into relatively low-interest-bearing German bonds, such capital flows in opposite directions are quite easily explained by the differing interests concerned. It can be attractive for German investors to hold a certain portion of their securities assets in the form of high-yielding foreign currency bonds and to accept the exchange rate risk of such paper, while at the same time non-residents consider the lower-yielding Deutsche Mark paper useful for supplementing their portfolios because of exchange and interest rate expectations.

Substantial purchases of foreign Deutsche Mark bonds by residents

In 1985 there were increased outflows of funds through the purchase of foreign Deutsche Mark bonds by residents (DM 7 billion). The crucial reason for the interest of German investors in such paper would appear to have been the yield advantage of foreign Deutsche Mark bonds over first-class domestic paper which had developed after the abolition of coupon tax in the autumn of 1984. Another factor was the considerable growth in net sales of foreign Deutsche Mark bonds to DM 21 billion, which had resulted from the opening of the market and the admission of new types of bonds. Compared with the increased issuing activity, net purchases by residents, at around one-third, remained roughly on the usual scale; the bulk of net sales thus continued to occur abroad. Finally, German investors also stepped up their purchases of foreign shares (DM 4 billion, excluding the acquisition of participations), particularly towards year's end when activity on the US stock exchange picked up again and the exchange rate risk on the lower dollar rate level was assessed as being less. In the remaining areas of long-term capital exports — particularly direct investment, development aid loans and long-term foreign credits of banks — the outflows of funds in 1985, at a total of DM 27 billion, were roughly on the level of the previous year. As a result of the trends described in long-term capital transactions, net outflows of long-term funds from Germany in 1985 declined to only DM 6.5 billion. Seen in the context of the balance of payments, the funds which had flowed in from abroad were channelled back onto the international capital market. In contrast to the previous year, only a minor part of the surplus on current account was balanced out or "financed" by movements of long-term funds.

Major items of the balance of payments



1) Including the balancing item of the balance of payments; decrease in monetary reserves: +.
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Since there was scarcely any change in the Bundesbank's net external assets, the current account was financed in 1985 almost entirely from short-term capital transactions (including the balancing item of the balance of payments), in which a record amount of DM 31 billion was exported. There was a close correlation between the current account trend and the accompanying net exports of funds: since enterprises' export claims increased with the rise in exports, their

Surplus on current account "financed" mainly by exports of short-term capital trade credits went up by a good DM 3 billion. Moreover, there were net outflows of close on DM 10 billion through enterprises' short-term financial credits, both through an increase in financial investments at foreign banks and the repayment of funds which had been taken up abroad. A certain connection with export business can also be assumed here since, at least in the case of the large enterprises, liquidity increased and the interest rates offered on the Euro-market for the investment of substantial liquid funds tended to be more favourable than on the domestic market, even though these funds came from non-banks. However, the bulk of statistically recorded short-term capital exports was accounted for by the banks, whose short-term external assets, at DM 33 billion, grew unusually sharply in 1985, while their corresponding liabilities only went up by DM 5.5 billion. In practice this meant an inflow of funds to the banks on the Euro-market (particularly the offices of German banks), which granted Deutsche Mark credits[1] to non-banks in EMS countries; some of these funds were used to finance imports from Germany. However, the switching of short-term funds into higher-yielding long-term Deutsche Mark assets by foreign investors may also have been a contributory factor. The movements of funds across the border are therefore largely a reflection of the recycling of funds which flowed in through current and securities transactions. Given the absolute freedom of capital transactions, there were no major hindrances to this, even though it did have an effect on interest and exchange rates.

Upward movement of the external value of the Deutsche Mark supported by market forces, with monetary reserves almost unchanged

The Bundesbank only intervened to any major extent for fairly short periods on the foreign exchange market in 1985 to help correct exchange rate relations which are undesirable in the longer term. This was true, in particular, in the first few months of 1985 and after the meeting of the Group of Five in New York last September. However, when the tensions on the foreign exchange market eased in the periods following each of the interventions, the dollars which flowed "autonomously" to the Bundesbank (e.g. the interest receipts from foreign investments and the net funds resulting from dollar transactions with public authorities) were channelled back into the reserves. In the upshot, the net external assets of the Bundesbank at the end of 1985 (valued at balance sheet rates), at DM 67.7 billion, were only DM 1.3 billion down on the preceding year's level. While the Bundesbank has from time to time made certain efforts to correct the unduly high dollar rate, the consolidation of the changed exchange rate patterns also owes something to the fact that it was warranted by Germany's underlying external position. The dynamism of the processes of adjustment which were set in motion by the rise in the external value of the Deutsche Mark in the area of foreign trade and services transactions by the rise in the Deutsche Mark should not be underrated. It is in the nature of these processes that they can only have a gradual impact on Germany's overall balance of payments and that exogenous factors, like the latest fall in oil prices, at first prevent such effects from being reflected in the figures at all.

4. Continuity and flexibility in monetary policy

(a) Potential-oriented monetary targeting

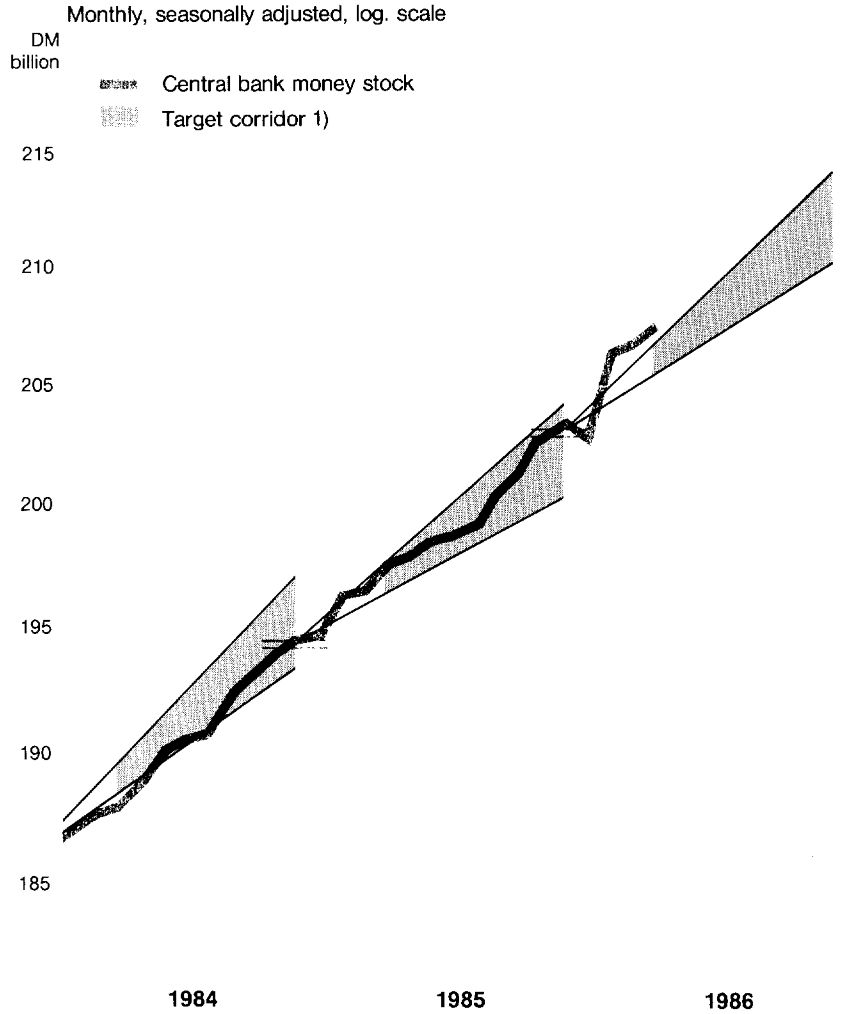
Lower monetary target corridor for 1985

For 1985 the Bundesbank aimed at keeping the expansion of the central bank money stock between the fourth quarter of 1984 and the fourth quarter of 1985 within a 3 to 5% range. The target corridor was thus set 1 percentage point lower than in 1984, when it had been 4 to 6%. However, the lowering of the corridor did not imply a tighter supply of money in the economy. It rather reflected the successes scored by stabilisation policy in the preceding years. These enabled the Bundesbank, when deriving the monetary growth target for 1985, to assume a large measure of price stability from the outset. The 1985

1 Including the Deutsche Mark component of ECU loans.

Growth of the central bank money stock *

Monthly, seasonally adjusted, log. scale



*) Currency in circulation and required reserves on domestic liabilities (calculated at constant reserve ratios, base: January 1974).- 1) Increase in the central bank money stock between the fourth quarter of the preceding year and the fourth quarter of the current year for 1984: 4% to 6%; 1985: 3% to 5%; and 1986: 3½% to 5½%.

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monetary growth target was chiefly based on the expected increase in production potential at current prices. This increase was put at an average annual rate of not quite 4½ %. Real fixed capacity in the economy was assumed to grow by a good 2 %. When deriving the 1985 target the Bundesbank for the first time refrained from defining the price component in the shape of an "unavoidable" rise in prices. Given the large measure of price stability achieved it would have been difficult to explain credibly why this concept should be retained. As in 1984, the monetary target provided scope for real GNP growth at a rate exceeding that of the production potential and hence for an increase in the utilisation of the factors of production. In the preceding years, notably in 1982 and 1983, the expansion of the money stock had also been "potential-oriented". At the time this meant a much higher rate of expansion than would have been consistent with the actual growth of real GNP.

Central bank money stock expansion on target over the year

In 1985 monetary expansion was kept within the limits envisaged by the Bundesbank at the beginning of the year. Growth of the central bank money stock was running at the top edge of the target range until well into the spring. In the ensuing months the pace of expansion slowed a little. The main reason for this was the rather weak demand for currency during this period. In the shorter run the demand for currency often shows major swings. Favoured by the progressive easing of interest rates on the money and capital markets and the resumed growth of cash holdings, central bank money stock expansion regained momentum in the late summer. In the last quarter its year-on-year increase averaged 4.5%. It was thus in the upper half of the target corridor.

Fall in interest rates encouraged by steady monetary policy stance

By the end of last year the central bank money stock had been growing fairly steadily for more than two years at a trend rate of some 4½%. This continuous monetary growth was facilitated by the overall economic situation which, in contrast to earlier years, was not subject to sudden disruptions. At the same time the Bundesbank sought to encourage the desired fall in interest rates by adopting a stabilisation policy stance which was conducive to strengthening confidence rather than by concentrating on interest rate cuts on the money market. The Bundesbank lowered its own interest rates in line with the interest rate tendencies in the market and fostered these trends itself in turn. Normally interest rate policy measures were taken as part of current money market management. In the summer of 1985 the Bundesbank was able to lower the discount and lombard rates by ½ percentage point each.

Monetary policy stance unchanged after the "G-5 meeting"

The Bundesbank retained its monetary policy stance unchanged when, in the wake of the September meeting of the five largest western industrial countries, the decline in interest rates in the capital market in Germany came to a halt — probably because continued expectations of a sharp appreciation of the Deutsche Mark no longer seemed altogether warranted. As part of its current money market management the Bundesbank tried at that time, where possible, to keep interest rates at the level reached in the late summer. Hence it concluded revolving securities repurchase agreements on virtually unchanged terms while time deposit rates on the money market and capital market rates came under marked upward pressure. This helped to bring interest rate expectations on the financial markets back to normal quickly and to overcome the "interest rate hump" which had emerged last autumn in a comparatively short time.

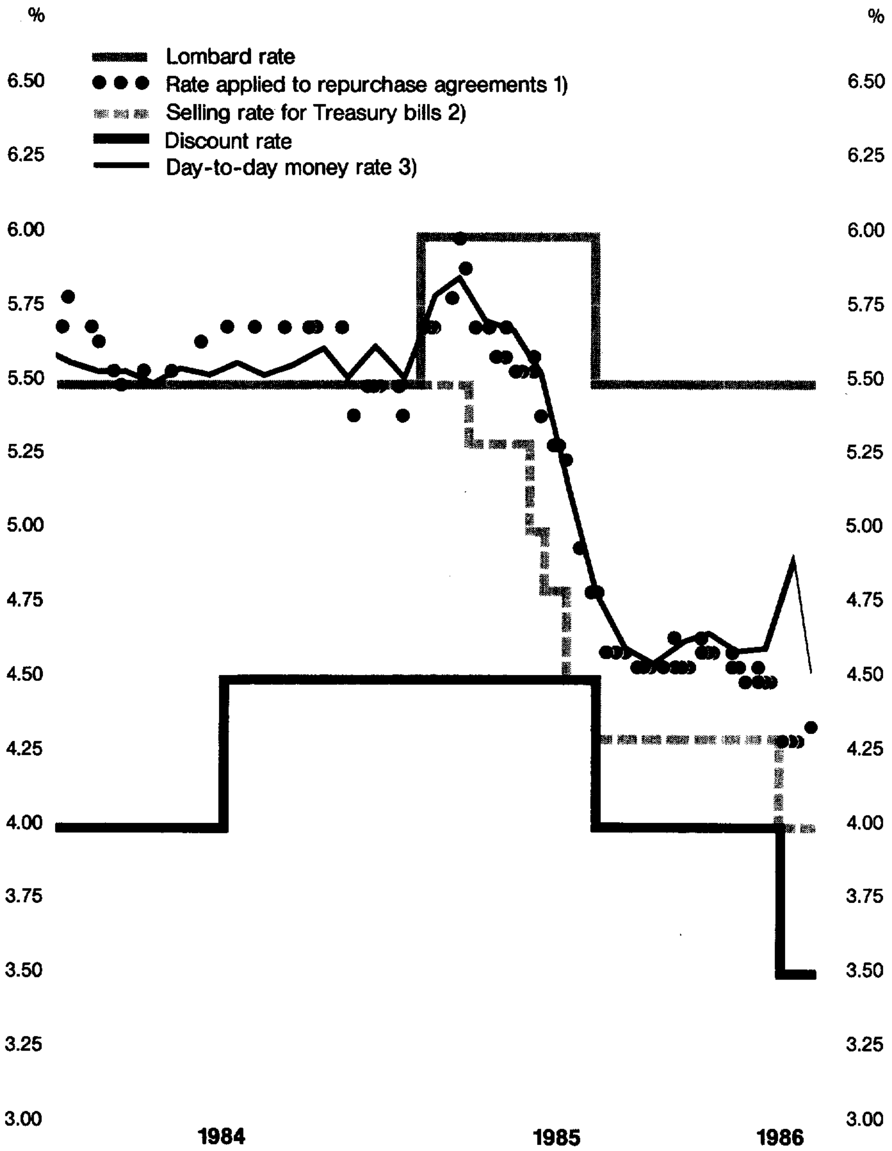
Faster growth of potential allowed for in the 1986 monetary target

In setting the 1986 monetary growth target the Bundesbank's main consideration was, on the one hand, to provide adequate scope for strong economic growth through the envisaged monetary expansion while, on the other hand, safeguarding the large measure of price stability already attained. To achieve these overall economic objectives the Bundesbank considers an expansion of 3½ to 5½% in the central bank money stock between the fourth quarter of 1985 and the fourth quarter of 1986 to be appropriate. The derivation of this target range was based on the assumption of an average annual growth of 4½% (at current prices) or 2½% (at constant prices) in production potential. Since a target range of 2 percentage points was retained, as it has been for the last few years, this yielded the target corridor mentioned above for four-quarter growth in the current year. The raising of the target corridor by ½ percentage point compared with 1985 thus results, under the derivation procedure, from the steeper rise in real production potential anticipated for 1986. This assumption seemed justified because the expansion of the stock of utilisable fixed assets will accelerate as investment activity picks up and the rise in potential man-hours worked is likely to speed up over the year in view of the increase in participation rates in the labour force.

"Entry" into the new target corridor impeded by special influences

At the beginning of the new target period the central bank money stock initially expanded at an exceptionally rapid pace. There was an upsurge both in currency in circulation and in the reserve component, which mirrors the growth of deposits with domestic banks (such deposits being part of the money balances in the hands of non-banks). Fluctuations in the demand for currency around the turn of the year were quite frequent in earlier years, too. They seem to be connected with changes in non-banks' spending patterns and are probably also in-

Interest rates of the Bundesbank and day-to-day money rate



1) Fixed rate (volume tender) or allotment rate (interest rate tender) for securities repurchase agreements on the date the transaction is credited.- 2) Normally for 3 days.- 3) Monthly averages.

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fluenced by working-day variations around the turn of the year. The strong growth of bank deposits, as reflected in the reserve component, was mainly attributable to large inflows of funds from abroad and corporate transactions. Quite apart from that, the underlying trend of overall monetary developments has clearly been comparatively expansionary since the autumn of last year.

(b) More flexibility in the money market

Need for more flexibility felt

At the beginning of February 1985 the Bundesbank started to make the short-term money market rates somewhat more flexible, so as to be better placed to make any minor monetary policy adjustments which might seem called for. At the same time lombard borrowing — which was originally designed as an exceptional refinancing facility only — was to be limited once more to meeting temporary peak needs of funds on the money market. Hence the Bundesbank offered the banks revolving securities repurchase agreements on a major scale. In the preceding years, too, it had sought to explore, in small steps, the scope for interest rate and liquidity policy changes by means of preparatory open-market measures. Greater flexibility in its money market management seemed particularly advisable in the light of the growing linkage of the German money and capital markets with international markets. Moreover, short-term, small-scale changes in money market conditions have a chance of not being immediately regarded and misconstrued as indicating a fundamental change in the thrust of monetary policy.

Disadvantages of the earlier control procedure

Throughout the years of tighter monetary policy banks had drawn virtually continuously on the lombard facility offered by the Bundesbank and had eventually come to regard it as a permanent source of central bank money. Any easing or tightening of conditions on the money market has therefore been reflected in recent years in changes in the level of lombard borrowing, while the day-to-day money rate has remained closely tied to the lombard rate. To gain more flexibility in day-to-day money market management frequent, small changes in the lombard rate were out of the question. Instead of quasi-automatic access to lombard loans, more securities repurchase agreements were consequently offered. In transactions of this kind the initiative as regards pricing and timing over short spells of time lies with the Bundesbank. Greater use of repurchase agreements to satisfy residual requirements in the money market could thus from the outset be expected to provide additional scope for influencing money market conditions in the short run too.

Transition to greater flexibility in money market management under unfavourable basic conditions

These considerations were reflected in the Bundesbank's decision to raise the lombard rate from 5½ to 6% with effect from February 1, 1985, and to offer the banks — more or less as a substitute for the previous "standing" lombard facility — securities repurchase agreements at rates below the new lombard rate. The raising of the lombard rate, which in the final analysis was of a technical nature only, was essential under the external conditions then prevailing — e.g. the US dollar cost some DM 3.20 at the time — to ensure that lowering the repurchase rates did not set any undesirable signals indicating an easier policy stance. In order to prevent an unduly sharp drop in the day-to-day money rate, which might perhaps have been triggered by the increased use of repurchase agreements, the Bundesbank at the same time offered the banks until further notice an investment facility in the shape of Federal Treasury bills running normally for 3 days at a rate of initially 5½%. Thanks to this procedure the Bundesbank has since then been able to control the day-to-day money rate at short range, holding it within a band defined by the selling rate for Treasury bills (bottom edge) and the lombard rate (top edge) by varying the repurchase rates — and when appropriate the terms of complementary fine-tuning measures (such as foreign exchange swap and repurchase agreements) — accordingly. It took some time for the banks to get used to this more flexible money market management concept. In February and March the money market presented an asymmetrical picture. Up to mid-month the banks had excessive recourse to lombard loans. At the same time the day-to-day money rate remained at the level of the lombard rate. Subsequently, it fell markedly under pressure from emerging surplus minimum reserves. At this stage, the banks took up the Bundesbank's offer and temporarily invested major amounts of excess central bank balances in Treasury bills. At the beginning of March the picture became even more confused when the dollar rebounded, generating expectations that the Bundesbank would in response adopt new interest rate policy measures. As early as April, however, conditions in the money and exchange markets returned to normal. Since then the banks have generally restricted their lombard borrowing to very low residual amounts, and the day-to-day money rate has moved, with fluctuations, within the band delimited by the lombard rate and the Treasury bill selling rate.

Monetary developments

Change during year 1

Item	1979	1980	1981	1982	1983	1984	1985
	DM billion						
A. Central bank money requirements of banks and liquidity policy measures of the Bundesbank 2							
1. Provision (+) or absorption (−) of central bank balances by							
Rise in central bank money 3 (increase: −)	− 7.8	− 6.5	− 2.7	− 7.5	− 10.1	− 7.1	− 6.6
Foreign exchange movements (excluding foreign exchange swap and repurchase transactions)	− 5.2	− 24.6	− 3.1	+ 1.7	− 2.0	− 3.9	− 0.7
Cash transactions of the central and regional authorities (including shifts of Federal balances under section 17 of the Bundesbank Act)	+ 3.9	+ 0.3	+ 1.1	− 4.1	+ 1.7	+ 1.3	− 4.2
Transfer of the Bundesbank's profit to the Federal Government	−	−	+ 2.3	+ 10.5	+ 11.0	+ 11.4	+ 12.9
Other factors	− 5.2	− 7.9	− 9.3	− 12.1	− 9.7	− 12.1	− 14.0
Total 1	− 14.3	− 38.8	− 11.8	− 11.4	− 9.0	− 10.6	− 12.5
2. Liquidity policy measures							
Change in minimum reserves	− 3.2	+ 10.5	+ 4.1	+ 5.4	− 0.2	− 0.4	+ 0.1
Change in refinancing facilities	+ 5.1	+ 12.1	+ 5.1	+ 7.7	− 0.7	+ 7.8	+ 3.3
Open market transactions (with non-banks, in "N paper" and in long-term securities)	+ 2.7	+ 4.5	− 0.1	+ 1.5	+ 2.4	− 3.9	+ 0.1
Securities repurchase agreements	± 0.0	+ 6.0	+ 4.4	− 1.4	+ 6.6	+ 7.7	+ 16.5
Other assistance measures in the money market 4	− 2.3	+ 4.5	− 0.5	+ 1.6	− 3.4	± 0.0	+ 0.6
Total 2	+ 2.4	+ 37.6	+ 13.0	+ 14.8	+ 4.7	+ 11.3	+ 20.6
3. Remaining deficit (−) or surplus (+) (1 plus 2)	− 11.9	− 1.2	+ 1.2	+ 3.4	− 4.3	+ 0.7	+ 8.1
covered or absorbed by							
Recourse to unused refinancing facilities (reduction: +)	+ 9.7	− 1.4	+ 1.3	− 3.5	+ 3.3	− 1.0	− 3.1
Raising (+) or repayment (−) of lombard or special lombard loans	+ 2.2	+ 2.6	− 2.5	+ 0.1	+ 1.0	+ 0.3	− 5.0
	%						
B. Key monetary indicators							
Central bank money stock 2, 5	+ 5.6	+ 5.5	+ 3.2	+ 5.9	+ 6.8	+ 4.5	+ 4.2
Memorandum item: As an annual average	11 + 9.1	+ 4.8	+ 4.4	+ 4.9	+ 7.3	+ 4.8	+ 4.5
M1 (= currency in circulation and sight deposits)	+ 3.7	+ 4.2	− 0.9	+ 6.7	+ 7.9	+ 5.7	+ 5.3
M2 (= M1 plus time deposits and funds borrowed for less than 4 years)	+ 8.2	+ 8.9	+ 8.8	+ 5.2	+ 2.5	+ 5.1	+ 4.6
M3 (= M2 plus savings deposits at statutory notice)	+ 5.7	+ 6.0	+ 4.9	+ 7.2	+ 5.8	+ 4.7	+ 5.1
Lending by banks and the Bundesbank to domestic non-banks	+ 11.5	+ 9.4	+ 8.9	+ 6.5	+ 6.5	+ 5.9	+ 5.1
	DM billion						
C. Money stock and its counterparts							
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 39.2	+ 42.8	+ 36.1	+ 54.8	+ 45.3	+ 41.3	+ 45,4
Counterparts in the balance sheet							
1. Volume of credit 6	+ 139.0	+ 126.3	+ 132.0	+ 104.4	+ 113.2	+ 108.1	+ 98.2
of which							
Bank lending to domestic non-banks	+ 140.9	+ 122.4	+ 129.9	+ 106.1	+ 111.3	+ 110.0	+ 100.7
− to enterprises and individuals 7	+ 67.5	+ 56.3	+ 41.7	+ 30.0	+ 44.0	+ 47.4	+ 48.8
− to the housing sector 8	+ 44.8	+ 44.5	+ 40.7	+ 36.1	+ 48.1	+ 43.5	+ 32.9
− to public authorities	+ 28.5	+ 21.6	+ 47.5	+ 40.0	+ 19.3	+ 19.1	+ 18.9
2. Net external assets 9	− 21.8	− 10.6	+ 11.9	+ 4.5	+ 1.2	+ 0.8	+ 30.1
3. Monetary capital	+ 75.8	+ 61.7	+ 86.0	+ 46.5	+ 67.1	+ 69.7	+ 75.2
of which							
Savings deposits at agreed notice	+ 3.3	− 1.9	− 2.1	+ 4.3	− 2.0	+ 6.0	+ 11.2
Bank savings bonds	+ 14.8	+ 17.8	+ 14.0	+ 11.9	+ 13.0	+ 16.3	+ 10.4
Time deposits and funds borrowed for 4 years and over	+ 18.7	+ 14.6	+ 13.8	+ 7.2	+ 27.2	+ 26.3	+ 34.5
Bank bonds outstanding 10	+ 33.6	+ 26.7	+ 53.6	+ 14.1	+ 22.6	+ 13.2	+ 9.5
4. Central bank deposits of domestic public authorities	− 1.7	− 1.9	− 0.2	+ 0.5	+ 0.9	− 1.2	+ 1.3
5. Other factors	+ 3.8	+ 13.2	+ 22.0	+ 7.2	+ 1.0	− 1.0	+ 6.4

1 Unless otherwise indicated, based on end-of-month figures. — 2 Based on daily averages of the last month of the period and the last month of the previous period, respectively. — 3 Currency in circulation (as from March 1978 excluding the banks' cash balances of domestic notes and coins, which are deductible from the required minimum reserves) and required reserves on the banks' domestic liabilities at current reserve ratios; changes in the required reserves resulting from changes in the reserve ratios are shown in item A2. — 4 Open market transactions under repurchase agreements in bills, foreign exchange swap and repurchase transactions, shifts of Federal balances under section 17 of the Bundesbank Act and sales of short-term Treasury bills. — 5 Reserve component calculated at constant reserve ratios (base: January 1974). — 6 Banks and the Bundesbank; including credit based on the purchase of securities. — 7 Excluding housing. — 8 Excluding credit based on the purchase of securities. — 9 Banks and the Bundesbank. — 10 Excluding banks' portfolios. — 11 The statistical break caused by the redefinition of the central bank money stock (see footnote 3) has been eliminated.
Discrepancies in the totals are due to rounding.

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Continuous reduction in money market rates

From the spring of 1985 onwards the Bundesbank gradually but consistently lowered the rates applied to securities repurchase agreements, thus bringing down the interest rate level on the money market. The process was facilitated and speeded up by the fact that the repurchase rates have become a benchmark for the money market rates as a result of the new technique of money market management. Notably the day-to-day money rate followed the gradual lowering of the repurchase rates almost immediately. At the same time, the Bundesbank indicated by parallel cuts in the Treasury bill selling rate that it was prepared to take money market rates further down. Last summer, the day-to-day money rate was finally 1¼ percentage points below its last peak in March 1985. The decline in time deposit rates was even more marked. The gradual relaxation of conditions in the money market was fully in keeping with the envisaged growth of the central bank money stock, which was weak around the middle of the year; the other economic "fundamentals" also provided scope for such falls.

Easing of conditions in the money market consolidated by lombard and discount rate adjustments

In August last year key money market rates closely approached the discount rate or even reached the same level. In the circumstances the Bundesbank — with effect from August 16, 1985 — reduced the discount rate from 4½% to 4% and the lombard rate from 6% to 5½%. The Bundesbank thus emphasised that the trend of the money market rates was consistent with its interest rate policy stance and at the same time indicated that further reductions in bank interest rates — notably those applied in retail business — were desirable. After the banks had adjusted their rates accordingly, the Bundesbank in the ensuing period sought to stabilise money market rates at the low level attained.

Enlarged role of securities repurchase agreements

The smooth transition to the more sophisticated money market management technique was greatly facilitated by securities repurchase agreements, which proved a very effective instrument of open market policy. Apart from the fact that they act as a guideline for interest rates in the interbank market, these transactions enable the Bundesbank over a minimum reserve period to react flexibly to short-term variations in bank liquidity. This reaction is aided by the Bank's practice of concluding several revolving agreements each month, whose volume it can vary as appropriate. The revolving use of securities repurchase agreements and the fact that individual transactions at times run for up to two months have brought home to banks the realisation that this facility tends to be a rather permanent major source of central bank balances which does not, however, reduce the role of traditional rediscount business. After the volume of securities repurchase agreements outstanding had reached DM 40 billion, the Bundesbank increased the banks' rediscount quotas by DM 3 billion with effect from August 1, 1985. The increased recourse to repurchase agreements and traditional refinancing policy thus dovetail smoothly.

Another discount rate reduction at the beginning of March 1986

Fostered by the favourable trend of the domestic and external fundamentals, the downward movement of longer-term interest rates continued in the first few months of 1986. The Bundesbank encouraged this movement, initially by cutting the allotment rates applied to securities repurchase agreements and ultimately also by lowering the three-day Treasury bill selling rate somewhat. At the beginning of March it reduced the discount rate from 4% to 3½%. By doing so it hoped — rightly, as it turned out — to spark off a more general fall in bank interest rates, just as in August 1985. To underline the continuity of its policy of flexible money market management, the Bundesbank left the lombard rate, which stood at 5½% at the time, unchanged. Moreover, it decided to cut the banks' rediscount quotas by DM 5 billion with effect from May 1, 1986. The Bundesbank thus set the stage for countering the increase in liquidity which will be caused by the transfer of the Bundesbank's profit for 1985 as from April this year and by the revision of the minimum reserve regulations with effect from May 1, 1986 (see page 51 of this Report).

Adequate expansion of the money supply

Following a similar path to that of the central bank money stock, the growth of overall money balances in the hands of domestic non-banks last year was consistent with stabilisation and growth policy requirements. The broadly defined money stock M3[1] increased by just over 5% (or DM 45 billion) between December 1984 and December 1985 compared with a good 4½% a year earlier. In view of its comparatively steady trend this aggregate, rather like the central bank money stock, is a fairly reliable indicator of the impact of monetary policy. Up to quite recently the underlying trend of the money stock M3 has largely paralleled that of the central bank money stock. While in 1985 the growth rate of the narrower aggregates M2 and M1 differed only a little from that of the broader aggregates (M3 and the central bank money stock) over the year as a whole, there were considerable deviations at times.

Reaction of monetary capital formation to rising and then falling interest rates

Residents' monetary capital formation at banks curbed monetary growth sharply again last year. In the first few months of the year such capital formation was particularly buoyant. Against the background of a higher level of long-term interest rates there was an unwinding of pent-up investment demand on the bond market which had been building up since the autumn of 1984, and for a short while non-banks acquired bank bonds on a large scale. In the later part of the year, when the long-term interest rate dropped to its lowest level since the second half of 1978, inflows of longer-term funds to banks slackened perceptibly. Over the year as a whole longer-term monetary capital formation at banks came to DM 75 billion (as against DM 70 billion a year earlier). As "price imagination" in the bond market faded, there was an increasing shift to forms of financial asset acquisition which carry no price risk. Long-term time deposits, in particular, were stepped up substantially (by just over DM 34 billion). They were evidently used as a substitute investment facility for purchases on the bond market because of temporary interest rate uncertainties. Most of these funds were placed by institutional investors. Insurance companies, for example, bought large amounts of borrowers' note loans and registered bank bonds with not-too-long maturities, which have the advantage that they do not have to be written down in balance sheets when coupons start to rise again. Savings deposits at agreed notice also increased strongly. At DM 11 billion, they saw the steepest rise since 1976. This "renaissance" of longer-term savings accounts owed something to the fact that the interest rate advantage of competing investment instruments dwindled in the wake of the continued fall in interest rates. Moreover, savings accounts include an increasing number of special saving schemes offering premium rates. The rise in savings deposits was apparently above all associated with a fall in sales of bank savings bonds. Such sales declined appreciably in 1985 (to DM 10 billion). The amount of bank bonds sold to domestic non-banks, which had dropped as early as 1984, fell further (to just over DM 9 billion). In the second half of 1985 domestic non-banks reduced their bank bond portfolios on balance. During that period sizeable amounts of funds were invested in higher-yielding foreign currency bonds, whose exchange rate risk investors obviously considered to be small (see page 46). In addition, a large amount of shorter-term bank bonds, which are chiefly held by larger enterprises as a liquid interim investment, was due for redemption. The bulk of the redemption proceeds was not "reinvested" on the bond market, but was used to finance spending and bolster liquidity.

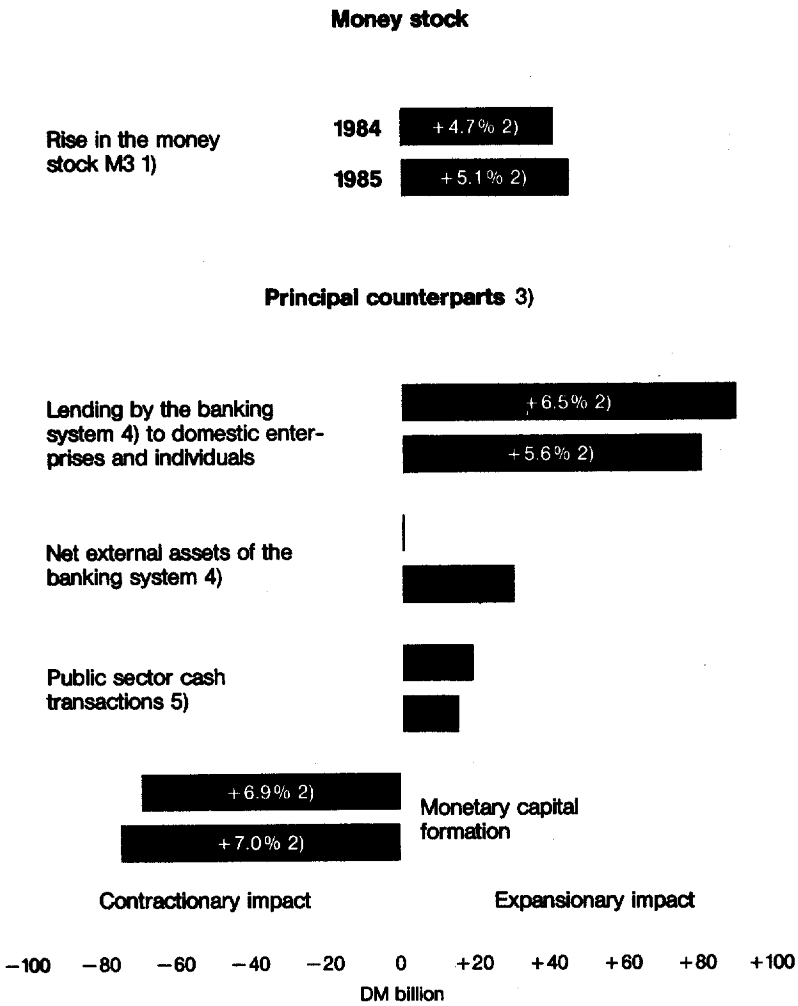
External component of money creation more significant

Lending by the banking system stimulated monetary growth strongly again last year. Compared with previous years, the main emphasis of money creation shifted from the domestic to the external component. Bank lending to domestic non-banks weakened somewhat. At the same time, the growth of the banks'

1 The money stock M1 comprises currency and sight deposits, M2 the aggregate M1 plus time deposits and funds borrowed for less than four years, and M3 the aggregate M2 plus savings deposits at statutory notice.

The money stock and its principal counterparts

Change in DM billion



1) Currency, sight deposits, time deposits and funds borrowed for less than four years, savings deposits at statutory notice.- 2) Increase in %.- 3) The change in the counterparts as shown reflects their expansionary (+) or contractionary (−) impact on the money stock.- 4) Banks and the Bundesbank.- 5) Lending by the banking system to public authorities less public sector deposits at the Bundesbank.

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external assets accelerated. The net external assets of the banking system (including the Bundesbank), which had hardly changed in 1983 and 1984, rose by the record amount of DM 30 billion. In the final analysis, the banks thus "monetised" non-banks' external assets, which stemmed from the current account surpluses and in part also from inflows of foreign capital. The growing influx of funds arising from non-banks' current and capital transactions with the rest of the world kept the domestic money supply at a high level and at the same time dampened non-banks' new borrowing from banks, which in the preceding years had been by far the most important source of money creation.

Slower expansion of lending to domestic non-banks

The credit granted by the banking system (including the Bundesbank) to domestic non-banks was stepped up by 5% last year, compared with 6% a year before. In absolute terms it increased by DM 98 billion. Much as in the previous years, this increase slightly understates the actual strength of credit expansion because the banks wrote large amounts off their loans in the first few months of last year, thus reducing the level of lending. Not all of the amounts written off were covered by the banking statistics and re-added to bank lending. Among bank lending to domestic borrowers, the growth of lending to the public sector, at 3½ %, was again slower than the rise in lending to the private sector and also slightly weaker than a year before. This also reflects the central, regional and local authorities' willingness to switch increasingly to securities finance to meet their credit requirements, with the paper issued being placed among the general public. However, this moderate growth of borrowing from banks does not mirror the public sector's contribution to monetary growth in full. The transfer of altogether DM 12.9 billion of the Bundesbank's profit to the Federal Government (which was fully monetised) must also be added.

(d) Private demand for credit somewhat subdued

Enterprises' borrowing requirements reduced by ample liquidity and good profitability

Bank lending to enterprises and individuals slackened somewhat last year but remained rather strong. Bank credit granted to the private sector expanded by 5½ % over the year compared with 6½ % in 1984. Borrowing needs in the housing sector were smaller than a year earlier in view of the decline in construction activity. Overall, enterprises' demand for credit also slackened somewhat. Some enterprises' needs of funds were reduced not least by their high cash reserves and profits. Especially after mid-year, when the interest earned on short-term financial assets for a time dropped more sharply than lending rates, enterprises financed a greater part of their spending with maturing time deposits and short-term bank bonds. However, the trends in enterprises' borrowing from banks diverged fairly sharply. While the services sector, the distributive trades and the construction industry took up fewer bank credits than a year earlier, the energy industry and the manufacturing sector borrowed appreciably more. Notably those industries which are at the centre of the cyclical upswing — such as electrical and mechanical engineering and the manufacture of vehicles — borrowed heavily from banks. Bank lending to employees picked up last year; against the background of an upward trend in private consumer demand, including above all increased car purchases, consumer credit expanded fairly rapidly in the second half of the year. Over the year as a whole, lending to individuals went up by 7 %, lending to the housing sector by 5½ % and lending to enterprises by 5 %.

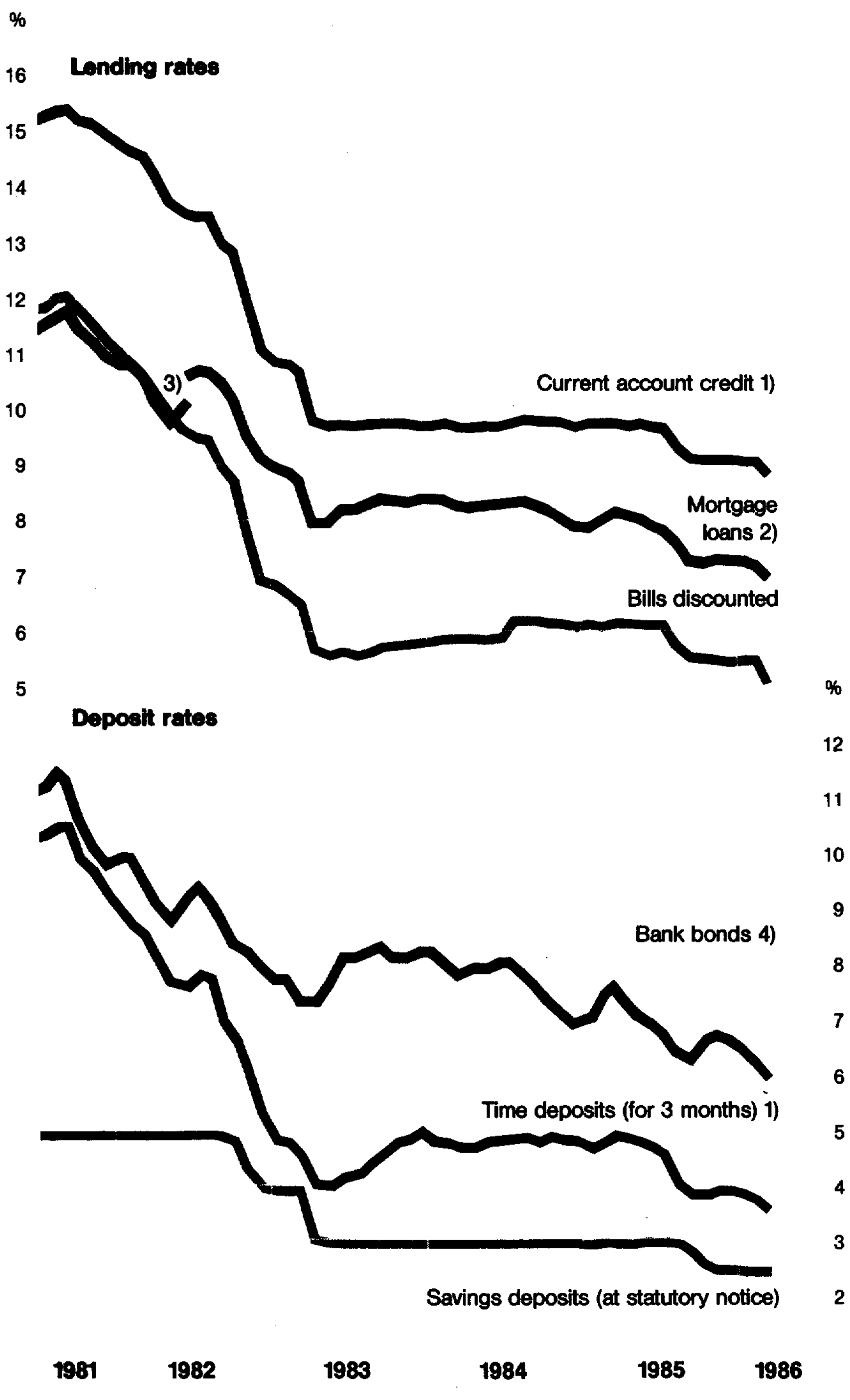
Longer-term credit more in demand

Private sector borrowing concentrated clearly on longer maturities in 1985, whereas a year before short-term lending had tended to predominate. The banks' longer-term direct advances to enterprises and individuals increased at broadly the same fast pace as in 1984, namely by 6½ %, while short-term lending grew by barely 2 % and thus much more slowly. In view of the relatively low level of interest rates, many borrowers evidently converted short-term debt into long-term fixed-rate loans. Interest rates were increasingly locked in for periods of ten years or longer. Enterprises showed a particularly strong preference for long-term finance. On balance, around 90 % of their borrowing from banks was in the form of longer-term loans as against 50 % in 1984.

Cost of credit declines over the year

The terms on which finance was available to borrowers continued to improve over the past year. After the rates charged for longer-term advances had fallen sharply in 1984, short-term bank lending rates also eased distinctly following the reduction of the Bundesbank's discount and lombard rates in August 1985. In long-term lending business effective interest rates went up at the beginning of 1985 in line with the trend of the long-term interest rate, but subsequently they dropped appreciably, with fluctuations. At the end of the year short-term bank lending was ¾ percentage point and longer-term bank lending ½ percentage point cheaper than at the end of 1984. In all, lending rates were thus at their lowest level since mid-1979.

Movement of selected bank interest rates



1) Under DM 1 million.- 2) Secured by residential real estate; effective rate.- 3) As from June 1982 only average interest rate for mortgage loans with variable interest rates; the figures are not fully comparable with previous data (June 1982 estimated).- 4) Yield on bonds outstanding.

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(e) Business situation and profitability of the individual categories of banks

Commercial banks catch up in domestic lending business

In lending business with domestic non-banks, last year — much as in 1984 — the commercial banks recaptured market shares which they had lost to the other categories of banks since the mid-seventies. This is true notably of the big banks, whose lending to domestic non-banks, at 9.3 %, increased much more than that of all banks taken together (5.3 %). But the domestic volume of credit of the regional banks and other commercial banks (5.4 %) and of private bankers (5.7 %) also grew at an above-average rate. The big banks pushed up their lending both to the public sector and to individuals and firms. In their corporate business they benefited from the fact that enterprises' demand for credit shifted back from the Euro-markets to domestic banks last year. Moreover, the principal borrowers were those industries which the big banks traditionally cater for. The private mortgage banks likewise increased their lending disproportionately fast (by 6.6%) in 1985. They profited most from buoyant demand for long-term fixed rate loans. By contrast, the market shares of the savings banks and — even more so — the credit cooperatives decreased somewhat in the wake of the recent movements in interest rates and structural shifts in the demand for credit. Their lending to domestic non-banks, which is mostly at variable rates, went up by 4.8% and a mere 3.4% respectively. In the case of the savings banks, the main reason for this was the low level of government and corporate borrowing. Among the credit cooperatives, housing loan business, too, was rather sluggish.

Continued "profit boom" buttressed by rising stock exchange turnover

By and large, the banks' profitability was satisfactory again in 1985. Their interest margin narrowed a little, it is true, as the average fall in lending rates over the year slightly outpaced that in deposit rates. But the associated decline in net interest received was in many cases offset by the expansion of the volume of business and the restructuring of lending and deposit business with a view to enhancing profitability. Most importantly, however, the banks' net commissions received were very high, above all because of their booming securities commission business. Hence their operating result was probably rather satisfactory in 1985, for the fifth successive year. Measured by the pre-tax annual profit, which includes earnings from securities business for the banks' own account and losses on loans and securities, their performance was presumably also quite good. Many banks' earnings from securities trading, and also from foreign exchange dealing, for their own account were very high. On the other hand, their profit and loss accounts were on balance affected less than a year before by losses incurred or provided for on loans and securities. In view of the continued revival of economic activity this would seem to apply widely to domestic lending business, although the number of insolvencies rose further and the situation in the housing market may have called for a revaluation of some outstanding loans. In international lending business, too, the situation appears to have been rather better in 1985 than it was in any other year since 1982. In particular, the weakening of the US dollar against the Deutsche Mark caused the amounts written off foreign currency lending, converted into US dollars, to increase in Deutsche Mark balance sheets, even though no additional Deutsche Mark funds were required. This enabled the banks to strengthen their reserves further without the profits available for distribution being reduced as much as in the past.

(f) Capital market on the move

More resources for investment and funding purposes pass through the capital market

Last year the capital market of the Federal Republic of Germany reinforced and extended its role as a "turntable" for domestic and foreign savings — a role which is of considerable importance for the German economy as a whole. At the same time, the market became more attractive to foreign investors. The amount raised on the bond market, which may be regarded as the centre of the markets for longer-term borrowed funds, went up by DM 16 billion in 1985 to DM 103 billion, even though overall borrowing by domestic enterprises declined. Transactions with non-residents increased strongly on both the capital import and capital export sides. Foreign bond purchases rose to about one-third of total sales on the domestic bond market. At the same time, however, German buyers purchased almost the same amount of bonds on markets abroad. The domestic share market, too, greatly increased in significance last year. The capital newly supplied to domestic enterprises through this sector of the capital market reached the record figure of DM 11 billion in 1985, compared with DM 6 billion in the previous year. Simultaneously, the German stock ex-

Acquisition of financial assets and incurrence of liabilities by the domestic non-financial sectors*

Item	1983 p DM billion	1983 p %	1984 p DM billion	1984 p %	1985 pe DM billion	1985 pe %	Memo item Change from previous year DM billion 1984	1985
Acquisition of financial assets								
Longer-term **1**	164.4	83.8	148.8	76.4	160.4	79.9	−15.6	+11.6
of which								
at banks	58.9	30.0	46.5	23.9	57.7	28.8	−12.4	+11.2
Bonds	31.0	15.8	37.7	19.4	29.8	14.9	+ 6.8	− 7.9
Shares	10.0	5.1	2.8	1.5	1.4	0.7	− 7.1	− 1.4
Short-term	31.8	16.1	46.1	23.6	40.2	20.1	+14.2	− 5.8
of which								
at banks **2**	22.9	11.7	25.3	13.0	26.6	13.3	+ 2.4	+ 1.3
Total	196.2	100	194.8	100	200.6	100	− 1.4	+ 5.8
Incurrence of liabilities and issue of shares								
Longer-term	189.2	91.5	163.9	82.4	165.2	91.1	−25.3	+ 1.3
of which								
at banks	100.2	48.5	84.8	42.6	81.2	44.8	−15.5	− 3.5
Bonds	33.8	16.4	36.3	18.2	43.5	24.0	+ 2.4	+ 7.2
Shares	5.9	2.8	4.6	2.3	6.8	3.7	− 1.3	+ 2.2
Short-term	17.5	8.5	35.0	17.6	16.1	8.9	+17.5	−18.9
of which								
at banks	14.4	7.0	22.9	11.5	8.7	4.8	+ 8.4	−14.2
Total	206.7	100	198.9	100	181.4	100	− 7.8	−17.6

* Households, enterprises (including housing), government (including social security funds). — **1** Financial assets with maturities of more than one year, including all savings deposits and all purchases of securities (regardless of their maturity). — **2** Including cash balances. — **p** Provisional. — **pe** Partly estimated. Discrepancies in the totals are due to rounding. BBk

changes attracted more foreign attention. In the course of these developments last year, Germany's international position as a financial centre — which will be discussed in more detail in a special concluding section of this part of the Report — strengthened further, taken as a whole.

Shifts of emphasis in the flow of funds

The incentives offered by the market for resorting more to capital market funding and the associated shifts of emphasis — i.e. away from financing through banks and towards more direct securitised debtor-creditor relationships — were mainly connected with the relatively sharp decline in domestic long-term interest rates. In 1985, for the first time since 1979, bond rates on the German market fell below 7 %, and in the second half of last year they were at around 6½ %. In view of the progressive cheapening of credit terms at the long end of the financial markets, the overall incurrence of liabilities in 1985 was characterised to a greater extent than in preceding years by the consolidation of debt and capital structures. Correspondingly, borrowing by the domestic non-financial sectors (primarily enterprises and the government) focused on the longer-term maturity categories, while these sectors greatly reduced their short-term borrowing. The outcome was that the total incurrence of liabilities and issue of shares in 1985, at DM 181.5 billion, was DM 17.5 billion lower than a year before. Banks' lending business, in particular, was hit by this decline. On the other hand, as already intimated, the financing operations of the domestic sectors (other than banks and insurance enterprises) on the bond market increased distinctly. In 1985 these came to DM 43.5 billion or DM 7 billion more than a year earlier. This represents almost one-quarter of the total amount they raised on the financial markets. Such a high ratio had not been reached in any of the preceding ten years. It must be borne in mind in this connection that some of the longer-term loans raised from banks are likewise funded by the latter issuing bank bonds. If this indirect recourse to the bond market is also taken into account, the greater significance of bond placement last year, as the "classical" source of finance for long-term capital, becomes even more apparent. Inclusive of the sales of bank bonds (DM 33 billion net), the share of the bond market in the total amount raised by the domestic non-financial sectors in 1985 can be estimated at about two-fifths, compared with one-third in the previous year.

Consolidation the salient feature of issuing activity on the bond market

Borrowers' efforts to consolidate their debts were reflected in the maturity pattern of new bond sales, too. While in the long-term maturity categories (over four years) net sales of domestic bonds increased by DM 11.5 billion to DM 85 billion in the year under review, in the shorter maturity classes redemptions outweighed new sales to an even greater extent than in the preceding year. The amount of such paper outstanding decreased by DM 9 billion in 1985 compared with DM 2.5 billion in 1984. Altogether, domestic bonds totalling DM 76 billion were placed last year. The greater part of this amount (DM 42.5 billion) was accounted for by public authority borrowing; this latter sum consisted almost entirely of issues with maturities of over four years. Three-quarters of this last amount (DM 32.5 billion) was made up of bonds issued by the Federal Government, which stepped up its sales of traditional bonds with ten-year maturities last year. As a result, through sales of these bonds and medium-term notes, it raised DM 17 billion in 1985 against DM 11 billion in 1984. The Federal Government also relied heavily on sales of five-year special Federal bonds (DM 10.5 billion). These securities, which have been offered in the form of tap issues since their introduction at the end of 1979, were the second most important source of borrowed funds for the Federal Government in 1985. Of the other public issuers, the Länder Governments placed their own bonds to the amount of DM 5.5 billion net. The Federal Post Office raised DM 3 billion on the bond market and the Federal Railways DM 1.5 billion.

Heavy sales of long-dated bonds by the issuing institutions

The shifts of emphasis in favour of the longer maturity categories were particularly marked in the case of bank bond sales. In line with the change in demand in the banks' lending business, the banks mainly took up long-term funds on the bond market last year (DM 42 billion against DM 37 billion in the previous year), and at the same time they redeemed more outstanding short-dated securities (DM 9 billion net against DM 2.5 billion in 1984). This shift in the maturity pattern reflects in large part the financing behaviour of public authorities. These rank among the most important customers in the lending business of the issuing institutions which prefer to fund their loans to public borrowers by issuing communal bonds. In mortgage lending, the second "classical" field of activity of these institutions, the tendency towards longer loan maturities was likewise unmistakable. This correspondingly stimulated sales of longer-term mortgage bonds. Even in the case of traditionally shorter-term "other" bank bonds, which are issued for general funding purposes by regional giro institutions as well as other banks, a shift in maturities towards the long end of the market has been apparent lately because many of the loans to trade and industry which have been funded by these instruments have been granted at longer term.

Market for foreign Deutsche Mark bonds attractive

In 1985 foreign borrowers also showed keen interest in funding through the issue of Deutsche Mark bonds. Overall, sales of foreign Deutsche Mark bonds more than doubled last year, at DM 21 billion net compared with DM 8.5 billion in 1984. Apart from the favourable interest rate conditions relative to those in other countries, it was particularly after new types of bonds had been admitted last spring that this sector of the market became attractive to issuers and investors. Securities with special terms accounted for over DM 8 billion and thus for more than one-third of the net sales of foreign Deutsche Mark bonds. These consisted in the main of floating rate notes (DM 7.5 billion), while zero bonds met with little interest. Supplies of floating rate issues were particularly large immediately after their original admission to the market and again in the last few months of 1985, when uncertainty about interest rate movements became wide-spread. Considered as a whole, this hardly impaired the attractiveness of traditional bonds. Indeed, sales of conventional bonds on the foreign Deutsche Mark bond market last year, at DM 13 billion, reached a record level. The growth of this traditional market sector also owes something to the fact that it has recently been utilised by domestic debtors, too, through their financing companies abroad. Last year DM 3.5 billion of total sales of foreign Deutsche Mark bonds was accounted for by such indirect financing operations by domestic industrial enterprises and banks. In particular, option bonds were commonly issued in this way. For domestic parent companies, which generally guarantee bond issues by their foreign financial subsidiaries, this financing method has a number of advantages over the direct issue of bonds on the domestic market despite the somewhat higher interest costs on the foreign Deutsche Mark bond market. These advantages are partly a consequence of tax considerations, and also owe something to the absence of authorisation requirements (under sections 795 and 808a of the Civil Code) in the field of foreign Deutsche Mark bonds. On the other hand, some domestic investors, too, apparently regarded such Euro-DM issues as an attractive alternative investment. After all, foreign Deutsche Mark bonds to the value of DM 7 billion were placed in Germany last year — two-fifths of them with banks. Some of the bonds bought by banks were, however, presumably "remnants" of issues still awaiting final placement by the syndicate banks. If the placing with residents of foreign Deutsche Mark bonds and foreign currency bonds is combined, the capital exports generated in this way accounted for no less than 26 % of the total funds raised on the bond market.

Strong demand stimuli from abroad

On the investors' side of the capital market as well, striking changes took place in 1985. Strong demand stimuli were imparted, in particular, by foreign buyers, who invested large amounts in the German securities markets, especially after the reversal in exchange rate trends at the beginning of March last year. In 1985 they bought domestic bonds totalling DM 31.5 billion net. Hence they took up over two-fifths of the overall domestic supply of bonds (DM 76 billion).

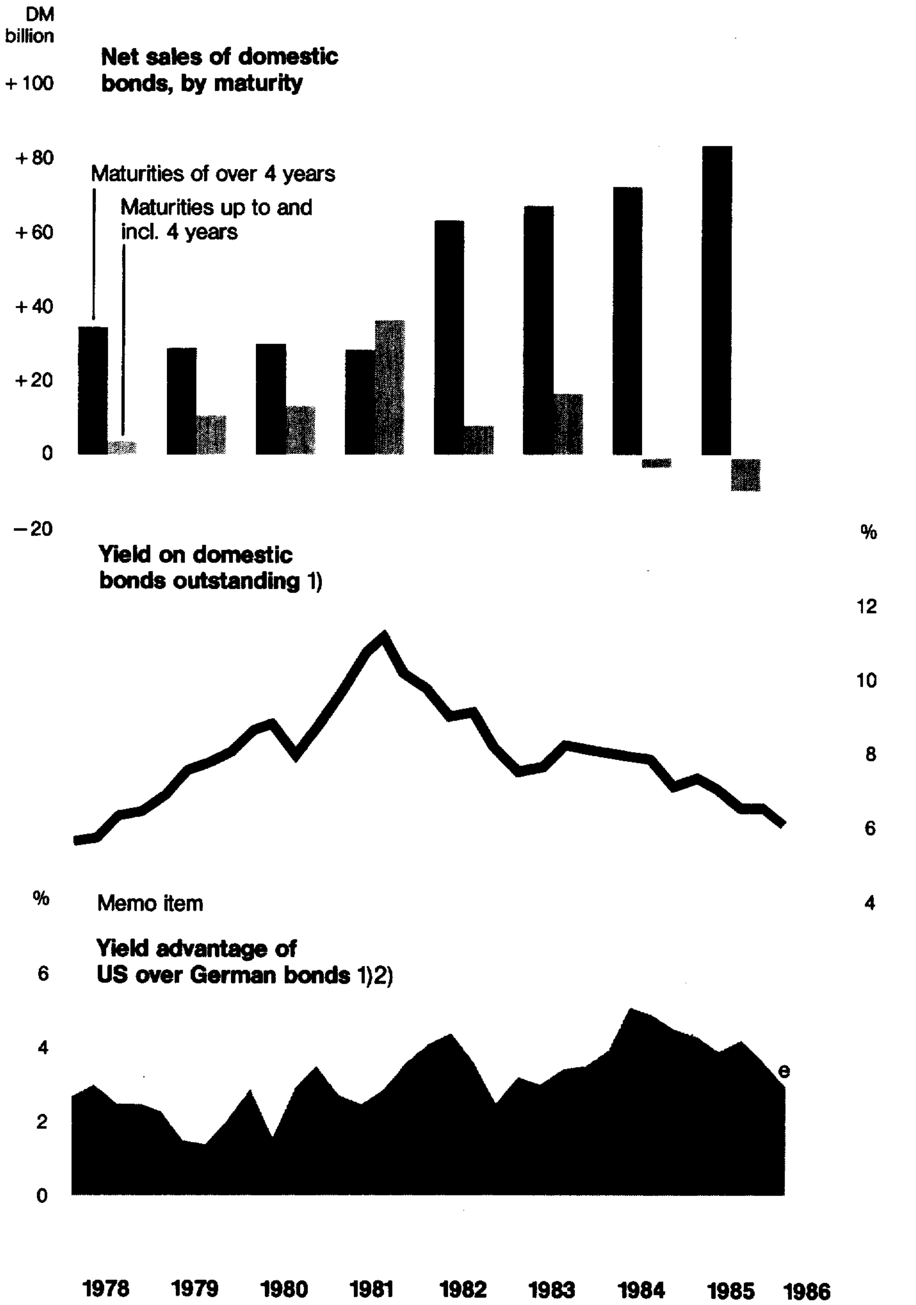
Heavy buying by banks

Stimulated by the prospect of a further fall in interest rates and by the sustained foreign demand for bonds, banks likewise stepped up their bond purchases in the course of last year. In this way they channelled some of the longer-term funds accruing to them from non-banks onto the bond market. With purchases of domestic and foreign bonds totalling DM 32.5 billion, they — like non-residents — constituted an important buyer group in 1985.

Non-banks withdraw from the German bond market

In the course of last year domestic non-banks' interest was focused increasingly on foreign bonds. They purchased securities of this type equivalent to no less than DM 23.5 billion; more than four-fifths of this sum was accounted for by high-yielding foreign currency bonds. On the domestic market — in view of the low interest rate level and the associated price risks — they increasingly placed funds in savings and time deposits, but somewhat fewer funds in bank savings bonds, Federal savings bonds and fixed interest securities with not-too-long maturities, such as five-year special Federal bonds. The upshot was that the domestic non-financial sectors' longer-term financial assets at banks (other than purchases of bank bonds) greatly increased in significance in 1985, at DM 57.5 billion, against DM 46.5 billion in the preceding year, whereas their investments in domestic and foreign bonds lost ground, at DM 30 billion compared with DM 38 billion a year earlier. Purchases of domestic bonds probably made up about one-fifth of the overall bond purchases of these sectors.

Trends on the bond market



1) Quarterly averages.- 2) Yields on public bonds in the United States less yields on public bonds in Germany.- e Estimated.

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Interest rate movements obscured at times by disturbances from abroad

Owing to the growing weight of banks and their foreign customers on the buyers' side of the German bond market, interest rates on the German capital market last year were affected much more than usual by interest and exchange rate movements on international markets. For example, in the first two months of last year the high-flying dollar led to a perceptible firming of the German bond market. After the turnaround in exchange rate movements at the beginning of March, however, this soon disappeared and eventually gave way to a prolonged period of bullish sentiment. With the bond market registering record turnovers, the capital market yield in Germany had fallen to the low level of 6⅓ % by the late summer of last year. Thereafter the market passed through a phase of marked uncertainty and stagnation. After the abrupt adjustment of exchange rates following the meeting of the Finance Ministers and Central Bank

Governors of the five largest industrial countries last September, the scope for the appreciation of the Deutsche Mark against the US dollar on the market seemed to have been more or less exhausted for a while. The substantial interest rate advantage of the dollar markets that had evolved in the course of last summer (some 4½ percentage points) began to weigh more and more heavily on the market. Together with the temporary slackening of "appreciation sentiment" for the Deutsche Mark, it resulted in a renewed rise in interest rates on the German capital market, while rates in the dollar sector tended to go down slightly at the same time. Not until the interest rate differential had dropped below 4 percentage points and developments on the foreign exchange markets warranted new expectations of an appreciation of the Deutsche Mark did interest rate trends on the German capital market start to move downwards again. At the end of March 1986 average yields on German bonds were below 6%, thus reaching their lowest level since the period of low interest rates in 1978.

Some shadows on the bond market despite relaxed market tone

The relaxed and easy tone and low interest rates that currently characterise the German bond market are in keeping with the favourable overall economic conditions. These include, in particular, the low inflation rate, the ongoing consolidation of the public sector budgets, the further improved but in general well-balanced economic outlook and the strengthened external situation of the Federal Republic of Germany. Even so, the bond market does exhibit a number of inherent weaknesses. Given the present interest rate level, domestic non-banks are reluctant in many cases to assume heavy long-term commitments on the German bond market because they are afraid that prices will fall, if anything, in future. For example, in every month from June 1985 to February 1986 inclusive, with the exception of January 1986, they not only failed to increase their portfolios of bank bonds but actually ran them down. Experience of interest rate movements in the past — which suggests, for instance, that yields of under 6% p.a. have rarely been of long duration — may make such a wait-and-see attitude seem understandable to a certain extent. In the fairly short run, banks and foreign buyers can bring about or accelerate falls in interest rates at the long end of the financial markets even without the direct participation of domestic private investors. However, the behaviour of these groups of buyers is often guided by speculative considerations. If the bond market is heavily dependent on buyers who are motivated chiefly by prospects of short-term profits on exchange rates and/or securities prices, this involves a danger of setbacks as long as the great majority of investors are showing greater or lesser restraint.

Share market in an upcurrent

Largely detached from the fluctuations in sentiment on the bond market, the upward movement on the German share market continued unabated in 1985. As measured by the share price index of the Federal Statistical Office, share prices went up on an average by 73% last year — a rise unparalleled in Germany since the fifties. In terms of the turnover on the German stock exchanges, too, the share market has now left the sidelines, and latterly it has even outstripped the bond market. With a turnover of almost DM 240 billion last year, the share market clearly outpaced simultaneous turnover in bonds (about DM 200 billion). The exceptional rise in prices was based on enterprises' much improved earnings prospects, on the favourable general economic outlook and not least on non-residents' keen interest in investment in German shares. The prominence of non-residents among the buyers may, however, yet prove to be a handicap to the further movement of prices, just as in the case of bonds.

Heavy sales of shares . . .

Enterprises qualifying for a stock exchange listing took advantage of the bull market to strengthen their capital base. Numerous listed firms offered new shares for subscription. In addition, a remarkable number of companies that had not hitherto been quoted on the stock exchange decided to go to the public share market for the first time. As a result, sales of domestic shares last year

Sales and purchases of bonds in the Federal Republic of Germany

Period	Sales, total	Sales 1 of domestic bonds: Total 2	of which issues: of banks	of which issues: of public authorities	Sales of foreign bonds 3	Memo item Balance of transactions with non-residents 4 (— = capital exports) col. 12 less col. 5
	1	2	3	4	5	6
	DM billion					
1980	52.6	45.2	41.5	4.9	7.3	− 7.0
1981	73.1	66.9	70.5	− 2.6	6.2	− 7.7
1982	83.7	72.7	44.8	28.6	11.0	− 8.7
1983	91.3	85.5	51.7	34.4	5.7	+ 5.1
1984	86.8	71.1	34.6	36.7	15.7	− 1.9
1985	103.2	76.1	33.0	42.7	27.1	+ 4.2
	% of total					
1984	100	81.9	39.9	42.2	18.1	—
1985	100	73.7	32.0	41.4	26.3	—

Period	Purchases, total	Purchases by ...: banks 5	domestic non-banks 6: Total	domestic non-banks 6: Domestic bonds	domestic non-banks 6: Foreign bonds	non-residents
	7	8	9	10	11	12
	DM billion					
1980	52.6	19.1	33.2	29.1	4.1	0.3
1981	73.1	17.4	57.1	51.5	5.7	− 1.5
1982	83.7	44.8	36.7	24.5	12.2	2.3
1983	91.3	37.6	42.9	36.4	6.5	10.8
1984	86.8	23.0	50.0	34.2	15.8	13.8
1985	103.2	32.5	39.3	16.0	23.3	31.3
	% of total					
1984	100	26.5	57.6	39.4	18.2	16.0
1985	100	31.5	38.1	15.5	22.6	30.4

1 Net sales at market values plus/less changes in issuers' holdings of their own bonds. — **2** Including industrial bonds, which are not shown separately. — **3** Transaction values. — **4** Purchases of domestic bonds by non-residents less sales of foreign bonds to residents. — **5** Including the Bundesbank. — **6** Residual. Discrepancies in the totals are due to rounding. BBk

reached the record amount of DM 11 billion (market value) — almost twice as much as in 1984. A particularly striking feature of this increase in sales is that it was concentrated on listed companies (DM 9.5 billion against DM 4 billion in the previous year), whereas sales of the shares of unlisted firms declined (from DM 2 billion to DM 1.5 billion).

... overstate a desirable reorientation of financing behaviour

Part of the capital newly raised on the market was taken up by financial enterprises, especially banks (DM 3 billion). These took advantage of the favourable market conditions, not least in view of the tighter capital requirements associated with the amendment of the Banking Act. The strengthening of the share as an instrument for financing trade and industry made less headway. Even so, as a percentage of the total amount raised by the domestic non-financial sectors in 1985, share issues accounted for just under 4% against 2½% in the previous year. An encouraging sign was the further growth in the number of "newcomers" to the stock exchange, who were admitted to the German stock exchanges for the first time last year or can be expected to be admitted in the very near future. This undoubtedly reflects a kind of reorientation of enterprises' financial behaviour. That such a spectacular rise in share prices should be required for the purpose goes to show how relatively unattractive this financing instrument long appeared to be to many enterprises. Recent developments give rise to hopes that the German stock exchanges may lastingly revert to their important economic function of supplying enterprises with liable capital through the market. But of course this necessitates a further step, namely to provide new shares with the full voting right, in other words to prevent a bunching of non-voting share issues, as had happened in 1985.

5. Germany's growing international importance as a financial centre

Markets for financial services characterised by progressive internationalisation and increased competition

The momentum on the domestic bond and share markets which was described in the previous section would not have been conceivable without strong additional stimuli from abroad; indeed, it is itself part of the increased activity on the closely-linked international financial markets. Liberalisation measures and deregulations in many larger industrial countries give market forces greater leeway. Innovations in the area of communications and payments technology give rise to a quick succession of new financial instruments and stimulate competition among the instruments and the financial institutions which offer them. However, the national credit systems are not only growing closer together but are competing among themselves for market shares in international financial business. The Federal Republic of Germany has the advantage that it possesses a monetary and credit system which is completely open; for a long time Germany's economic system has had two crucial assets: free currency convertibility and complete freedom from controls on capital transactions. Because of its domestic stability the Deutsche Mark became an internationally important reserve and investment currency. Of course, the changes in the international financial system, particularly the development of new financial instruments, are a constant challenge to the domestic financial markets. The regulatory principles of stability and free enterprise which are strictly adhered to in Germany create the right conditions for Germany to maintain and expand its position in the international arena.

Early domestic and external liberalisation

As mentioned above, Germany had removed many of the barriers in cross-border capital transactions at an early stage.[1] The last, scarcely significant, restrictions were lifted de facto in March 1981. Moreover, for almost two decades competition in the banking industry has been free from specific regulations, particularly restrictive interest rate controls. In addition, the tax privileges enjoyed by individual branches of the banking industry have been abolished in several stages. These measures encouraged competition among the banks but necessitated a greater diversification of the range of services offered in deposit business and ultimately strengthened the adaptability of the German banking industry. A good number of innovations, which have recently become a talking point abroad under the label of "deregulation", are of no current interest for Germany since the scope for banking and financial activity has for a long time been greater than in other countries.

Opening-up of the German bond market for new types of bonds and additional competitors

A number of additional measures have been taken of late which took up the liberalisation and competition policies of earlier years and were meant to facilitate further international capital transactions. They began in August 1984 with the abolition of coupon tax. The lifting of this withholding tax on foreign investors' interest income from domestic bonds made the market for Deutsche Mark bonds of domestic issuers fully competitive with foreign Deutsche Mark bonds. In a statement of April 12, 1985 the Bundesbank put aside its former reservations (which had been motivated by monetary policy considerations) about the issue of Deutsche Mark bonds with new features and at the same time allowed

1 See "Freedom of Germany's capital transactions with foreign countries" in Monthly Report of the Deutsche Bundesbank, Vol. 37, No. 7, July 1985, p. 13.

foreign-owned domestic banks, on a reciprocal basis, to lead-manage issues of foreign Deutsche Mark bonds. Now new types of bonds, such as floating rate notes and zero bonds, which are already well-established internationally, can compete with the traditional bond types on the German bond market. Competition in the international issue business was concurrently given a new boost. This can also be seen from the fact that the number of renowned foreign banks moving into the German market is continuing to grow and that the numerous foreign banks already represented here are consolidating their presence on Germany's financial market, both in terms of personnel and organisation.

Reduction of the minimum reserve burden promotes international competitiveness of German banks

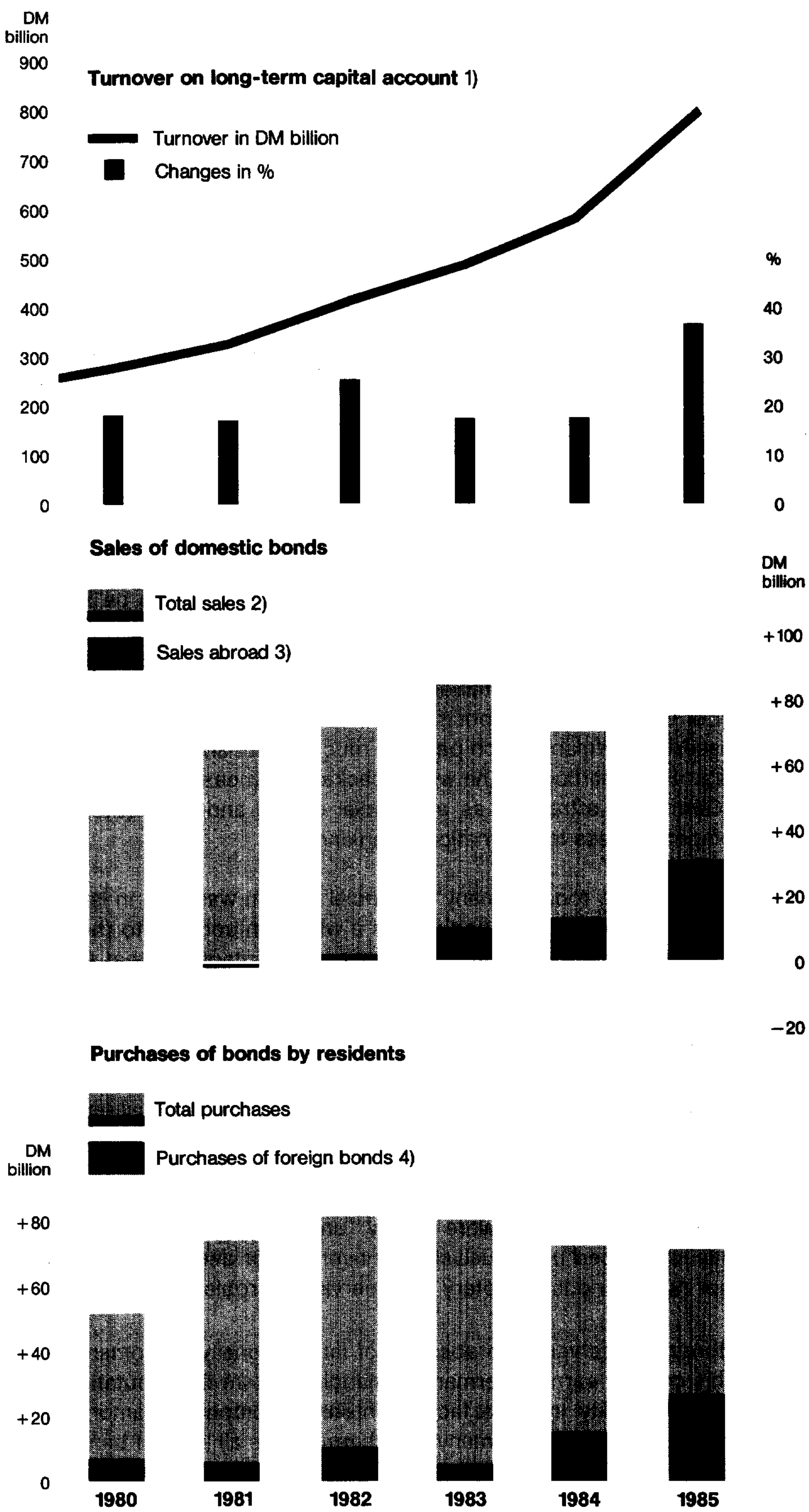
The same motives were behind the decision to change the minimum reserve regulations, which the Bundesbank made at the end of 1985 and which is to enter into force on May 1, 1986. Its principal aim is to reduce the cost disadvantages in domestic bank lending arising from the minimum reserve requirement vis-à-vis the Euro-markets. The reserve ratios for time liabilities and savings deposits are being lowered considerably. Moreover, the banks' foreign currency liabilities to non-residents will in future be largely exempted from reserve requirements as part of an offsetting arrangement which improves domestic banks' competitiveness in foreign currency business. However, the Bundesbank made it clear at that point that there is no prospect of "freezing" or completely dispensing with the minimum reserve instrument now or in the future. In accordance with this principle, short-term bank bonds, which can be regarded as a surrogate of reserve-carrying time deposits, will in future be subject to minimum reserve requirements. This step is to be seen not least in connection with the Bundesbank's intention not to raise any further objections to the issue of short-term bank bonds denominated in Deutsche Mark which have the characteristics of certificates of deposit, provided that the market for such paper remains based in Germany. Such paper is much in demand with large customers from abroad, in particular. The whole package of measures helps to further enhance Germany's attraction as a financial centre and strengthen German banks' competitiveness in international banking.

"Unspectacular innovations" evidence of efficiency of Germany's financial system

However, in the past, too, Germany's financial system was able in large measure to meet the needs of the economy as a whole. In addition to the high degree of deregulation in Germany, it has proved advantageous that Germany's universal bank system was also in the past in a position to cater for new and more complex customer requirements regarding financing and investment. In contrast to other financial centres, investors on the German market, for example, have for a long time been enjoying the opportunity to invest short-term funds with banks at money market-related rates or, for tax reasons, to purchase low-coupon bonds and discounted bank savings bonds. Conversely, domestic borrowers have always been free to take up variable rate loans or short-term bridge-over loans if they did not want to enter into long-term interest rate commitments. These were mainly "unspectacular innovations" which were mostly introduced unobtrusively and over longer periods of time, so that they did not raise serious monetary or supervisory problems.

To some foreign observers, the absence of internationally customary "innovations" in this country earned Germany's financial system the reputation of having a certain inflexibility. In actual fact the intensive competition among the various categories of banks in Germany, which embraces all lines of banking business, led to a level of banking facilities being offered which was remarkably high by international standards and which left no substantial gaps in the market. This is no doubt the reason why there has by no means been a run on the newly-offered investment facilities on the German market; up to now their growth has been fairly moderate.

External capital transactions of the Federal Republic of Germany



1) Sum of statistically recorded new investment and disinvestment (including redemptions) on long-term capital account.- 2) Net sales at market values plus/less changes in issuers' own holdings.- 3) Net purchases and net sales of domestic bonds by non-residents; transaction values.- 4) Net purchases of foreign bonds by residents; transaction values.

BBk

Flood of innovations on the international markets creates new problems

A significant proportion of the "spectacular innovations" seen in recent years on the international markets resulted not least from the efforts by foreign banks to get round institutional regulations and administrative restrictions in their home countries and thus open up new markets. To the extent that such developments are rapid and difficult to control, bank supervisors and possibly also monetary policy-makers are confronted with not inconsiderable problems. Of course, the task of banking and monetary policy, which is committed to market principles, cannot be to produce a flood of financial innovations, but rather is to create and maintain framework conditions within which the creative potential of the markets is channelled into a transparent and, as regards the risks involved, controllable provision of financial services. The success of such a policy is to be measured less by the growth rates which can be achieved in the short term in the individual lines of banking business than by whether it is possible to safeguard in the long term the functioning and stability of the financial system, both nationally and internationally.

Germany has maintained its international position as a financial centre

Measured by this yardstick, Germany has of late definitely maintained its international position as a financial centre. This can also be seen from the high esteem in which the Deutsche Mark is held by foreign debtors and investors. Thus the Deutsche Mark continued to be among the foremost international bond issue and reserve currencies in 1985, after the US dollar, with a share of around 7 % of the total international volume of issues and 14½ % of global foreign exchange reserves. At the beginning of the eighties the Deutsche Mark initially lost some ground in international lending and bond issues and as a reserve currency, since investors broadened the range of currencies in which they held their assets, aiming at greater portfolio diversification. With the refirming of the Deutsche Mark on the international foreign exchange markets, which began in 1985 and continued sharply in the first few months of 1986, and the introduction of new types of bonds on the German bond market, the Deutsche Mark was able to consolidate once again its international position as an investment currency.

Germany's key role as an international centre for channelling savings to investors

The international esteem in which the Deutsche Mark is held can also be seen from Germany's growing significance as a centre for international capital transactions.[1] The turnover volume in cross-border long-term capital transactions has almost tripled in the last five years, corresponding, on an annual average, to a growth rate of 23 %; the volume of portfolio transactions, taken by itself, went up by an average annual rate of no less than 41 % in the same period. Particularly since the abolition of coupon tax foreign investors have shown increasing interest in Deutsche Mark bonds of domestic issuers. Thus in 1984 around 20 % of domestic bonds was sold to non-residents, and in 1985 this share doubled to over 40 %. At the same time, as mentioned, domestic investors stepped up their purchases of foreign bonds. Much the same is true of both cross-border sales and cross-border purchases of shares. In terms of the overall international portfolio transactions of the five major industrial countries, Germany ranked third between 1980 and 1984, with a share of 16 %, behind the United States and Japan (in each case around 30 %) and ahead of the United Kingdom (14 %) and France (8 %).

Market for foreign Deutsche Mark bonds based in Germany's financial system

For a long time now the Deutsche Mark — along with the Swiss franc and the yen — has been one of the major currencies of issue on international primary markets, after the US dollar. The market for foreign Deutsche Mark bonds, in particular, has always played a key role in channelling international savings to investors, even though, unlike the Euro-dollar bond market, it has always remained firmly based in Germany's financial system. In a wider context, Ger-

1 See "Recent trends in securities transactions with foreign countries" in Monthly Report of the Deutsche Bundesbank, Vol. 37, No. 11, November 1985, p. 30.

many's role as a financial intermediary in the overall flow of funds is no less important than the part it plays in international goods and services transactions. Measured by the sum of all financial flows in the economy as a whole, the share of foreign assets and liabilities in 1984 and 1985 came to around 15% and 17%, respectively, compared with close on 11% in 1980.[1] In this global analysis of flow of funds relations with the rest of the world Germany recently occupied second place behind the United Kingdom (18%), followed by France (12%) and, lagging some distance behind, Japan (7%) and the United States (4%) — the latter two, of course, countries with fairly large domestic assets markets.

Increasing presence of foreign banks

At the same time the increasing presence of foreign banks in Germany highlights Germany's considerable attraction as a financial centre. While at the beginning of the eighties there were indeed around 250 foreign banks with representative offices, branches and subsidiaries in Germany, this figure increased again appreciably to about 300 by the end of 1985. At that point, the aggregate volume of business carried out by foreign-owned bank offices amounted to approximately DM 160 billion; this corresponds to a share of roughly 5% in the volume of transactions of all banks domiciled in Germany (excluding the assets of German branches abroad).

Offices of German banks abroad strengthen competitiveness

Germany's competitiveness as a financial centre was also strengthened in the past by the fact that German banks consolidated further their presence abroad and thus increased their international potential for attracting business.[2] Banks with their head office in Germany were represented abroad by 67 banks of independent legal status and 99 (dependent) branches at the end of 1985. Since 1980 the total number has gone up by close on one-third to 166. Offices of German banks abroad currently account for around 12% of the volume of business of all banks domiciled in Germany. Moreover, domestic banks maintained a total of 133 representative offices abroad at the end of 1985. These offices of German banks abroad ultimately extend the scope for foreign transactions by the parent companies in Germany and thus again strengthen Germany's competitiveness as a financial centre. At the end of 1985 total foreign assets of banks domiciled in Germany (excluding their foreign branches) amounted to approximately one-tenth of their volume of business.

Germany's share in traditional banking business

At first sight, these favourable trends would appear to contradict the figures from the Bank for International Settlements (BIS) on the relative importance of individual countries in international banking business — which, of course, only represents one, albeit the most important, line of financing business. With regard to banking business, Germany ranks behind the United States, the United Kingdom, Japan and France as well as the banking centres of Switzerland and Luxembourg. This order of rank partly reflects positions which have developed in the past and partly the "locational advantages" for the banks in these financial centres which were created through specific promotional measures. However, these data only refer to banking business; in other words they do not include the transactions outside the banking systems which in recent years have assumed increasing importance, i. e. securities finance and direct (non-intermediated) credit transactions between non-banks (enterprises and government offices).

1 These figures include the financial relationships between the individual domestic sectors and between these sectors and foreign countries, including trade credit links. Excluding the latter, the following shares result for Germany: 1980: 6%, 1984: 11%, 1985: 16%. The marked increase in the share of foreign assets and liabilities in the overall domestic flow of funds can therefore also be seen in this narrower definition. Due to a lack of similar adjustment possibilities for all other countries, only the data including trade credits were used in the comparison with foreign countries.

2 See "The offices of German banks abroad" in Monthly Report of the Deutsche Bundesbank, Vol. 37, No. 5, May 1985, p. 25.

Financial external links between the five major industrial countries *

Percentage of total

Country	1980	1981	1982	1983	1984	1985 **pe**
Federal Republic of Germany	10.6	10.6	8.4	7.4	14.5	17.2
France	15.7	9.4	6.9	8.3	11.5	...
Japan	6.6	6.1	3.9	5.8	7.4	...
United Kingdom	26.4	27.6	20.9	19.8	17.6	...
United States	5.1	4.9	1.9	4.2	4.2	...

* Financial asset acquisition and borrowing by non-residents as a percentage of the total financial asset acquisition and borrowing in each country. — **pe** Partly estimated.
Source of basic data: Capital finance account of the Bundesbank and OECD Financial Statistics. BBk

Germany's continued development as a financial centre enhanced by the elimination of tax, organisational and procedural obstacles . . .

However, for international banking in the narrower sense there is no justification for the fear that Germany as a financial centre might fall behind the international trend. Of course, it cannot be denied that Germany's role as a financial centre and the development of its banking system could be enhanced further if in future it were possible to eliminate some remaining tax, organisational and procedural obstacles. Securities transfer tax, for instance, is a distinct burden on trading in the secondary market in Germany. This is particularly true of types of bonds that are similar to money market paper like, for example, floating rate notes, for which, not least for this reason, no secondary market of any consequence has developed in Germany so far. An alignment of international standards would strengthen Germany's competitiveness as a financial centre, as would the implementation of plans for an extensive reform of the stock exchange. Both should be achieved soon. Nevertheless, it is extremely doubtful whether Germany would be well-served by entering into "imitative competition" in every respect with the leading international financial centres. Off-balance sheet financial transactions, for instance, entail considerable risks.

. . . without departing from the established regulative policy stance

The monetary authorities have the task of observing these trends, identifying undesirable developments and containing them as far as possible. However, effective controls in this area are only possible if the monetary authorities in each country act together, since these developments tend to occur outside the national authorities' own areas of influence. The central banks and supervisory authorities of the major industrial countries have been working together here for some time, and this cooperation needs to be intensified further. Germany does not consider it acceptable to create domestic conditions for banking and other financial transactions along the lines of those in exotic off-shore centres, quite apart from the fact that the banks themselves, independent of supervisory regulations, cannot be freed from their responsibility for their own transactions. Adhering to the basic monetary and banking policies pursued up to now and, where necessary, adapting them to changes in financing techniques would probably be the best way of guaranteeing that Germany continues in future to develop as a financial centre on solid foundations.

II. International monetary developments and policy

1. The situation in the world economy

Economic growth temporarily weaker in the industrial countries

There was an improvement in the preconditions for sustained, non-inflationary growth in the world economy in the year under review. Although economic growth in the OECD countries in 1985, at 2.7 % in real terms, was lower than in 1984, and was also slightly less than had initially been expected, this was primarily due to the fact that, after the strong upswing in the preceding year, the rate of growth slowed down in the United States. The boost to demand given by rising US budget deficits gradually slackened, and the deterioration in the competitive position of the United States vis-à-vis other countries became a distinct burden on US exports. The pace of growth also moderated in Japan, primarily owing to declining US domestic demand. Although economic growth in other major industrial countries was also slightly lower in comparison with the preceding year, economic activity accelerated in a number of these countries as the year progressed. The overall slower rate of growth in the industrial countries and the associated weaker increase in world trade had negative effects for the developing countries, in particular. This vitiated the efforts of not a few heavily indebted countries to overcome their payments problems and restore their creditworthiness on the international financial markets.

Strengthening of economic forces in the current year

According to the latest forecasts, economic growth in the industrial countries as a group will accelerate slightly again in the current year, particularly as interest rates and oil prices have fallen to a greater degree than was to be expected some while ago. Although fiscal policy impulses will probably cease to operate in the United States now that measures have been adopted to reduce the large US Federal deficit, this may be offset by the more favourable prospects for US exporters owing to the shift in exchange rates as well as by the lower interest rates and the drop in oil prices. The dynamism behind growth in countries whose currencies have appreciated strongly vis-à-vis the US dollar and which at the same time — as in the case of Japan — depend heavily on exports to the United States might be dampened accordingly. In the other countries, however, these setbacks should be more than offset by domestic expansionary stimuli, which have meanwhile become more evident. Last year domestic demand in Europe contributed considerably more to economic growth than previously, so that growth has become less dependent on exports.

Improved prospects on the labour market

The fact that investment activity has become the principal driving force behind economic activity is particularly welcome. This development is now being followed by a more marked rise in consumer demand. As a result, growth in the future should be more balanced than in the initial stage of the upswing in economic activity. Moreover, the generally greater emphasis being given to the operation of the principles of a free market economy warrants the hope that the dynamic forces behind economic activity will increasingly gain in basic strength and hence become self-sustaining. This also opens up encouraging prospects that the high level of unemployment obtaining in many countries can be reduced and finally overcome.

Further upswing in economic activity also supported by greater price stability

Favourable signs of a continued upward development in economic activity are also to be seen in the fact that success has been achieved in most industrial countries in further containing the rate of price increases and that the danger of a general rekindling of inflationary forces appears to have been averted for the time being. Wherever this is not so, the domestic causes are in most cases quite evident. Further efforts to reduce inflation should be facilitated by the relief deriving from the reduced price of oil. However, relief attributable to oil price movements is an advantage which takes effect on prices only once; after it ceases to operate, the underlying upward trends in prices will become more evident again in the statistics. For this reason there must not be any slackening in the fight against inflation.

Development of the exchange rate of the US dollar returns to normal

After the external value of the US dollar had lost touch with fundamental economic conditions until well into the year 1985, the subsequent correction in the development of the dollar rate made an important contribution to an improvement in the world economic situation. Although a rapid and marked decline in the exchange rate had become increasingly probable in the light of the speed of the preceding appreciation of the US dollar and of the exchange rate level that had been reached, this did not prevent the markets from pushing up exchange rates still further. Once the countermovement got under way in the spring of 1985, an overreaction could not be ruled out from the start. The US dollar did indeed weaken considerably on the foreign exchange markets, but the development of the exchange rate did not get seriously out of control at any time. The monetary authorities even found themselves obliged on several occasions to help events along. It can hardly be said with any certainty whether the pattern of exchange rates which has meanwhile emerged is appropriate; no unambiguous criteria exist for ascertaining this. Moreover, although one can expect a lot from mere shifts in exchange rates, one should not expect everything from them. The contribution that the current pattern of exchange rates can make towards correcting the large US deficits on trade and current accounts and the corresponding surpluses of other countries depends primarily on how quickly the United States restricts the share of domestic expenditure in its national product — not least by reducing its budget deficit — in favour of higher exports of goods and services, and on whether such a development is supported by a satisfactory rate of economic growth in the major partner countries of the United States.

Enhanced cooperation in economic and monetary policy

Last year economic and monetary policy cooperation among the major industrial countries became closer. For example, within the context of the decisions taken by the "Group of Five", in September 1985 the United States explicitly undertook to reduce the excessively high US Federal deficit, while the other countries reaffirmed their intention to ensure sustained, non-inflationary growth. The United States has thus adopted a policy which pays greater attention again to the exchange rate of its currency. This reorientation owes much to the fact that, with the rise in the dollar rate, problems arose for the US economy to an increasing extent and protectionist demands became more vociferous. Other countries have lived for a long time with the fact that they cannot leave the exchange rate of their currency entirely to itself but must take it into account when formulating their economic, financial and monetary policies.

Target zones not a way to achieve greater long-run exchange rate stability

Though desirable, more stable exchange rate relationships between the major currencies cannot mean that the exchange rates of these currencies should be formally tied more closely to each other again, as is, for example, the aim behind proposals to agree upon more or less binding target zones. Apart from the difficulties involved in determining and negotiating "correct" exchange rates or exchange rate zones, such ideas are subject to serious objections, particularly from the standpoint of central banks. Given the problems associated with the anti-cyclical and flexible conduct of financial policy, the burden of domestic adjustment in order to maintain agreed target zones would have to be borne primarily by monetary policy, as is also being demanded by some proponents of target zone schemes. Clearly, a central bank cannot ignore the development of the exchange rate of its currency. But it could no longer devote itself single-mindedly to its primary task of safeguarding the domestic value of money if it had to subordinate its monetary policy to the obligation to maintain a target zone for the exchange rate of its currency. On a realistic appraisal of the scope for economic policy coordination, monetary policy would therefore be faced in the final analysis with conflicts similar to those encountered in the final stage of the system of fixed dollar parities. It also appears doubtful whether market expectations could be effectively stabilised with respect to the world's key currencies through target zones. Market participants would probably call such target zones into question and test them if they believed they could discern signs of incompatibilities between exchange rate targets and the financial and monetary policies of a given country.

Additional efforts required to overcome the debt crisis

A radical improvement in the world economic situation also depends on progress being made in overcoming the problems of a large number of highly-indebted countries. It remains quite difficult to achieve this, particularly since the recovery process suffered setbacks again last year. The uncertainty that this engendered prompted the US Administration in the autumn of 1985 to submit new proposals which met with a positive response in general although they call for considerable new efforts from all those involved, and especially from the debtor countries and their creditors. However, it is proving to be difficult to transform these proposals into concrete action because up to the present the debtor countries fail to fulfil all the necessary preconditions or are unwilling to join unreservedly in the effort. Although falling interest rates and declining oil prices are helpful in alleviating the financing problems of many countries, they cannot basically improve their situation. Besides, in some cases the drop in oil prices is tearing new gaps in the balance of payments. It therefore continues to be an urgent task for the highly-indebted countries to undertake further efforts of their own to cope with their problems. The industrial countries will make a major contribution to this if they continue to pursue policies geared to non-inflationary growth and persistently combat protectionist tendencies.

2. International trade and current transactions

Weaker increase in world trade

After world trade had expanded particularly strongly (at a rate of 9 % in real terms) in 1984, mainly under the impact of the powerful economic growth in the United States, it rose by only a modest 3 % last year. This partly reflected a swing in the development of trade in oil; after a temporary increase in real terms in 1984, trade in crude oil and crude oil products declined again in 1985. Excluding oil, the volume of world trade consequently rose last year by 4 %. In the industrial goods sector the rate of increase was as high as 5 % — compared, however, with 11 % in the preceding year. The lower rate of growth in aggregate world trade as well as in trade in industrial goods was, of course, primarily due to the fact that for cyclical reasons US imports rose less strongly than in 1984; in inflation-adjusted terms their rate of increase slowed from 26 % to 4 %. In the countries of Europe as well, imports grew somewhat more slowly because impulses originating from the stock cycle had become weaker in comparison with the initial stage of the economic recovery. With the reduced pace of economic activity in Japan, moreover, Japanese imports of industrial goods stagnated. In addition, a dampening effect was exercised by the fact that, under the impact of changed conditions on the oil market, the oil-exporting developing countries once again cut back their imports strongly.

Further rise in the US trade deficit

Despite the weaker growth in US imports, the trade deficit of the United States increased considerably once again. While US imports rose by only 1 % in value terms in 1985, US exports, which recovered in 1984 from a setback they had suffered before that, declined again slightly. Although US exports of industrial goods continued to rise — albeit at a slower pace than in the preceding year — the United States sustained considerable losses in its foreign sales of agricultural products and industrial raw materials. US agricultural exports, in particular, which accounted for over 17 % of total US exports in 1984 and which are subject to strong price competition, evidently also distinctly felt the effects of the high value of the dollar on the foreign exchange markets; they dropped by one-quarter. In the event, the deficit on the US balance of trade (as defined in the balance of payments statistics) rose last year by $ 10 billion to $ 124 billion.

Balance of payments of the United States

US$ billion

Item	1980	1981	1982	1983	1984	1985 **pe**	Change in 1985 from 1984 **1 pe**
A. Current account 2							
Merchandise trade							
Exports	224.3	237.1	211.2	201.7	219.9	214.0	− 5.9
Imports	249.7	265.1	247.6	268.9	334.0	338.3	− 4.3
Balance	− 25.5	− 28.0	− 36.4	− 67.2	−114.1	−124.3	−10.2
Foods, feeds and beverages	+ 17.6	+ 20.1	+ 14.5	+ 13.1	+ 10.1	+ 2.4	− 7.7
Capital goods	+ 43.0	+ 44.9	+ 35.3	+ 25.8	+ 12.5	+ 11.7	− 0.8
Automotive vehicles, parts and engines	− 10.4	− 11.1	− 16.7	− 24.8	− 34.8	− 40.8	− 6.0
Consumer goods (non-food)	− 17.8	− 22.3	− 24.9	− 32.9	− 47.4	− 51.9	− 4.5
Petroleum and products	− 76.3	− 73.7	− 54.8	− 50.1	− 52.8	− 45.4	+ 7.4
Other industrial supplies and materials	+ 14.9	+ 8.5	+ 7.1	− 1.2	− 8.1	− 7.1	+ 1.0
Other	+ 3.4	+ 5.7	+ 3.0	+ 2.9	+ 6.4	+ 6.8	+ 0.4
Investment income							
Receipts of income on US assets abroad	72.5	86.4	84.8	78.0	87.6	90.5	+ 2.8
Payments of income on foreign assets in the United States	42.1	52.3	55.3	52.6	68.5	65.8	+ 2.7
Balance	+ 30.4	+ 34.1	+ 29.5	+ 25.4	+ 19.1	+ 24.7	+ 5.6
Other services and military transactions	+ 4.0	+ 7.1	+ 7.0	+ 4.7	− 0.9	− 3.3	− 2.3
Unilateral transfers	− 7.1	− 6.8	− 8.1	− 8.9	− 11.4	− 14.8	− 3.4
Balance on current account	+ 1.9	+ 6.3	− 8.1	− 46.0	−107.4	−117.7	−10.3
B. Capital account							
(capital imports: +)							
Foreign assets in the United States							
Direct investment	+ 16.9	+ 25.2	+ 13.8	+ 11.9	+ 22.5	+ 16.3	− 6.3
Portfolio investment	+ 8.1	+ 10.1	+ 13.4	+ 17.4	+ 35.4	+ 71.6	+36.2
Liabilities reported by enterprises	+ 6.9	+ 0.9	− 2.4	− 0.1	+ 4.3	**4** − 3.5	**4** − 7.8
Liabilities reported by banks	+ 10.7	+ 42.1	+ 65.9	+ 49.3	+ 31.7	+ 40.6	+ 8.9
Liabilities reported by US Government	+ 0.6	− 0.3	+ 0.7	+ 0.6	+ 0.5	+ 0.1	− 0.3
Total	+ 43.2	+ 78.0	+ 91.5	+ 79.1	+ 94.3	+125.2	+30.8
US assets abroad							
Direct investment	− 19.2	− 9.6	+ 4.4	− 5.4	− 4.5	− 19.1	−14.6
Portfolio investment	− 3.6	− 5.8	− 8.1	− 7.0	− 5.1	− 7.9	− 2.8
Claims reported by enterprises	− 3.2	− 1.2	+ 6.6	− 6.5	+ 6.3	**4** + 1.2	**4** − 5.1
Claims reported by banks	− 46.8	− 84.2	−111.1	− 29.9	− 8.5	− 5.9	+ 2.6
Claims reported by US Government	− 5.2	− 5.1	− 6.1	− 5.0	− 5.5	− 2.6	+ 2.9
Total	− 78.0	−105.9	−114.3	− 53.8	− 17.3	− 34.3	−17.0
Balance on capital account							
Direct investment	− 2.3	+ 15.6	+ 18.2	+ 6.6	+ 18.0	− 2.8	−20.8
Portfolio investment	+ 4.5	+ 4.3	+ 5.3	+ 10.4	+ 30.4	+ 63.8	+33.4
Enterprise sector	+ 3.7	− 0.3	+ 4.2	− 6.6	+ 10.6	**4** − 2.3	**4** −12.8
Banks	− 36.1	− 42.0	− 45.1	+ 19.4	+ 23.2	+ 34.7	+11.5
US Government	− 4.5	− 5.4	− 5.4	− 4.5	− 5.1	− 2.5	+ 2.6
Total	− 34.7	− 27.8	− 22.8	+ 25.2	+ 77.0	+ 90.8	+13.8
C. Statistical discrepancy	+ 25.0	+ 20.3	+ 32.8	+ 16.7	+ 30.5	+ 32.7	+ 2.3
D. Balance on official reserve transactions							
Official reserve assets **3**	+ 7.0	+ 4.1	+ 5.0	+ 1.2	+ 3.1	+ 3.9	+ 0.7
Liabilities to foreign official institutions (increase: −)	− 14.9	− 5.3	− 3.0	− 5.2	− 3.0	+ 2.1	+ 5.0
Balance on official reserve transactions (A plus B plus C)	− 7.9	− 1.2	+ 2.0	− 4.0	+ 0.2	+ 5.9	+ 5.8

1 − = decrease in receipts or increase in payments. — **2** Excluding unilateral military transfers to the rest of the world. — **3** Excluding SDR allocations. — **4** For the fourth quarter of 1985 these transactions are included in the item "Statistical discrepancy". — **pe** Partly estimated.

Discrepancies in the totals are due to rounding.
Source: United States Department of Commerce.

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US current account deficit increased by the same amount as the trade deficit

In 1985 the United States' current account deficit went up by the same amount as its trade deficit, thus reaching a total of $ 118 billion (in this connection it should be borne in mind that, owing to the global statistical coverage problems, changes in current account balances are quite generally of greater informative value than balances themselves). Although there was a further increase in net US expenditure on transfer payments and a number of services, this was accompanied — rather unexpectedly — by a similarly large improvement in the US investment income account. In contrast, the US investment income account had deteriorated considerably in the preceding years after the burden of interest payments on the United States had grown strongly as it became increasingly indebted to the rest of the world; the US surplus fell from $ 34 billion in 1981 to $ 19 billion in 1984. The recent improvement resulted both from lower expenditure due to the fall in interest rates and from the more favourable profit situation abroad plus the advantage that in the second half of 1985 the dollar rates were lower than in the same period of 1984, so that income earned abroad was higher when converted into US dollars. As these special influences cease to be effective, it is therefore to be expected that the US investment income account will deteriorate again, with the result that the US balance on "invisible" transactions (i. e. the overall balance on services account in the widest sense plus transfer payments), the surplus on which formerly made a major contribution towards offsetting deficits on the trade balance, might likewise move into deficit in the future. This would also make it particularly clear that the tendency for the US current account to deteriorate will increasingly gain a momentum of its own, the longer the United States runs a massive deficit on current account and the higher the level of US debt vis-à-vis the rest of the world correspondingly rises.

Reduction in the US current account deficit urgent also in the interests of the world economy

A turnaround in the development of the US current account is absolutely essential. This is in the interests both of the United States itself and of better equilibrium in the world economy. The growing protectionist forces in the United States — should they gain the upper hand — represent a danger with unforeseeable implications for world trade and economic performance of all countries. Moreover, the United States cannot rely on its persistently large current account deficits being financed completely smoothly at all times. However, with the decline in the value of the US dollar on the foreign exchange markets one of the major conditions for a correction of the US current account deficit has improved.

Japan, Germany and other industrial countries run current account surpluses

Last year the growing deficit on the current account of the US balance of payments contrasted with an increase of $ 22 billion net in the current account surplus of the other OECD countries. It was Japan's surplus that grew most strongly, rising by $ 14 billion to $ 49 billion. Of this considerable increase, $ 6 billion was accounted for by higher exports, mainly through increased sales on the US market. Declining Japanese imports contributed a further $ 6 billion; the main reason for this fall in Japan's imports was that Japanese industry reduced its unusually large stocks of oil and hence imported a correspondingly smaller amount. The remaining improvement resulted primarily from higher net investment income, reflecting the growth in Japan's investment abroad; this is in turn the mirror-image of the burden of interest payments on the United States which is tending to rise. Germany also registered a rise of $ 8 billion (to a total of $ 14 billion) in its current account surplus, but this surplus is not comparable with that of Japan with respect either to its size or to its structure. The current account balances of other OECD countries also improved in 1985. In the United Kingdom, the surpluses in oil trade and on services account rose while the deficit on other transactions in goods — which profited in the first half of 1985 from a steep rise in UK exports — fell. In the event, the UK balance on current account improved by $ 3 billion and thus registered a surplus of $ 5 billion. On the other hand, a large number of industrial countries suffered a deterioration

Current account balances of selected countries and groups of countries

US$ billion

Group of countries/Country	1980	1981	1982	1983	1984	1985 **p**	Change in 1985 from 1984 **p**
A. OECD countries							
United States	+ 2	+ 6	− 8	− 46	−107	−118	− 10
Six other major countries	− 35	− 6	+ 3	+ 28	+ 41	+ 64	+ 23
Japan	− 11	+ 5	+ 7	+ 21	+ 35	+ 49	+ 14
Canada	− 1	− 5	+ 2	+ 1	+ 2	− 1	− 3
Federal Republic of Germany	− 16	− 5	+ 3	+ 4	+ 6	+ 14	+ 8
France	− 4	− 5	− 12	− 4	− 1	+ 1	+ 1
United Kingdom	+ 7	+ 13	+ 8	+ 5	+ 2	+ 5	+ 3
Italy	− 10	− 9	− 6	+ 1	− 3	− 4	− 1
Other countries	− 36	− 25	− 23	− 10	− 2	− 3	− 1
Total	− 69	− 25	− 28	− 28	− 69	− 57	+ 12
B. OPEC countries							
Low-population **1**	+ 81	+ 63	+ 8	− 0	− 8	− 12	− 4
High-population **2**	+ 22	− 15	− 30	− 11	− 1	− 1	+ 0
Total	+103	+ 48	− 22	− 11	− 10	− 13	− 3
C. Other developing countries							
Highly-indebted Latin American countries **3**	− 28	− 39	− 32	− 9	− 2	− 3	− 1
Other countries	− 37	− 46	− 35	− 26	− 20	− 25	− 5
Total	− 65	− 85	− 67	− 35	− 22	− 28	− 6
D. Eastern European countries 4	− 2	+ 0	+ 8	+ 11	+ 11	+ 5	− 6
E. Statistical discrepancy (Total A to D)	− 33	− 62	−109	− 63	− 90	− 93	− 3

1 Kuwait, Libya, Qatar, Saudi Arabia, United Arab Emirates and the non-member Oman. — **2** Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Nigeria, Venezuela. — **3** Argentina, Brazil, Chile, Colombia, Mexico, Peru. — **4** Albania, Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Romania, USSR. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Sources: OECD, IMF and national statistics. BBk

in their current account balances, albeit on a modest scale in most cases. Canada was an exception; as a result of a sharp rise in imports, the current account of Canada's balance of payments deteriorated by $ 3 billion, with the balance switching from a small surplus to a deficit.

Renewed slight rise in the current account deficit of the developing countries

The non-OPEC developing countries, which according to the definition of the OECD for the first time include China, South Africa and Yugoslavia, did not succeed in 1985 in maintaining the former trend towards equilibrium in their aggregate balance of trade. These countries were once again squeezed between rising imports and weaker exports. Particularly countries with a considerable volume of commodity exports, which include a number of the most highly-indebted countries, were badly off in this respect since most commodity prices declined further in 1985. The renewed deterioration in the trade balances of the developing countries also caused the current account deficit of this group of countries to rise again. After this deficit had decreased continuously from 1982 to 1984, it rose last year — according to provisional OECD calculations — by $ 6 billion to $ 28 billion.

Current account deficit of the OPEC countries higher, too

The current account balances of the OPEC countries, which have been in deficit on aggregate since 1982, also deteriorated according to the available and partly only estimated data. As calculated by the OECD, the deficit of this group of countries rose in 1985 by $ 3 billion to $ 13 billion. At all events, the oil exports of the OPEC countries fell sharply again. This was partly due to a renewed decline in the consumption of oil by the OECD countries; after the industrial countries' demand for oil in real terms had fallen continuously from 1979 to 1983 by a total of 16 % and had risen in 1984 by only 2 %, it fell again in the first three quarters of 1985 by 3% in comparison with the corresponding period of the previous year. Moreover, the OPEC countries lost further shares of the world oil market; in 1985 they accounted for only half of world crude oil exports after a share of 80% in 1979. However, not only the volume of the OPEC countries' exports of oil but also the prices they obtained were much lower last year than in the two preceding years even before the dramatic drop in prices that began in December 1985. The oil-exporting countries consequently cut back their imports as well to a considerable extent. The low-population countries, which still have substantial financial reserves dating from the period when they were running large current account surpluses, were no exception in this respect, particularly since Saudi Arabia has been showing more restraint for quite some time owing to certain signs of saturation. However, the reduction in the imports of the low-population countries was still considerably smaller than their export losses, with the result that the deterioration in the aggregate current account balance of all the OPEC countries primarily affected the low-population, but financially strong countries within this group.

Continued large discrepancies between surpluses and deficits in the global pattern of current accounts

Taking the current account balances of all countries in the world together, it turns out that — contrary to what one might expect — the surpluses and deficits have not corresponded to each other for many years; instead, the sum total of all the surpluses has as a rule been far lower than the sum total of all the deficits. According to studies conducted by the OECD and the IMF, this is primarily due to the fact that in the field of international services transactions — and particularly in the sphere of investment income — a large volume of receipts is not statistically recorded. The current accounts of many countries are accordingly more in surplus or less in deficit than the official statistics show. According to the studies conducted by the above-mentioned international bodies, it is probably the current account balances of the industrial countries and the OPEC countries that need to be corrected most. This is suggested by the fact that the industrial countries are also the most important providers of international services, whereas in the case of the OPEC countries there is an evident disproportion between the volume of their foreign investments and the investment income they publish. Under the auspices of the IMF, a special international working group is meanwhile undertaking an investigation of these statistical problems. It is, however, hardly to be expected that the gaps in the coverage of the relevant data will be closed very soon to any substantial degree. The analysis of the balance of payments is greatly complicated by these problems even if, according to the available data, at least the changes in the current account balances of all countries taken together were by and large compatible with each other in 1985.

3. Exchange rate developments and policy

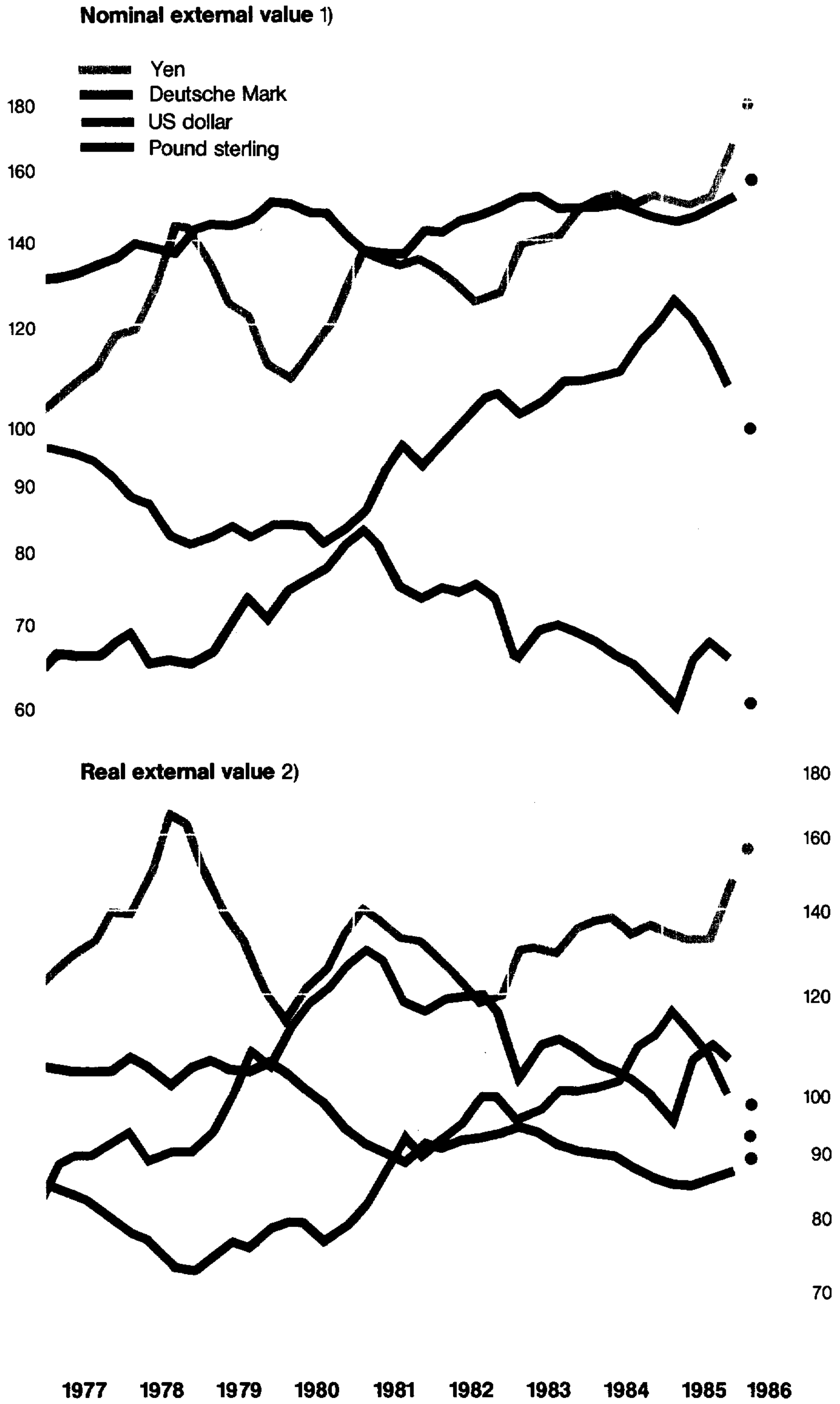
(a) Events in the dollar market

Turnaround in the movement of the dollar rate

In 1985, developments on the foreign exchange markets were dominated by the reversal in the movement of the dollar rate. The preceding rise in the rate of the US currency, which — albeit with fluctuations — had continued for several years, ceased in the spring of last year; it was replaced by a distinct weakening in the rate, which became more marked in the autumn. Since then, the weighted external value of the US dollar against the currencies of 14 other industrial countries, which according to the Bundesbank's method of calculation, based on monthly averages, in March 1985 reached its highest level since the beginning of the upswing in the dollar, has fallen — by 22% up to February 1986. The US dollar has thus lost much more than half of the appreciation it had experienced from its lowest level in the autumn of 1978 up to the spring of 1985; its weighted appreciation in comparison with October 1978 declined from 62% in March 1985 to 26% in February this year. As the rise in prices in the

Weighted external value of major currencies

End-1972=100, quarterly averages, log. scale



1) In each case against the currencies of 14 other industrial countries; geometrically weighted on the basis of the trade flows of industrial products between 1980 and 1982, taking account of third-market effects.- 2) Weighted nominal external value, adjusted for discrepancies in consumer price movements.- ● =February 1986.

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United States since the spring of 1985 has been hardly any stronger than the average of the other 14 countries which, according to the Bundesbank's method of calculation, are included in the weighted external value of the US currency, the depreciation of the dollar in real terms since the turnaround on the foreign exchange markets was only slightly lower than its depreciation in nominal terms. This marked reversal in the movement of the dollar rate brought the weighted external value of the US currency in both real and nominal terms roughly back to the level of spring 1982.

Rise in the dollar rate gathered pace at the beginning of 1985

Before the reversal in the movement of the dollar rate could materialise, the US currency once again soared to new record levels at the beginning of 1985. This was partly due to the fact that the course of economic activity in the United States was initially better than expected and that interest rates on the US money and capital markets, which had fallen distinctly in the second half of 1984, tended to rise again for a time. But above all else, the rise in the rate of the US currency increasingly gained a momentum of its own due to one-sided market expectations. The US currency thus strengthened by leaps and bounds against many other major currencies in the second half of February, owing also to large-scale speculative purchases of US dollars financed by contracting short-term debt in other currencies available at low rates of interest ("going long").

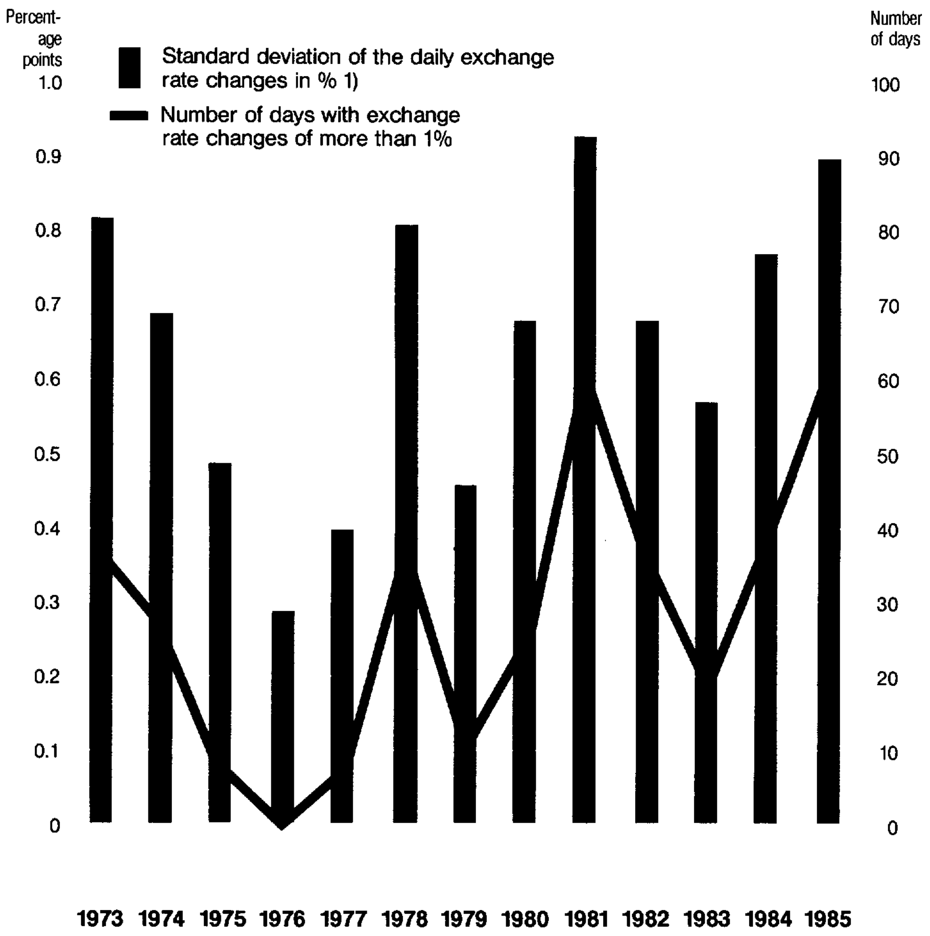
Countermeasures by central banks initially not without problems of coordination

The persistent rise in the US dollar was bound to appear increasingly problematical against the background of large and rapidly growing US deficits on trade and current accounts. It gave, in particular, additional force to the always latent protectionist tendencies in the United States. For many other countries the strengthening of the US dollar entailed considerable increases in their import prices; it thus endangered the progress they had achieved in fighting inflation. As a consequence, in mid-January 1985 the Finance Ministers and Central Bank Governors of the five major industrial countries reaffirmed their determination to counter developments on the dollar market with coordinated foreign exchange market operations, too, if necessary. Only a few days later, the Bundesbank and a number of other central banks actually did sell substantial amounts of dollars on the foreign exchange market for a short time. This is the reason why the total sales of US dollars by the countries participating in the daily concertation of foreign exchange market operations in January 1985, at $ 1.3 billion, were markedly higher than in December 1984 ($ 0.5 billion). These intervention operations did not, however, calm the situation on the dollar market to a lasting extent, especially as doubts arose in the market with respect to the scope of the agreements on intervention policy. It became evident, moreover, that operations on the foreign exchange market can be expected to be successful only if the monetary authorities are willing to cooperate closely also as regards the size of the amounts involved and the length of the periods over which intervention operations are conducted. Furthermore, the impression gained ground that there is a prospect of giving weight to the intentions of the central banks on the markets only if the US monetary authorities provide vigorous support.

One-sided orientation of the market corrected by enhanced monetary policy cooperation

On February 27, 1985 it seemed to the Bundesbank and most of the central banks with which it cooperates that a suitable moment for successful intervention had come. After the US currency had shot up to new peaks against all the currencies of Europe up to the preceding day, it declined again. In this situation most of the central banks participating in the concertation procedure decided to sell US dollars on a large scale, with the Federal Reserve Bank of New York now also intervening in limited amounts. On the three days up to March 1, 1985 the central banks participating in the concertation procedure sold a total of $ 4.6 billion on the spot and forward markets, with more than half ($ 2.7 billion) being accounted for by the Bundesbank. As a result, the net amount of US dollars sold on the market by these countries rose from as little as $ 0.1 billion in the fourth quarter of 1984 to $ 10.2 billion in the first quarter of 1985 (with the shares accounted for by the Bundesbank totalling $ 1.7 billion and $ 3.9 billion, respectively). These massive sales of US dollars by the central banks, which led to a considerable decline in their aggregate gross monetary reserves, reminded the markets of the large exchange rate risks posed by the high level

Short-term variability of the Deutsche Mark/dollar rate since the beginning of floating



1) The standard deviation shows to which extent the daily exchange rate changes in % deviate on average from their arithmetic mean. It is thus a yardstick of exchange rate variability which takes no account of trend-induced exchange rate changes (such as are reflected in the arithmetic mean of all changes). Since the standard deviation is ascertained on the basis of deviations which have previously been squared, it simultaneously shows more pronounced deviations with greater weight.

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which the exchange rate of the dollar had reached and contributed towards market participants giving up their one-sided orientation. In the event, as time passed the upper hand was gained by those market forces which tended to expect a slackening of the dynamism of the US economy and an upturn in the expansionary forces in other countries, and hence paved the way for a lower valuation of the US dollar. However, frequently burgeoning expectations in favour of the US dollar led at the same time to the gradual decline in the rate of the US currency being accompanied by exceptionally wide daily fluctuations in exchange rates. The short-term shifts in the exchange rate of the US dollar — measured in terms of the Deutsche Mark/dollar rate — increased considerably in 1985 and reached an extent that, since the transition to floating, was experienced only in 1981.

Further decline in the dollar rate after the "G-5" meeting of September 1985

A second stage on the way to a lower level of the exchange rates of the US dollar was initiated by a renewed meeting of the "Group of Five" in September 1985. The Finance Ministers and Central Bank Governors of the five major industrial countries, who met in New York on September 22, 1985, announced on the same day that in their opinion the basic changes in the economic situation of their countries had not been reflected adequately in exchange rates. In this context, they pointed out that a further rise in the exchange rate of the principal partner currencies of the US dollar was desirable and that they were prepared to foster such a rise, if necessary, through closer cooperation.[1] After the US dollar had firmed distinctly immediately prior to this meeting, not least because the strong growth of the money stock in the United States aroused the expectation that the Federal Reserve System would seek to counteract this through interest rate policy measures, the exchange rate of the US dollar fell sharply on every major foreign exchange market immediately upon the opening of business as a result of this announcement. Market participants evidently anticipated to a greater degree than previously that the monetary authorities were prepared to intervene on the foreign exchange markets once again and in considerable amounts. The central banks did indeed subsequently sell relatively large amounts of US dollars on several occasions in order to influence the exchange rate of the US dollar and to dampen technically induced countermovements. From the beginning of these operations on September 23 until they petered out on November 8, 1985 the central banks participating in the concertation procedure sold a total of $ 12.8 billion, with about half each being accounted for by Japan, the United States and Canada on the one hand and the countries of Europe on the other. Although owing to the conditions on the German foreign exchange market the Bundesbank had to intervene directly only in small amounts in comparison with earlier operations, it also contributed indirectly towards these concerted intervention operations: it provided various partner central banks within the EMS with US dollars for intervention purposes in exchange for Deutsche Marks after their currencies had come under pressure in the EMS in connection with the change in the Deutsche Mark/dollar rate without it being possible to counter this in a satisfactory manner in the given situation through sales of Deutsche Marks. As regards the sustained decline in the exchange rate of the US dollar it was, however, also important that all the countries involved undertook to adopt economic policy measures in order to counter domestic and external disequilibria and that the United States, in particular, made it credible in doing so that, after a long period of "benign neglect", it would pay greater attention in its economic policy in future to the development of the external value of its currency and the repercussions thereof.

Satisfactory initial outcome of the depreciation of the US dollar

The weakening of the US dollar on the foreign exchange markets undoubtedly made it easier for the US Administration to resist, for the time being, the flood of protectionist demands with which it was confronted, particularly last year. Moreover, despite the considerable decline in the rate of the US dollar, the fears frequently apostrophised as a "hard landing" of the dollar were not confirmed. The reduction in the US trade deficit that is intended through the decline in the external value of the US currency will probably occur only gradually, particularly since the exchange-rate-induced rise in the price of US imports will tend to lead to a further increase in the deficit over the short term ("perverse" effect). Apart from this, it will probably be possible for the partner countries of the United States to cope with a basic improvement in the US trade balance all the more easily as their dependence on exports has diminished distinctly in the present stage of recovery in economic activity.

1 The announcement by the "Group of Five" of September 22, 1985 specifically states the following with respect to international monetary policy:

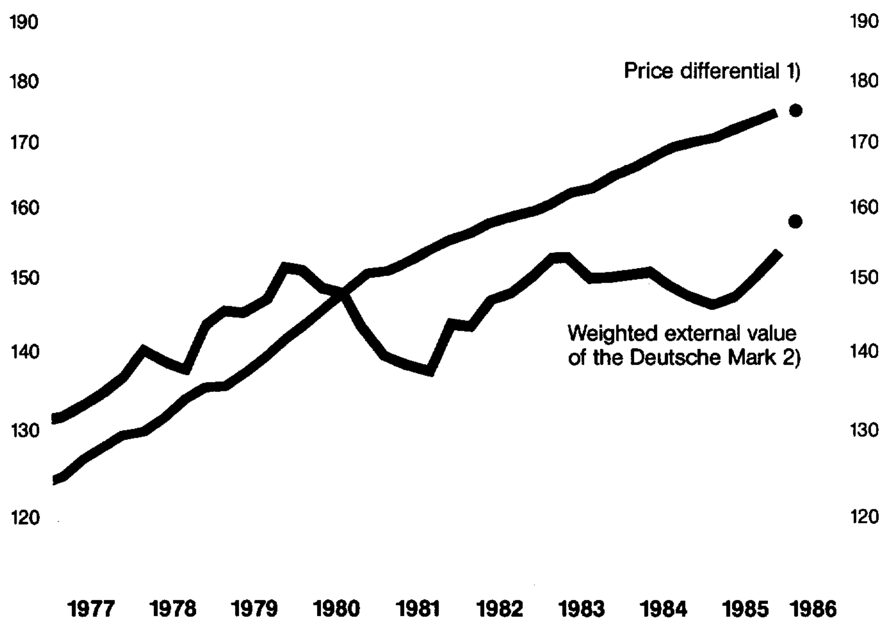
"(5) Ministers and Governors were of the view that recent shifts in fundamental economic conditions among their countries, together with policy commitments for the future, have not been reflected fully in exchange markets. ...

(18) The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful."

The complete text of the English original version of this announcement was printed by the Bundesbank in its "Auszüge aus Presseartikeln", No. 62, of September 23, 1985.

External value of the Deutsche Mark and price differential

December 1972=100, quarterly averages, log. scale



1) Geometrically weighted average of consumer price movements in 14 other industrial countries relative to those in the Federal Republic of Germany; weighting pattern based on the trade flows of industrial products between 1980 and 1982, taking account of third-market effects.- 2) Geometrically weighted average against the currencies of 14 other industrial countries.- ●=February 1986.

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Danger of persistent pressure on the dollar not entirely averted

Only the future will show whether the current pattern of exchange rates is sufficient to bring the US deficit on current account back to a level at which it can be financed without overly large inflows of capital. At all events, the burden of interest payments on the United States resulting from financing the cumulative US current account deficits will tend to rise further and hence militate against the reduction of the current account deficit. For this reason, despite the decline of the US dollar on the foreign exchange markets, the danger has not been entirely averted that financing the US current account deficits might become more difficult and the US currency be exposed to persistent downward pressure. However, the structure of US net capital imports suggests that the inflow of capital to the United States is more stable than has been expected in many quarters. For example, new investments by non-residents in US securities, which had already risen strongly in 1984, shot up again last year despite the more evident exchange rate risk. As a result, they became the most important counterpart of the US deficit on current account.

(b) Trends among the other floating currencies

Weighted average rate of the Deutsche Mark at the beginning of 1986 somewhat above its previous peak

After reaching its lowest point on February 26, 1985 (corresponding to a rate of DM 3.47 to the US dollar), the value of the Deutsche Mark vis-à-vis the US currency rose by 49% by February 1986 (based on the average monthly rate of DM 2.33 per dollar). This means that the Deutsche Mark has made good about half of the loss in its exchange rate which it suffered between reaching its record level at the beginning of 1980 (with an official spot rate of DM 1.71 per US dollar) and February last year. At the same time, the weighted external value of the Deutsche Mark rose by 10%. An even greater weighted appreciation was mainly prevented by the fact that the currencies of Europe firmed to more or less the same extent vis-à-vis the dollar. For this reason the position of the Deutsche Mark vis-à-vis these currencies, which represent Germany's major trading partners, improved to only a slight degree at first. Against all the major currencies of Europe taken together, the external value of the Deutsche Mark rose by 4% up to February 1986, in comparison with February 26, 1985; in the process it strengthened most against the Italian lira, which had been devalued within the EMS in July 1985, whereas it declined slightly against the Swiss franc. At the same time the Deutsche Mark also firmed against the Japanese yen by 5% and thus made good earlier exchange rate losses to a certain extent; however, only one-tenth of this appreciation was reflected in the weighted external value of the Deutsche Mark. In the event, by February 1986 the weighted external value of the Deutsche Mark had risen slightly above its previous record level of spring 1983. However, over the same period of time prices abroad continued to rise faster than those in Germany. For this reason the real external value of the Deutsche Mark remained lower than at the beginning of 1983, i.e. despite the renewed rise in the Deutsche Mark on the foreign exchange markets early in 1986, German industry was more competitive internationally in price terms than it had been two and a half to three years before. However, in relation to the dollar area where Germany's competitiveness had improved particularly strongly owing to the depreciation of the Deutsche Mark, a marked correction has now come about. Through the realignment of central rates in the EMS in April 1986, the competitive advantages of German enterprises arising from the lower inflation rate have been further offset vis-à-vis major European trading partners as well.

Sales of dollars on the exchange market by the Bundesbank offset by other foreign exchange movements

Although the Bundesbank influenced events on the foreign exchange market last year through large-scale sales of US dollars, its net external position actually improved slightly. Calculated at current exchange rates and on a transactions basis, sales of US dollars on the exchange market by the Bundesbank amounted to DM 14.6 billion in 1985. As a result of operations in the same direction conducted by the Federal Reserve Bank of New York (purchases of Deutsche Marks), which led, however, to only a minor increase in US holdings of Deutsche Marks at the Bundesbank, Germany's net reserve position declined by a further DM 1.9 billion. But this decline was accompanied by net foreign exchange receipts totalling DM 19.4 billion from transactions not carried out through the foreign exchange market. Consequently the Bundesbank's net external assets rose by DM 2.7 billion in 1985 according to this method of calculation, which differs slightly from that employed when drawing up the balance of payments. In this context, the Bundesbank's holdings of dollars (excluding the dollar balances contributed to the EMCF) went up by as much as DM 3.9 billion.[1]

Yen at record level against the dollar

After the external value of the yen had likewise dropped to a low point against the dollar in February 1985, it went up by 42% up to February 1986 and continued to rise even afterwards. As a result, in the middle of March 1986 the external value of the yen vis-à-vis the US dollar regained its historical peak of October 1978 (corresponding to a rate of 176 yen per dollar).

Weighted external value of the yen also distinctly higher

Although the yen rose slightly less than the Deutsche Mark against the US dollar from February 1985 onwards, the increase in its weighted external value, at 20%, was twice as steep as that of the Deutsche Mark. This is due to the fact that, given the structure of Japan's foreign trade, the appreciation of the yen against the dollar carries far greater weight in the calculation of the trade-weighted external value of the currency than is the case with the Deutsche Mark. Moreover, the nominal external value of the Japanese currency has been rising strongly for quite some time because, during the period when it was declining, the yen still maintained its value on the dollar market better than

1 At constant exchange rates and ascertained in accordance with the value dates, the Bundesbank's net external assets fell by DM 1.3 billion, while the dollar holdings (excluding the balances contributed to the EMCF) increased by DM 2.8 billion.

Changes in the net external position of the Bundesbank due to operations on the foreign exchange market and other foreign exchange movements*

DM million

Period		Net external position, total	Operations on the foreign exchange market: Deutsche Mark/ dollar market **1**	Operations on the foreign exchange market: EMS **2**	Other foreign exchange movements
1984	January	− 203	− 2,021	−	+ 1,818
	February	+ 4,223	− 63	+ 2,464	+ 1,822
	March	+ 3,083	− 266	+ 1,941	+ 1,408
	April	+ 339	− 523	−	+ 862
	May	− 324	− 2,127	−	+ 1,803
	June	− 1,038	− 2,429	−	+ 1,391
	July	− 1,507	− 3,007	− 85	+ 1,585
	August	+ 427	− 1,881	− 114	+ 2,422
	September	− 6,283	− 6,682	− 359	+ 758
	October	− 786	− 1,440	−	+ 654
	November	− 262	− 1,012	− 110	+ 860
	December	− 916	− 1,707	− 100	+ 891
	Total	− 3,247	−23,158	+ 3,637	+16,274
1985	January	− 2,942	− 1,940	− 160	− 842
	February	− 6,646	− 8,272	−	+ 1,626
	March	− 2,378	− 3,188	−	+ 810
	April	+ 1,688	−	−	+ 1,688
	May	+ 2,527	−	−	+ 2,527
	June	+ 1,231	−	−	+ 1,231
	July	+ 2,904	−	−	+ 2,904
	August	+ 2,468	−	−	+ 2,468
	September	+ 187	− 664	−	+ 851
	October	− 1,808	− 2,037	−	+ 229
	November	+ 1,993	− 288	−	+ 2,281
	December	+ 3,509	− 129	−	+ 3,638
	Total	+ 2,733	−16,518	− 160	+19,411
1986	January	+ 1,476	−	−	+ 1,476
	February	+ 1,292	−	−	+ 1,292
	March	− 1,080	−	+ 2	− 1,082
	1st quarter	+ 1,688	−	+ 2	+ 1,686

* Excluding liquidity swaps. Recorded at current exchange rates and according to the date on which the transaction was conducted; this results in discrepancies between these figures and those of the balance of payments statistics. — **1** Incl. US operations, where they affect the external position of the Bundesbank. — **2** Incl. operations by other central banks, where they affect the external position of the Bundesbank. BBk

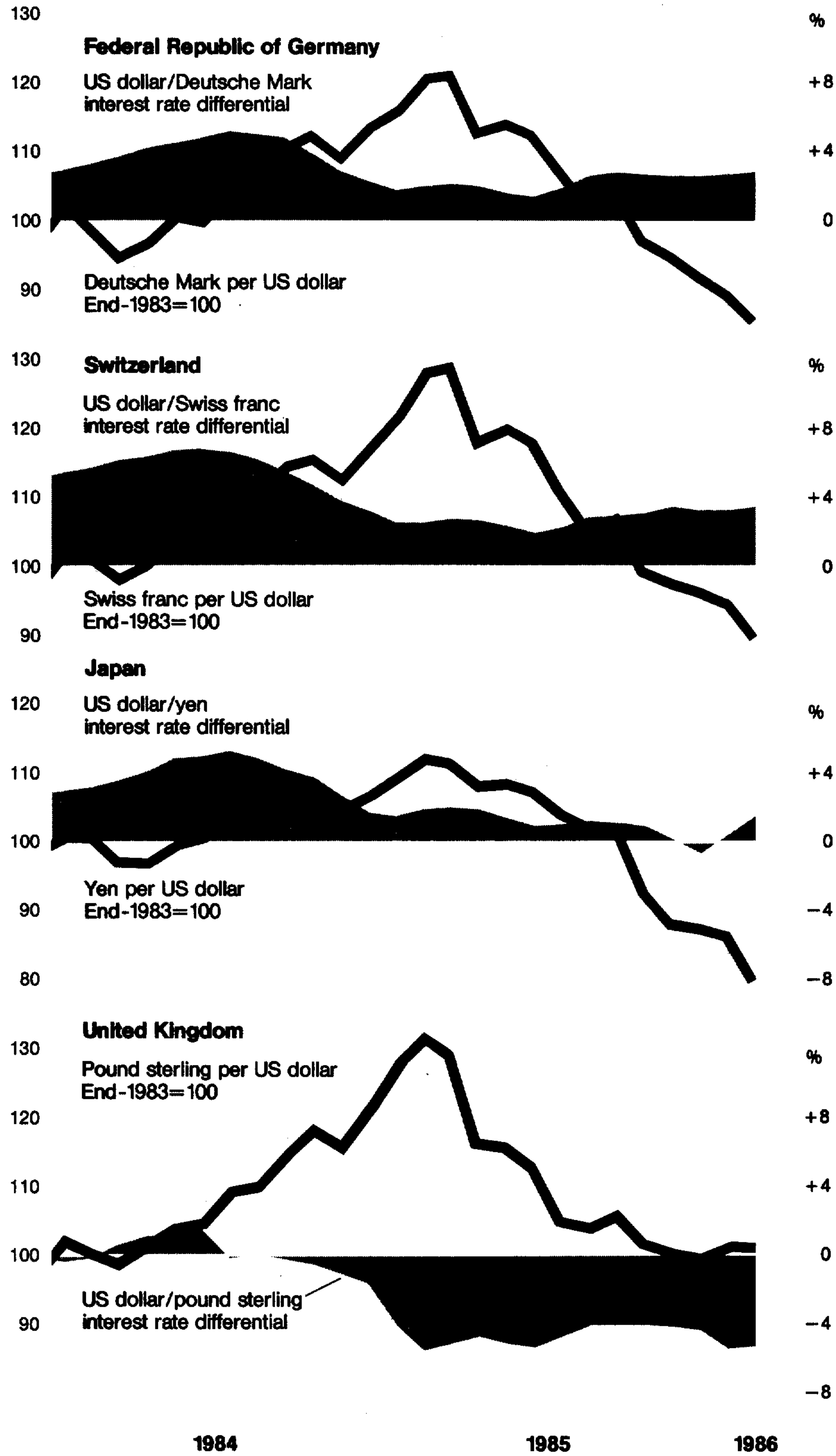
other major currencies and to this extent was able to achieve exchange rate gains against them. For these reasons the weighted appreciation of the yen reached its highest level by far in 1985, which also appears to be warranted, in the light of Japan's extremely large surpluses on current account. In real terms, the external value of the yen increased to almost the same extent as in nominal terms last year. However, the real external value of the yen remained considerably below its previous record level, reached in 1978. This persistent differential is primarily due to the fact that in the seventies, as a result of a marked rise in the price level in Japan, the real external value of the yen increased substantially more for a time than its value on the foreign exchange market; thus in 1974 the monthly rate of inflation in Japan reached peaks of over 26% in relation to the same months of the preceding year — peaks that were far above the rate of inflation in major partner countries.

Temporary support for appreciation of the yen through interest rate policy

In view of Japan's large current account surpluses the Bank of Japan had for a long time advocated an appreciation of the yen on the foreign exchange markets and supported this development, not least through interest rate policy measures. Particularly in October 1985, i.e. following the decisions of the "Group of Five" in New York, it gave a further upward push to the yen by re-

Exchange rates of the US dollar and external interest rate differentials*

Monthly averages



* Measured in terms of money market rates. United States: 3-month CDs; Federal Republic of Germany: 3-month funds; Switzerland: 3-month Euro-funds; United Kingdom: 3-month funds; Japan: call money.- Latest position: February 1986.

BBk

stricting bank liquidity and hence triggering a rise in money market rates in Japan. For example, the cost of call money rose from 6.4% to 8.1% between September and December last year, resulting in Japan's short-term interest rates exceeding those in the United States, for the first time since 1980. Since then, however, they have fallen below the level of September 1985 and hence also below the level of US rates. Interest rates on the capital market in Japan likewise moved slightly up for a while, but they, too, are at present once again below their initial level. This is benefiting the distinctly slackening pace of economic activity in Japan but is at the same time encouraging outflows of long-term capital from Japan, which have been unusually heavy since 1984 and — should they continue on the same scale — could put the yen under slight downward pressure on the foreign exchange market in the future, too. At all events, Japan's net long-term capital exports rose from $ 42 billion in 1984 to $ 60 billion in 1985; thus in both years they were still considerably higher than the inflows of foreign exchange deriving from the current account surpluses in the same period.

Swiss franc moves largely in parallel with the Deutsche Mark

Last year the Swiss franc strengthened against the US dollar to a slightly greater extent than the Deutsche Mark. After the Swiss currency had also reached a low point towards the end of February 1985, it rose by 50 % up to February 1986. The exchange rate of the Swiss franc in terms of the Deutsche Mark correspondingly remained more or less stable last year. In the event, the rise in the weighted external value of the Swiss franc against the currencies of 14 other industrial countries during the above-mentioned period, at 9 %, was only slightly smaller than in the case of the Deutsche Mark. Such a parallel movement of the Swiss and German currencies was by no means to be expected from the outset. In the seventies the weakening of the US dollar frequently put the Swiss franc under greater upward pressure than the Deutsche Mark, whereas it was initially less affected by the subsequent recovery of the dollar. As a result, its external value in relation to the Deutsche Mark tended to rise considerably in former years and at the same time also went up against all other major currencies (on a weighted average) to an extent that up to the present has not been equalled even by the yen. However, since the beginning of 1984 the special development of the Swiss franc has ceased; in fact, its exchange rate vis-à-vis the Deutsche Mark weakened again slightly before it stabilised — under the favourable influence of a renewed rise in interest rates in Switzerland — at its lower level.

After strong recovery induced by interest rate movements, sterling again under pressure owing to declining oil prices

Up to the beginning of 1985 sterling had fallen particularly strongly against the US dollar, but afterwards it was able to strengthen very much faster than all the other major currencies. Starting from the general turning point on the dollar markets at the beginning of 1985, the UK currency rose by 31 % up to July 1985, compared with simultaneous gains of 19 % for the Deutsche Mark and of as little as 8 % for the yen. Subsequently, however, sterling's exchange rate vis-à-vis the US dollar went up very much more slowly. Sterling correspondingly strengthened only temporarily against most European currencies as well as against the yen. After sterling came under renewed downward pressure on the dollar market in December and hence also declined further in value against the other major currencies, this development continued at the beginning of 1986. The steep rise in the UK currency up to the summer of last year was prompted primarily by the movement of interest rates. In response to the preceding marked weakening of sterling the British monetary authorities sharply increased the level of interest rates in the United Kingdom at the beginning of 1985; in the first half of 1985 UK money market rates were frequently more than 5 percentage points above the level in the United States. Although the interest rate advantage of the United Kingdom was only slightly less in the second half of 1985, this benefited sterling to a far smaller extent because at the same time there were increasing signs of the possibility of an appreciable decline in crude oil prices on the world markets, with the result that the economic prospects for the United Kingdom as one of the main oil-exporting countries deteriorated. The UK currency was handicapped all the more when crude oil prices did indeed slump from December 1985 onwards. However, the lower valuation of sterling on the foreign exchange markets is also in line with the movement of labour costs in the United Kingdom; they rose appreciably more than in other major countries last year as a result of considerable increases in wages accompanied by declining rates of growth in productivity.

(c) Developments within the EMS

Cohesion of the EMS not seriously affected by the turnaround on the dollar market

Despite the pronounced and persistent weakening of the US dollar on the foreign exchange markets, no major tensions arose within the EMS last year, in contrast to earlier experience. This is partly connected with the fact that the most recent decline in the dollar's exchange rate took place under completely different circumstances from those in the seventies. At that time, the US currency had come under extreme pressure as a result of intermittent outflows of capital from the dollar area, with a lax US monetary policy being one of the factors behind these outflows. In contrast, such capital movements caused by lack of confidence have been of practically no significance at all up to the present. Moreover, the internal cohesion of the EMS has increased considerably in the meantime, as is reflected, inter alia, in the fact that the changes made to central rates since the dollar began to weaken have all in all been small-scale.

Further progress on the way to greater convergence

Above all, however, the economic foundations for better cohesion within the EMS have improved owing to further progress on the way towards greater convergence in the economic and monetary policies of the member countries. Although prices are still rising more quickly in most partner countries than in Germany, this discrepancy has constantly diminished up to the present — in the relationship between France and Germany, for example, from about 8 percentage points in 1980 to only 3 in December 1985. Moreover, confidence in the EMS has been strengthened by the fact that in recent years every member country has adopted an economic policy stance that is geared to giving as much scope as possible to free market forces. The dismantling of a number of restrictions on capital movements last year by Denmark, France and Italy is a reflection of this policy, just as it at the same time underlines the progress achieved in the convergence of economic and monetary policies. Denmark in particular thus further pursued its policy of progressive liberalisation, the last stage of which was initiated in 1983 and continued in 1984. However, the freedom of capital movements in a number of countries still falls far short of what not only appears to be indispensable in a closely-knit economic arrangement but is also explicitly required by the provisions of Community law.

Devaluation of the lira and temporary exchange rate tensions ...

Of course, the remaining divergencies in the economies of the member countries were not without consequences on the foreign exchange markets last year. Italy's balance on current account, which had shifted into considerable deficit in 1984, threatened to deteriorate all the more as competitive advantages vis-à-vis the dollar area were lost owing to the turnaround on the dollar market. As early as July 1985 — also under sudden market pressure — Italy therefore felt obliged to devalue the lira against all the other EMS currencies, by 7.8 % on balance. Noticeable tensions built up within the EMS afterwards, especially at the turn of 1985-86 — likewise under the impact of the decline in the US dollar; they arose chiefly between the Deutsche Mark and the Netherlands guilder on the one hand and the Italian lira, French franc and Belgian franc on the other. In order to counter these tensions, the countries with weaker currencies — in addition to the operations on the dollar market mentioned above — at times also undertook intramarginal sales of Deutsche Marks on a considerable scale, primarily utilising reserves of Deutsche Marks which they had accumulated in preceding periods of weakness of the Deutsche Mark (above all, subsequent to the general exchange rate realignment of March 1983). Moreover, as part of a package of measures designed to protect the lira,

Consumer price movements in the European Community

Increase from previous year in %

Group of countries/Country	1980	1981	1982	1983	1984	1985 p
Federal Republic of Germany	5.4	6.3	5.3	3.3	2.4	2.2
EEC partner countries participating in the EMS exchange rate mechanism 1	14.3	13.4	12.2	10.0	7.8	6.2
France	13.5	13.4	11.8	9.6	7.4	5.8
Italy	21.2	17.8	16.5	14.7	10.8	9.2
Netherlands	6.5	6.7	5.9	2.8	3.3	2.3
Belgium	6.6	7.6	8.7	7.7	6.3	4.9
Denmark	12.3	11.7	10.1	6.9	6.3	4.7
Ireland	18.2	20.4	17.1	10.5	8.6	5.4
Luxembourg	6.3	8.1	9.4	8.7	5.6	3.1
Other EEC partner countries 1	17.6	13.6	11.4	8.2	8.3	8.0
United Kingdom	18.0	11.9	8.6	4.6	5.0	6.1
Spain **2**	15.5	14.6	14.4	12.1	11.3	8.8
Greece **3**	24.9	24.5	21.0	20.2	18.5	19.4
Portugal **2**	16.6	20.0	22.4	25.5	29.3	19.2
All EEC partner countries 1	15.6	13.5	11.9	9.4	8.0	6.9
Relative rise in foreign prices compared with those in Germany in %						
EEC partner countries participating in the EMS exchange rate mechanism	8.4	6.7	6.6	6.5	5.3	3.9
Other EEC partner countries	11.6	6.9	5.8	4.7	5.8	5.7
All EEC partner countries	9.7	6.8	6.3	5.9	5.5	4.6

1 Weighted with private consumption expenditure between 1980 and 1982. — **2** Member since the beginning of 1986. — **3** Member since the beginning of 1981. — **p** Provisional.
Sources: National statistics and OECD. BBk

Italy reintroduced a number of foreign exchange restrictions which had previously been lifted.

. . . followed by general realignment of central rates

Furthermore, at the request of the French Government a general realignment of central rates in the EMS was undertaken at the beginning of April 1986. In the event, the Deutsche Mark and the Netherlands guilder were revalued by approximately 6% against the French franc, by 3% against the Italian lira and the Irish pound and by 2% against the Belgian and Luxembourg francs and the Danish krone. In terms of the central rates, the external value of the Deutsche Mark thus rose by a weighted average of some 3% against the partner currencies within the EMS. This general adjustment in exchange rates offset shifts in competitive positions that had arisen among the EMS countries through discrepancies in the movement of costs and prices, after the earlier devaluation of the lira had already brought about relatively large corrections. At the same time the French Government announced that it would radically dismantle French foreign exchange controls and also largely abolish the regulations governing industrial producer prices that still exist in France. As a result, the prospects of even greater convergence between the member countries in the fields of economic and monetary policy have improved further. On the basis of the present pattern of exchange rates, similar progress might be possible in other countries as well, particularly since the faster decline in oil prices — if it is exploited in the right way — temporarily opens up additional opportunities in this respect.

Incorporation of economic and monetary policy cooperation in the EEC Treaty

In their efforts to make further headway in economic and monetary policy cooperation in Europe, the member countries decided in December 1985 to incorporate obligations to this effect in the EEC Treaty. The EEC Treaty is accordingly to be amended by a chapter entitled "Cooperation in economic and monetary policy (Economic and Monetary Union)" and providing specifically as follows:

"(1) In order to ensure the convergence of economic and monetary policy which is necessary for the further development of the Community, Member States shall co-operate in accordance with the objectives of Article 104. In so doing, they shall take account of the experience acquired in co-operation within the framework of the European Monetary System and in developing the ECU, and shall respect existing powers in this field.
(2) Insofar as further development in the field of economic and monetary policy necessitates institutional changes, the provisions laid down in Article 236 shall be applicable. The Monetary Committee and the Committee of Governors of the Central Banks shall also be consulted regarding institutional changes in the monetary area."

Amendment of the Treaty without intervention in existing responsibilities

This amendment of the EEC Treaty, which together with a number of other reforms (relating in particular to the completion of the domestic market) still has to be ratified by the national parliaments, was preceded by protracted negotiations in which the EC Commission, in particular, developed far-reaching ideas. With the new provisions, the EEC Treaty also reflects the fact that greater monetary policy cooperation must be accompanied by parallel progress on the way towards greater convergence in the economic performance and economic policies of the member countries. At the same time, the new provisions in the Treaty make it clear that existing Community and national responsibilities must not be affected by them. Hence the ability of the Bundesbank to pursue a policy geared to the statutory objective of monetary stability free from instructions from other bodies remains entirely intact. Moreover, these provisions reaffirm the fact that institutional changes at Community level, to the extent that they appear necessary in the interests of economic and monetary policy cooperation, will continue to need to be ratified by the national parliaments, as is equally the case as regards transferring responsibilities to organs of the Community that already exist as well as with respect to creating new institutions.

Increase in the ceiling for Community loans

In the context of monetary policy cooperation in the Community, the ceiling for issuing Community loans (i.e. the raising of funds by the Community on the capital market in favour of individual member countries) was lifted in 1985 from ECU 6 billion to ECU 8 billion. At the same time it was decided that in future this facility can be used not solely, as in the past, in the event of balance of payments difficulties caused by oil price movements, but in the event of balance of payments problems of any kind. On the other hand, in future — in contrast to previous practice — no member country will be able to have recourse to more than one-half of the total amount.

Possibility of mobilising ECU balances held with the EMCF used for the first time

The possibility agreed upon in March 1985 by the central banks belonging to the EMS of temporarily mobilising part of the ECU balances held with the EMCF (as related in the Report of the Deutsche Bundesbank for the Year 1984) was taken advantage of for the first time by a partner central bank at the end of last year. In this operation, all the other central banks provided amounts of foreign exchange against the transfer of ECU balances in the form of three-month swaps. These funds were used primarily for intramarginal interventions within the EMS. The envisaged possibility of renewing such a mobilisation of ECU balances once was taken advantage of in March 1986 with respect to part of the amount involved.

4. The development of global monetary reserves

Renewed increase in global monetary reserves . . .

In 1985 there was a further increase in the official gross monetary reserves of the member countries of the IMF taken as a whole. According to preliminary IMF data and expressed in US dollars, reserve holdings rose by $ 41 billion.

Components of international monetary reserves*

US$ billion

Type of reserves	Level at end of year		Change: due to transactions 1		Change: due to value adjustments 2		Change: Total	
	1983	1985 p	1984	1985 p	1984	1985 p	1984	1985 p
Gold 3	40.0	40.0	– 0.0	+ 0.1	–	–	– 0.0	+ 0.1
Special drawing rights	15.1	20.0	+ 2.1	+ 1.8	– 1.1	+ 2.1	+ 1.0	+ 3.9
Reserve positions in the IMF	40.9	42.5	+ 2.5	– 3.0	– 2.7	+ 4.8	– 0.2	+ 1.8
ECU balances	45.3	40.7	– 1.3	+ 0.4	– 6.3	+ 2.6	– 7.6	+ 3.0
– against gold	33.8	30.2	+ 0.0	+ 0.0	– 6.2	+ 2.6	– 6.2	+ 2.6
– against US dollars	10.6	10.5	– 0.5	+ 0.4	–	–	– 0.5	+ 0.4
– arising from very short-term financing	0.9	–	– 0.8	–	– 0.1	–	– 0.9	–
Foreign exchange	276.4	335.1	+36.8	+11.7	–10.2	+20.4	+26.6	+32.1
US dollars	187.0	201.6	+10.0	+ 4.6	–	–	+10.0	+ 4.6
Deutsche Mark	32.3	50.0	+10.5	+ 1.6	– 5.1	+10.7	+ 5.4	+12.3
Yen	13.6	23.6	+ 4.4	+ 2.2	– 1.1	+ 4.6	+ 3.3	+ 6.8
Pounds sterling	7.5	9.9	+ 3.4	– 1.2	– 1.9	+ 2.1	+ 1.5	+ 0.9
Swiss francs	6.7	7.3	+ 0.7	– 0.4	– 1.1	+ 1.5	– 0.4	+ 1.1
French francs	3.1	3.7	+ 0.6	– 0.4	– 0.5	+ 0.9	+ 0.1	+ 0.5
Netherlands guilders	2.4	3.3	+ 0.4	+ 0.2	– 0.4	+ 0.7	+ 0.0	+ 0.9
Unidentified assets	23.8	35.6	+ 6.8	+ 5.1	–	–	+ 6.8	+ 5.1
Total reserves	417.7	478.3	+40.1	+11.0	–20.3	+29.9	+19.8	+40.9

* Gross monetary reserves of all IMF member countries plus Switzerland and Taiwan. — **1** In the case of monetary reserves not denominated in gold and dollars, the changes in units of the reserve asset concerned have been converted into dollars at average rates based on the rates on the relevant reference dates. To the extent that the ECU balances are based on the contribution of gold and dollars, the changes in these gold and dollar contributions are shown. — **2** Difference between the change in levels on a dollar basis and the change due to transactions; also including the change caused by variations in the gold price in the ECU balances based on the contribution of gold to the EMCF. — **3** Valued at US$ 42.22 per ounce of fine gold. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Sources: IMF and BIS. BBk

Within that total, foreign exchange reserves increased by $ 32 billion whereas holdings of SDRs originating from the IMF went up by $ 4 billion. The remaining increase was accounted for in the main by higher ECU balances as well as a rise in IMF reserve positions. In contrast, reserve holdings as published by the IMF on an SDR basis declined last year by SDR 6.6 billion. These differing results reflect the strong depreciation of the US dollar on the foreign exchange markets; this produced an exchange-rate-induced rise in the dollar value of reserve holdings denominated in other currencies, SDRs and ECUs, whereas the SDR value of reserve assets not denominated in special drawing rights fell on balance for exchange rate reasons owing to the weight of the large holdings of dollars. However, parallel developments result on a dollar and SDR basis if the reserve changes are not derived from dollar or SDR holdings calculated at current exchange rates but instead are based on the original reserve assets and the changes in these are translated at average rates into a common unit. Eliminating valuation changes in this way, global monetary reserves went up in 1985 by $ 11 billion, or SDR 10.6 billion. In 1984, by contrast, the volume of gross monetary reserves of the IMF member countries rose by $ 40 billion, or SDR 39.7 billion.

. . . through growing foreign exchange reserves

Excluding valuation changes, the rise in global monetary reserves can be attributed in the main to the fact that there was an overall increase in foreign exchange reserves again. In addition, holdings of special drawing rights outside the IMF went up slightly. On the other hand, there was a distinct decline in the sum total of IMF reserve positions.

Further rise in Deutsche Mark reserves

Of the increase in global foreign exchange reserves of $ 12 billion resulting from actual transactions, the greater part was accounted for by a rise in dollar balances if it is assumed that almost all of the increase in unidentified foreign

Regional distribution of international monetary reserves*

US$ billion

Group of countries/Country 1	Level at end of year 1983	Level at end of year 1985 p	Change 1984	Change 1985 p
OECD countries	251.3	285.3	+ 5.9	+28.1
of which				
EEC countries	130.4	138.9	− 4.3	+12.8
United States	33.7	43.2	+ 1.2	+ 8.3
Japan	25.6	27.7	+ 1.9	+ 0.2
Canada	4.3	3.4	− 1.0	+ 0.1
Federal Republic of Germany	46.7	48.4	− 2.5	+ 4.2
France	23.3	30.0	+ 1.1	+ 5.6
United Kingdom	12.1	13.7	− 1.9	+ 3.5
Italy	22.7	18.3	+ 0.9	− 5.3
OPEC countries	71.4	76.0	− 2.1	+ 6.7
Low-population	41.5	40.6	− 4.6	+ 3.7
High-population	29.9	35.4	+ 2.5	+ 3.0
Other developing countries	80.6	92.0	+11.5	− 0.1
Highly-indebted Latin American countries	14.2	23.0	+10.2	− 1.4
Other countries	66.4	69.0	+ 1.3	+ 1.3
Remaining countries	14.3	25.1	+ 4.6	+ 6.2
All countries	417.7	478.3	+19.8	+40.9
Memorandum items				
Total reserves excluding ECU balances arising from contributions of gold 2	387.5	451.8	+26.0	+38.3
of which				
OECD countries	221.1	258.8	+12.1	+25.6
EEC countries	100.2	112.4	+ 1.9	+10.3
Federal Republic of Germany	38.3	41.0	− 0.8	+ 3.5
France	16.1	23.7	+ 2.6	+ 5.0
United Kingdom	10.4	12.2	− 1.5	+ 3.3
Italy	16.8	13.1	+ 2.1	− 5.8

* Gross monetary reserves of all IMF member countries plus Switzerland and Taiwan. — **1** For the definition of the groups of countries see the table on p. 61. — **2** The gold underlying the ECU balances was included in the other gold holdings again. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Sources: IMF and BIS. BBk

exchange assets is to be added to dollar holdings (for which there are certain indications). Of the other investment currencies, reserves in yen and in Deutsche Marks rose most strongly (by $ 2.2 billion and $ 1.6 billion, respectively). Expressed in Deutsche Marks, reserves held in German currency rose last year from just under DM 119 billion to over DM 123 billion. In the process, identified Deutsche Mark reserves had risen to their historically highest level of DM 126 billion by mid-1985 before declining again in the second half of 1985. The differences in trend in the course of last year were mainly a result of the relevant situation within the EMS which initially made it possible for the partner central banks to purchase sizeable amounts of Deutsche Marks through intra-marginal interventions but which subsequently led to sales of Deutsche Marks in the same way; the outcome was that last year a number of EMS countries registered net additions of Deutsche Marks totalling an estimated DM 3.7 billion, whereas others sold an aggregate amount of DM 6.7 billion. Thus, with an overall increase in Deutsche Mark reserves of more than DM 4 billion in 1985, the sales of Deutsche Marks by a number of EMS countries were more than offset by net additions outside the EMS. A part was played in this process by the fact that amounts of Deutsche Marks were accumulated by the United States from its foreign exchange market operations.

The marked appreciation of the Deutsche Mark vis-à-vis the dollar since the end of 1984 was also reflected in a considerable increase in the dollar value of Deutsche Mark reserve holdings. As a result, the share in aggregate foreign exchange reserves accounted for by the Deutsche Mark went up perceptibly; it rose in 1985 from 12.0% to 14.5% if the dollar reserves underlying the ECU balances are again included among other foreign exchange reserves.

Rise in the share of the Deutsche Mark in global foreign exchange reserves

Of the nominal increase in published global monetary reserves in dollars a good two-thirds ($ 28 billion) was accounted for by the OECD countries. The remaining increase was distributed in the main among the OPEC countries and Taiwan (which is not counted as a developing country in the IMF statistics). Among the group of industrial countries the largest rise in monetary reserves, at $ 8 billion, was accounted for by the United States, reflecting not only its purchases of Deutsche Marks mentioned above but also considerable US purchases of yen. Apart from this, the gross monetary reserves of France, Germany, Norway and the United Kingdom registered an aggregate increase of $ 18 billion. At over $ 5 billion, Italy at the same time recorded the largest loss in reserves.

Increase in reserves concentrated on a small number of countries

5. The debt problems of the developing countries

Since the outbreak of the debt crisis in 1982 considerable success has been achieved all in all through far-reaching cooperation among all those involved in finding a lasting solution to the debt problems of the developing countries, above and beyond mere crisis management. Above all, the countries concerned were able to appreciably reduce their current account deficits. Six of the most heavily indebted countries of Latin America — Argentina, Brazil, Chile, Colombia, Mexico and Peru — reduced their combined current account deficit from $ 39 billion in 1981 to an estimated $ 3 billion in 1985, even though no further progress in adjustment was achieved last year (in 1984 the corresponding deficit had amounted to $ 2 billion). At the same time, there was a distinct rise in the level of economic activity in the developing countries burdened by high foreign debts again after the real GNP of these countries had fallen considerably in the years 1982-83. Moreover, a large number of highly-indebted countries have recently succeeded in stepping up their imports somewhat which they had had to cut back sharply at the beginning of the debt crisis. However, other problems confronting these countries have remained or even become exacerbated. This applies above all to the level of their budget deficits and the rate of inflation. Thus, for example, another 22 percentage points was added to the rise in consumer prices in Latin America on average in 1985 against the previous year, taking the rate to 145%. Moreover, the economic forces in many developing countries are frequently paralysed by excessive government interference. The citizens of countries with debauched currencies and a lack of scope to develop their abilities have reacted to such a situation for a long time by withdrawing their confidence, as is revealed most conspicuously in large-scale outflows of capital. In the difficult situation in which the highly-indebted countries find themselves and where such outflows can dramatically exacerbate their external financing problems it would appear to be all the more urgent for them to vigorously counteract the causes behind these outflows of capital.

Distinct progress in adjustment since 1982

Considering the success achieved so far by the highly-indebted countries in adjusting their economies, the danger of a radical shock to the international financial system like that which suddenly occurred in 1982 as a result of the payment problems of these countries is no longer acute. This does not exclude the possibility that setbacks will occur in the effort to overcome the developing countries' debt problems on a durable basis. Thus, for example, renewed payment difficulties arose last year in a number of countries. One of the main causes behind this was the slower rate of economic growth in the industrial

Considerable setbacks despite improved overall situation

External debt of the developing countries *

US$ billion

Item	1980	1981	1982	1983	1984	1985
A. **Long-term**	455	526	594	666	708	754
Public	175	198	221	248	270	290
Private	280	329	373	418	438	464
B. **Short-term**	113	136	158	133	133	124
C. **Total** (A plus B)	568	662	752	798	841	878
By foreign trade structure						
Oil exporters	179	218	250	267	277	291
Oil importers	389	444	502	531	564	587
By region						
Latin America	231	287	329	341	356	366
Middle East	41	48	55	63	68	73
Rest of Asia	133	152	175	194	207	226
Africa	94	103	117	125	129	127
Europe	68	72	75	77	81	86
Memorandum items						
Debt service payments	88	110	120	111	126	131
Interest	44	61	69	65	72	72
Repayment of long-term loans	44	50	51	46	54	60
Debt service as a percentage of receipts from exports of goods and services	17.1	20.5	23.6	22.0	22.9	24.1

* All developing countries, excluding the eight major oil exporters of the Middle East (Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates), but including some less developed OECD countries and the eastern European members of the IMF. — Excluding debt to the IMF.
Discrepancies in the totals are due to rounding.
Source: IMF. BBk

countries which led to a slower rise in the volume of exports of the developing countries than in 1984. One of the chief factors here was the particularly marked slackening of economic growth in the United States which is the principal export market for the highly-indebted countries of Latin America. As already mentioned above, the exports of the developing countries also suffered from the further decline in commodity prices on the world markets, quite apart from the particularly heavy losses in receipts that arose for the oil-exporting debtor countries like Mexico and Nigeria through the recent slide in oil prices. In the event, the export receipts of the developing countries — playing, as they do, a key role with respect to their economic growth as well as their ability to service their debts — declined somewhat last year. With their imports rising at the same time, this resulted in an additional need for financing which makes it all the more difficult to resolve the issues surrounding the servicing of their debts in the future. However, problems arose last year also through the fact that the most highly indebted countries had to pay for their success in external adjustment so far with a drastic cut in their standard of living. The revival in their economic growth did not essentially alter this picture as their population continued to rise strongly in recent years in most countries. It therefore became more difficult for many debtor countries to adhere to the stance of economic policy agreed with the IMF.

Slower growth again in contracting new debt

These renewed problems further reduced the developing countries' access to financial sources abroad. This is reflected most clearly in the fact that the voluntary granting of fresh bank credits to countries with debt-servicing problems practically came to a halt in 1985. In the event, the aggregate volume of net new debt contracted by the developing countries last year fell slightly despite the rise in the current account deficit of these countries as a group. At $ 37 billion, it was approximately $ 5 billion lower than in 1984; just under half of the new funds continued to be provided by private creditors, as in the preceding year. This curtailment was brought about by the fact that, in contrast to 1984, the developing countries practically refrained from building up their monetary reserves any further with the help of loans from abroad.

Further multi-year rescheduling arrangements

Since 1984 various longer-term rescheduling agreements have been negotiated with a number of highly-indebted countries and in most cases have also been ratified. All these agreements relate not only to credits due over the short term but also cover longer maturities extending over several years (multi-year rescheduling arrangements). In 1984 arrangements of this kind were agreed with Mexico, Venezuela, the Philippines and Ecuador; they have meanwhile entered into force. In 1985 similar agreements in principle were made in addition with Chile and Yugoslavia. Together with other rescheduling agreements, this means that in 1984 $ 116 billion worth of developing countries' foreign debts were rescheduled, with $ 112 billion being accounted for by liabilities to banks and the rest by debts to foreign official creditors. After these large-scale operations, the liabilities given similarly favourable treatment last year totalled only $ 31 billion, with the lion's share this time being accounted for by liabilities to official creditors ($ 19 billion). Moreover, in March 1986 an agreement was concluded with Brazil envisaging the rescheduling of foreign debts amounting to $ 31 billion. In this context, debts due in 1985-86 totalling $ 16 billion were rescheduled over the longer term, with lower interest charges being agreed at the same time; moreover, the maturity of short-term trade and interbank credits was extended by one year. This agreement was designed to build a bridge for a future multi-year rescheduling arrangement.

"Baker initiative" to foster export-led growth

As no progress was made in the debate surrounding the debt problems, the US Administration seized the initiative at the annual meeting of the IMF and World Bank in September 1985 and proposed additional measures. Basically, this project, which is named after the US Secretary of the Treasury, Mr. Baker, aims at improving the preconditions for the developing countries affected most seriously by debt-servicing problems to be able to practically "grow out" of their problems by steady, export-led economic growth. To this end all those involved — i. e. besides the debtor countries and the banks, international bodies and the governments of the creditor countries as well — must in the opinion of the US Administration further strengthen their cooperation. The US Administration proposes to achieve this within the framework of a "three-point plan" the main elements of which are as follows:

- The debtor countries should continue their external and domestic adjustment efforts at a stronger pace, giving more scope in the process to private initiative and putting supply-side, market-oriented elements of their economic and monetary policies in the foreground. This is intended not least to enhance the attractiveness of the countries involved for foreign capital.

- Besides this, the United States gives its support to the IMF being able to continue vigorously carrying out its successful central role in overcoming the debt problems. At the same time, the World Bank and the regional development banks should increase their disbursements to a group of 15 countries with considerable debt-servicing problems (Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia) by one-half in comparison with 1985 to $ 9 billion per year, initially in each year from 1986 to 1988. As a result, net of repayments, this group of countries would receive new funds totalling $ 20 billion in this three-year period, corresponding to an annual net increase in the commitments of these institutions vis-à-vis the countries concerned of 20 %.

- Finally, the United States proposes that the commercial banks increase their commitment vis-à-vis this group of countries also by $ 20 billion net, or about 2½ % per year, over the same three-year period.

Conditions in each individual case in centre of all assistance measures

These proposals met with a positive echo from all those concerned. However, nobody can expect that financial sluice-gates are now going to open for the highly-indebted developing countries. The "Baker Plan" does not alter the fact that all conceivable measures of assistance must be based on the particular conditions relating to each individual case. Their being put into effect therefore depends upon the extent to which, in the opinion of the relevant international bodies involved, durable success in adjustment can be expected in the individual countries, thus preparing the ground for further advances in the development not failing simply owing to financial bottlenecks. This does not exclude the possibility that debtor countries not explicitly mentioned in the proposals put forward by the United States can also be considered as beneficiaries of special assistance measures if they qualify. The governments of the creditor countries can help to realise the proposals of the United States above all by putting the international organisations in a position in good time to actually be able to provide the contributions expected of them.

6. The international financial markets

Aggregate international new lending at a practically unchanged level

About the same volume of new funds was raised on the international financial markets in 1985 as in the preceding year. According to BIS calculations, the total volume of new short, medium and long-term lending amounted to some $ 150 billion; this figure excludes exchange-rate-induced changes in non-dollar bank positions, as well as interbank positions, redemptions of loan issues and a number of other types of double-counting between credit and bond markets. However, considerable changes occurred in the forms of international lending last year. There was a shift away from bank credit to the securities markets. Purchases of securities by banks were also significant here.

Slight decline in the growth of the gross volume of new syndicated credits . . .

According to the available data, the gross volume of new medium and long-term international syndicated credits declined by $ 2 billion to $ 60 billion. Excluding credits or credit lines granted to developing countries in connection with rescheduling operations or which only replace facilities granted in the past, the volume of new syndicated credits fell by $ 11 billion to $ 32 billion. This was mainly due to the fact that the voluntary granting of new credits to developing countries was curtailed further. At the same time, there was hardly any increase in the industrial countries' demand for international syndicated credits since they preferred to tap the securities markets, making arrangements on a considerable scale with the banks to place money market paper. This increasing "securitisation" in international financing has further sharpened the already strong competition in the market for syndicated credits. As a consequence, the spreads over LIBOR that are staggered according to the credit standing of the debtor and which averaged 0.9 percentage points for all borrowers in 1984, declined further to 0.6 percentage points despite the fact that, if anything, the credit standing of the debtors has probably deteriorated as many top-quality borrowers are turning to other types of financing.

. . . accompanied by a further surge in the gross volume of international bond issues

The gross volume of issues on the international bond markets rose last year by $ 56 billion, or 50%, to $ 168 billion. Within this total, issues of floating rate notes and multi-year certificates of deposit, which also carry a floating rate of interest, taken together, went up by $ 20 billion to $ 58 billion. However, the greater volume of floating rate note issues led to hardly any increase in the size of the market. A large part of this increase served only to replace higher-coupon loans which had been called in before maturity by the issuers. The remaining growth in FRNs was mainly accounted for by banks which frequently used the funds raised to finance the rescheduling of claims on highly-indebted developing countries over the longer term. Another special factor behind the rise in the gross volume of issues on the international bond markets is to be seen in the issue of non-redeemable variable rate bonds in the United Kingdom

International credit and bond markets

US$ billion

Item	1981	1982	1983	1984	1985 p
A. Medium and long-term international bank loans and back-up facilities	108.6	103.6	76.7	90.8	109.9
Types of loans					
Bank loans **1**	94.6	98.2	67.2	62.0	60.1
Euro-credits	91.3	90.8	60.2	53.2	53.5
Traditional credits	3.4	7.4	6.9	8.8	6.6
Back-up facilities **2**	14.0	5.4	9.5	28.8	49.9
Borrowing countries **3**					
OECD countries	54.8	57.7	39.0	55.3	80.1
OPEC countries	6.0	8.5	7.5	3.5	3.7
Other developing countries	45.2	34.8	25.6	25.7	17.8
Eastern European countries **4**	1.5	0.7	1.1	3.3	4.8
International organisations **5**	1.0	1.9	3.4	3.0	3.5
Borrowing sectors					
Public **6)**	59.3	68.6	52.2	60.1	54.6
Private	49.3	35.0	24.5	30.7	55.3
Purpose of the loans					
New loans under rescheduling arrangements	—	—	14.3	11.3	7.1
Replacement or change of existing facilities	—	2.3	3.9	29.8	59.5
Bank loans	—	2.3	1.1	8.2	21.4
Back-up facilities	—	—	2.8	21.6	38.1
Other	108.6	101.3	58.5	49.7	43.3
Memorandum items					
Non-underwritten facilities	—	—	—	0.7	18.3
Standby credits in connection with mergers and take-over bids	39.1	—	4.0	26.5	7.0
B. International bond issues 7	52.8	75.5	77.1	111.5	167.8
Types of issues					
Euro-bonds **8**	31.3	50.3	50.1	81.7	135.4
Traditional foreign bonds **9**	20.5	25.2	27.0	27.8	31.0
Special issues **10**	1.0	—	—	2.0	1.3
Borrowing countries **3**					
OECD countries	40.6	60.2	60.3	94.8	139.9
OPEC countries	0.4	0.5	0.4	0.5	0.8
Other developing countries	3.9	3.9	2.7	4.1	7.9
Eastern European countries **4**	0.1	—	—	0.0	0.4
International organisations **5**	7.8	10.9	13.7	12.0	18.8
Borrowing sectors					
Public **6**	28.2	42.0	43.5	54.8	73.2
Private	24.6	33.5	33.6	56.7	94.6
Types of bonds					
Variable rate bonds	11.3	15.3	19.6	38.2	58.4
Other bonds	41.5	60.2	57.5	73.3	109.3
Issue currencies and units of account					
US dollar	32.9	48.2	43.9	71.6	102.5
Swiss franc	8.4	11.3	13.5	13.1	14.9
Yen	3.3	3.9	4.1	6.1	12.8
Deutsche Mark	2.7	5.4	6.7	6.7	11.2
ECU	0.2	0.8	2.2	2.9	7.0
Pound sterling	1.4	1.9	3.0	5.6	6.8
Other	3.9	4.0	3.8	5.5	12.5
C. Total (A plus B)	161.5	179.1	153.8	202.3	277.7

1 Publicised new loans running for more than one year granted mostly by international bank syndicates (Euro-credits) or in national currency by national bank syndicates (traditional foreign credits) which have not necessarily been taken up yet. — **2** Financing commitments to back up the revolving placement of money market paper by international bank syndicates. — **3** For the definition of the groups of countries see the table on p. 61. Borrowing operations by foreign financing companies are included under the country of domicile of the parent company. — **4** Including CMEA institutions. — **5** Including regionally unattributable loans. — **6** Including public enterprises and financial institutions and including international organisations. — **7** Including private placements and medium-term certificates of deposit with variable interest rates. — **8** Issued by international bank syndicates. — **9** As a rule nationally syndicated issues in national currency. — **10** Direct placements and specially targeted issues of public borrowers in the United States. — **p** Provisional. Discrepancies in the totals are due to rounding.
Source: OECD. BBk

totalling some $ 6 billion; the UK supervisory authorities count "perpetual" bonds of this kind as part of the banks' capital base.

Proliferation of currency and interest rate swaps on the bond markets

The surge in the total volume of issues on the international markets was also fostered by the fact that in many cases it was possible to adjust the conditions attached to bonds to the wishes of the borrowers through currency and interest rate swaps.[1] In this way it was possible for individual issuers to contract debt in coveted currencies even if directly tapping the market involved would have been difficult or at least more expensive. This favoured not least issues denominated in ECUs as well as a number of currencies that are in themselves less important for bond issues. Circuitous transactions of this kind necessarily reduce the transparency of the market and this can, in turn, be detrimental for the market participants as well as for monetary policy. The possibility can also not be ruled out that the redistribution of currency and interest rate exposures can give rise to critical concentrations of risk. If major issuers were to encounter difficulties as a result, this could have repercussions on the whole network of the swap markets. This further increases the responsibility of commercial banks for the smooth functioning of the international bond markets.

Industrial countries continue to dominate the bond markets

As in the preceding years, almost all of the increase in the volume of issues was accounted for by the OECD countries. At $ 41 billion, issuers from the United States took up $ 15 billion more in funds than in the previous year, followed by issuers from the United Kingdom with an increase of $ 10 billion to $ 15 billion, and by issuers from Japan who stepped up the volume of their newly issued bonds by $ 4 billion to $ 21 billion. At the same time issues by the developing countries went up by $ 4 billion to $ 7 billion, with access to the international bond markets being open chiefly to a number of countries in South East Asia that are not burdened with debt-servicing problems thanks to the large volume of their exports. Moreover, there was a further increase in issues by the international development banks.

Yen moved up to third most important currency of issue after the US dollar and the Swiss franc

The US dollar remained the most important currency of issue even though it lost some ground. Of total bond issues, 61 % were denominated in US dollars as against 64 % in the preceding year. At the same time, the relative importance of the Swiss franc on the international bond market has also declined. Its share fell from 12 % in 1984 to 9 % last year; one reason for this may have been Switzerland's disapproval of Euro-bond issues denominated in Swiss francs. The Swiss currency could nevertheless still maintain its position as the second most important currency of issue after the US dollar. In contrast, the share of the market accounted for by the Japanese yen rose by 2 percentage points to 8 %. The yen thus moved up for the first time to the position of the third most important currency of issue, followed by the Deutsche Mark whose share also slightly increased, i.e. to 7 %. The increase in the market shares of these two currencies is essentially associated with the fact that in 1985 Japan and Germany opened up the markets for issues in their currencies to floating rate notes and that great use was made of these possibilities. As mentioned above, there was also an appreciable rise in the volume of issues denominated in ECUs. With a market share of over 4 %, the ECU even gained slightly greater importance on the international bond market than sterling. At the same time, France permitted the market for Euro-currency issues denominated in French francs to be re-opened whereas Italy allowed Euro-lira issues for the first time.

Marked rise in back-up facilities

Last year there was also a considerable further increase in raising funds through combined credit and placing facilities (underwritten or back-up facili-

1 In the case of currency swaps the partners involved temporarily swap the principal amount of the bonds denominated in different currencies as well as the interest commitments in the relevant currency and at the relevant level. If, in addition, an interest rate swap has been agreed, the partners involved also swap the nature of their interest commitments, with normally a fixed interest rate being exchanged for a floating rate.

ties); some of these, however, merely replaced existing credit lines. In comparison with the preceding year, the volume of new back-up facilities granted went up by $ 21 billion to $ 50 billion; it was thus five times the level registered in 1983 when these facilities played a greater role for the first time in borrowing in the international market. These financial innovations involve financing commitments that are intended to back up the revolving sale of mostly short-term money market paper, with the maturity of the facilities being normally between five and seven years, hence ensuring the issuer the availability of funds over the longer term, as in the case of syndicated Euro-loans. But, in comparison with the conditions on the credit markets, the issuer obtains the funds he requires on more favourable terms, helped by a great degree of flexibility in drawing down the facility. However, the commitment of the banks to help out with credits if the sale of the money market paper involved proves difficult or to take up the securities themselves for the time being not only blurs the borderlines between the international credit and securities markets but also raises problems relating to liquidity and credit standing. For the banks the fees they charge for arranging back-up facilities of this kind are undoubtedly welcome in that they strengthen their earnings. However, the liquidity risks of the banks which can arise when banks are actually called upon on a major scale to extend credits under facilities of this nature should not be underestimated. Moreover, such off-balance sheet transactions are frequently not sufficiently backed up by capital resources. For this reason, in spring 1985 the Bank of England decided to include underwriting obligations in the United Kingdom at a weight of 0.5 in the calculation of the risk asset ratio just as other types of commitments. The German Federal Banking Supervisory Office has proposed a similar requirement for banks subject to bank supervision in Germany. In the United States and Japan regulations are being prepared which specify that 30 % of the value of such facilities is to be included in measurements of capital adequacy for the purposes of bank supervision.

Non-underwritten facilities also on the advance

Besides underwriting facilities involving a standby arrangement, facilities for the placing of money market paper were arranged on a relatively large scale for the first time in 1985 that were not underwritten by the banks. Their volume reached an estimated $ 18 billion. Through such facilities, which evolved along the lines of the commercial paper programmes in the United States, the banks only commit themselves to do all they can to place the paper in question. However, they can be all the more confident in this respect as financing facilities of this type are available exclusively to borrowers of the highest credit rating. Moreover, on the basis of experience, the borrowers see them primarily as standby facilities. Despite these special characteristics the possibility cannot be excluded that the liquidity position of the banks could also be affected by facilities of this kind if market conditions became extremely poor. Particularly where well-established ties exist with their customers, the banks will hardly be able to reject requests for finance in the event of a bottleneck on the market.

Stock-taking exercise with respect to financial innovations by international working group

Last year a detailed study was made of the large number of innovative techniques in the international credit and bond markets by a special working group comprising representatives of the central banks of all member countries of the Group of Ten. The results of this study, which is to be published shortly, underline above all the risks associated with them for market participants as well as for the international financial system as a whole and point out a number of difficulties that can arise for monetary policy. Moreover, the members of the working group agreed that the increasing extent of "securitisation" in international financial transactions is seriously impairing the value of the financial statistics that are currently available. The working group therefore spoke out in favour of extending the coverage of international banking statistics, which have hitherto been restricted to cross-border credit relationships, to include international securities transactions.

7. The activities of the IMF and the international development banks

(a) Development of financial assistance

Marked decline in new IMF lending

Lending by the International Monetary Fund, which has for a long time benefited almost exclusively developing countries troubled by balance of payments problems, had risen exceptionally strongly at the beginning of the eighties. Net of repayments, the volume of new lending by the IMF surged to SDR 10.6 billion in 1983 after a negligible amount in 1980. However, since then there has been an equally marked decline in annual net drawings on the Fund's credit facilities; in 1984 they fell to SDR 5 billion and went down further last year to only SDR 0.4 billion. This reversal in tapping the Fund for new credits reflects not only the progress in adjustment meanwhile achieved by the developing countries but also the difficulties of a number of countries in adhering to the stabilisation programmes agreed with the IMF which are a prerequisite for borrowing from the Fund. However, the importance of the Fund in overcoming the balance of payments problems of many countries is not solely determined by the level of its lending. Even more important than its direct assistance through credits is its role as a catalyst that helps to mobilise other financial resources for countries in balance of payments difficulties. In this respect, the tasks of the Fund have tended to grow recently. Special mention deserves to be made of the fact that last year the IMF declared its willingness in principle to exercise surveillance in individual cases upon request, even where it has no credit commitment of its own, over the adjustment programmes of countries that have achieved a certain amount of success in adjusting their economies and which intend to restructure their liabilities to commercial banks through multi-year rescheduling arrangements. This "enhanced surveillance" is intended to foster the restoration of normal relations between debtor countries and the banks; it is, of course, in no way a substitute for independent economic evaluations by commercial banks, which retain full responsibility for their credit decisions based on their own assessments.

Repeated extension of the "Enlarged Access" policy only a safety measure

In the light of the persistent balance of payments problems of numerous developing countries the IMF decided at the end of 1985 to initially continue its "Policy of Enlarged Access to Fund Resources" until the end of 1986 which was temporarily introduced after the second oil price hike and was afterwards extended several times; at the same time the ceilings for drawings were lowered slightly. As the development of lending by the Fund reveals, the temporary greater scope for drawing on the IMF is not necessarily tantamount to greater recourse being taken to the Fund; it is to be seen more in terms of a safety net.

Growth of credit commitments of the international development banks also halted

Last year a number of difficulties in the developing countries also led to lending by the international development banks coming almost to a stop. Delays occurred primarily because the investment plans of a number of countries had to be changed or cut back in order to better harmonise them with the goal of stabilising the economic situation of the countries in question and to foster structural change. As a consequence, the credit commitments of the World Bank group, which also includes the International Finance Corporation (IFC), declined by $ 0.9 billion in the 1984-85 financial year to $ 15.3 billion. The loan commitments of the regional development banks for Latin America, Africa and Asia also fell in 1985 in comparison with the preceding year by $ 0.6 billion to $ 6.1 billion. However, this decline in credit commitments will have a dampening effect on capital flows only in the years ahead. But the volume of disbursements to the developing countries increased last year only slightly, and even stagnated in the case of the World Bank group.

Purchases and repurchases under IMF credit facilities

SDR billion

Item	1980	1981	1982	1983	1984	1985
Credit tranches	1.8	3.4	2.5	4.9	3.1	2.6
Extended Fund Facility	0.6	2.1	2.1	4.6	3.3	0.4
Compensatory Financing Facility	1.0	1.2	2.6	2.8	0.8	0.9
Buffer Stock Facility	—	—	0.1	0.3	0.0	—
Total purchases	3.4	6.8	7.4	12.6	7.3	4.0
Total repurchases	3.2	2.1	1.6	2.0	2.3	3.6
Net purchases	0.2	4.7	5.8	10.6	5.0	0.4

Discrepancies in the totals are due to rounding.
Source: IMF. BBk

Special World Bank facility for the Sahel zone

Through an agreement between the World Bank and 14 countries, including Germany, a facility for special financial assistance was created in February 1985 to help the sub-Saharan countries which are confronted with a persistent crisis. This special facility, which had financing commitments totalling $ 1.2 billion at its disposal when it entered into force, is intended to help finance economic reforms in countries in the Sahel zone over a period of three years. The credits are available to countries which have already begun to implement appropriate medium-term programmes of economic reform or which have undertaken to initiate programmes of this kind.

German capital market continues to be important source of finance for the international development banks

Falling interest rates on the international financial markets prompted the international development banks to increase their borrowings despite the slow growth of their disbursements and credit commitments. In the financial year 1984-85 the World Bank group increased its gross borrowings in comparison with the previous year by $ 2.7 billion to $ 14 billion. In addition, the funds borrowed by the regional development banks went up in 1985 by $ 0.2 billion to $ 3.7 billion. In this context, the German capital market continued to be an important source of funds. Last year, its share of aggregate medium and long-term borrowing by the international development banks was some 14%. Including amounts of Deutsche Mark procured through currency swaps, i. e. without direct recourse to the German market, its share was as large as 16%, as against 18% in the preceding year. Calculated on this basis, greater calls were made only on Japan's and Switzerland's financial markets. Through the proposed increase in the disbursements of all international development banks under the "Baker initiative" an additional burden could easily be placed on the bond markets that play the most important role at present. This makes it appear all the more urgent for a number of major industrial countries to open up their capital markets to a greater extent.

(b) The discussion on the functioning of the international monetary system

Increasing criticism of "overshooting" of exchange rates

Under the auspices of the IMF as well as in other bodies various studies have been undertaken in recent years dealing with the question of the extent to which the existing international monetary system characterised by floating exchange rates between the major currencies has proved to be operable. All these studies had their origin in the increasing concern about the fact that at times the external value of major currencies deviated to an unexpectedly large degree from the fundamental factors that are decisive for them over the long term. An "overshooting" of exchange rates of this kind would appear to be problematical chiefly because exchange-rate-induced competitive disadvantages of a given country are frequently grist to the mill of protectionism whereas other countries whose currencies are valued too low expose themselves to the danger of imported inflation and thus lose room for manoeuvre in their interest rate policy. The above-mentioned studies were not able to give a conclusive answer to the question as to whether a misalignment of exchange rates can be exclusively put down to shortcomings in economic policies in the major countries or whether the regime of floating exchange rates itself also plays a role. There is, however, general agreement that without more consistency in economic and monetary policies both at the national and the international level it will not be possible to achieve greater exchange rate stability. However, the opinion has recently grown that international exchange rate regulations, even in a very loose form, would in all countries engender greater pressure towards economic and monetary policies that are more closely geared to the exchange rate. This discussion was also fostered by the fact that the exchange rates between the major currencies have meanwhile largely returned to normal, thus moving the question into the foreground as to what could be done to ensure a realistic development of exchange rates on a durable basis.

Improvements in the functioning of the international exchange rate system achievable only through a pragmatic approach

On the basis of all experience, ideas that are tantamount to introducing formal exchange rate regulations overestimate the disciplinary effect they can have on the economic and monetary policies of the countries concerned. Above all, however, the experience is ignored that under the present conditions of large-scale international capital transactions satisfactory possibilities hardly exist of shielding national monetary policy from disturbing foreign exchange movements in the absence of floating exchange rates among the major currencies. At all events, the Bundesbank was put in a position to pursue a monetary policy geared to stability on a lasting basis despite repeated massive inflows of capital only by floating the Deutsche Mark against the dollar. From the point of view of monetary policy, even relatively wide target zones for the exchange rates between the major currencies would, in the final analysis, not be any different from a system of fixed exchange rates; if target zones are to fulfil their purpose then they would also need to be defended — with all the consequences to which this can give rise for monetary stability. In this context, the fact must also not be overlooked that less flexible exchange rates would undoubtedly strengthen calls for additional financing facilities and hence further increase the risks to stabilisation policy. Moreover, proposals of this nature can distract from the fact that exchange rate issues constitute only part of the difficulties that beset the world economy at present. An agreement on target zones could even give rise to the illusion that the chief problems of the world economy had been addressed whereas in reality it would have to be feared that they had been postponed all the more. For all these reasons it is advisable to adopt as pragmatic an approach as possible on the issue of exchange rates. A promising path in this direction was shown by the decisions of the "Group of Five" of September 1985. Much would be gained by this approach being further developed in the sense that the major countries also try in the future to agree in their assessment of given exchange rate trends and, in the event of problems, to consult with each other on the crucial economic policy issues involved. In this context, interventions by central banks on the foreign exchange markets would continue to be no more than complementary in their significance.

Part B: Notes on the Deutsche Bundesbank's annual accounts for 1985

1. Legal basis, classification and valuation

Legal basis, accounting system and annual accounts

The legal basis of the annual accounts of the Bank is provided by section 26 of the Deutsche Bundesbank Act (Gesetz über die Deutsche Bundesbank) of July 26, 1957 (Federal Law Gazette I, page 745); the provisions of that section regarding the accounting system and the annual accounts remained unchanged during the year under review.

Layout of the annual accounts

On the assets side of the balance sheet, item 3 "Claims on the European Monetary Cooperation Fund in connection with the European Monetary System" has been restructured as follows:

3.1 ECU balances
less
Difference between the ECU value and the book value of the gold and dollar reserves contributed
3.2 Other claims.

The former sub-items 3.1 and 3.2 have been combined and the designation has been changed. In addition, the asset items 7 to 10, which show lending to domestic banks, have been brought together as follows:

7 Loans to domestic banks
7.1 Domestic bills of exchange
7.2 Securities bought in open market transactions under repurchase agreements
7.3 Foreign bills of exchange
7.4 Lombard loans.

Thus this lending is now shown in one item, as the deposits of banks on the liabilities side already were.

The former item 12 "Treasury bills and Treasury discount paper" has been deleted.

The liabilities items and the layout of the profit and loss account remain unchanged against the previous year.

Valuation

The provisions of the Companies Act (Aktiengesetz) were applied mutatis mutandis in the valuation (section 26 of the Bundesbank Act).

2. Annual accounts

The annual accounts for 1985 are attached to this Report as an Appendix; as usual, the notes on them appear in the same order as the items in the balance sheet and profit and loss account. At the same time a report is rendered on the Bank's activities during 1985.

Balance sheet

Comparison of balance sheet figures

The balance sheet total at December 31, 1985 was DM 216,896.5 million, as against DM 208,248.9 million at end-1984.

Comparison of balance sheet figures

DM million

Assets	December 31 1984	December 31 1985	Liabilities	December 31 1984	December 31 1985
Gold	13,687.5	13,687.5	Banknotes in circulation	100,636.0	105,416.0
Reserve position in the International Monetary Fund and special drawing rights			Deposits of banks	54,254.3	55,824.1
			Deposits of public authorities		
			Federal Government	414.1	1,152.9
Drawing rights within the reserve tranche	9,173.6	7,418.2	Equalisation of Burdens Fund and ERP Special Fund	7.4	6.1
Loans under special borrowing arrangements	2,632.5	1,955.1	Länder Governments	511.0	1,052.3
Special drawing rights	4,288.1	3,806.6	Other public depositors	49.4	38.1
Claims on the European Monetary Cooperation Fund in connection with the European Monetary System			Deposits of other domestic depositors		
			Federal Railways	8.6	8.4
			Federal Post Office	2,082.7	699.5
ECU balances 1	14,341.3	17,185.5	Other depositors	720.9	859.6
Balances with foreign banks and money market investments abroad	37,475.4	39,477.5	Liabilities arising from mobilisation and liquidity paper sold	6,513.7	8,767.8
Foreign notes and coins	24.7	24.3	Liabilities arising from external transactions	11,439.2	14,620.4
External loans and other external assets			Counterpart of special drawing rights allocated	3,736.0	3,273.3
Loans to the World Bank	2,455.7	2,449.0			
Loans to domestic banks			Provisions	8,739.2	5,792.2
Domestic bills of exchange	47,767.6	44,082.3	Other liabilities	183.9	411.3
Securities bought in open market transactions under repurchase agreements	25,735.6	41,627.0	Deferred expenses and accrued income	366.9	439.1
			Capital	290.0	290.0
Foreign bills of exchange	14,814.9	17,301.3	Reserves	5,093.6	5,321.7
Lombard loans	7,967.5	2,314.8	Unappropriated profit	13,202.0	12,923.7
Cash advances	2,440.4	178.9			
Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin	8,683.6	8,683.6			
Securities	4,340.2	4,134.6			
German coins	987.4	983.8			
Balances on postal giro accounts	148.0	201.8			
Land and buildings	1,567.1	1,837.8			
Furniture and equipment	129.4	153.6			
Items in course of settlement	5,588.8	6,421.4			
Other assets	3,962.4	2,934.7			
Prepaid expenses and deferred income	37.2	37.2			
Balance sheet total	208,248.9	216,896.5	Balance sheet total	208,248.9	216,896.5
Contingent claims	0.0	0.1	Contingent liabilities	0.0	0.1

1 After deduction of the difference between the ECU value and the book value of the reserves contributed.

Assets

Gold

The gold holding at December 31, 1985, amounting to 95 million ounces of fine gold (excluding the gold reserves provisionally contributed to the European Monetary Cooperation Fund), is shown at the same figure as at end-1984, viz. DM 13,687.5 million.

Reserve position in the International Monetary Fund and special drawing rights

Drawing rights within the reserve tranche

As at December 31, 1985 the level of drawing rights within the reserve tranche in the IMF amounted to DM 7,418.2 million (= SDR 2,743.9 million) against DM 9,173.6 million (= SDR 2,973.0 million) at end-1984. It corresponds to the difference between the German quota of SDR 5,403.7 million and the Deutsche Mark balances equivalent to SDR 2,659.8 million at the disposal of the IMF at the end of the year. Increases equivalent to SDR 187.3 million due to other members' Deutsche Mark drawings and other transactions of similar effect were accompanied by decreases equivalent to SDR 416.4 million due to other members' Deutsche Mark repayments and other transactions of similar effect.

Loans under special borrowing arrangements

Loans under special borrowing arrangements amounted to DM 1,955.1 million at December 31, 1985 against DM 2,632.5 million at end-1984. The loans outstanding at the end of 1985 solely comprise claims on the IMF totalling SDR 723.1 million and arising from the financing of other members' drawings under the Supplementary Financing Facility.

Special drawing rights

The amount of special drawing rights (SDRs) held at December 31, 1985 is shown at DM 3,806.6 million (= SDR 1,408.0 million) against DM 4,288.1 million (= SDR 1,389.7 million) at end-1984. It is composed of SDR 1,210.8 million of SDRs allocated, the counterpart of which is shown on the liabilities side, and SDR 197.2 million of SDRs purchased. In the year under review the Bank received SDR 57.0 million through designations, SDR 60.0 million through repayments and SDR 236.1 million through interest payments and remunerations. The Bank sold a total of SDR 334.8 million in freely agreed transactions in the year under review.

Claims on the European Monetary Cooperation Fund in connection with the European Monetary System

This item comprises the Bank's ECU balances and the claims arising from recourse to the very short-term financing arrangement by other central banks.

ECU balances

The ECU balances, amounting to DM 39,822.3 million, arise mainly from the provisional contribution of 20% of the Bank's gold and dollar reserves to the European Monetary Cooperation Fund (EMCF) in the form of three-month swaps. For the first time, this item also includes balances which arose from the mobilisation of reserve ECUs, as provided for in the amended Agreement on the European Monetary System (EMS).

less Difference between the ECU value and the book value of the gold and dollar reserves contributed

The gold and dollar reserves provisionally contributed to the European Monetary Cooperation Fund in connection with the European Monetary System against the crediting of ECUs were transferred at market prices and therefore at values higher than those shown in the balance sheet. This is also true of the dollar reserves supplied in the context of the mobilisation mechanism. The resulting difference of DM 22,636.8 million is deducted in this sub-item.

Other claims

At end-1985 no other ECU claims arising from loans under the very short-term financing arrangement were outstanding.

Balances with foreign banks and money market investments abroad

The balances with foreign banks and money market investments abroad, the vast bulk of which are denominated in US dollars and bear interest, amounted to DM 39,477.5 million at end-1985 against DM 37,475.4 million at December 31, 1984.

Foreign exchange deals

Owing to smaller dollar sales on the foreign exchange market, the Bank's turnover in foreign exchange spot deals (foreign currency against Deutsche Mark) declined to DM 37,054.4 million in the year under review against DM 45,555.1 million in 1984. The number of deals fell from 6,966 in 1984 to 5,297. The deals consisted of

	1984		1985	
	Number	DM million	Number	DM million
Purchases	2,147	9,446.7	1,877	6,424.7
Sales	4,819	36,108.4	3,420	30,629.7
	6,966	45,555.1	5,297	37,054.4.

The volume of cross deals (foreign currency against foreign currency) declined in the year under review from DM 7,306.6 million to DM 4,479.9 million, although the number of deals remained unchanged, at 343. The number of SDR/US dollar and SDR/Deutsche Mark deals fell from 70 (equivalent to DM 2,813.9 million) in 1984 to only 45 (equivalent to DM 1,155.2 million). In addition, 185 US dollar inter-centre switch transactions totalling US$ 26.9 million were concluded (1984: 195 transactions amounting to US$ 28.7 million).

15 forward ("outright") sales of US dollars totalling US$ 425.0 million were effected, compared with 124 US dollar sales totalling US$ 1,106.4 million in the previous year.

To regulate the money market, 37 US dollar swaps equivalent to DM 4,994.2 million were conducted with domestic banks to increase liquidity during the year under review (against 27 transactions amounting to DM 3,318.2 million in 1984). 16 foreign exchange repurchase agreements equivalent to DM 6,594.9 million served to reduce liquidity in 1985.

External payments

The Bank executed the following payment orders in the context of external payments:

External payments

Number of orders

Year	in foreign currencies	in Deutsche Mark	Total	of which: Processed by automated standing order procedure	of which: Processed automatically via S.W.I.F.T. [1]
	Outgoing external payment orders				
1984	426,074	2,116,182	2,542,256	2,270,475	174,195
1985	410,623	2,196,172	2,606,795	2,349,463	177,912
	Incoming external payment orders			of which: Payments received via S.W.I.F.T.	
1984	14,977	210,584	225,561	203,477	
1985	15,370	218,464	233,834	205,425	

1 S.W.I.F.T. (= Society for Worldwide Interbank Financial Telecommunication) is a Belgian society which transmits external payments messages by means of data telecommunication. The Bank is a member of the society and has been using the services provided by S.W.I.F.T. since the middle of 1978.

Sales of foreign cheques

During 1985 16,553 (1984: 17,001) foreign cheques payable to order totalling DM 516.6 million (1984: DM 470.2 million) were sold. In addition, the Bank sold 28,334 traveller's cheques amounting to DM 3.3 million against 27,742 traveller's cheques totalling DM 3.3 million in 1984.

Simplified collection procedure for foreign cheques

In 1985, too, fewer cheques than in the preceding year were presented under the simplified collection procedure for foreign cheques. Details are given in Appendix 3 of the German original of this Report.

Foreign commission business

The Bank took in the following for realisation on a commission basis:

	1984 Number	1985 Number
Bills, cheques, etc.	39,836	39,868
Foreign notes and coins	5,711	5,652
	45,547	45,520.

Foreign notes and coins

The amount of foreign notes and coins shown at end-1985, at DM 24.3 million, was DM 0.4 million lower than at end-1984. During the year under review, the Bank effected 22,727 purchases (1984: 22,585) and 40,742 sales (1984: 41,090) of foreign notes and coins.

External loans and other external assets

As in the preceding year, only loans to the World Bank are shown in this item. Loans under the EEC medium-term monetary assistance arrangement and other loans to foreign monetary authorities were not granted in the year under review.

Loans in connection with EEC medium-term monetary assistance

Other loans to foreign monetary authorities

Loans to the World Bank

As in previous years, the loans to the World Bank were mainly granted against borrowers' notes denominated in Deutsche Mark.

Loans to domestic banks

This item reflects domestic banks' refinancing at the Bank.

Domestic bills of exchange

At the end of 1985 the Bank's portfolio of domestic bills amounted to DM 44,082.3 million against DM 47,767.6 million at the end of 1984. The Bank's average portfolio of domestic bills on all return days, at DM 47,355 million, was also lower than in the preceding year (DM 48,367 million). The domestic bill portfolio comprised:

	Dec. 31, 1984 DM million	Dec. 31, 1985 DM million
Domestic bills discounted	44,095.6	40,627.5
Prime bankers' acceptances acquired in the course of open market operations	3,672.0	3,454.8
	47,767.6	44,082.3.

Purchases of domestic bills of exchange in the Land Central Bank areas

	1984		1985	
Land Central Bank	Thousands	DM million	Thousands	DM million
Baden-Württemberg	639	30,820.1	641	31,391.1
Bavaria	401	28,876.3	390	28,473.3
Berlin	23	4,794.5	24	5,026.5
Bremen	40	3,413.1	39	3,253.4
Hamburg	120	15,061.7	122	13,960.2
Hesse	335	40,189.8	345	38,402.7
Lower Saxony	183	14,677.7	181	15,566.6
North Rhine-Westphalia	609	51,038.1	626	49,937.9
Rhineland-Palatinate	109	6,824.8	107	6,767.6
Saarland	29	2,709.9	27	2,384.8
Schleswig-Holstein	42	3,626.5	39	3,438.0
Total	2,530	202,032.5	2,541	198,602.1

The average value of the bills purchased in the year under review was DM 78,200 compared with DM 79,900 in the previous year.

Of the bills purchased, the following were returned and charged, in the absence of payment, to the parties presenting them for rediscounting:

	1984		1985	
	Number	DM million	Number	DM million
	13,226	168.3	15,036	185.2
as % of the total purchased	0.52	0.08	0.59	0.09.

Discount rate

During the year under review the Bank's discount rate for domestic and foreign bills was 4½ % until August 15 and 4 % as from August 16.

Prime bankers' acceptances

The amount of prime bankers' acceptances which the Bank is prepared to purchase in the course of its open market operations, at DM 4 billion, remained unchanged during the year under review. Throughout the year the Bank's buying rate for prime bankers' acceptances was 0.5 percentage point below the discount rate, and thus considerably lower than the money market rates; hence prime bankers' acceptances continued to be used heavily as a source of funding. During the year the Bank's purchases through Privatdiskont-Aktiengesellschaft came to DM 16,599.3 million (DM 19,171.9 million in the previous year). There were no resales to the market via the broker in 1985.

DM 16,816.5 million remained in the Bank's portfolio until payment on maturity (DM 17,063.7 million in the preceding year). At December 31, 1985 the Bank held prime bankers' acceptances stemming from open market operations totalling DM 3,454.8 million (end-1984: DM 3,672.0 million).

Securities bought in open market transactions under repurchase agreements

To provide liquidity for a limited period, during the year under review the Bank again offered the banks, by tender, open market transactions under repurchase agreements in securities on a larger scale than in earlier years. In these transactions the Bank bought securities eligible as collateral for lombard loans subject to the condition that the sellers repurchased them forward. The repurchase periods varied between 27 and 65 days, and the interest rates between 4.55 % and 6.0 %. At the end of the year the Bank held DM 41,627.0 million of securities deriving from such transactions.

Foreign bills of exchange

At the end of 1985 the portfolio of foreign bills accumulated through purchases in Germany amounted to DM 17,301.3 million, compared with DM 14,814.9 million at December 31, 1984. The share of Deutsche Mark bills in the total value of the foreign bills purchased averaged roughly 96 % in 1985 (1984: about 90 %).

Purchases of foreign bills of exchange in the Land Central Bank areas

Land Central Bank	1984		1985	
	Number	DM million	Number	DM million
Baden-Württemberg	45,379	6,080.8	52,285	8,468.4
Bavaria	28,162	6,506.7	31,360	8,559.4
Berlin	1,903	3,199.6	2,230	4,297.7
Bremen	2,413	640.6	2,697	939.3
Hamburg	13,534	6,560.8	14,595	8,761.1
Hesse	26,860	14,802.9	29,479	18,936.0
Lower Saxony	6,384	1,553.9	8,611	2,309.5
North Rhine-Westphalia	40,530	12,732.5	45,559	18,134.4
Rhineland-Palatinate	9,132	1,519.0	9,632	2,036.2
Saarland	3,132	903.7	3,763	1,083.1
Schleswig-Holstein	2,558	939.2	2,180	1,167.9
Total	179,987	55,439.7	202,391	74,693.0

Lombard loans

At the end of 1985 the outstanding amount of lombard loans granted to banks by the Bank was DM 2,314.8 million against DM 7,967.5 million at end-1984. The average level of such loans on all return days of the year under review was DM 1,882 million compared with DM 6,451 million in the previous year. The outstanding amount of such loans was subject to marked fluctuations, as in preceding years; it was largest on January 16, 1985, at DM 15,700 million.

Lombard rate

In the year under review the lombard rate was 5½% until January 31, 6% as from February 1 and 5½% as from August 16.

Cash advances

Section 20 (1) 1 of the Bundesbank Act lays down the following credit ceilings:

	DM million
for the Federal Government	6,000
for the Federal Railways	600
for the Federal Post Office	400
for the Equalisation of Burdens Fund	200
for the ERP Special Fund	50

for the Länder Governments DM 40 per inhabitant; for Berlin, Bremen and Hamburg DM 80 per inhabitant.

As well as cash advances, Treasury bills which the Bank holds in its portfolio or has undertaken to purchase are to be counted against these credit ceilings.

Federal Government, Equalisation of Burdens Fund, Länder Governments

Cash advances outstanding

DM million

Borrower	December 31, 1984	December 31, 1985
Federal Government	1,773.4	–
Länder Governments		
Bavaria	–	7.5
Bremen	49.7	47.9
Hesse	13.9	–
North Rhine-Westphalia	506.0	–
Rhineland-Palatinate	–	0.9
Saarland	9.7	39.8
Schleswig-Holstein	87.7	82.8
Total	2,440.4	178.9

The Equalisation of Burdens Fund and the ERP Special Fund took up no cash advances during the year under review.

Federal Railways, Federal Post Office

No cash advances to the Federal Railways or Federal Post Office were outstanding at December 31, 1985; such advances, together with claims arising from the purchase of Treasury bills and Treasury discount paper, are to be shown in the item "Loans to the Federal Railways and Federal Post Office" on the assets side of the Bank's balance sheet.

Throughout the year the rate of interest charged for cash advances was identical with the Bank's discount rate.

Treasury bills and Treasury discount paper

In the issuing of Treasury discount paper in 1985 the Bank again acted as the selling agent for the Federal Government. This paper, which serves financing purposes, is distinct from the mobilisation and liquidity paper issued pursuant to sections 42 and 42a of the Bundesbank Act, which is reported on below. No Treasury bills serving financing purposes were issued during the year under review.

Federal Government

To meet the credit requirements of the Federal Government, Treasury discount paper amounting to DM 7,401.7 million (1984: DM 3,461.0 million) was issued. The bulk of the rise in sales was accounted for by Treasury discount paper type "BN", which is not returnable before maturity; of this paper, DM 4,638.2 million (1984: DM 717.7 million) was placed with domestic banks. The total issue figure included DM 2,513.5 million (1984: DM 1,903.3 million) of Treasury "financing paper" of the Federal Goverment. The residual DM 250 million, consisting of paper returnable prior to maturity (type "B"), was purchased by an institutional investor.

After the redemption of DM 7,615.2 million (1984: DM 9,036.5 million) of matured Treasury discount paper (including Treasury "financing paper"), the total amount of Treasury discount paper types "B" and "BN" outstanding at December 31, 1985 was DM 10,391.8 million (end-1984: DM 10,605.3 million). Of this total, DM 1,090.0 million was repurchasable by the Bank (type "B"), as in the preceding year.

Federal Railways

During the year under review turnover in Treasury discount paper of the Federal Railways was confined to the redemption and reissue of a block of DM 131.0 million (type "Ba"); hence at December 31, 1985 the outstanding amount of returnable Treasury discount paper of the Federal Railways was again DM 131.0 million, just as at end-1984.

Federal Post Office

No Treasury discount paper of the Federal Post Office was outstanding at any time during the year under review.

The total amount of money market paper issued for the account of the Federal Government and its Special Funds and outstanding at December 31, 1985 was DM 10,522.8 million (end-1984: DM 10,736.3 million).

Money market paper issued for the account of the Federal Government and its Special Funds

DM million

Type of paper	Outstanding at Dec. 31, 1984	1985 Issued	1985 Redeemed	Outstanding at Dec. 31, 1985
Treasury discount paper of the Federal Republic of Germany types "B" **1** and "BN" **2**	10,605.3	7,401.7	7,615.2	10,391.8
of which Treasury "financing paper"	(3,355.7)	(2,513.5)	(1,923.4)	(3,945.8)
Treasury discount paper of the Federal Railways types "Ba" and "BaN" **2**	131.0	131.0	131.0	131.0
Treasury discount paper of the Federal Post Office type "PN" **2**	—	—	—	—
Total	10,736.3	7,532.7	7,746.2	10,522.8

1 The letter "B" serves to distinguish these bonds from the mobilisation and liquidity paper dealt with below. — **2** The letters "BN", "BaN" and "PN" denote securities which may not be returned before maturity.

Länder Governments

At end-1985, as in the preceding year, the Bank had no money market paper of the Länder Governments in its portfolio.

Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin

The Bank's equalisation claims on the Federal Government and the non-interest-bearing debt certificate in respect of Berlin remained unchanged during the year under review.

Loans to the Federal Railways and Federal Post Office

No loans to the Federal Railways or Federal Post Office were outstanding at December 31, 1985, as in the previous year. See also the notes on the items "Cash advances" and "Treasury bills and Treasury discount paper".

Securities

During the year under review the Bank's portfolio of securities — chiefly bonds of the Federal Republic of Germany, the Federal Railways and the Federal Post Office — fell by DM 205.6 million net to DM 4,134.6 million (end-1984: DM 4,340.2 million) owing to redemptions on account of maturity and transactions in the open market.

Issue of bonds

In 1985 13 bond issues totalling DM 24,250 million (1984: 12 bond issues amounting to DM 19,750 million) were launched through the Federal Bond Consortium, which is under the direction of the Bank. Of these bonds, an amount of DM 5,625 million was reserved for the issuers' own institutions and for market regulation purposes.

At the end of 1985 the outstanding amount of bonds of the Federal Republic of Germany was DM 91,683.4 million (end-1984: DM 77,102.6 million), that of the Federal Railways was DM 16,616.6 million (end-1984: DM 15,888.7 million) and that of the Federal Post Office DM 16,665.1 million (end-1984: DM 12,686.4 million).

Bond issues of the Federal Republic of Germany, the Federal Railways and the Federal Post Office in 1985

Issuer	Amount issued (DM million)		Terms				Start of sales
	Total	of which Sold through Federal Bond Consortium	Nominal interest rate (%)	Maturity (years)	Issue price (%)	Yield (%)	
Federal Republic of Germany	2,000	1,500	7	10	100.25	6.96	Jan. 2
Federal Railways	950	775	7.125	10	100	7.13	Jan. 21
Federal Republic of Germany	2,000	1,500	7.25	10	100.25	7.21	Jan. 29
Federal Republic of Germany	2,000	1,500	7.625	10	99.50	7.70	Feb. 26
Federal Republic of Germany	2,500	2,000	7.50	10	100.25	7.46	Mar. 26
Federal Republic of Germany	2,500	1,875	7.25	10	100.25	7.21	Apr. 22
Federal Post Office	1,000	800	7	12	100	7.00	May 23
Federal Republic of Germany	2,500	1,875	7	10	100.25	6.96	June 3
Federal Republic of Germany	2,500	1,875	6.75	10	99.75	6.79	July 29
Federal Post Office	1,500	1,200	6.50	10	100.25	6.47	Sep. 25
Federal Republic of Germany	2,500	1,875	6.50	10	100.50	6.43	Oct. 9
Federal Railways	800	650	7	10	100	7.00	Oct. 31
Federal Post Office	1,500	1,200	6.625	10	100	6.63	Dec. 5

Issue of Federal savings bonds

With the assistance of the Bank (selling operations through banks and sales of its own), Federal savings bonds to the value of DM 5,439.7 million (gross) were placed with private purchasers in 1985 (1984: DM 6,014.3 million).

During the year under review the rate of interest paid on Federal savings bonds was raised twice and lowered five times to bring it into line with market rates.

During 1985 DM 92.9 million (1984: DM 337.2 million) of Federal savings bonds from earlier tranches were returned to the issuer before maturity, and a further DM 550.7 million were redeemed on maturity. The amount of Federal savings bonds outstanding accordingly rose from DM 21,124.5 million at end-1984 to DM 25,920.6 million at December 31, 1985.

Gross sales, interest rates and yields of Federal savings bonds in 1985

Issue	Sales period 1985	Gross sales (DM million) Total	Federal savings bonds type A 1	Federal savings bonds type B 2	Interest rate (I) in, and yield (Y) after, the respective year after issue (% p. a.)	1st	2nd	3rd	4th	5th	6th	7th
1985/ 1+2	[3] Jan. 2– Feb. 14	[4] 1,159.1	546.1		I	5.00	6.50	7.00	7.25	7.50	8.00	
					Y	5.00	5.73	6.13	6.38	6.58	6.77	
				613.0	I	5.00	6.50	7.00	7.25	7.50	8.00	8.00
					Y	5.00	5.75	6.16	6.43	6.65	6.87	7.03
1985/ 3+4	Feb. 15– Apr. 15	839.3	349.0		I	5.00	7.00	7.50	8.00	8.25	8.50	
					Y	5.00	5.97	6.45	6.80	7.05	7.25	
				490.3	I	5.00	7.00	7.50	8.00	8.25	8.50	8.50
					Y	5.00	6.00	6.49	6.87	7.14	7.37	7.53
1985/ 5+6	Apr. 16– June 5	548.4	255.9		I	5.00	6.50	7.00	7.25	7.50	8.50	
					Y	5.00	5.73	6.13	6.38	6.58	6.84	
				292.5	I	5.00	6.50	7.00	7.25	7.50	8.50	8.50
					Y	5.00	5.75	6.16	6.43	6.65	6.95	7.17
1985/ 7+8	June 6– July 22	752.4	369.6		I	5.00	6.25	6.50	7.00	7.00	8.50	
					Y	5.00	5.61	5.89	6.14	6.29	6.60	
				382.8	I	5.00	6.25	6.50	7.00	7.00	8.50	8.50
					Y	5.00	5.62	5.91	6.18	6.35	6.70	6.96
1985/ 9+10	July 23– Aug. 23	599.0	300.7		I	4.50	6.00	6.25	6.50	7.00	8.50	
					Y	4.50	5.23	5.55	5.77	5.99	6.34	
				298.3	I	4.50	6.00	6.25	6.50	7.00	8.50	8.50
					Y	4.50	5.25	5.58	5.81	6.05	6.45	6.74
1985/ 11+12	Aug. 26– Oct. 31	607.4	287.6		I	4.00	5.00	6.00	6.25	6.50	8.00	
					Y	4.00	4.49	4.97	5.26	5.48	5.84	
				319.8	I	4.00	5.00	6.00	6.25	6.50	8.00	8.00
					Y	4.00	4.50	5.00	5.31	5.55	5.95	6.24
1985/ 13+14	Nov. 1– Dec. 19	860.6	366.2		I	4.00	6.50	6.75	7.00	7.50	8.50	
					Y	4.00	5.22	5.70	5.99	6.26	6.57	
				494.4	I	4.00	6.50	6.75	7.00	7.50	8.50	8.50
					Y	4.00	5.24	5.74	6.06	6.34	6.70	6.95
1986/ 1+2	Dec. 20– Dec. 31 [5]	73.5	27.5		I	4.00	5.50	6.00	7.00	7.50	8.00	
					Y	4.00	4.73	5.13	5.56	5.90	6.20	
				46.0	I	4.00	5.50	6.00	7.00	7.50	8.00	8.00
					Y	4.00	4.75	5.16	5.62	5.99	6.32	6.56
Total	Jan. 2– Dec. 31 [5]	5,439.7	2,502.6	2,937.1								

1 With annual payment of interest. — 2 With accrual of interest. — 3 Start of sales on December 6, 1984. — 4 Sales from December 6, 1984 to December 31, 1984 FSB/A DM 140.3 million, FSB/B DM 181.5 million = total DM 321.8 million. — 5 Sales not completed on December 31, 1985.

Issue of five-year special Federal bonds

With the assistance of the Bank (selling operations through banks and sales of its own), DM 16,568.5 million of newly-issued five-year special Federal bonds were sold (1984: DM 13,289.3 million). In addition, an amount of DM 2,484.9 million was reserved for market regulation purposes after the completion of the issue of each series.

During the year under review the terms of special Federal bonds were brought into line with market conditions on 23 occasions.

Series 2 to 9 of the special Federal bonds to the amount of DM 7,900 million were redeemed upon maturity in the year under review. The outstanding amount of five-year special Federal bonds at end-1985 was DM 73,639.1 million (end-1984: DM 62,328.0 million).

Sales and terms of issue of five-year special Federal bonds in 1985

Designation of series	Start of sales	Terms (%) Nominal interest rate	Issue price	Yield	Amount issued (DM million) Sales per issue price	Sales Total	Price regulation share	Total	Date of admission to stock exchange dealing
S. 52 of 1984 (1989)	1 Jan. 2 Jan. 25 Jan. 31	6.75	99.70 99.20 98.80	6.82 6.94 7.04	402.6 75.5 295.1	2 773.2	421.0	1,400	Feb. 26
S. 53 of 1985 (1990)	Feb. 15 Feb. 27 Mar. 22 Apr. 2	7.25	99.50 98.70 99.50 100.20	7.37 7.57 7.37 7.20	489.4 2,487.9 693.1 583.0	4,253.4	246.6	4,500	Apr. 30
S. 54 of 1985 (1990)	Apr. 16 May 15	7.00	99.60 100.20	7.10 6.95	1,978.9 574.0	2,552.9	347.1	2,900	June 3
S. 55 of 1985 (1990)	May 22 June 6 July 8 July 10	6.75	99.60 100.00 100.40 100.80	6.85 6.75 6.65 6.56	604.1 1,316.3 130.2 254.1	2,304.7	395.3	2,700	Aug. 6
S. 56 of 1985 (1990)	July 23 July 31 Aug. 12	6.50	99.80 100.40 101.00	6.55 6.40 6.26	496.4 1,272.6 290.3	2,059.3	440.7	2,500	Aug. 28
S. 57 of 1985 (1990)	Aug. 19 Aug. 26 Oct. 16 Oct. 29	6.25	100.30 100.80 99.60 99.00	6.18 6.06 6.35 6.49	302.1 342.5 121.0 36.3	801.9	298.1	1,100	Nov. 12
S. 58 of 1985 (1990)	Nov. 1 Nov. 5	6.75	100.20 101.00	6.70 6.51	2,574.8 305.4	2,880.2	219.8	3,100	Nov. 25
S. 59 of 1985 (1990)	Nov. 8	6.50	100.30	6.43	883.7	883.7	116.3	1,000	Jan. 10, 1986
S. 60 of 1986 (1991)	Dec. 20	6.25	99.80	6.30	59.2	59.2	3 –	3 –	Mar. 13, 1986

1 Start of sales on December 6, 1984. — 2 Sales from December 6 to December 31, 1984 = DM 205.8 million. — 3 Sales of series not completed on December 31, 1985.

Issue of medium-term notes

Through the agency of the Bank, DM 3,211.3 million of Treasury bonds (medium-term notes) of the Federal Republic of Germany and the Federal Railways were sold in five issues by three tenders in 1985 (in the preceding year DM 3,482.5 billion by four tenders).

At the end of 1985 the outstanding amount of medium-term notes of the Federal Republic of Germany was DM 15,473.1 million (end-1984: DM 12,924.4 million), that of the Federal Railways DM 1,924.0 million (end-1984: DM 1,394.1 million) and that of the Federal Post Office DM 1,687.5 million (end-1984: DM 1,903.7 million).

Treasury bonds (medium-term notes) of the Federal Republic of Germany and the Federal Railways sold by tender in 1985

Issuer	Amount sold (DM million)	Nominal interest rate (%)	Maturity (years)	Selling price (%)	Yield on issue (%)	Month of sale
Federal Republic of Germany	830.2	6.375	3	99.60	6.51	January
Federal Republic of Germany	600.6	6.625	4	99.40	6.80	January
Federal Railways	529.9	7.25	3	99.80	7.33	March
Federal Republic of Germany	987.2	6.75	3½	99.60	6.88	May
Federal Republic of Germany	263.4	6.875	4½	99.10	7.12	May

Admission to stock exchange dealing

The Bank introduced the new bond issues of the Federal Republic of Germany, the Federal Railways, the Federal Post Office and the Reconstruction Loan Corporation, as well as the five-year special Federal bond series 52 to 58, to official dealing on all German stock exchanges; it also introduced ten issues of bearer bonds of the Equalisation of Burdens Bank to semi-official dealing on the Düsseldorf stock exchange.

The Bank likewise introduced the new issues of medium-term notes of the Federal Republic of Germany and the Federal Railways to semi-official dealing on the Frankfurt stock exchange.

In addition, the Bank introduced the new issues of bearer bonds and medium-term notes of the Reconstruction Loan Corporation to official dealing or semi-official dealing on particular German stock exchanges.

Price regulation operations

In the year under review, as in preceding years, the Bank conducted price regulation operations for the account of the issuers on the eight German stock exchanges in respect of the bonds issued by the Federal Government and its Special Funds, five-year special Federal bonds and the bonds issued by the Reconstruction Loan Corporation and the Equalisation of Burdens Bank.

The Bank as paying and collecting agent for bonds

As paying and collecting agent for, in particular, bonds (including external bonds) of the Federal Government and its Special Funds, the Bank paid 366,701 interest coupons and matured bonds in 1985 (1984: 583,725).

German coins

The amount of German coins held by the Bank at end-1985 was DM 983.8 million (end-1984: DM 987.4 million). In 1985 DM 352.0 million was credited to the Federal Government in respect of coins taken over from the Mints and DM 9.1 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1985 the Bank — acting for the account of the Federal Government — took over coins amounting to DM 11,981.3 million and redeemed DM 1,694.9 million of coins which were no longer fit for circulation or had been called in.

The total amount of coins in circulation at the end of 1985 (DM 9,302.6 million) divided by the number of inhabitants of the Federal Republic of Germany including Berlin (West) on September 30, 1985 (61.0 million) yields a coin circulation of DM 152.50 per head of population (end-1984: DM 146.58).

During the year under review the DM 5 commemorative coins "Europäisches Jahr der Musik" (European Music Year) and "150 Jahre Eisenbahn in Deutschland" (150 years of railways in Germany) were put into circulation.

Balances on postal giro accounts

At December 31, 1985 the postal giro account balances, including the branch offices' transfers in transit to the postal giro account of the Bank (Central Office) in Frankfurt am Main, amounted to DM 201.8 million (1984: DM 148.0 million). The Bank's credit balances on the latter account and on the postal giro account of the Land Central Bank in Berlin, other than those required for current payments, are offset daily, in rounded amounts, against the giro account balances of the Central Cash Office of the Federal Post Office and the Berlin (West) Postal Giro Office.

Postal giro transactions with third parties

Area	1984				1985			
	Transfers received from third parties		Transfers made to third parties		Transfers received from third parties		Transfers made to third parties	
	Number	DM million	Number	DM million	Number	DM million	Number	DM million
Land Central Bank								
Baden-Württemberg	62,319	18,930.8	5,177	2,803.5	43,026	20,319.2	5,101	3,112.6
Bavaria	40,837	13,723.8	8,484	8,227.4	38,639	14,206.6	9,531	8,750.8
Berlin	16,587	2,686.4	1,886	1,741.6	5,706	2,847.9	1,836	1,871.9
Bremen	4,704	370.4	111	0.0	4,760	361.7	125	0.0
Hamburg	99,456	18,863.6	1,927	676.9	46,938	19,430.2	1,801	517.4
Hesse	81,345	8,889.4	4,111	8,218.3	51,426	7,231.0	4,251	8,474.7
Lower Saxony	46,531	9,356.0	4,019	3,057.5	38,728	9,607.0	4,346	3,559.1
North Rhine-Westphalia	123,521	21,495.4	9,703	6,160.5	92,243	19,119.4	9,150	5,287.6
Rhineland-Palatinate	21,624	1,085.5	4,253	827.0	25,912	1,044.8	4,187	810.9
Saarland	5,541	2,079.8	137	0.1	4,072	2,042.1	156	0.1
Schleswig-Holstein	5,224	85.6	497	0.4	5,811	90.2	509	0.5
Total	507,689	97,566.7	40,305	31,713.2	357,261	96,300.1	40,993	32,385.6
Bundesbank — Central Office —	5,966	2,739.5	904	3.7	7,040	2,609.7	1,119	2.7
Grand total	513,655	100,306.2	41,209	31,716.9	364,301	98,909.8	42,112	32,388.3

Land and buildings

After additions of DM 360.8 million and depreciation totalling DM 90.1 million, land and buildings are shown at DM 1,837.8 million.

Furniture and equipment

The balance sheet value of furniture and equipment works out at DM 153.6 million after additions totalling DM 89.0 million and depreciation amounting to DM 64.8 million.

Items in course of settlement

The "Items in course of settlement" mainly comprise the intercity credit and debit transfers proceeding inside the Bank at the end of the year and the cheques and direct debits being cleared. At December 31, 1985 the balance of items in course of settlement stood at DM 6,421.4 million against DM 5,588.8 million at end-1984.

Other assets

In this item, other assets are shown at end-1985 at DM 2,934.7 million (end-1984: DM 3,962.4 million). This item primarily contains the interest due in 1986 but assignable to the profit and loss account for the year under review on funds invested abroad and securities (DM 2,443.5 million against DM 3,390.6 million at end-1984) and the balance arising from intra-German settlements (commercial payments under the "Berlin Agreement"), which amounted to DM 191.5 million (1984: DM 273.3 million). The regulations governing intra-German payments are outlined in Part A IV of the German original of this Report.

This item also contains the Bank's 30% share (DM 93 million in nominal terms) in the capital of the Liquidity Consortium Bank of Frankfurt am Main (set up as a private limited company). The provision included in the articles of association of that bank that, if necessary, further capital is to be paid up in proportion to the existing share entails for the Bank a maximum commitment of DM 279 million.

Prepaid expenses and deferred income

The prepaid expenses and deferred income almost exclusively comprise salary and pension payments made in the year under review but relating to 1986.

Banknotes in circulation

The amount of banknotes in circulation at December 31, 1985, at DM 105,416.0 million, was DM 4,780.0 million larger than at end-1984.

Currency in circulation

DM million

End of	Bundesbank notes	Federal coins	Currency in circulation, total
1980	83,730.3	7,461.0	91,191.3
1981	83,790.3	7,816.6	91,606.9
1982	88,574.7	8,120.2	96,694.9
1983	96,073.0	8,619.3	104,692.3
1984	100,636.0	8,956.1	109,592.1
1985	105,416.0	9,302.6	114,718.6

The denominations of the Bundesbank notes and Federal coins in circulation are shown in Appendix 3 to the German original of this Report.

In the year under review the Bank again took over new Bundesbank notes from the printing works and put them into circulation or made them ready for that purpose.

The following banknotes (including monetary tokens) were destroyed as being no longer fit for circulation or after having been called in:

	1980	1981	1982	1983	1984	1985
Number (millions)	466.4	662.3	834.5	582.9	569.0	575.4
Value (DM million)	18,495.1	28,793.9	39,604.0	24,938.5	25,098.5	26,046.7.

The number and value of the counterfeit Bundesbank notes and Federal coins detained in payments in the Federal Republic of Germany and Berlin (West) went up in the year under review. The small increase in counterfeit Bundesbank notes was due to the incidence of counterfeit DM 50 notes, which has meanwhile declined. Among the coins, there was a particular rise in the number of counterfeit DM 2 coins detained.

Counterfeits detected in payments

	Bundesbank notes		Federal coins	
Year	Number	DM thousand	Number	DM thousand
1976	2,709	275.0	8,249	31.0
1977	9,754	946.0	6,754	25.7
1978	6,341	586.4	9,835	35.5
1979	3,388	296.6	7,405	24.3
1980	2,421	183.4	9,428	25.1
1981	2,896	219.1	17,172	34.3
1982	3,317	250.7	19,975	43.3
1983	2,156	181.7	26,607	56.1
1984	7,318	710.3	21,365	49.3
1985	7,585	712.2	24,617	57.7

Deposits of banks

The banks' deposits on giro accounts are mainly composed of the minimum reserves to be held at the Bank. The sub-item "Other" contains the deposits of domestic banks on US dollar accounts. At the end of the year, compared with end-1984, the deposits were made up as follows:

	Dec. 31, 1984 DM million	Dec. 31, 1985 DM million
Deposits on giro accounts	54,239.7	55,809.6
Other	14.6	14.5
	54,254.3	55,824.1.

Deposits of public authorities

In the item "Deposits of public authorities" the current balances of public authorities are shown as follows:

	Dec. 31, 1984 DM million	Dec. 31, 1985 DM million
Federal Government	414.1	1,152.9
Equalisation of Burdens Fund and ERP Special Fund	7.4	6.1
Länder Governments	511.0	1,052.3
Other public depositors	49.4	38.1
	981.9	2,249.4.

Deposits of other domestic depositors

The deposits of other domestic depositors were composed as follows:

	Dec. 31, 1984 DM million	Dec. 31, 1985 DM million
Federal Railways	8.6	8.4
Federal Post Office (including postal giro and postal savings bank offices)	2,082.7	699.5
Other depositors	720.9	859.6
	2,812.2	1,567.5.

Giro transactions, simplified cheque and direct debit collections

In 1985 the turnover on the giro accounts of the Bank increased over the previous year by about 6 %, both in terms of the number of transactions and in terms of the amount involved. Once again, almost 100 % of the turnover was processed on a cashless basis; in sum, only 2.6 million cash payments were made. The number of intercity transfers went up again, viz. by roughly 5 %. The number of items presented by the banks under the simplified collection procedure for cheques and direct debits grew by more than 7 % (1984: 6 %).

Annual turnover on the giro accounts of the Bank

Type of turnover	1984 Number of transactions Thousands	1984 Total amount DM million	1984 Average amount DM thousand	1985 Number of transactions Thousands	1985 Total amount DM million	1985 Average amount DM thousand
(a) Credits						
Cash payments	1,060	231,831	218.7	1,056	241,927	229.1
Clearings with account-holders	3,817	5,513,711	1,444.5	3,781	5,857,901	1,549.3
Local transfers	80,539	5,984,224	74.3	76,476	6,361,361	83.2
Intercity transfers	334,611	5,957,454	17.8	349,661	6,309,123	18.0
Cheque and direct debit collections (total presented)	1,225,530	2,324,732	1.9	1,316,209	2,487,983	1.9
Total	1,645,557	20,011,952	–	1,747,183	21,258,295	–
(b) Debits						
Cash payments	1,572	238,898	152.0	1,557	248,345	159.5
Clearings with account-holders	2,908	5,329,107	1,832.6	2,899	5,713,373	1,970.8
Local transfers	80,539	5,984,224	74.3	76,476	6,361,361	83.2
Intercity transfers	335,542	6,135,343	18.3	350,671	6,455,790	18.4
Cheque and direct debit collections (total paid)	1,224,327	2,321,823	1.9	1,309,405	2,482,139	1.9
Total	1,644,888	20,009,395	–	1,741,008	21,261,008	–
(c) Percentage of total turnover (credits and debits)						
Cash payments	0.08	1.18	–	0.08	1.15	–
Clearings with account-holders	0.20	27.09	–	0.19	27.22	–
Local transfers	4.90	29.91	–	4.38	29.92	–
Intercity transfers	20.37	30.21	–	20.08	30.02	–
Cheque and direct debit collections (total presented and paid)	74.45	11.61	–	75.27	11.69	–
Total	100.00	100.00	–	100.00	100.00	–

In the year under review 99 % of the 517 million vouchers presented for collection and more than 98 % of the 228 million paper-based credit transfers, as well as 799 million direct debits (1984: 687 million) and 122 million credit transfers (1984: 115 million) recorded on magnetic tape, were processed by the Bank's computer centres. The volume of payments executed through the paperless exchange of data media (EDM) was about 15 % higher than in the preceding year. Such payments now account for more than 55 % of the payment items presented under the automated procedure. Altogether, more than 99 % of the intercity transfers — paper-based as well as paperless — were processed automatically in the year under review.

The strong increase in the direct debits recorded on magnetic tape is mainly due to the truncation procedure (CT) introduced in mid-1985 for cheques up to DM 1,000. The Bank has encouraged banks to convert cheques, in particular, by crediting the proceeds of CT payment items presented to it for EDM on the day of presentation. The conversion in the Bank's own computer centres of cheques eligible for the CT procedure but still presented in paper form was started in two Land Central Bank areas during the year under review. A charge (currently 2 Pfennig per cheque) is being made for the conversion and filing operation.

Automation of intercity transfers

Year	Collection orders presented							Intercity credit transfers presented						
	Total	processed						Total	processed					
		in paper-based operations				through the paperless exchange of data media			in paper-based operations				through the paperless exchange of data media	
		conventional		automated					conventional		automated			
	millions	millions	%	millions	%	millions	%	millions	millions	%	millions	%	millions	%
1974	374	142	38	232	62	0.2	0	123	75	61	48	39	0.1	0
1975	423	143	34	272	64	8	2	163	85	52	73	45	5	3
1976	501	83	17	313	62	105	21	174	62	36	83	48	29	16
1977	587	47	8	359	61	181	31	169	36	21	87	51	46	28
1978	694	31	5	412	59	251	36	183	26	14	89	49	68	37
1979	775	15	2	441	57	319	41	192	13	7	95	49	84	44
1980	873	11	1	473	54	389	45	230	7	3	125	54	98	43
1981	1,023	8	1	490	48	525	51	271	7	2	162	60	102	38
1982	1,098	7	1	512	46	579	53	291	6	2	180	62	105	36
1983	1,159	6	1	524	45	629	54	319	5	2	202	63	112	35
1984	1,226	6	1	533	43	687	56	335	4	1	216	65	115	34
1985	1,316	6	1	511	39	799	60	350	4	1	224	64	122	35

If local payments and clearing transactions — which, apart from local credit transfers in Hamburg, are not yet processed automatically — are also taken into account, 81 % of cashless payments at the Bank is automated. It should be borne in mind in this connection that, as part of the conventional clearing procedure, magnetic tapes containing payments are being exchanged locally between banks on a considerable scale; however, only the total amounts of the magnetic tape data files are being cleared in this way.

Liabilities arising from mobilisation and liquidity paper sold

In the year under review sales of mobilisation and liquidity paper pursuant to sections 42 and 42a of the Bundesbank Act rose considerably. The increase was mainly due to the deployment of short-term Treasury bills (running as a rule for three days), which have been sold in larger quantities to domestic banks since February 1985 as part of the reorientation of money market policy for the sake of controlling liquidity. These transactions alone came to DM 53,597.0 million. In addition, just as in the preceding years, Treasury bills were again issued for the purpose of the revolving investment of funds by foreign institutions and the investment of funds by domestic public authorities. Altogether, sales amounting to DM 79,104.9 million (1984: DM 30,692.5 million) were accompanied by redemptions totalling DM 76,846.6 million (1984: DM 30,515.9 million), so that the amount outstanding increased to DM 8,505.7 million (1984: DM 6,247.4 million).

Mobilisation and liquidity Treasury discount paper to the amount of DM 186.7 million was issued (1984: DM 201.2 million); after redemptions totalling DM 190.9 million (1984: DM 160.1 million), the amount of such paper outstanding at December 31, 1985 was DM 262.1 million (end-1984: DM 266.3 million).

At December 31, 1985 the total liabilities arising from mobilisation and liquidity paper outstanding came to DM 8,767.8 million (end-1984: DM 6,513.7 million).

Mobilisation and liquidity paper sold and redeemed

DM million

Type of paper	1984 Outstanding at December 31	1985 Sold	Redeemed	Outstanding at December 31
Treasury bills (running for up to 90 days)	6,247.4	79,104.9	76,846.6	8,505.7
Treasury discount paper (running for 6 to 24 months)	266.3	186.7	190.9	262.1
Total	6,513.7	79,291.6	77,037.5	8,767.8

Liabilities arising from external transactions

The liabilities arising from external transactions grew to DM 14,620.4 million at end-1985 compared with DM 11,439.2 million at end-1984. The liabilities to foreign monetary authorities increased most. Specifically, the liabilities arising from external transactions were made up as follows:

	Dec. 31, 1984 DM million	DM million	Dec. 31, 1985 DM million	DM million
Deposits of foreign depositors				
Banks	11,118.2		14,289.8	
Other depositors	313.2	11,431.4	304,8	14,594.6
Other				
Provision of cover for credits, etc.	4.9		12.8	
Miscellaneous liabilities	2.9	7.8	´13.0	25.8
		11,439.2		14,620.4.

Counterpart of special drawing rights allocated

The counterpart of the special drawing rights allocated by the International Monetary Fund and shown on the assets side of the balance sheet in sub-item 2.3 corresponds to the allocations of SDRs to the Federal Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,210.8 million.

Provisions

Provisions for pensions

After the withdrawal of DM 135.2 million for the payment of retirement pensions and widows' and orphans' pensions and an increase of DM 80.2 million, the provisions for pensions amount to DM 2,011 million (end-1984: DM 2,066.0 million); they correspond to the actuarially calculated requirements.

Provisions for other purposes

To offset losses arising from the valuation of the monetary reserves and other foreign currency positions, DM 2,892.0 million (net) was withdrawn from the provisions for other purposes, which serve primarily to cover general risks inherent in domestic and external transactions and risks posed by pending forward commitments (see also the notes below on the item "Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions"). As a consequence, at December 31, 1985 the provisions for other purposes amounted to DM 3,781.2 million against DM 6,673.2 million at end-1984.

Other liabilities

The other liabilities rose by DM 227.4 million to DM 411.3 million. The main reason for this was the higher level of liabilities in respect of securities commission business at end-1985.

Deferred expenses and accrued income

Deferred expenses and accrued income amounted to DM 439.1 million at December 31, 1985 (end-1984: DM 366.9 million). As before, this item mainly comprised interest received in the year under review, but relating to the following year, on domestic and foreign bills of exchange and US Treasury Notes.

Capital

The capital of the Bank amounts to DM 290 million; it is held by the Federal Government (section 2 of the Bundesbank Act).

Reserves

In accordance with the decision taken by the Central Bank Council on April 11, 1985, the legal reserves were increased by DM 228.1 million out of the profit for 1984. After this increase, the legal reserves totalled DM 5,031.7 million; they thus reached the maximum level permissible by law of 5% of the amount of banknotes in circulation, which came to DM 100,636.0 million at end-1984. The other reserves had already reached the statutory ceiling of DM 290 million at the end of 1980.

Unappropriated profit

See the notes on page 109 of this Report.

Contingent liabilities and claims

The contingent liabilities and claims amounted to DM 75,000 against DM 3,000 at end-1984.

Profit and loss account

Comparison of expenditure and receipts

DM million

Expenditure	1984	1985	Receipts	1984	1985
Interest paid on foreign exchange swap and repurchase transactions with domestic banks	13.5	5.8	Interest received		
Interest paid on mobilisation and liquidity paper	270.4	258.4	Funds invested abroad	10,690.5	9,005.1
Other interest paid	10.5	11.6	Lending to domestic banks	3,563.9	4,631.1
	294.4	275.8	Equalisation claims	81.4	81.4
Administrative expenditure			Securities	540.5	341.5
Staff costs	729.8	746.6	Cash advances	65.3	107.0
Other	172.1	196.8	Other interest received	3.1	3.0
Note printing	139.5	174.6		14,944.7	14,169.1
Depreciation	144.4	154.9	Fees received	17.1	18.8
Increases in provisions			Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	2,238.2	279.5
for pensions	133.2	80.2	Other receipts	223.8	146.0
for other purposes	2,547.0	—			
Pension payments in respect of the Reichsbank	26.3	24.1			
Other expenditure	35.1	36.7			
Profit for the year (= unappropriated profit)	13,202.0	12,923.7			
Total	17,423.8	14,613.4	Total	17,423.8	14,613.4

Interest

	1984 DM million	1985 DM million
Interest received amounted to	14,944.7	14,169.1;
after deduction of interest paid, namely	294.4	275.8,
interest is shown in the profit and loss account at	14,650.3	13,893.3.

In the year under review total interest income, at DM 14,169.1 million, was DM 775.6 million lower than in 1984. The interest received from external transactions decreased from DM 10,690.5 million to DM 9,005.1 million. In contrast to 1984, this was mainly because the appreciation of the Deutsche Mark reduced the Deutsche Mark equivalent of the interest income paid in US dollars. Receipts from lending to domestic banks — domestic bills of exchange, securities repurchase agreements, foreign bills bought in Germany and lombard loans — increased by DM 1,067.2 million to DM 4,631.1 million, mainly on account of the more extensive securities repurchase agreements. The interest received from securities dropped by DM 199.0 million to DM 341.5 million, the average securities portfolio being smaller than in the preceding year. The interest received from equalisation claims remained unchanged, at DM 81.4 million. Other interest income rose by DM 41.6 million to DM 110.0 million, chiefly owing to the rise in interest received from cash advances.

The interest paid, at DM 275.8 million, fell by DM 18.6 million against the previous year. Specifically, DM 258.4 million (1984: DM 270.4 million) was disbursed on Treasury bills and Treasury discount paper of the Federal Government (mobilisation and liquidity paper pursuant to sections 42 and 42a of the Bundesbank Act); and DM 5.8 million (1984: DM 13.5 million) was spent on foreign exchange repurchase agreements and swap transactions with domestic banks.

Fees

Fees totalling DM 18.8 million were received in the year under review (1984: DM 17.1 million).

Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions

This item contains the results of the valuation of the monetary reserves and other foreign currency positions. Valuation losses owing to exchange rate changes of the Deutsche Mark were offset by the release of valuation gains retained among the provisions in earlier years, so that the amount of DM 279.5 million (1984: DM 2,238.2 million) shown here mainly comprises receipts stemming from purchases and sales of foreign currencies. The claims denominated in US dollars have been valued, as before, at DM 1.7275.

Other receipts

The other receipts are shown at DM 146.0 million (1984: DM 223.8 million).

Expenditure

Administrative expenditure

Staff costs

Administrative expenditure on personnel increased against the previous year by DM 16.8 million to DM 746.6 million. This was attributable, firstly, to the higher incomes of the Bank's staff and, secondly, to the rise of 138 in the number of staff members to a total of 15,077 (+ 0.9%). More than one-third of this rise was accounted for by trainees, the number of whom grew by 52 compared with the preceding year. Thus, as in previous years, additional trainee positions were created within the Bank.

Staff of the Bank

Staff	Beginning of 1985 Central Office	Land Central Banks	Total 1	of whom male	female	Beginning of 1986 Central Office	Land Central Banks	Total 1	of whom male	female
Civil servants	907	5,504	6,411	5,879	532	925	5,520	6,445	5,877	568
Other salaried staff	1,549	5,903	7,452	3,485	3,967	1,599	5,952	7,551	3,509	4,042
Wage earners	233	843	1,076	199	877	238	843	1,081	198	883
Total	2,689	12,250	14,939	9,563	5,376	2,762	12,315	15,077	9,584	5,493

1 Including 110 (1985: 102) salaried staff working outside the Bank or released to work for international institutions; 681 (1985: 662) trainees; 559 (1985: 501) part-time salaried staff and 750 (1985: 748) part-time wage earners.

Payments to serving members of the Directorate of the Bank and the Central Bank Council amounted to DM 7,416,258.24 in the year under review. Former members of these bodies and of the Board of Directors and Board of Managers of the Bank deutscher Länder and the Managing Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 8,140,693.87.

Changes in staff regulations

In 1985 the Bank again entered into a number of pay agreements, thereby bringing the legal status of its wage and salary earners — with due regard to the special conditions prevailing at the Bank — into line with the regulations applying to the wage and salary earners of the Federal Government.

Other

Other (non-staff) administrative expenditure increased by DM 24.7 million to DM 196.8 million during the year under review.

Note printing

Expenditure on note printing amounted to DM 174.6 million against DM 139.5 million in the previous year.

Depreciation and increases in provisions

Depreciation of land and buildings and of furniture and equipment was discussed in connection with the respective balance sheet items, as were increases in provisions.

Pension payments in respect of the Reichsbank

Payments to members of the former Deutsche Reichsbank and other persons to whom the Act concerning Article 131 of the Basic Law applies, for whom the Bank is required to provide in accordance with section 41 of the Bundesbank Act, at DM 24.1 million, continued to decline in the year under review.

Other expenditure

Other expenditure is shown at DM 36.7 million (1984: DM 35.1 million).

Unappropriated profit

		DM
The profit and loss account for 1985 shows a profit for the year of which is recorded in the balance sheet as unappropriated profit (net profit).		12,923,680,827.33

Proposed distribution of profit

	DM	
In accordance with section 27 of the Bundesbank Act, the Directorate proposes to the Central Bank Council that the following appropriations should be made:		
to the legal reserves	239,100,000.00	
to the Fund for the Purchase of Equalisation Claims	30,000,000.00	269,100,000.00
The balance of		12,654,580,827.33
will be transferred to the Federal Government.		

After these appropriations, the legal reserves will amount to DM 5,270,800,000.00; as in the previous year, they will then come up to the statutory ceiling of 5% of the amount of banknotes in circulation, which totalled DM 105,416,043,935.00 at the end of 1985. The other reserves reached the statutory ceiling of DM 290,000,000.00 at the end of 1980.

Frankfurt am Main, April 1986

Deutsche Bundesbank
The Directorate
Pöhl Prof. Dr. Schlesinger
Dr. Emde Dr. Gleske Prof. Dr. Köhler Werthmöller

Part D: Report of the Central Bank Council

The annual accounts of the Deutsche Bundesbank for 1985 and the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1985, have been audited by Treuarbeit Aktiengesellschaft Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft of Frankfurt am Main and Dr. Wollert — Dr. Elmendorff KG Wirtschaftsprüfungsgesellschaft of Düsseldorf, whom the Central Bank Council had appointed to be auditors in accordance with section 26 of the Bundesbank Act.

In their certificates of audit the auditors confirmed without qualifications that the annual accounts for 1985 and the bookkeeping as shown by the books at December 31, 1985, comply with German law and that the Fund for the Purchase of Equalisation Claims was properly administered.

The Central Bank Council approved the annual accounts for 1985 on April 10, 1986, and accepted the Directorate's proposal in respect of the profit distribution. At the same time it approved the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1985.

Since the publication of the Report for the Year 1984 the following changes have taken place in the Central Bank Council and the Directorate of the Deutsche Bundesbank:

Retired
as at the close of May 31, 1985
Professor Fritz Duppré
President of the Land Central Bank in Rhineland-Palatinate,

as at the close of September 30, 1985
Dr. Werner Tratzsch
Vice-President of the Land Central Bank in Berlin.

Reappointed
with effect from August 1, 1985
Helmut Holzmaier
member of the Managing Board of the Land Central Bank
in Baden-Württemberg,

with effect from February 1, 1986
Gerhard Jennemann
Vice-President of the Land Central Bank in the Free and
Hanseatic City of Hamburg,

with effect from March 1, 1986
Ottomar Werthmöller
member of the Directorate of the Deutsche Bundesbank,

Dr. Dieter Hiss
President of the Land Central Bank in Berlin,

Helmut Röthemeier
Vice-President of the Land Central Bank in North Rhine-Westphalia,

Edgar Krug
member of the Managing Board of the Land Central Bank in
North Rhine-Westphalia,

with effect from April 1, 1986
Dr. Walter Gulden
member of the Managing Board of the Land Central Bank in Bavaria.

Appointed
with effect from June 1, 1985
Johann Wilhelm Gaddum
President of the Land Central Bank in Rhineland-Palatinate,

with effect from October 1, 1985
Dietger Oberndorfer
Vice-President of the Land Central Bank in Berlin.

The Central Bank Council, acting also on behalf of the Directorate and the Managing Boards of the Land Central Banks, expresses its thanks to the entire personnel of the Deutsche Bundesbank — civil servants, other salaried staff and wage earners alike — for their loyal and understanding efforts during 1985. The Council likewise wishes to record its appreciation of the continued excellent collaboration with the staff representative committees.

Frankfurt am Main, April 1986

Karl Otto Pöhl
President of the Deutsche Bundesbank

Appendix to Part B

Balance sheet of the Deutsche Bundesbank as at December 31, 1985

 Assets

		DM	DM
1 Gold			13,687,518,821.70
2 Reserve position in the International Monetary Fund and special drawing rights			
2.1 Drawing rights within the reserve tranche		7,418,219,964.70	
2.2 Loans under special borrowing arrangements		1,955,062,523.22	
2.3 Special drawing rights		3,806,614,356.32	13,179,896,844.24
3 Claims on the European Monetary Cooperation Fund in connection with the European Monetary System			
3.1 ECU balances	39,822,313,075.55		
less Difference between the ECU value and the book value of the gold and dollar reserves contributed	22,636,810,854.95	17,185,502,220.60	
3.2 Other claims		—	17,185,502,220.60
4 Balances with foreign banks and money market investments abroad			39,477,523,317.91
5 Foreign notes and coins			24,263,656.34
6 External loans and other external assets			
6.1 Loans in connection with EEC medium-term monetary assistance		—	
6.2 Other loans to foreign monetary authorities		—	
6.3 Loans to the World Bank		2,448,960,750.—	2,448,960,750.—
7 Loans to domestic banks			
7.1 Domestic bills of exchange		44,082,283,367.26	
7.2 Securities bought in open market transactions under repurchase agreements		41,627,008,278.07	
7.3 Foreign bills of exchange		17,301,270,501.64	
7.4 Lombard loans		2,314,806,800.—	105,325,368,946.97
8 Cash advances			
8.1 Federal Government		—	
8.2 Equalisation of Burdens Fund		—	
8.3 Länder Governments		178,917,465.—	178,917,465.—
9 Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			8,683,585,988.93
10 Loans to the Federal Railways and Federal Post Office			
10.1 Cash advances		—	
10.2 Treasury bills and Treasury discount paper		—	—
11 Securities			4,134,644,224.81
12 German coins			983,785,048.16
13 Balances on postal giro accounts			201,816,781.11
14 Land and buildings			1,837,791,755.40
15 Furniture and equipment			153,583,303.—
16 Items in course of settlement			6,421,386,402.29
17 Other assets			2,934,727,093.23
18 Prepaid expenses and deferred income			37,202,549.12
Rights of recourse in respect of contingent liabilities		75,000.—	
			216,896,475,168.81

	DM	DM
1 Banknotes in circulation		105,416,043,935.—
2 Deposits of banks		
2.1 Deposits on giro accounts	55,809,583,899.89	
2.2 Other	14,466,711.35	55,824,050,611.24
3 Deposits of public authorities		
3.1 Federal Government	1,152,945,686.23	
3.2 Equalisation of Burdens Fund and ERP Special Fund	6,107,719.42	
3.3 Länder Governments	1,052,313,725.52	
3.4 Other public depositors	38,071,230.25	2,249,438,361.42
4 Deposits of other domestic depositors		
4.1 Federal Railways	8,428,493.12	
4.2 Federal Post Office (including postal giro and postal savings bank offices)	699,442,516.65	
4.3 Other depositors	859,600,287.44	1,567,471,297.21
5 Liabilities arising from mobilisation and liquidity paper sold		8,767,800,000.—
6 Liabilities arising from external transactions		
6.1 Deposits of foreign depositors	14,594,603,194.57	
6.2 Other	25,790,168.26	14,620,393,362.83
7 Counterpart of special drawing rights allocated		3,273,338,090.40
8 Provisions		
8.1 Provisions for pensions	2,011,000,000.—	
8.2 Provisions for other purposes	3,781,200,000.—	5,792,200,000.—
9 Other liabilities		411,240,642.50
10 Deferred expenses and accrued income		439,118,040.88
11 Capital		290,000,000.—
12 Reserves		
12.1 Legal reserves	5,031,700,000.—	
12.2 Other reserves	290,000,000.—	5,321,700,000.—
13 Unappropriated profit		12,923,680,827.33
Contingent liabilities	75,000.—	
		216,896,475,168.81

Profit and loss account of the Deutsche Bundesbank for the year 1985

Expenditure

	DM	DM
1 Administrative expenditure		
1.1 Staff costs	746,574,412.26	
1.2 Other	196,819,607.30	943,394,019.56
2 Note printing		174,627,323.82
3 Depreciation		
3.1 of land and buildings	90,096,868.75	
3.2 of furniture and equipment	64,827,990.48	154,924,859.23
4 Increase in provisions		
4.1 for pensions	80,218,117.80	
4.2 for other purposes	—	80,218,117.80
5 Pension payments in respect of the Reichsbank		24,125,346.26
6 Other expenditure		36,634,349.24
7 Profit for the year (= unappropriated profit)		12,923,680,827.33
		14,337,604,843.24

Receipts

	DM
1 Interest	13,893,289,501.99
2 Fees	18,750,323.69
3 Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	279,532,695.05
4 Other receipts	146,032,322.51
	14,337,604,843.24

Frankfurt am Main, February 12, 1986

Deutsche Bundesbank
The Directorate
Pöhl Prof. Dr. Schlesinger
Dr. Emde Dr. Gleske Prof. Dr. Köhler Werthmöller

According to the audit which we have carried out in accordance with our mandate, the bookkeeping and annual accounts comply with German law and the Bank's by-laws.

Frankfurt am Main, March 7, 1986

Treuarbeit Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

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Goldbach, Certified Auditor

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