Deutsche Bundesbank Annual Report 1993

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on April 1, 1994

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Note

The current monetary policy regulations are no longer included in the Annual Report, and are published separately: Deutsche Bundesbank, Monetary policy regulations, Frankfurt am Main, April 1994.
The Principles Concerning the Capital and Liquidity of Banks, which are likewise no longer included in the Annual Report, will be published shortly in:
Deutsche Bundesbank, Banking Act of the Federal Republic of Germany, Frankfurt am Main, 1994.
These publications are available to interested parties free of charge.

Abbreviations and symbols

e	Estimated
p	Provisional
pe	Partly estimated
r	Revised
...	Figure available at a later date
.	Figure unknown, not to be published or not meaningful
0	Less than 0.5 but more than nil
–	Nil

Discrepancies in the totals are due to rounding.

Foreword
by the President
of the Deutsche Bundesbank

Foreword

Altogether, the German economy had an uphill road to travel in 1993. In western Germany the downturn in business activity had a profound impact on output and employment; in eastern Germany the manifold adjustment problems were reflected in a persistently wide gap between domestic demand and domestic production, which had to be filled by sustained massive transfer payments from the west. But there are some encouraging indications as well. For instance, economic activity in the west has now stabilised, albeit at a low level, and there appear to be signs of a recovery in some sectors. In the east, notwithstanding the dimensions of the tasks still to be performed, significant headway in the catching-up process has been made in particular areas. However, all this cannot disguise the fact that structural aberrations have accumulated in the west and the east alike, especially in the past few years. Such distortions can be overcome only by efforts extending over several years. Those responsible for economic policy remain faced with a twofold challenge, namely, to help resolve the current difficulties and to set the stage for the future in such a way that domestic stability is safeguarded over the long term, and that both the international competitiveness of the German economy and employment prospects in Germany can be durably improved. This applies above all to wage-rate policy, to social policy and to fiscal policy at all levels. Besides cost containment, the German economy needs, in particular, a higher degree of flexibility, and the further dismantling of undue government and other regulations can contribute materially to that. The wage settlements negotiated at the beginning of this year, all involving moderate rates of pay rises and significant indications of an increase in the corporate room for manoeuvre, constitute an encouraging sign of the adaptability of the German economy to a nationally and globally changed environment.

Last year monetary policy was directed towards further curbing inflation, and at the same time creating the underlying monetary conditions for overcoming the recessionary trends. The tensions this inevitably involves between anti-inflation policy and business cycle policy do not present an insoluble dilemma for monetary policy as long as that policy remains geared to the medium term. In this context, the Bundesbank carefully sounded out the scope available to it and lowered central bank interest rates by gradual degrees. Just how difficult this balancing act was is shown by the overshooting of the monetary target, and not least also by the various changes in sentiment in the capital and foreign exchange markets.

Considered as a whole, however, the Bundesbank can feel satisfied with the outcome of its policies. In the course of last year the inflation rate declined perceptibly, the long-term interest rate reached its lowest level of the past six years, and national and international confidence in the Deutsche Mark was maintained. Monetary policy was not and is not impeding the economic recovery process. Quite the contrary, in fact; upon the moderation of the persistent price increases, and given the consequent favourable developments in the financial and foreign exchange markets, the conditions for appropriate and lasting economic growth have substantially improved, even if the excessive monetary expansion (due mainly to special factors) continues to call for careful attention.

A monetary policy geared to the short term that lowered central bank interest rates aggressively, and regardless of rekindling inflation expectations, would hardly have yielded these successes. A cautious approach, intent on steadying expectations, was ultimately in the interests of the other European countries, too. Precisely in the light of entry into the second stage of the European economic and monetary union in 1994, and of the establishment of the European Monetary Institute (based in Frankfurt am Main), it was unacceptable for any doubts to arise as to German monetary policy makers' commitment to price stability. It was imperative to keep the anchor role of the Deutsche Mark in the European Monetary System intact, against the backdrop of the wider fluctuation margins in the EMS exchange rate mechanism since last August and of the associated greater individual responsibility of the participating countries.

At the same time, monetary stability in Germany and in its west European partner countries is an indispensable mainstay of global economic cooperation. The lessons of the past few years have served to show how laborious and time-consuming it can be to alleviate the burden of inflationary exaggerations and distortions accumulated in the past. The major economic challenges presented by the current decade (such as the further integration of central and eastern Europe – and of a large number of developing countries – in world markets, and the utilisation of the scope for growth that has opened up as a result of reaching the GATT accord) will be all the easier to cope with, the more capable the major industrial nations are of keeping their own house in order.

In its operations, the Bundesbank has always taken due account of the close correlation between national and international factors. This is reflected in the present Annual Report for 1993, which addresses itself to major issues of

German monetary policy, as well as to European and global economic developments. At the same time, the Bank publishes in this Report its annual accounts for 1993, which were approved by the Central Bank Council on April 14, 1994, after having been audited by two firms of external auditors. Just as in previous years, the Bundesbank had numerous technical tasks to perform in the context of its monetary policy functions – with respect to the provision of currency, the settlement of payments, the issuance of Federal securities, foreign exchange dealing, and in the fields of currency legislation and national and international banking supervision. Acting also on behalf of the Central Bank Council, I should like to thank all the staff members of the Bank for the sterling efforts they made in 1993 and for the commitment with which they discharged their exacting duties. I also wish to thank the staff representative bodies for their cooperation in a spirit of mutual trust.

Frankfurt am Main, April 1994

Dr Hans Tietmeyer
President of the Deutsche Bundesbank

The currency and the economy

I. International economic fundamentals

Global economic activity has bottomed out

After three years of weakness now, global economic activity seems to have bottomed out in 1993. Significant growth processes have taken hold in a number of countries. To that extent, last year saw a brightening of the international environment in which the German economy operates. On the other hand, there has not been any broadly-based upward trend as yet. In 1993 as a whole, the weakness of global business activity left a clear mark in most industrial nations. On average, the real gross domestic product in the western industrial countries rose by only just under $1\frac{1}{2}$ %, while the number of employed declined further. World trade expanded only moderately, at $2\frac{1}{2}$ %. The misalignments and excesses of earlier years had obviously weakened the growth forces to such an extent that the world-wide process of recovery gained hold only hesitantly, with the level of economic activity differing markedly from country to country.

Turn-around in the Anglo-Saxon countries

The Anglo-Saxon countries, in particular, where recessionary tendencies had set in earlier and more sharply than in other countries, are now setting the pace in the recovery as well. Although these countries had long been incapable, despite attempts actively to stimulate business activity, of overcoming the weakness of economic growth, because structural problems (not least the excessive indebtedness of both households and enterprises) had curbed the propensity to spend, economic activity in North America, in particular, has meanwhile gained considerable momentum again, after these tensions had largely been eliminated. In 1993 the real domestic product in the United States expanded at a rate of 3.0 %, while that in Canada grew by 2.4 %, and thus followed in the footsteps of that upward movement. In Australia, too, business activity has returned to a sounder footing. The United Kingdom has seen the emergence of a significant recovery of economic activity, after key weaknesses in the fiscal area had been overcome – much the same as in the aforementioned countries – and private domestic demand was able to provide the upward movement with the support it required. Last year world trade was once again stimulated particularly strongly by persistently dynamic growth in the newly industrialising countries in eastern Asia and in China. Economic developments in a number of Latin American countries likewise contributed to the stabilisation of global business activity.

Stabilisation of output in continental Europe in the course of 1993

The favourable cyclical trends in the Anglo-Saxon economies and the strong expansion in other growth regions were to the benefit of the countries in continental Europe. In the course of 1993 this led to first signs of an improvement

Key macroeconomic variables in selected industrial countries

Table 1

Country	Real gross domestic product		Consumer prices[1]		Financial balance of the public sector[2]		Balance on current account[3]	
	1992	1993 p	1992	1993 p	1992	1993 p	1992	1993 p
	Change from previous year in %				as % of GDP		US$ billion	
Industrial countries	+ 1.6	+ 1.3	+ 3.0	+ 2.6	– 4.0	– 4.5	– 36.5	+ 3.0
of which								
European Community	+ 1.1	– 0.2	+ 4.2	+ 3.4	– 5.0	– 6.4	– 61.0	– 7.0
of which								
France	+ 1.4	– 0.7	+ 2.4	+ 2.1	– 3.9	– 5.9	+ 3.7	+ 10.5
Germany[4]	+ 2.1	– 1.2	+ 4.0	+ 4.2	– 2.6	– 3.3	– 22.1	– 21.2
Italy	+ 0.9	– 0.7	+ 5.1	+ 4.5	– 9.5	– 10.0	– 26.8	+ 3.0
United Kingdom	– 0.6	+ 2.1	+ 3.7	+ 1.6	– 5.9	– 7.6	– 15.1	– 12.6
United States	+ 2.6	+ 3.0	+ 3.0	+ 3.0	– 4.5	– 3.8	– 66.5	– 109.1
Japan	+ 1.1	+ 0.1	+ 1.6	+ 1.3	+ 1.5	– 0.4	+ 117.6	+ 131.3
Canada	+ 0.7	+ 2.4	+ 1.5	+ 1.8	– 6.6	– 6.8	– 23.0	– 19.5

Sources: EC Commission, IMF and national statistics. — **1** Cost-of-living index. — **2** As defined in the national accounts. — **3** On account of recording deficiencies, the current account deficit of the group of industrial countries is overstated statistically. — **4** Germany as a whole; the growth of west German real GDP amounted to + 1.6% in 1992 and to – 1,9% in 1993. Consumer prices for western Germany only.

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in that region as well. All in all, however, retarding influences continued to predominate, and the losses in output recorded on an annual average were marked in some cases. The major continental European countries all had to accept a downturn in their gross domestic product in 1993. Even among the smaller economies there, only a few were able under their own steam to avoid that general trend. A number of south European and Scandinavian countries gained some relief from the depreciation of their currencies.

Japan in the midst of a difficult adjustment process

Japan, which is being confronted with considerable structural problems, recorded a sharp drop in its gross domestic product in the course of last year. On average in 1993, Japan registered zero growth for the first time in two decades. As was the case even earlier in the Anglo-Saxon and most of the Scandinavian countries, past liquidity excesses, which were initially tolerated with a view to their short-term stimulating effects, are now likewise proving to be a persistent curb on growth in Japan. Industrial enterprises' propensity to invest, in particular, suffered from the need for price adjustments in the share and real estate markets. In addition, the sustained appreciation of the yen led to a weakening of the Japanese export industry's competitiveness in the international markets. Private consumers have responded with restraint to the unfavourable income prospects. Finally, these developments are being exacerbated by more cautious lending behaviour by banks, which have come under pressure to adjust as a result of both significant bad debts and the need to write down their securities and real estate assets. The Japanese government is attempting to counter the associated dampening effects with massive fiscal policy stimulating measures.

Fiscal policy in great need of corrective action

In most countries, however, fiscal policy makers have long exhausted whatever scope they had for supporting demand in the traditional sense. Yet, in many cases consideration of the sustained trends towards cyclical weakness led to a renewed acceptance of higher public deficits. The public sector deficits in all major countries, except the United States, consequently rose further in 1993 as well. At 4.5 % of the average gross domestic product of the western industrial countries, and at 6.4 % of that of the European Community alone, the deficit ratios have meanwhile taken on alarming proportions. At the same time, public debt climbed to new record levels. As the burden of debt rises, however, the "automatic stabilising effects" of credit-financed expenditure growth, or of cyclically-induced revenue shortfalls, are increasingly opposed by the danger of a loss of confidence, and thus by growth-retarding influences, which can be overcome in the long run solely through credible consolidation efforts and serious spending discipline. What is essential in that context is also to restructure the public budgets so as to make them more conducive to growth. Nor may the budgets of social security funds, which have surged in many countries, be excluded from such endeavours. The sizeable task of fiscal policy consolidation confronting almost all industrial countries will no doubt take several years to resolve, but it should not be delayed on grounds of its alleged contractionary effects on demand. A return – as early as possible and in a manner oriented convincingly to the medium term – to sound government finances, which would restore the freedom of action which private investors and savers had lost earlier, should actually mobilise repressed growth forces and open up new perspectives.

Monetary policy against the background of declining inflationary tensions

Although the generally unsatisfactory utilisation of production capacities and the decline in inflationary tensions on a broad front facilitated a more expansionary monetary policy stance, and thus led to an easing of interest rate levels throughout the world, it was essential to keep a sense of proportion and to avoid an excessive liquidisation of the economy so as to prevent the anti-inflation policy successes achieved from being put at risk. At any rate, it proved possible in 1993 to reduce the average rate of inflation in the western industrial countries to 2.6 %. A number of countries thus came close to attaining the goal of price stability last year. Even economies with traditionally higher inflation rates made remarkable progress in combating this phenomenon. However, the downturn in the rates of price increases must be seen against the background of the lengthy recession, so that monetary policy makers will have to remain on their guard in future as well. The US central bank initiated a course correction in the first few months of this year. What is essential on the part of the monetary policy authorities of a number of European countries, not least with a view to further progress in the process of monetary integration, is to ensure that there is no doubt that the degree of stability achieved has become the standard for the future.

Further exchange rate tension in the EMS

Just how difficult it is to make up for a loss of confidence once it has occurred was indicated by the repeated tension in the European exchange markets, which imposed heavy burdens on the European Monetary System (EMS) up to the summer of last year. Despite extensive interventions by the central banks involved and despite several realignments in the wake of the crisis of autumn and winter 1992, the markets ultimately called the agreed parities in question time and again. Against the background of, in particular, the sustained recession, many EMS partner countries came under pressure to cut their interest rates, and in spring 1993 a number of central banks initiated accelerated interest rate reductions to give their domestic monetary policies a more expansionary stance. In summer 1993 this led to renewed severe tension which only faded away after the margins of fluctuation in the exchange rate mechanism were widened to ± 15 %. However, only very cautious use was made by partner countries of the resulting latitude for greater monetary policy differentiation. They thus underlined their determination to retain the longer-term orientation of their anti-inflation policy stance even under these altered conditions. After a relatively brief period of uncertainty, the consistency of these priorities in the winter months of 1993-4 resulted in a return by all currencies participating in the exchange rate mechanism to the margins applicable earlier; wherever temporary over and undershooting took place, it remained limited, all in all (see also page 55). The markets thus furnished impressive proof of the correctness both of the exchange rate pattern achieved in the meantime and of convergence-oriented monetary policies of the central banks participating in the EMS.

Divergent trends in the floating currencies

The sharper divergence of the trends in business activity led to shifts in the Deutsche Mark's exchange rate vis-à-vis the US dollar in 1993. After the financial markets' initial uncertainty regarding the sustainability of the process of recovery in the United States had been overcome, with new confidence in the progress of the United States' cyclical upswing taking its place, Deutsche Mark assets lost some of their interest rate lead over dollar assets, so that the dollar became stronger. On balance, the Deutsche Mark depreciated by $6^1/_2$ % against the dollar over the year. Apart from short-lived disruptions, the trend in the exchange rate developed along orderly lines. Noticeably sharper changes, by contrast, were recorded in the Deutsche Mark's exchange rate vis-à-vis the yen. Persistent Japanese foreign trade surpluses tended to make the yen extremely strong world-wide, so that the value of the Deutsche Mark against the yen declined by just over 16 % in the course of the year. The Swiss franc, which once again proved to be a particularly stable investment currency, likewise appreciated perceptibly. On the other hand, currencies suffering from heavy cyclical and structural burdens, such as the Iberian currencies, the Italian lira and the Swedish krona, had to accept significant declines in value. All in all, however, the various trends in the exchange rates of individual currencies and currency groups vis-à-vis the Deutsche Mark largely offset one another, so that its weighted external value vis-à-vis the currencies of 18 industrial countries changed only little, at a drop of $1^1/_2$ % in the course of 1993.

GATT negotiations brought to a successful conclusion

The regulatory policy signals set at a global level will remain effective over and beyond last year. An outstanding event in this context was the ultimate conclusion, at the end of 1993, of the GATT negotiations as a key step towards a further liberalisation of world trade. Viewed over the short term, this averted an inestimable loss of confidence in the global economy, as would have been inevitable as a result of a failure of the negotiations which had already run for more than seven years. In the medium term, the agreed dismantling of trade barriers in the industrial sector, in the textiles and agricultural sectors as well as – for the first time – in the exchange of services will provide welcome stimuli to growth. Of significance are also the regulations on the protection of intellectual property rights and the progress made in the code on anti-dumping and subsidies. The agreements reached can be viewed as a clear sign of better international cooperation.

Persistent risks to free world trade

The picture presented by the global economy is nevertheless still far removed from the ideal of truly free trade in many areas, and the danger of protectionist setbacks has certainly not been eliminated. Some sectors, for instance, were set aside in the liberalisation agreements, and in some cases there are rather long transitional periods before the measures adopted take full effect. The recently increasing trend towards "strategic trade policies" is a cause for grave concern.

Moreover, the persistent divergencies in the international current account pattern added fuel to the potential for regional conflicts last year. The deficit on current account in the United States, for instance, climbed to almost US$ 110 billion in 1993, while the Japanese surplus rose to just over US$ 130 billion. It is against this background that the trade policy tension between the two regions has intensified, especially just recently. But Europe, too, is revealing tendencies to erect barriers against other regions. Within the European Union (EU), for instance, the conclusion of the GATT negotiations was accompanied by a relaxation of requirements in respect of the majority vote necessary to impose anti-dumping and compensatory tariffs (the previously needed "qualified" majority was changed into a "simple" majority). Although this decision allowed the noticeably more far-reaching demands of both the EC Commission and other member states to be avoided, the risk remains that it may have reduced the inhibitions against a revival of attempts to resolve global economic conflicts through protectionist measures. In future it will therefore be even more essential than before to ensure that the progress made in the liberalisation of trade is not adversely affected, or even reversed, by generous exemptions or the use of trade policy instruments.

Structural reforms at home foster an open world trading system

Past experience has shown that the world's free trading system is placed at risk whenever major trading nations attempt to resolve domestic structural problems with the aid of protectionist measures. Coping with the need for adjustment at home is therefore not only of paramount importance for the functioning of the respective domestic markets but also a key prerequisite for a frictionless exchange of goods between countries, for stable financial markets and for efficient exchange markets. Sustainable international cooperation cannot therefore be based solely on common sets of rules and endeavours to coordinate overall economic developments. It is also crucially dependent on the elimination of structural deficits and supply-side inefficiencies within the economies involved. In the long run, the best guarantee of fruitful cooperation at the international level is to be found in economies which are efficient and capable of adjustment at home. The fact that stability and growth begin "at home", and that structural shortcomings at the national level impose a burden on the world economy as a whole, has been confirmed anew in the last few years.

Disillusioning performance of the reforming countries

A special challenge confronting the world economy is still the process of reconstruction in the reforming states of central and eastern Europe. In many cases the move towards an economic system organised along free market lines has proved to be more protracted and difficult than had been assumed in the euphoria prevailing at the outset. Half-heartedly initiated reforms were not only unsuccessful, but have – in the essence – occasionally even discredited the reform process as such and given a fresh impetus to forces obstructing any change. In view of serious macroeconomic misalignments and sustained losses in output, most of the successor states to the former Soviet Union seem to be suffering from severe disillusionment which has made them blind as to the actual underlying causes and has undermined the vigour of the forces behind the reforms. So far, only a few countries in central and eastern Europe have been able to achieve a decisive breakthrough; this has been possible only in those countries that initiated the required reforms early and consistently. Poland, in particular, saw a strengthening of the upswing in the course of the year, while both the Czech Republic and Hungary recorded a distinct slowdown in the initially very high production losses. The Baltic states, too, can look back on some successes. All these countries are now beginning to reap the fruits of several years of determined efforts to stabilise and reform their economies. The initiation of far-reaching steps to restructure their economies has now enabled them to gain a foothold in the world markets with their products. The western industrial countries, in particular, are called upon to support this historically significant process by opening up their markets.

II. Economic trends in Germany and central bank policy

1. Recession in the west, tendencies towards an improvement in the east

Unfavourable record of the German economy in 1993

In 1993 the overall record of the German economy was not favourable: the real gross domestic product declined, unemployment increased, and average inflation was high last year. However, this all-German record conceals substantial differences between the old and the new Länder. Around the turn of 1992-3 the west German economy slipped into a severe recession. While rock bottom was reached in the course of last year, a far-reaching recovery has not yet come about, despite some noteworthy positive signals. In eastern Germany the growth process that had started a year earlier strengthened in 1993. In addition, it was supported more than before by endogenous driving forces and has meanwhile spread to the most important areas of the economy in the new Länder.

(a) Western Germany

Sharp decline in the real gross domestic product

In the old Länder the real gross domestic product dropped by 2 % last year, and thus more sharply than in any year in the history of the Federal Republic of Germany. Nevertheless, it is not appropriate to view the recession as the severest of the post-war period. For, although utilisation of the overall production potential was distinctly down on the exceptionally high level reached in 1991, it remained higher than in the last recession year 1982.

Weakness of foreign demand

One of the main causes of the most recent recession is no doubt to be found in the weakness of foreign demand which set in as early as 1990 and which gradually intensified until 1993. On average in 1993, the foreign orders received by the west German manufacturing sector declined by a further 3 %; in terms of volume, they thus remained 14 % below their high in 1989. For quite some time after the beginning of the unification process, the slowdown in exports was initially masked by the exceptionally strong demand stimuli from eastern Germany, which were largely financed by high west German transfers and which triggered a boom in the old Länder. The primary reason for the fall in export demand were recessionary tendencies throughout the world. Temporarily, however, there was a connection between the weakness in foreign business and the stimuli to demand from the new Länder insofar as west German manufacturing enterprises initially focused on the new east German market, the medium-term sales prospects of which they may have overrated, so that they neglected their export opportunities to some

Key economic variables in western Germany

Table 2

Item	Unit	1992	1993	1992	1993
				Change from previous year in %	
Aggregate demand (real)					
Private consumption	DM billion	1,452.1	1,451.5	+ 1.7	- 0.0
Fixed capital formation	DM billion	571.4	531.9	+ 1.1	- 6.9
Machinery and equipment	DM billion	252.6	214.6	- 3.9	- 15.0
Construction	DM billion	318.8	317.4	+ 5.5	- 0.5
Domestic expenditure	DM billion	2,503.0	2,437.7	+ 1.5	- 2.6
Foreign balance [1]	DM billion	+ 177.5	+ 177.7	.	.
Exports	DM billion	1,054.1	1,001.7	+ 3.8	- 5.0
Imports	DM billion	876.5	823.9	+ 5.9	- 6.0
Gross national product at 1991 prices	DM billion	2,680.5	2,615.4	+ 1.0	- 2.4
Memorandum items					
Orders received (volume)					
by the manufacturing sector	1985=100	117.8	108.9	- 3.5	- 7.6
by the construction sector	1985=100	138.9	138.0	+ 1.2	- 0.6
Distribution of income					
Wage and salary income	DM billion	1,508.4	1,527.8	+ 6.0	+ 1.3
do. as a percentage of national income	%	71.1	72.5	.	.
Gross income of producing enterprises	DM billion	449.3	438.9	- 1.7	- 2.3
do. as a percentage of national income	%	21.2	20.8	.	.
National income	DM billion	2,122.3	2,108.0	+ 4.6	- 0.7
Output					
in the producing sector (excluding construction sector) [2]	1985=100	118.3	109.7	- 1.9	- 7.3
in the construction sector [2]	1985=100	135.7	132.4	+ 6.2	- 2.4
Gross domestic product at 1991 prices	DM billion	2,676.0	2,626.0	+ 1.6	- 1.9
Employment					
Employed in western Germany	Millions	29.5	29.0	+ 0.9	- 1.6
Unemployed	Thousands	1,808.3	2,270.3	+ 7.0	+ 25.6
do. as a percentage of the total labour force	%	5.9	7.3	.	.
Prices and wages					
Cost-of-living index	1985=100	115.1	119.9	+ 4.0	+ 4.2
Overall construction price level	1985=100	130.5	135.6	+ 5.3	+ 3.9
Index of import prices	1985=100	80.1	78.5	- 3.3	- 2.0
Gross income per employee (in western Germany)	DM	57,600	59,500	+ 5.4	+ 3.2
Unit labour costs in the economy as a whole [3]	DM	0.63	0.66	.	.
do. on the 1991 price basis	1991=100	104.7	108.3	+ 4.7	+ 3.5
Productivity [4]	1991=100	100.7	100.4	+ 0.7	- 0.3
do. in absolute figures [5]	DM	90,800	90,500	.	.
Overall negotiated wage and salary level (on an hourly basis)	1985=100	138.6	144.4	+ 6.0	+ 4.2

1 Balance of transactions in goods and services with the rest of the world; in contrast to the balance of payments statistics, deliveries to and supplies from eastern Germany (including direct purchases by households in western or eastern Germany) are included in exports or imports. — **2** Results for kinds of activity units, adjusted for working-day variations. — **3** Index of gross wage and salary income per employee generated in western Germany divided by index of GDP per employed person calculated at 1991 prices. — **4** GDP per employed person at 1991 prices. — **5** Relative to GDP at 1991 prices. — The data from the national accounts and the figures on employed persons are provisional.

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extent. This, inter alia, resulted in the emergence of some structural distortions in the allocation of resources and in the range of products on offer in western Germany.

Sharp pay increases

Apart from this external factor, home-grown causes were decisive for the recession. In the first place, the sharp pay increases must be mentioned which were agreed in 1991 under the impact of the then prevailing boom conditions and which persisted in the 1992 pay round, despite the distinct cyclical slowdown. The public authorities imposed further burdens on enterprises, among other things, in the form of higher social security contributions. In view of the world-wide economic weakness, which not only limited the sales opportunities of German exporters in foreign markets, but also led to surging imports which fuelled competition in the domestic markets, manufacturing enterprises, in particular, succeeded less and less in passing on the rising labour costs in their sales prices. The resulting pressure on profit margins caused profit expectations to deteriorate visibly, not least in view of the sustained slack in exports. This increasingly impaired the propensity to invest; the slowdown spread to other parts of domestic demand, and thus led to growth and employment losses.

Decline in corporate investment

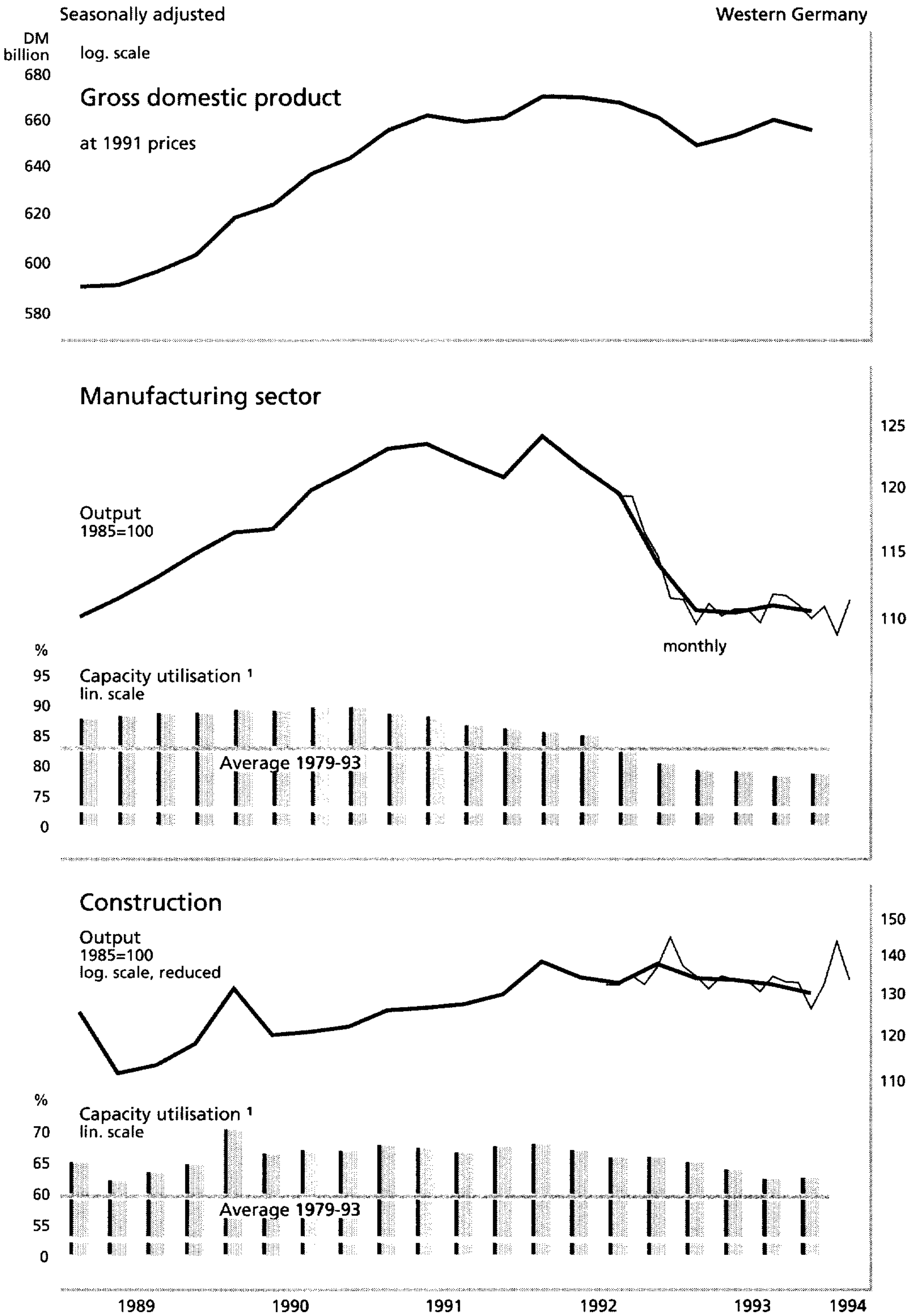
The profits of west German producing enterprises generally contracted further in 1993, although the trends differed distinctly from sector to sector. Not least under the impact of declining yields and correspondingly less favourable expectations, producing enterprises reduced their gross fixed capital formation by 12 % in value and 13 % in volume, compared with 1992. Just as the downturn in export business, the sharp decline, which was even more pronounced in the case of investment in machinery and equipment than in that of industrial buildings, hit primarily the manufacturing sector, which thus became the centre of cyclical weakness in the west German economy. This can be seen, inter alia, from the fact that industrial enterprises cut their output once more last year, namely by 7 1/2 %, and thus far more sharply than in the previous year.

Further increase in investment in housing construction

Unlike the situation in previous recessionary phases, construction activity in 1993 was relatively buoyant; it was supported by the sustained expansion in demand for housing construction. Especially as a result of the unusually high number of immigrants, bottlenecks had emerged in the west German housing market in the past few years, which were reflected in sharp increases in rents – with corresponding implications for the profitability of both new dwellings and the existing stock of housing. But the supply of dwellings rose steeply as well. At 430,000, the number of completed dwellings exceeded the 1992 figure by

Output

Chart 1



1 Results of the ifo business survey.

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15 1/2 %. The associated comparatively strong growth in the stock of housing units is in clear contrast to the decline in output in industrial and public construction. All in all, construction investment last year went up by 3 % in nominal terms, and nearly regained the high 1992 level in real terms.

Households' income and consumption

The recession affected households' income, consumption and saving. Above all, the sharp reduction in employment and the associated income losses resulted in total wages and salaries rising by only 1 %, both in gross and in net terms. Owing to a growing number of recipients of government transfers, with which some of the income losses caused by the recession are offset, the public authorities' transfer payments went up considerably (by 6 1/2 %). Nevertheless, households' disposable income, the calculation of which has been subject to major uncertainties for some time now, increased comparatively little, at 2 1/2 %; in view of the persistently high rates of price increases, this, taken as a whole, actually meant a substantial decline in real income. Private consumption grew by a nominal 3 1/2 % in 1993, and thus more strongly than disposable income, but it stagnated in real terms. In spite of the tight income scope, expenditure on holiday travel abroad continued to rise steeply. On the other hand, demand for motor vehicles, in particular, was much smaller in 1993 than in 1991 and 1992. In the two preceding years the total number of newly registered cars, which reflected predominantly private car purchases and to a lesser extent industrial investment, reached record figures in western Germany. Last year almost one-fifth fewer new passenger cars were registered in the old Länder than in 1992. However, owing to further considerable price increases, households' spending on car purchases did not decline quite as sharply.

Private saving

The expansion of consumption expenditure was steeper than nominal income growth, and was thus at the expense of saving. At 13 1/2 % in 1993, households' saving ratio, as defined in the national accounts, decreased by 1/2 percentage point against the year before. It is possible, however, that the actual amount of saving and the saving ratio are understated; much the same might apply to households' disposable income. On the one hand, an ever-greater part of the income from private investment abroad cannot be recorded in the balance of payments statistics. On the other hand, the not inconsiderable shifts of private assets to countries abroad, as seem to have been triggered, inter alia, by the flat-rate tax on residents' interest income, reduce households' income and saving in the national accounts.

Private investment

Accordingly, the volume and structure of private financial asset acquisition are subject to major uncertainties. Investment operations were characterised, above all, by factors related to the introduction of the flat-rate tax on interest income. This was reflected, inter alia, in a sharp inflation of private liquid assets; taken together, households' cash holdings presumably grew by more than DM 140 billion in 1993, and thus accounted for more than half of total private financial asset acquisition. In addition, savers preferred investment with which they could circumvent or largely avoid the flat-rate tax on interest income. In this context, purchases of units of share-based funds and real estate funds stood in the foreground. Interest in acquiring foreign investment fund units, by contrast, declined in the course of 1993, and, as from autumn, returns of such units actually predominated in connection with the taxation of income from foreign growth funds realised in Germany, which was introduced at the beginning of 1994. On balance, private direct investment in the securities markets (as far as it can be recorded) decreased significantly again.

Sharp fall in employment

The situation in the labour market deteriorated perceptibly in the recession year 1993. Employment decreased considerably, and unemployment rose to a high level. On average last year, 29.0 million persons were employed in western Germany – 475,000, or 1 ½ %, fewer than in 1992. The manufacturing sector, where the reduction in staff levels had started as early as the spring of 1991, was hit particularly hard. By January this year the number of persons employed in that sector had fallen by over 1 million, or 14 %. Towards the end of 1993 employment was reduced, on balance, in the other sectors of the west German economy as well. This trend presumably persisted in the first few months of 1994.

Considerable increase in unemployment

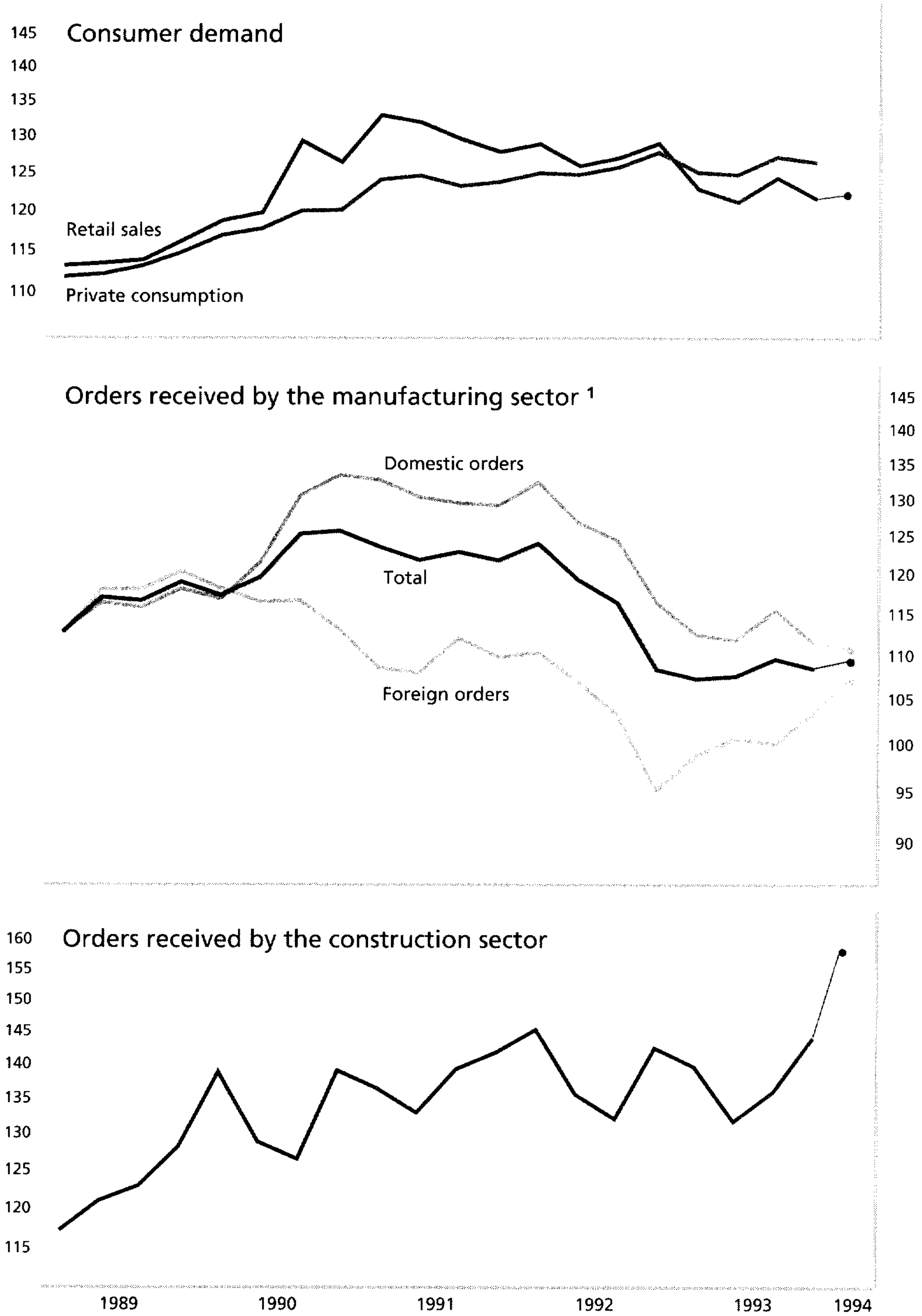
On average in 1993, 2.27 million persons were unemployed in western Germany; compared with 1992, this was a rise of 460,000. The unemployment rate thus reached a level of 7.3 %. The fact that the reduction in employment was focused on the manufacturing sector is reflected in the particularly strong increase in male unemployment as men hold a disproportionately large number of jobs in this sector. All in all, the number of unemployed in 1993 rose by one-quarter against the preceding year, while that of men increased by 30 % and that of women by 20 %. In the course of last year apparently many persons who had previously had to accept short-time working were dismissed. By the spring of 1993, the number of short-time workers had risen considerably to 1.06 million; subsequently, it declined to 555,000 until the end of the year, and was thus lower than a year earlier. Unemployment continued to increase after the turn of 1993-4. At the

Trends in demand

Chart 2

Volume, 1985=100, seasonally adjusted, log. scale

Western Germany



1 Excluding food, drink and tobacco industry. — • = Latest position: January-February 1994; in the construction industry January 1994

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end of March 2.57 million persons were affected, seasonally adjusted; this corresponded to 8.3 % of the total labour force. Past experience has shown that the reduction in employment and the increase in unemployment persist for some time after the start of an upswing. In contrast to the situation in the years before, the total labour force, i. e. employed and unemployed taken together, did not increase any further in 1993. Immigration declined perceptibly. In part, however, it is likely that some persons have left the work-force, at least temporarily.

Lower wage and salary rises in the 1993 pay round

Not least under the impact of the worsening labour market situation, pay agreements were reached in the 1993 wage round, which – at 3 1/2 % on a monthly basis and 4 % on an hourly basis – were considerably lower than in the two preceding pay rounds (which had provided for average increases of 6 % and 6 1/2 %, respectively). Actual earnings rose much less than negotiated wages and salaries last year – namely by not quite 3 % per employee. The fact that the hikes in pay rates deviated even more sharply than before from the rises in actual earnings is due, on the one hand, to the increase, against 1992, in average short-time working and to the further reduction in overtime; on the other hand, it owed something to the fact that actual earnings were in some cases raised only by the rate of increase in the mostly substantially lower negotiated wages and salaries and that voluntary company payments were reduced. In 1991 and 1992 labour costs per unit of the real gross domestic product had risen by a total of 9 %, i. e. by an average of 4 1/2 % per year. Last year the rise was distinctly lower, at 3 1/2 %, but still comparatively high. This was due also to the fact that, as a result of the recession-induced decline in output, which owed much to the wage policies pursued in the previous years, productivity per employed person decreased slightly. The moderate pay agreements in this year's wage round open up prospects for higher corporate profit margins, and thus for more profitable production.

Sharp upward movement of consumer prices

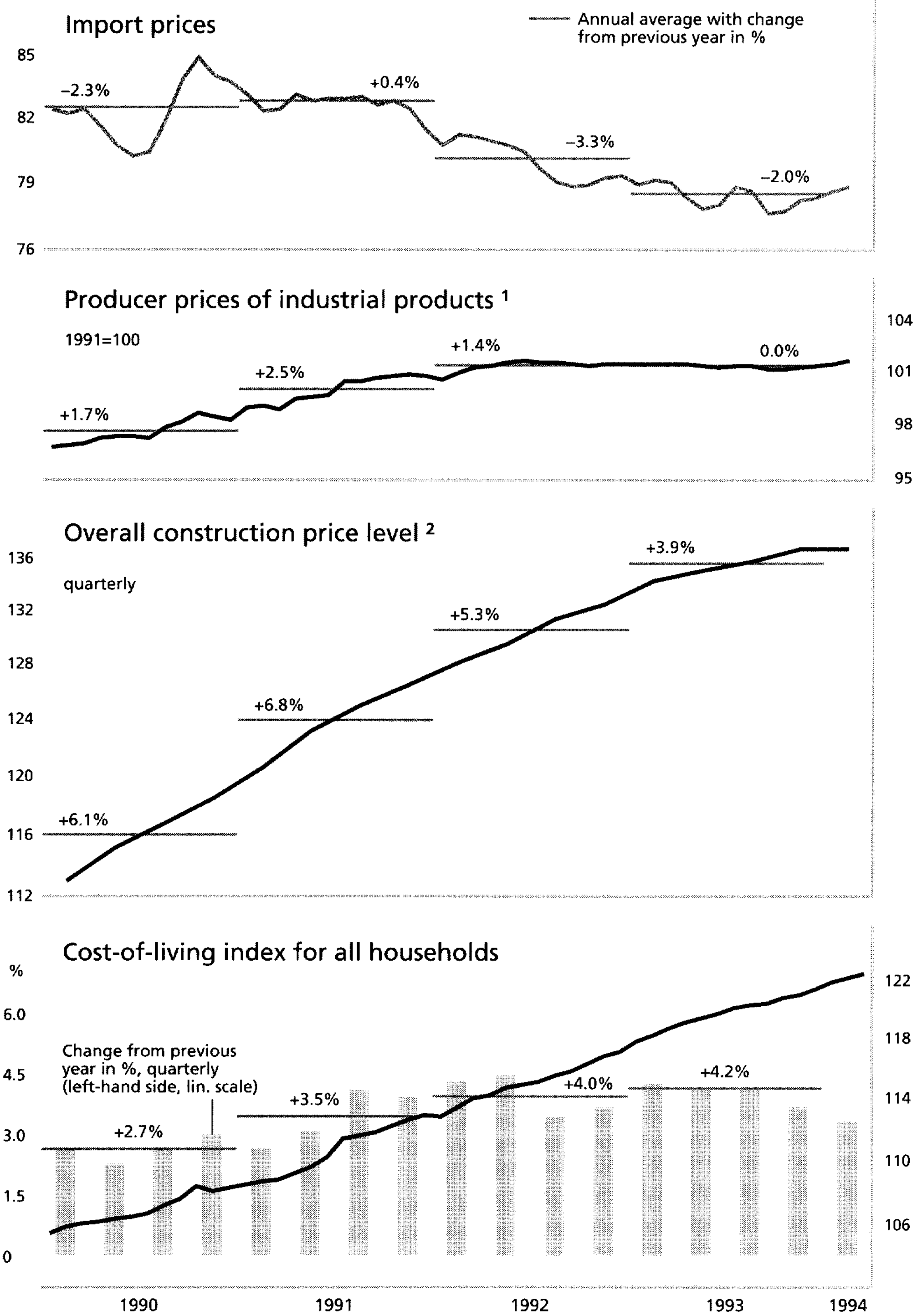
The latest pay settlements will foster a return to price stability. At the consumer stage in western Germany, the price level rose by 4.2 % in 1993, and thus even more sharply than a year earlier (4.0 %). This owed something to the increase in value-added tax which entered into force at the beginning of 1993 and which raised the cost of living in Germany by about 1/2 percentage point. Furthermore, the government increasingly raised charges, contributions and other administered prices; in part, this reflected, with a certain time-lag, the pay hikes in the public sector, while other measures – particularly at the local authority level – marked attempts to limit the growing recession-induced deficits. Rents went up particularly sharply in 1993, not least on account of persistent bottlenecks in the housing market, but partly probably also as a result of a substantial increase in the prices

Prices

Chart 3

1985=100, seasonally adjusted, log. scale

Western Germany



1 Domestic sales. — 2 Calculated by the Bundesbank.

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of construction work. Moreover, the prices of private services were raised perceptibly again. On the other hand, the trend in the prices of food and mineral oil products generally curbed the upward movement of prices in 1993. However, given the increase in mineral oil tax at the beginning of 1994, which raised the cost-of-living index by 0.3 %, the prices of mineral oil products went up considerably in January. Despite this surge in prices, the year-on-year rate of increase fell to 3.3 % in the first quarter of 1994 (compared with 3.8 % in the final quarter of 1993), inter alia because the impact of the rise in value-added tax at the beginning of last year had been even greater. If the increase in the price level as a result of the rise in mineral oil tax at the beginning of 1994 is disregarded, the upward movement of consumer prices has slowed down significantly in the past few months; from September 1993 to March this year, the seasonally adjusted cost-of-living index went up at an annual rate of less than 3 %.

Significant external relief for the price climate

In 1993 the price climate in Germany was relieved perceptibly, above all from the external side. All in all, imports cheapened by another 2 %, after import prices had declined by as much as 3 1/2 % in 1992. The associated drop in the costs of imported intermediate goods contributed much to the fact that the price level at the industrial producer stage remained unchanged in 1993. It is probably ascribable, above all, to the declining wage cost pressure that the upward movement of prices for (particularly labour-intensive) construction work likewise slowed down markedly last year. The overall construction price level in the old Länder was nevertheless still almost 4 % higher than in 1992, in which it had risen by 5 1/2 %.

(b) Eastern Germany

Notable economic growth

The economic situation in eastern Germany continued to improve in 1993. The real gross domestic product rose sharply again. Although the growth rate of 7 % was lower than in 1992 (9 1/2 %), it would be inappropriate to assess this as a slowdown of the growth process. Quite apart from considerable statistical problems in the new Länder, the fact that large areas of the manufacturing sector, too, returned to a sounder footing in the course of last year and expanded their output again for the first time since German unification is a great advance in the adjustment process of the east German economy. The growth process in the new Länder is thus more broadly based, after the high west German transfer payments had initially been reflected in increased public construction orders which, in turn, gave a first boost to economic reconstruction. Last year the

Key economic variables in eastern Germany

Table 3

Item	Unit	1992	1993	1992 Change from previous year in %	1993 Change from previous year in %
Aggregate demand (real)					
Private consumption	DM billion	192.5	195.5	+ 7.3	+ 1.5
Fixed capital formation	DM billion	108.1	125.0	+ 24.0	+ 15.6
Machinery and equipment	DM billion	46.3	50.1	+ 10.8	+ 8.1
Construction	DM billion	61.8	74.9	+ 36.2	+ 21.3
Domestic expenditure	DM billion	391.8	415.4	+ 11.3	+ 6.0
Foreign balance [1]	DM billion	– 182.1	– 192.8	.	.
Exports	DM billion	74.3	73.6	+ 16.8	– 0.9
Imports	DM billion	256.4	266.4	+ 13.6	+ 3.9
Gross national product at 1991 prices	DM billion	209.7	222.6	+ 10.4	+ 6.1
Memorandum items					
Orders received (value) by the manufacturing sector	2nd hf of 1990=100	73.0	82.6	– 7.5	+ 13.2
by the construction sector	2nd hf of 1990=100	212.3	275.2	+ 48.0	+ 29.6
Income					
Wage and salary income	DM billion	223.0	241.8	+ 20.0	+ 8.4
do. as a percentage of national income	%	112.6	105.6	.	.
Households' disposable income	DM billion	244.2	262.0	+ 26.0	+ 7.3
of which Current transfers received	DM billion	93.0	108.4	+ 29.3	+ 16.6
Households' saving ratio [2]	%	13.2	11.4	.	.
Output					
in the producing sector (excluding construction sector) [3]	2nd hf of 1990=100	67.9	71.2	– 6.1	+ 4.9
in the construction sector [3]	2nd hf of 1990=100	128.7	156.4	+ 29.1	+ 21.5
Gross domestic product at 1991 prices	DM billion	198.4	212.5	+ 9.7	+ 7.1
Employment					
Employed in eastern Germany	Millions	6.3	6.1	– 12.1	– 3.4
Unemployed	Thousands	1,170	1,149	+ 28.2	– 1.8
do. as a percentage of the dependent labour force	%	14.8	15.8	.	.
Prices and wages					
Cost-of-living index for all employee households	2nd hf of 1990/ 1st hf of 1991=100	120.4	131.0	+ 11.2	+ 8.8
Price index of residential buildings	1989=100	182.4	195.2	+ 11.0	+ 7.0
Gross income per employee (in eastern Germany)	DM	34,700	39,500	+ 37.9	+ 13.7
Unit labour costs in the economy as a whole [4]	DM	1.11	1.14	+ 10.5	+ 2.6
Productivity [5]	DM	31,300	34,700	+ 24.7	+ 10.9

1 Balance of transactions in goods and services with the rest of the world; in contrast to the balance of payments statistics, deliveries to and supplies from western Germany are included in exports or imports. – **2** Saving as a percentage of disposable income. – **3** Results for kinds of activity units, adjusted for working-day variations. – **4** Index of gross wage and salary income per employee generated in eastern Germany divided by index of GDP per employed person calculated at 1991 prices. – **5** GDP per employed person at 1991 prices. – The data from the national accounts and the figures on employed persons are provisional.

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expansion in the construction industry not only continued, but also attained a broader base on account of the far more buoyant demand for housing construction work. Apart from the rehabilitation and modernisation of the stock of dwellings, the construction of new housing is becoming more and more important. The high level of construction activity thus encompasses all areas of this sector. Its strength can be seen from the fact that the orders placed with the construction industry as a whole increased by 29½ % in value and by 25½ % in volume. Construction output failed to keep pace with this rise, as is apparent from the renewed expansion of the forward reach of orders on hand. Total construction investment went up by 28 % in nominal terms and by 21 % in real terms in 1993. This includes the output of the finishing trades, which probably expanded even more sharply than that of the construction industry as a whole.

Reversal of the trend in the manufacturing sector

The turn-around in the manufacturing sector in the new Länder is based on a whole series of interlinked causes, many of which are generally responsible for the growth process in the east German economy. They include the progress made in the reconstruction and extension of the public infrastructure and the public administration as well as the dismantling of administrative barriers – say, the priority accorded to investors over the restitution of property in clarifying ownership relations.

Successful privatisation

Of particular importance, especially for the manufacturing sector, was the successful privatisation by the Treuhand agency. Of the originally 12,300 enterprises, roughly one-half of which were active in manufacturing, more than 6,300 had been returned to either full or majority private ownership by the beginning of April 1994, while over 1,800 firms had been restored to the former private owners or to the ownership of local authorities, and 3,200 are in liquidation. In April 1994 purchasers were still being sought for 230 comparatively large enterprises. The Treuhand agency sees good chances of completing its privatisation activities by the end of the current year.

Growing demand for east German industrial products

Not least owing to the rapid privatisation, more and more industrial enterprises from the new Länder have apparently succeeded in developing competitive products and in offering them successfully in the German market. Domestic orders for east German industrial products, which comprise orders by east and west German customers, have been rising since as early as the second half of 1992; this demand tended to increase in the course of last year. On average in 1993, domestic orders exceeded the 1992 level by 17 % in nominal terms. On the other hand, the efforts of east German industrial enterprises to expand their foreign business met with little success. After their traditional sales markets in central and eastern Europe had largely broken down, they have not yet succeeded, in view of the recession in many industrial countries, in opening up more export opportunities in new markets. Orders by foreign customers declined once more, though by only 1 %. Despite the persistent weakness in export business, the demand situation in the east German manufacturing sector improved so much under the impact of sharply rising domestic orders that – in contrast to 1992 – output expanded markedly, at 7 1/2 %.

Further improvements in the standard of living

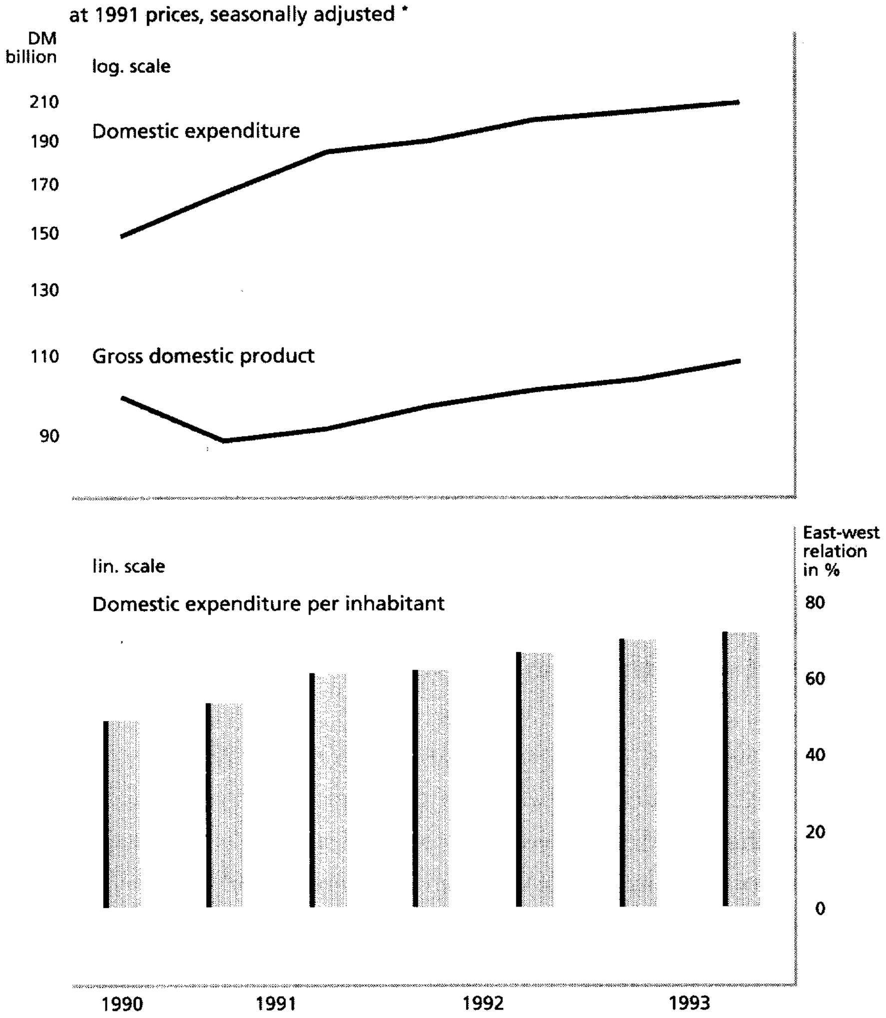
This notable increase in industrial production and the associated larger supply of domestic industrial products in the east German market contributed much to the fact that the growth of the real gross domestic product for the first time exceeded that of real domestic demand in 1993. In relative terms, the gap between these two variables has thus narrowed, albeit only slightly in a first step. Calculated per capita of the east German population, real domestic demand, which can be regarded as a reflection of the current standard of living (in the form of consumption) and the future standard of living (in the form of investment), increased by 6 1/2 % and has meanwhile reached 71 % of the west German level (compared with only 50 1/2 % in the second half of 1990).

Renewed surge in pay

In 1993 productivity in the east German economy rose more sharply than the real gross domestic product, namely by 11 % per employed person, so that it came to 38 1/2 % of the west German level. The renewed surge in productivity in the east German economy should not be seen independent of the trend in wages, however. For, in a market economy system, productivity adjusts to the wage level, over the medium term at any rate, not least through corresponding changes in employment. Last year total gross wages and salaries per employee in eastern Germany rose by 13 %, and thus to 69 1/2 % of the west German average; at the end of 1993 the negotiated wage and salary level in the new Länder came to about 80 % of west German basic pay. There is still a big gap between wages and productivity in the east German economy. Should the wage policy course of an accelerated adjustment to the west German level continue, the pressure to narrow this gap through a further reduction in employment would increase. The difference between wages and productivity can be seen from the fact that in 1993 labour costs per unit of the gross domestic product were about three-quarters higher in eastern Germany than in the old Länder.

Domestic expenditure and gross domestic product in eastern Germany

Chart 4



* Seasonal adjustment subject to increased uncertainty.

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Sustained, but slower reduction in employment

A considerable proportion of the great number of jobs lost in the course of the process of transforming the east German economy from a socialist centrally planned economy to a social market economy is to be ascribed to the wage policy stance, which was aimed at adjusting wages and salaries to west German levels as rapidly as possible, without paying regard to employment and productivity. In addition, the obsolete capital stock as well as inadequacies in terms of both the production technology used and the quality of the goods produced with it played a role. When comparing the level of employment before German unification, i.e. that of $9^3/_4$ million employed persons in 1988, for instance, with that of 6.13 million in 1993, it must, of course, be borne in mind that the employment level in the old system was excessive, more or less artificially, for manifold reasons. Last year the reduction in employment persisted, but at a distinctly slower pace; it fell by 220,000 persons, or 3 1/2 %. Above all, the manufacturing sector, which is exposed to international competition more strongly than other sectors of the economy and which is thus hit particularly hard by surging wages and salaries, cut its staff levels by another 190,000, or one-fifth; this decline may have come to a standstill in the first few months of the current year. Since the number of staff has now been rising for some time in large areas of the services sector and in the construction sector, the phase of the reduction in jobs in the east German economy as a whole may gradually be coming to an end.

High unemployment

At 1.15 million unemployed persons and an unemployment rate of 15.1 % of the total labour force, unemployment in eastern Germany was alarmingly high in 1993 as well. However, it did not rise further last year, but declined by about 20,000, compared with the annual average of 1992; the number of unemployed in the first three months of the current year, however, was distinctly higher than a year earlier. Moreover, short-time working lost further in significance in 1993; at 180,000, the number of short-time workers was only half as high as in 1992. Concealed unemployment (concealed by the use of labour market policy instruments) likewise decreased considerably. On an annual average, 640,000 persons, and thus 235,000 fewer than in 1992, participated in vocational further training courses and job creation schemes – a result which was due probably not least to the strict limitation of the financial resources available for such measures.

Price movements at the consumer stage

On an annual average, the price level at the consumer stage in eastern Germany increased by 8.8 % in 1993, and thus far more sharply than in western Germany. The difference between the rates in the old and the new Länder, where consumers all had to accept the increase in value-added tax, is due mainly to the fact that at the beginning of last year east German rents were brought closer to the actual cost of accommodation in a second step. On average, this meant an increase of roughly one-half in rents and one of about 5 % in the total cost of living. The burden on consumers associated with this, which ultimately serves to improve the housing quality by rehabilitating and modernising the partly poor stock of existing dwellings, was largely offset by housing allowances, at least in the lower income brackets. The significant increase in the prices of both private and public services, which reflected not least the surging rise in wages and salaries, was largely due to market factors. Much the same applies to construction prices. Price movements for industrial products at the consumer stage have largely approximated those in western Germany. At the beginning of 1994 the year-on-year rate of increase in the cost-of-living index declined sharply; in the first quarter it came to 3.6 %. This owes much to the fact that the influence of last year's rise in rents on the year-on-year rate of increase has now ceased to be effective. Although the beginning of this year, too, saw hikes in some rent surcharges, the resulting increase in the level of rents was much smaller than at the beginning of last year.

(c) Economic perspectives

Recovery of foreign demand

The perspectives for the German economy have brightened recently. According to the available information, there have, admittedly, as yet been no signs of a clear upward trend in overall output in western Germany in the first few months of the current year. Nevertheless, the signs for an economic recovery and thus for finally overcoming the recession have improved distinctly. Particularly foreign demand, the sustained weakness of which was one of the major reasons for the recession, was significantly higher than before, seasonally adjusted, towards the end of last year and in the first two months of this year; between October 1993 and February 1994 it exceeded its previous year's level by 9 % in value and 8 % in volume. Although the export orders placed with the west German manufacturing sector had increased noticeably in the course of last year, this rise was not steady; in the summer months export orders remained at their spring level. In the meantime the situation in the world economy has taken a turn for the better, so that a sustained recovery of foreign orders has become more likely from this side; this applies at least if the recovery in the world economy continues and if the west German economy proves capable of improving its competitiveness further.

More favourable supply conditions

The supply-side conditions in the west German economy have improved perceptibly, above all on the wage side. The 1994 pay round has so far led to very moderate wage and salary adjustments; in individual agreements path-breaking arrangements were also reached to render labour costs and working hours more flexible. In the chemical industry, where management and labour signed an agreement with a life of 15 months, negotiated wages and salaries were increased by 2 % as from February 1, after three "zero months"; what are known as the Christmas bonuses were exempted from this increase (they remain unchanged until the end of 1995), so that the improvement in income amounts to 1½ %, if referred to a life of the agreement of one year. Furthermore, the agreement makes it possible for the first time to recruit long-term unemployed at a wage or salary below the negotiated pay level. All in all, the pay agreement in the metal-working industry, which is of particular significance for the manufacturing sector, provides for virtually no increase in income for employees, compared with the 1992 pay agreement, and thus no additional costs for enterprises. In times of weak ordering activity, the agreement now reached offers some cost relief insofar as, if the agreed working time (at present 36 hours) is undercut by up to six hours, wages and salaries are reduced correspondingly. The cut in staff levels had an even greater quantitative impact on the reduction in labour costs. Together with the results achieved in the 1994 pay round so far, this is an important step on the road towards improving the competitiveness of the west German export industry.

Opportunities for the east German economy in the export markets

Given the renewed buoyancy of global business activity, the east German economy, too, has greater chances in its search for new sales opportunities in the export markets. The first sales successes in the internationally open German market justify some hope. However, this requires further efforts to strengthen competitiveness, which – in the first place – necessitate a change in wage policy. In line with the agreement for the metal-working sector, the negotiated basic pay will gradually be adjusted to 100 % of the west German level by July 1996. After basic pay had been raised to 80 % of the west German level in December last year, a further step towards adjustment to 87 % is envisaged in July 1994; on an average of the current year, basic pay rates would thus be 12 1/2 % higher than in 1993. An end of the catching-up process could contribute much to maintaining existing jobs and to improving the chances of a reintegration of persons affected by open or concealed unemployment into the labour force. Stronger wage differentiation between the west and the east would be more in line with the existing differences in productivity and could reverse the still ongoing process of adjusting wages and salaries as rapidly as possible to the west German level, at the expense of employment.

2. Public finance marked by the recession and the need for medium-term consolidation

Fiscal policy – a difficult balancing act

Owing to the recession, the public sector budgets ran large additional deficits last year. Moreover, expenditure on reconstruction in the new Länder and on the adjustment of living conditions to west German levels continued to grow. Against the background of the overall situation (which had become more unfavourable), fiscal policy makers were faced with the necessity of setting the stage for a consolidation of the budgets over the medium term. Initially, the deterioration of the current budgetary situation was accepted to a large extent; the deficits increased and borrowing was expanded, thus allowing the "built-in stabilisers" of demand to take their course in 1993. However, in view of the deficits, which had been large before, as well as the development of the burden of debt and interest rates, the scope for such a course of action was limited. In these circumstances, the budget estimates for 1994 were characterised by increased efforts to curb the expansion of expenditure, after the Federal Consolidation Programme adopted in spring 1993 (which is to be regarded as a contribution towards coping with the unification-induced burdens) had provided for tax increases, above all, in 1995.

Consolidation no impediment to growth

The fact that a further increase in the public sector deficit is being counteracted by retrenchment measures is no obstacle to economic recovery; this conclusion is borne out by the experience of the consolidation policy pursued in Germany a decade ago. Maintaining confidence in the ability of fiscal policy makers to cope with the current difficulties is a factor whose importance should not be underrated, since it affects expectations as to the future development of the German economy and thus of the environment in which an upswing can unfold. Although expenditure cuts curb the demand that is directly associated with public spending, any additional expansion of the deficits would have given rise to fears that public levies would have to be increased further in future; adverse effects on locational conditions and price movements in Germany would be the inescapable consequence of that. The prospect of a medium-term reduction in new public sector borrowing is also a major factor in the assessment of the capital market outlook, and thus in the movement of long-term interest rates, which has an important bearing on capital spending. The consolidation measures taken probably already had a favourable effect on last year's capital market sentiment.

Expansion of the overall deficit

On balance, the deficit of the central, regional and local authorities increased in 1993, compared with the previous year, by almost DM 30 billion to approximately DM 140 billion. The social security funds ran a small surplus (of approximately DM 3 billion), after having incurred a deficit of DM 7 billion in 1992; in this context, the positive effects on the financial situation of the statutory health insurance funds of the Act on the Structure of the Health Sector were accompanied by a deterioration in the financial situation of the pension insurance funds.[1] As a

1 In accordance with the system applied here, the sharply increased deficit of the Federal Labour Office is reflected not in the figures of the social insurance funds, but in those of the central, regional and local authorities, since it is financed by Federal grants.

Public sector finance *

Table 4

Item	1991 pe	1992 pe	1993 pe	1992 pe	1993 pe
	DM billion			Change from previous year in %	
Central, regional and local authorities					
Expenditure					
Personnel expenditure	293	322	337.5	+ 10	+ 5
Other operating expenditure	145.5	153	155.5	+ 5.5	+ 1.5
Transfers [1]	292	301.5	339.5	+ 3.5	+ 12.5
Interest paid	77	101	102.5	+ 30.5	+ 1.5
Fixed capital expenditure	90	103.5	101.5	+ 15.5	- 1.5
Financial aid [2]	71.5	83	84	+ 16	+ 1
Total expenditure [3]	970	1,064	1,119	+ 9.5	+ 5
of which					
Federal Government	405.5	431	462	+ 6.5	+ 7
West German Länder Governments [4]	329	351.5	367.5	+ 7	+ 4.5
East German Länder Governments	78.5	86	92.5	+ 9.5	+ 7.5
West German local authorities	229	252	263.5	+ 10	+ 4.5
East German local authorities	48	62	66	+ 29	+ 6.5
EC [5]	33	35.5	38	+ 8	+ 6
Receipts					
Tax revenue	661.9	731.7	748	+ 10.5	+ 2
Other receipts	183.5	220.5	231.5	+ 20.5	+ 5
Total receipts [3]	847	953	982	+ 12.5	+ 3
of which					
Federal Government [6]	353.5	399.5	401	+ 13	+ 0.5
West German Länder Governments [4]	310	333	341	+ 7.5	+ 2.5
East German Länder Governments	68	73	76.5	+ 7.5	+ 5
West German local authorities	222.5	241.5	252.5	+ 8.5	+ 4.5
East German local authorities	50	54.5	60.5	+ 9	+ 10.5
EC	33	35.5	38	+ 8	+ 6
Deficit (–)	– 122.5	– 110.5	– 137	.	.
of which					
Federal Government	– 52	– 32	– 61	.	.
West German Länder Governments [4]	– 19	– 18.5	– 26.5	.	.
East German Länder Governments	– 10.5	– 13	– 16	.	.
West German local authorities	– 6.5	– 10.5	– 11	.	.
East German local authorities	+ 2	– 7.5	– 5.5	.	.
"German Unity" Fund	– 30.5	– 22.5	– 13.5	.	.
Debt-Processing Fund	+ 0.5	+ 0.5	– 0	.	.
ERP Special Fund	– 6.5	– 6.5	– 1.5	.	.
Social security funds					
Expenditure	548.5	627	669	+ 14.5	+ 6.5
Receipts	563	620	672	+ 10	+ 8.5
Surplus (+) or deficit (–)	+ 14.5	– 7	+ 3	.	.
Public sector, total					
Expenditure	1,448.5	1,614	1,690	+ 11.5	+ 4.5
Receipts	1,340.5	1,496	1,556	+ 11.5	+ 4
Deficit (–)	– 108	– 118	– 134	.	.

* Whole of Germany. 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** Mainly social expenditure and current grants to the enterprise sector. – **2** Expenditure on investment grants and loans to third parties, plus the acquisition of participating interests. – **3** Including differences in clearing operations. – **4** Including Berlin. – **5** EC expenditure financed out of EC revenue in Germany. – **6** The Bundesbank's profit transfer is included in full in this figure as Federal Government revenue.

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percentage of GDP, the public sector deficit came to 4.3 % last year, after having reached 3.9 % in 1992. In the definition used in the national accounts, the public sector deficit reached 3.3 % of GDP in 1993. Hence the deficit ceiling of 3 % laid down in the Maastricht Treaty was overshot.

Budgetary trends at the various levels of government

Of the various central, regional and local authorities, the Federal Government's budgetary situation was particularly tight as the labour-market-induced extra expenditure and the further increase in requirements arising in the course of the integration of eastern Germany mainly affected that level of government. Its budget deficit came to DM 67 billion, compared with DM 39 billion in 1992; if one regards as revenue that part of the Bundesbank's profit transfer (entered in the budget) which exceeds the basic amount of DM 7 billion, the deficit came to DM 61 billion (against DM 32 billion a year before). The deficit of the old Länder and their local authorities also increased (as a result of shortfalls in tax revenue due to the recession), viz. by DM 29 billion, taken together, to a total of about DM 38 billion (including Berlin). In eastern Germany the deficit of the local authorities probably fell somewhat short of the very high level it had reached one year earlier, but it increased once again at the Länder level, with expenditure continuing to grow strongly. Altogether, the deficit run by the east German central, regional and local authorities reached approximately DM 22 billion in 1993; thus, calculated per head of the population, it was more than twice as high as in the west. Through the "German Unity" Fund, the Länder and local authorities in the east received just over DM 35 billion, which was slightly more than a year before. On the one hand, net borrowing, and thus the Fund's deficit, decreased by DM 9 billion to DM 13 1/2 billion; on the other hand, the Fund received higher transfers, which accrued to it notably from the revenue resulting from the raising of value-added tax from the beginning of 1993.

Weak growth of tax revenue

Owing to the slowdown in economic activity, the tax revenue of the central, regional and local authorities went up by no more than 2 1/4 % in 1993. The amendments of tax law largely cancelled out in their impact on tax revenue. On the one hand, relief measures affecting trade tax, corporate property tax and the taxation of the lower income groups came into force and, moreover, the solidarity surcharge expired in mid-1992; on the other hand, VAT was raised in 1993. Tax receipts fell DM 13 billion short of the comparable tax revenue forecast of November 1992, on which the 1993 budgets had been based to a large extent. This owed a great deal to the fact that business activity developed more unfavourably than had previously been expected, and that, viewed in fiscal terms, the introduction of the new interest income tax deducted at source at the beginning of 1993 has so far failed to live up to the expectations originally entertained. Compared with the forecast of spring 1992, the pattern of tax revenue in 1993 deteriorated overall by roughly DM 25 billion, primarily because of the recession. The other receipts of the central, regional and local authorities grew more sharply than the tax revenue, mainly owing to steep increases in fees and charges at the local authority level. Overall, the receipts of the central, regional and local authorities increased by 3 % in 1993 (compared with 12 1/2 % a year before).

Tax ratio and government levy ratio

Whereas the national tax ratio remained in 1993 at the level it had reached in the preceding year, the overall government levy ratio continued to rise, viz. by approximately 1/2 percentage point. This was attributable, among other things, to the fact that statutory health insurance contributions had been increased both in autumn 1992 and early in 1993. In the definition used in the national accounts, the government levy ratio came to 44 % of GDP last year. By contrast, it had stood at 42 1/2 % in the old Länder in 1989, and at 40 1/2 % in 1990, after the tax reform carried out in that year.

Further rise in public sector spending ratio

Although, compared with 1992, the expansion of expenditure in the public sector budgets likewise slackened on balance, it was still quite significant, at 4 1/2 %. The public sector spending ratio, as a percentage of GDP, continued to rise – according to the financial statistics, by just over 1 percentage point to about 54 1/2 %. (In the definition used in the national accounts, the ratio, at just over 51 %, ran at a somewhat lower level.) In 1989, by contrast, the government spending ratio in the old Länder amounted to just over 47 % (or just under 46 %, according to the definitions of the national accounts); the previous peak level reached in 1982 was now significantly overshot as well.

Steep increase in the total expenditure of the central, regional and local authorities

In 1993 the expenditure of the central, regional and local authorities increased by 5 %, after having risen by as much as 9 1/2 % a year before. This growth was affected by two contrasting trends: on the one hand, large additional burdens were imposed, in particular, by the west German labour market; on the other, retrenchment efforts were made at all levels of government – a fact which led to a moderation of the growth in expenditure in the course of the year. The Federal Government's expenditure in the whole of 1993 exceeded the previous year's level by just over 7 %; this increase was largely due to higher grants to the Federal Labour Office, additional expenditure on unemployment assistance and increased transfers to the "German Unity" Fund; the latter include the financial contributions of the Länder Governments and local authorities from their tax revenue, which are channelled through the Federal budget. The old Länder (including Berlin) recorded a growth of approximately 4 1/2 % in expenditure (after 7 % in 1992). In view of the particularly large proportion of personnel expenditure in Länder spending, it was of great significance in this context that wages and salaries in the public sector were not increased as steeply as a year before. In the case of the local authorities in the old Länder, the initial response to the unfavourable financial situation was mainly reflected in the fact that restraint was now exercised in expenditure on construction investment, and that the other operating expenditure went up less strongly than before. However, the surge in expenditure on social assistance measures continued. All in all, the expenditure of west German local authorities increased by approximately 4 1/2 % in 1993, and thus only about half as fast as in 1992. In 1993 the new Länder spent about 7 1/2 % more than a year before; the expenditure of their local authorities, however, probably grew less steeply, in spite of the sharp increase in social assistance expenditure that was recorded in that area, too. In eastern Germany, on the one hand, considerable additional financial burdens were caused by the gradual adjustment of public sector wages and salaries to west German levels; on the other hand, not least owing to the pressures exerted by the budgetary situation, the inexorable reduction of staff levels, which in some areas are still relatively high, continued.

Diverging trends in spending on social security

In the individual branches of social security, expenditure developed along very divergent lines in 1993; moreover, western and eastern Germany presented a very mixed picture in this respect. The expenditure of the Federal Labour Office in the old Länder sky-rocketed (rising by almost one-quarter). By contrast, the growth of expenditure in the east slowed down (to 10 %), owing to the gradual stabilisation of labour market conditions and to cutbacks in job creation and vocational training measures, which had previously been exceptionally wide-ranging. In the east the expenditure of the pension insurance funds grew by 26 %, and thus far more steeply than in the old Länder (just over 6 %), on account of the higher pension adjustment rates, which in the old Länder were geared to the increase in net wages, and the adoption of western pension legislation from early 1992 onwards. In the case of the statutory health insurance institutions, expenditure decreased slightly in the west, owing to the retrenchment measures incorporated in the Act on the Structure of the Health Sector, whereas it increased by about one-tenth in the east.

Huge transfers from western to eastern Germany

Within the public sector, the transfers from western to eastern Germany increased once again. As much as DM 40 billion (almost DM 25 billion of which came from the Federal budget) was required for financing the deficit incurred by the Federal Labour Office in the east. In net terms, i.e. less the receipts of the Federal Govern-

Indebtedness of the central, regional and local authorities

Table 5

DM billion

Item	1992	1993 pe	1992	1993 pe
	Level at end of year		Change from previous year	
Borrowers' note loans	564.3	604	+ 7.9	+ 39.5
Securities	697.4	817.5	+ 95.0	+ 120
Other debt	83.5	88	+ 68.5	+ 4.5
Total indebtedness	1,345.2	1,509.5	[5] + 171.4	[5] + 164
Federal Government	611.1	685.5	+ 24.6	+ 74
West German Länder Governments	366,6	394	+ 19,2	+ 27,5
East German Länder Governments	22.5	40	+ 17.6	+ 17.5
West German local authorities [1]	141.3	152.5	+ 9.3	+ 11
East German local authorities	13.2	20	+ 4.6	+ 7
"German Unity" Fund	74.4	87.5	+ 23.9	+ 13.5
Debt-Processing Fund [2]	91.7	101	+ 64.3	+ 9.5
ERP Special Fund	24.3	28.5	+ 7.9	+ 4
Memorandum items				
Treuhand agency [3]	106.8	168.5	+ 67.4	+ 61.5
Federal Railways-East German Railways [4]	53.5	66	+ 10.4	+ 12.5
Federal Post Office	96.6	104.5	+ 15.4	+ 8

1 Including municipal special-purpose associations. — **2** Including the hitherto assumed liabilities to the Currency Conversion Equalisation Fund, which amounted to DM 64.6 billion at the end of 1992, and to DM 73.9 billion at the end of 1993. — **3** Including assumption of old loans and liabilities arising from equalisation claims of enterprises. — **4** After adjustment for the borrowing of the East German Railways from the Federal Railways. — **5** The figure for net borrowing given in the text on this page is lower than the increase in indebtedness, which also includes the assumption of old debt.

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ment in the east, the transfers amounted to almost DM 140 billion, or about 4 1/2 % of west German GNP. This means that just over 30 % of domestic expenditure in eastern Germany was financed by transfers from western Germany. An estimated three-quarters of the transfers to the new Länder was applied to consumption.

Sharp increase in public sector borrowing

Last year the central, regional and local authorities resorted to the credit markets to the tune of almost DM 160 billion, primarily by issuing securities. The other public borrowers (Treuhand agency, post office and railways) raised about DM 60 billion (net) all told. Overall, net public sector borrowing in the market, at about DM 220 billion, exceeded the volume reached in 1992 by DM 62 billion. This enormous demand was met without any difficulty – and, indeed, at declining capital market rates – since confidence in the stability of the Deutsche Mark remained intact. Foreign investors, in particular, bought German securities on a large scale. An important precondition for their doing so was the fact that the large public sector deficit is apparently not being regarded as a lasting phenomenon, owing to the measures which have been initiated, and that the consolidation efforts announced are being taken seriously. Hence it is most important that they should be duly implemented.

Level of indebtedness

The necessity of budgetary consolidation is underlined not only by the size of the current deficit but also by the development of the level of indebtedness. The local authority debt level reached about DM 1,510 billion at the end of 1993, and was thus just over 60 % higher than at the end of 1989. If one adds the old debt of the railways, which was assumed by the Federal Railways Fund (a new subsidiary budget) at the beginning of 1994, and the debt of the Treuhand agency, which is to be transferred to the Unwelcome Legacy Repayment Fund at the beginning of 1995, the debt level at the end of 1993 amounted to no less than a good DM 1,740 billion, or about 56 % of GDP; hence it nearly reached the 60 % reference value for the debt ratio laid down in the Maastricht Treaty.

Federal Consolidation Programme and the need for sharper cuts in expenditure

The Federal Consolidation Programme of spring 1993 and the cost-cutting decisions taken in the context of budget planning for 1994 set the stage significantly for the future development of public finance. The Federal Consolidation Programme focuses on tax increases, to be effected in 1995, and particularly on the introduction of a new solidarity surcharge on income tax. In this connection, it is accepted that the improvement in tax conditions for enterprises, as envisaged in the Location Protection Act (passed in mid-1993, and in force since the beginning of 1994), will be accompanied by additional burdens in the shape of the solidarity surcharge. In the course of 1993, the fiscal policy makers found themselves faced with additional deficits, on account of the trend of business activity and the slightly more muted medium-term expectations as to economic growth. It seemed unjustifiable to raise taxes once again, since an additional steep increase in the total burden of levies is already being implied by the adoption of the Federal Consolidation Programme, the raising of mineral oil tax from the beginning of 1994 (to finance the reform of the railways), and the increasing of the contribution rate to the pension insurance funds (likewise from the beginning of 1994); taxes and public levies cannot constantly be pushed up further without jeopardising economic growth and stability. Thus efforts aiming at the containment of the deficits are now focusing increasingly on the expenditure side.

Federal budget for 1994

When planning its 1994 budget, the Federal Government pursued the aim of limiting the deficit to DM 70 billion, the order of magnitude envisaged in the 1993 supplementary budget. In summer 1993 the Federal Cabinet presented a Retrenchment, Consolidation and Growth Programme which was designed primarily to take pressure off the Federal budget. Most of the measures entailed amendments of the law. In accordance with the decisions taken by Parliament in December 1993, notably wage substitutes paid by the Federal Labour Office were reduced, and children's benefits were modified. As adopted, the budget provides for a deficit of just under DM 70 billion, with Federal expenditure rising by 4.9 % compared with 1993; about two percentage points of the increase are attributable to the railway reform. To be able to keep to the envisaged expenditure ceiling, a blanket expenditure cut of DM 5 billion was made. In January 1994 this reduction in expenditure was assigned to specific government departments. The compromise reached between the Bundestag and Bundesrat, after the adoption of the budget, on the contents of the retrenchment laws left a gap of DM 2 1/2 billion, which is to be filled during the implementation of the budget.

Länder and local authority budgets

Judging from their budgets for 1994, the old Länder intend to limit the rise in their expenditure to 2 1/2 %. Even this rate somewhat overshoots the envisaged growth of revenue, so that the deficit will go on rising. However, the public sector pay settlement agreed in March 1994, along with the postponement of increases in the remuneration of civil servants, will probably enable the Länder Governments to keep the growth of their expenditure – which owes a great deal to personnel spending – within narrower bounds. The budgets of the new Länder provide for expenditure which is about 10 % higher than the amount envisaged for 1993, with receipts being expected to grow by just under 6 %. In the assessment of the local authority central associations, which is based on the results of surveys, the local authorities' budgetary situation in 1994 – which is marked by large deficits overall – will hardly improve at all, in spite of considerable retrenchment efforts. Among the Länder Governments and local authorities, it will be of particular importance to curb the further growth of current expenditure in order to ensure that any restrictions do not affect capital spending alone.

Subsidiary budgets

The east German Länder and their local authorities will receive another approximately DM 35 billion in 1994 via the "German Unity" Fund; in this context, the deficit of the Fund, financed by borrowing, will decline by just over DM 10 billion to no more than DM 3 billion, and transfers by the Federal and Länder Governments will increase further. In 1994 the reform of the railways – as mentioned above – will give rise to a new subsidiary budget, the Federal Railways Fund; that Fund will assume those burdens incurred by the former Federal Railways and the East German Railways which would obstruct the transformation of the Deutsche Bahn AG into a high-performance transport enterprise. Such burdens include, above all, the old debt of the railways and their payments to pensioners. The expenditure of the Federal Railways Fund will be financed largely by Federal Government transfers; however, in 1994 a deficit of presumably just under DM 6 billion will have to be financed by net borrowing.

Stabilisation of the overall budget situation

Altogether, there is a prospect – according to the budgets – that the deficit run by the central, regional and local authorities in 1994 can be limited to the order of magnitude it reached last year, in spite of cyclical burdens which will persist for the time being. Judging by the official tax estimate of November 1993, tax receipts may go up in 1994 by just under 4 %, and by approximately 5 % if one includes the increase in mineral oil tax; this conclusion is based on the expectation that all-German GNP will grow in 1994 by 4 % in nominal terms (and by between 1 and 1 1/2 % in real terms). The other receipts will probably once again rise more sharply than tax revenue. However, the stabilisation of the budget situation also depends on the envisaged expenditure ceiling not being ultimately overshot. According to the adopted budgets, it appears likely that central, regional and local authority expenditure will increase by 4 1/2 %, or by 3 1/2 % if one excludes the impact of the reform of the railways.

Start of planning for 1995

When drawing up the 1995 budgets, it will be important to stick to a rigorous retrenchment policy in order to bring about the requisite consolidation over the medium term. Even if the prospects for tax revenue become more favourable as economic activity starts to pick up, restraint in expenditure must not be relaxed. The reform of the revenue-sharing arrangements, which (together with the scheme for regulating the "debt legacy") is due to come into force at the beginning of 1995, puts further pressure on the Federal Government, as well as on the old Länder Governments and their local authorities, to restrain their expenditure. Among the Länder Governments and local authorities in the east, the objective of the new revenue-sharing arrangements – which consists in putting their budgets on a sound basis and reducing their hitherto massive deficits to an acceptable level – can be achieved only if consumption expenditure (and not least personnel spending) is kept in check. Broad areas of the public sector in eastern Germany are still overmanned.

Problem posed by the burden of taxes and social security contributions

For budgetary and overall economic reasons, the gradual reduction of the deficits or of the new debt of the central, regional and local authorities must initially be given priority. However, in growth policy terms, the heavy and, for the time being, still growing burden of levies is increasingly moving into the forefront as a critical factor affecting the locational conditions for the German economy. Up to 1995, in the light of the decisions taken so far, the government levy ratio will probably rise to about 45 % of GDP. Germany is already among the countries with the highest government levy ratios. Scope for easing the burden of levies over the somewhat longer term can be created only by the public sector exercising strict restraint on the expenditure side of its budgets, by it carefully examining its duties and activities to identify potential savings, and by it reviewing existing priorities.

3. Foreign trade and payments influenced by cyclical weakness and exchange rate turbulence

Turnover losses in foreign trade

In 1993 Germany's external economic position was affected by weak cyclical trends at home and in its major markets abroad. Unprecedented turnover losses were recorded in both reported imports and exports of goods (15 % and 10 %, respectively). Declines were concentrated mainly in the first six months of last year when in Germany, as in many other countries, economic activity had reached its lowest point. To a not inconsiderable extent, however, the fall in reported imports and exports was also due to a change in the statistical collection procedure and the teething difficulties associated with this. These arose because, when frontier controls disappeared in the single European market, the enterprises concerned were asked to report direct instead of submitting reports to the customs authorities.[1]

Current account deficit virtually unchanged

Imports stabilised in the course of the year, while exports started to rise again. On balance, the surplus on exports increased by DM 25 billion to DM 74 1/2 billion in 1993.[2] However, as the rather long-standing deficits on services and transfer payments, which together amounted to DM 105 billion, were again higher than in the previous year, the overall deficit on Germany's current account last year, at DM 35 billion (according to the – in some cases significantly revised – data), was much the same as in the preceding two years.[3]

Revival of exports in the second half of the year

There had already been signs of a turning point for German exports in the spring of 1993 when foreign orders placed with west German industry increased noticeably. In the second half of 1993 exports were a seasonally adjusted 2 1/2 % higher

1 For further details see Deutsche Bundesbank, Germany's balance of payments in 1993, Monthly Report, March 1994, page 35 ff., and the notes on the changes in the foreign trade statistics, Deutsche Bundesbank, Monthly Report, June 1993, page 64.

2 Exports and imports are calculated on an f. o. b. basis, excluding supplementary items.

3 The revised balance of payments statistics differ, in some cases significantly, from the figures published previously, for example, in the Monthly Report of March 1994. As already stated in the Monthly Report, the revisions mainly concern the investment income receipts as well as capital transactions and the balancing item.

Major items of the balance of payments*

Table 6

DM billion

Item	1990	1991	1992	1993
I. Current account	+ 75.7	- 32.2	- 34.4	- 35.2
1. Foreign trade	+ 118.6	+ 38.1	+ 49.3	+ 74.5
Exports (f.o.b.)[1]	662.0	665.8	671.2	603.5
Imports (f.o.b.)[1]	543.5	627.7	621.9	529.1
2. Supplementary trade items and merchanting trade[2]	- 1.6	+ 1.4	+ 0.7	- 4.8
3. Services	- 4.8	- 13.3	- 34.4	- 53.3
of which				
Investment income	+ 28.2	+ 32.1	+ 24.5	+ 15.0
Foreign travel	- 30.7	- 34.2	- 39.9	- 44.6
4. Transfer payments	- 36.5	- 58.5	- 50.0	- 51.7
of which				
Net contributions to the EC budget	- 11.6	- 19.1	- 22.0	- 23.6
Other official payments to non-residents (net)	- 13.3	- 27.7	- 14.5	- 14.6
II. Long-term capital transactions	- 65.4	- 27.3	+ 39.7	+ 186.5
1. German investment abroad (increase: –)	- 106.6	- 95.9	- 116.8	- 97.0
Direct investment	- 37.4	- 38.0	- 27.7	- 19.3
Securities	- 22.9	- 27.3	- 70.4	- 40.3
Loans	- 43.0	- 26.2	- 14.2	- 32.4
Other investment	- 3.3	- 4.4	- 4.5	- 4.9
2. Foreign investment in Germany (increase: +)	+ 41.2	+ 68.6	+ 156.5	+ 283.4
Direct investment	+ 4.1	+ 7.1	+ 3.8	- 0.5
Securities[3]	+ 15.3	+ 61.7	+ 123.8	+ 241.7
Loans	+ 22.1	+ 0.0	+ 29.3	+ 42.7
Other investment	- 0.3	- 0.2	- 0.3	- 0.4
III. Short-term capital transactions of non-banks[4]	+ 0.3	+ 20.2	- 0.4	- 84.4
1. Enterprises and individuals	- 19.3	+ 11.1	+ 3.6	- 60.5
with foreign banks	- 24.7	+ 3.0	- 36.4	- 58.5
with foreign non-banks[5]	+ 5.3	+ 8.1	+ 40.0	- 2.0
2. Official	- 5.0	- 3.8	- 7.3	- 2.6
3. Balancing item of the balance of payments	+ 24.6	+ 12.9	+ 3.3	- 21.3
IV. Short-term capital transactions of banks[4]	+ 0.4	+ 39.7	+ 63.8	- 102.6
V. Balancing item in respect of the Bundesbank's external position[6]	- 5.1	+ 0.5	- 6.3	+ 1.5
VI. Change in the Bundesbank's net external assets[7] (increase: +) (I plus II plus III plus IV plus V)	+ 5.9	+ 0.8	+ 62.4	- 34.2

* From July 1990 including the external transactions of the former GDR. – 1 Special trade. – 2 Mainly warehouse transactions for account of residents and deduction of goods returned and of processing. – 3 Including official domestic borrowers' notes. – 4 Net capital imports: +. – 5 Including trade credits. – 6 Counterpart of changes in the Bundesbank's external position which are not due to external current and capital transactions: changes in the Deutsche Mark value of the Bundesbank's foreign currency-denominated assets and liabilities due to the revaluation at the end of the year as well as differences between the transaction values of the Bundesbank's foreign exchange dealings and the changes in the external position shown at balance sheet rates. – 7 Valued at balance sheet rates.

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than they had been in the first six months of the year. There was also a discernible improvement in the export expectations of enterprises. According to the ifo institute, positive reports predominated again in the institute's corporate surveys towards the end of 1993 for the first time in two years. Support for Germany's export business came mainly from the cyclical revival in the United States and other Anglo-Saxon countries. However, demand from the newly industrialising countries in east Asia and the closer economic ties between Germany and the People's Republic of China also had a positive effect on the German economy, which – in view of the deteriorated sales opportunities at home and in the European export markets – increasingly turned its attention to markets outside Europe that, at times, had probably been somewhat neglected. Furthermore, the strength of the US dollar and the spectacular appreciation of the yen, together with the increased efforts to lower German industrial prices, made German exports more competitive in these regions, which are growing disproportionately fast.

Imports stabilised at a low level

After the sharp decline in reported imports at the beginning of last year, much of which – as already mentioned – was probably of a statistical nature, imports stabilised at a lower level later in the year. Consequently, the trend in imports was largely in line with domestic economic activity. The decrease in reported imports mainly concerned those from member states of the European Community; imports from other industrial countries both inside and outside Europe fell much less sharply. However, it must be assumed that the reorganisation of the statistical recording procedure is considerably distorting the figures on intra-Community trade. Of the non-European countries, it was notably Japan that registered a relatively sharp drop in sales in Germany. This was partly a reflection of the significant fall in demand for cyclically sensitive categories of goods within the mechanical engineering and automobile sectors. However, the sharp appreciation of the yen and the associated disadvantages for the competitiveness of Japanese suppliers probably also played a part. On the other hand, there was a welcome improvement in trade with the reforming countries of central and eastern Europe, which – in contrast to the general trend – expanded their exports to Germany.

Further rise in the deficit on services account

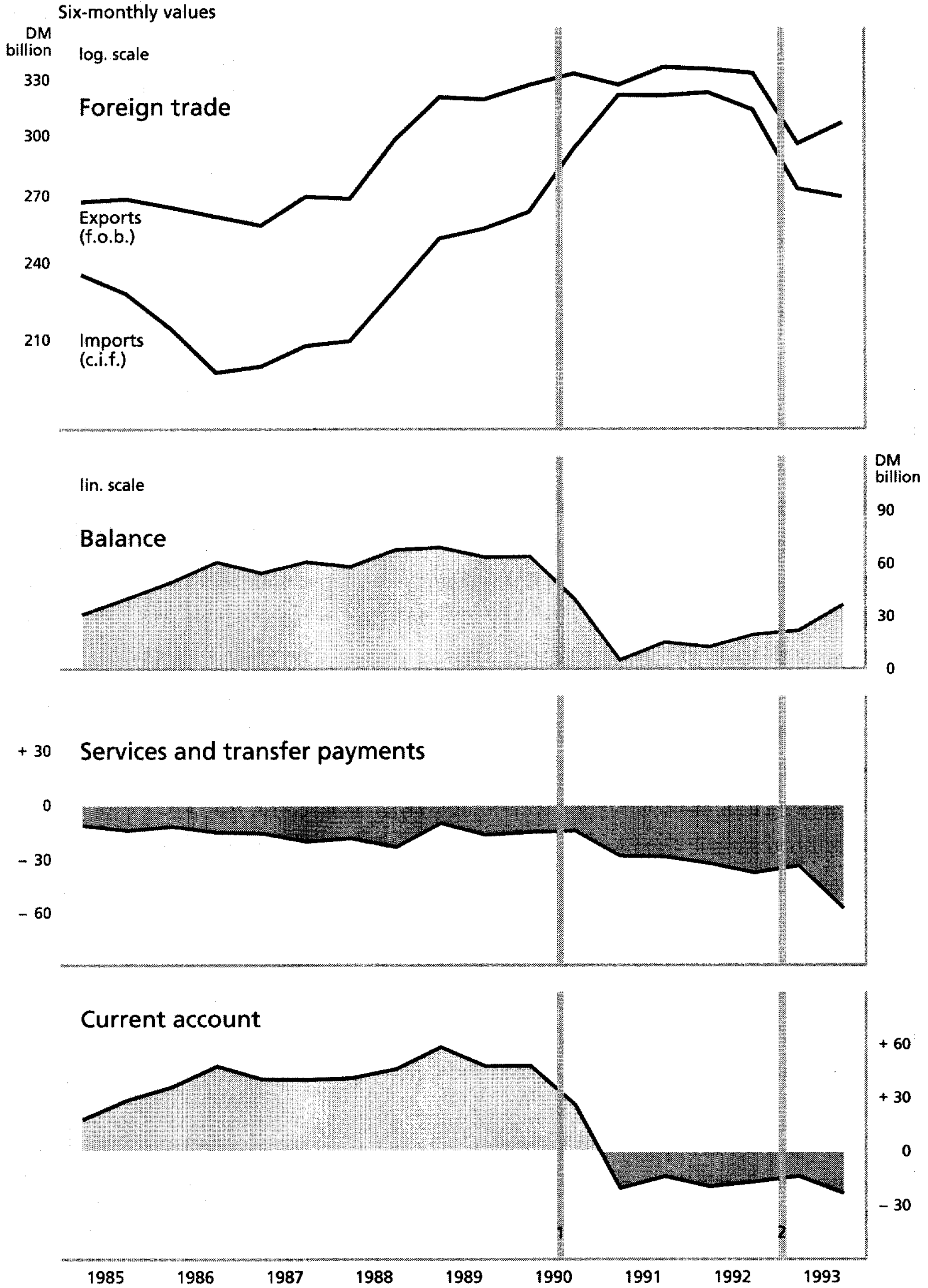
In 1993 the negative trend continued in external service transactions which have been running growing deficits since the beginning of the nineties. Overall, the deficit on Germany's services account rose from DM 34 billion in 1992 to DM 53 billion in 1993.[1]

1 In the definition of imports of goods used here (f. o. b. basis), expenditure on services includes the transport and insurance costs incurred in connection with the import of goods.

Foreign trade and current account

Chart 5

Six-monthly values



1 From July 1990 Germany as now territorially defined. — **2** From January 1993 figures subject to major uncertainties owing to changes in the recording of foreign trade.

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Increasing expenditure on foreign travel

There was a rapid increase in expenditure on foreign travel, in particular. While rising deficits had been recorded in this sector during the past few decades, ultimately reflecting the growing prosperity of the German people and the natural competitive edge of warmer holiday countries, this trend has accelerated markedly since the beginning of the nineties. The pent-up demand of east Germans for foreign travel in the west and the sharp increase in households' disposable income during the early nineties are the main reasons for this. The general cyclical downturn and the consequent risks for employment and income trends have had virtually no impact on spending in this sector. The overall deficit on foreign travel account rose by a further DM 4 ½ billion (to DM 44 ½ billion) in 1993.

Declining investment income

Until the beginning of the nineties rising investment income had provided an important counterweight in the services account to the persistent increase in foreign travel expenditure. The opposite is now true; the surpluses on investment income payments have declined considerably. A contributory factor here was the persistent current account deficits, as a result of which Germany's external liabilities and the interest to be paid on them rose more sharply than its external assets and the income arising from these. At the same time, the interest rate advantage of Deutsche Mark assets over dollar assets for most of 1993 further impaired Germany's investment income account because Deutsche Mark interest on the expenditure side had a considerably greater impact, owing to the fact that most of the country's external liabilities are denominated in Deutsche Mark, than on the receipts side, where the dollar interest rates are important. In the end, net investment income from abroad amounted to DM 15 billion last year; that was DM 9 ½ billion less than in 1992 and equivalent to no more than just under one-half of the net investment income in 1991 (DM 32 billion).[1]

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1 The figures for 1993 and earlier years were amended, in some cases significantly, in the course of this year's annual revision and therefore differ from those published previously; see Deutsche Bundesbank, Germany's balance of payments in 1993, Monthly Report, March 1994, page 35 ff. Two statistical recording problems, in particular, have been taken into account: firstly, account has been taken, where possible, of the fact that the rerouting of capital through foreign financial centres for tax reasons has resulted in a significant inflation of Germany's investment income payments to "non-residents" as some of these payments are actually attributable to residents, although they have so far not been appropriately recorded under residents' investment income. Owing to the revised investment income, the surplus on investment income account has increased. Secondly, as a result of the correct classification of accrued interest in the case of cross-border purchases and sales of fixed-interest securities, the recording of interest claims in the appropriate period has now been ensured. Accrued interest – being part of the amount actually paid – was previously booked under capital transactions, and investment income was distorted accordingly.

Persistently high transfer payments

At DM 52 billion, the deficit on unrequited payments to non-residents was unchanged in 1993. In this way Germany provided non-residents with funds amounting to more than 1 1/2 % of its gross domestic product. Germany's net contributions to the EC budget accounted for almost one-half of this. Of the other transfer payments in the public sector the most important are government pensions and maintenance payments to non-residents or to Germans living abroad (DM 6 1/2 billion) and development aid (just over DM 3 billion). In addition, the Federal Government paid just under DM 3 1/2 billion to the successor states to the former Soviet Union under the agreement concluded with that country on the withdrawal of Soviet troops from eastern Germany. Payments under the building programme for civilian dwellings were particularly important here (DM 2 billion). DM 13 1/2 billion net was exported as a result of private transfers; as in the past, remittances by foreign workers in Germany to their home countries accounted for most of this (just under DM 7 billion).

Capital transactions marked by currency unrest and expectations of falling interest rates

Capital transactions with non-residents in 1993 were significantly affected by renewed currency unrest in the EMS and persistent expectations that interest rates would fall. This sustained the interest of foreign investors in the German capital market for virtually the whole year. The outcome was that net inflows of foreign investible funds to the German capital market in 1993 reached an all-time record of almost DM 190 billion – a sum which not only far exceeded the simultaneous deficit on current account but also outclassed all previous yardsticks. Although the domestic savings which were transferred abroad to avoid the flat-rate tax on residents' interest income and were then invested in the German securities markets from there probably represented a considerable share of this, the extent of the capital imports recorded suggests that most of these funds consisted of "genuine" inflows from foreign sources.

Record investment by non-residents

Foreign capital investment in Germany, taken by itself, far exceeded the abovementioned net amount in 1993. At just under DM 285 billion, it was, in fact, almost twice as much as in the previous year, when it was already unusually high. Securities purchases by foreign investors alone resulted in inflows of DM 242 billion into Germany at a time of sharply expanding turnover. Including the "spurious" foreign investment which is quantitatively unidentifiable, public bonds worth DM 160 1/2 billion were transferred to safe custody accounts abroad, which means that approximately two-thirds of the net amount sold by the public sector was placed abroad. There was also considerable interest in bank bonds (DM 65 1/2 billion). As in 1992, most of these purchases were made by the Luxemburg investment funds of German banks, which mainly used this means to rechannel the investible funds they had received from German savers to the German capital market. For the first time since 1989 non-residents also invested a fairly substantial amount in the German share market (DM 12 billion, including investment fund units) and thus fostered the outstanding rise in prices in the German stock markets in 1993.

Increase in bank loans and stagnation of direct investment

Outside the field of securities transactions, it was essentially only the banks that imported long-term foreign funds. Their external liabilities from deposits and borrowers' note loans – which were closely linked to the expansion in their long-term foreign lending – rose sharply, at DM 38 billion. In some cases, this probably also concerned the proceeds of foreign Deutsche Mark bonds, which foreign financing subsidiaries of German banks issued in the international market in 1993. On the other hand, foreign enterprises did not increase their participating interests in Germany any further last year.

Lower capital exports

Capital exports through German investment abroad were appreciably lower, at DM 97 billion, in 1993 than they had been in 1992 (DM 117 billion), although it must be noted here that not all of the capital exported for tax reasons can be recorded in the statistics. The recorded decline is largely due to the dramatic loss of interest on the part of German savers in foreign investment fund units in the course of the year. On balance, only DM 18 billion (including the reinvestment of cumulative profits) was invested in such paper in 1993, compared with DM 61 billion in 1992. In the first few months after the introduction of the flat-rate tax on interest income at the beginning of 1993, residents invested substantial amounts in this paper. After the tax-induced shifts in assets, which had probably been the reason for the large level of investment at the turn of 1992-3, had tailed off in the spring of 1993, however, new investment fell discernibly in the summer. Besides this, in the middle of 1993 the income paid through domestic credit institutions from investment in foreign funds was subjected to the tax on interest income, with the result that this type of investment became less attractive for many savers. When finally in September 1993 the plans for tax amendments were published, which have meanwhile been implemented and which subjected, inter alia, the income from cumulative foreign investment funds paid through domestic banks to the flat-rate tax on interest income from January 1994, resident investors reduced their holdings of foreign investment fund units – which, including the cumulative profits, had reached approximately DM 140 billion in August 1993 – by just under one-quarter by the end of the year.[1] Of the remaining foreign securities it was particularly foreign shares which, at just over DM 8 billion, found favour with domestic investors, who thereby participated in the bullish movement in international share markets.

Decline in German direct investment

Once again German direct investment abroad, at DM 19 billion, was appreciably lower in 1993 than in 1992. This was probably due in the main to the cyclical weakness in the European partner countries, which for some years now have been the main target countries for German equity market investment.

Large exports of short-term funds by enterprises and individuals

In addition to the capital exports already mentioned, residents increased, in particular, their short-term financial investment abroad. Resident enterprises and individuals built up their Euro-market balances, which are mainly denominated in Deutsche Mark, by DM 58 ½ billion net. Much the same as in the case of resident savers' purchases of foreign investment fund units, these outflows were concentrated particularly in the first quarter of 1993, which suggests that avoidance of the flat-rate tax on interest income, which had been in force since the beginning of 1993, was a significant factor. The large negative balancing item of the balance of payments (DM 21 billion) also indicates that the "spurious" foreign purchases in the German securities market which were mentioned above and which are likewise to be seen in the light of the flat-rate tax on interest income probably amounted to an appreciable sum. The major part of the balancing item in the balance of payments statistics is probably an adjustment item to the "purchases by non-residents", which are overstated to this extent.

Significant net inflows of funds were recorded in the current and capital transactions of non-banks last year. Inversely, the banks' net external assets rose sharply. In addition, the banks – partly in connection with the Deutsche Mark borrowings of European partner central banks in the Euro-market to repay their intervention liabilities to the Bundesbank – exported fairly substantial sums to the Euro-market. Consequently, the short-term external position of German credit institutions improved by DM 102 ½ billion net last year.

Decline in the net external assets of the Bundesbank

The net external assets of the Bundesbank – calculated at transaction values – declined by DM 36 billion in 1993. Both the DM 23 billion fall in monetary reserves and the DM 13 billion rise in external liabilities, which arose essentially in connec-

1 For the amendment of the tax regulations and the effects of the tax on interest income, see Deutsche Bundesbank, Revenue from and economic implications of the tax on interest income, Monthly Report, January 1994, page 43 ff.

Changes in the net external position of the Deutsche Bundesbank*

Table 7

DM billion; increase in foreign exchange: +

Period	Net external position, total	Operations in the foreign exchange market[1]			Other transactions				
		Total	Deutsche Mark/ dollar market	EMS intervention and debt settlement[2]	Total	US dollar interest income and US dollar receipts from US troops	Official (net)	Other foreign exchange movements (net)	Sales of Bundesbank Treasury discount paper (liquidity paper)
1993 Jan.	- 11.4	- 11.0	–	- 11.0	- 0.4	+ 1.0	- 0.8	- 0.6	–
Feb.	- 12.3	- 4.4	–	- 4.4	- 7.9	+ 1.8	- 0.8	- 8.9	–
Mar.	- 23.6	- 6.0	–	- 6.0	- 17.6	+ 1.1	- 0.8	- 7.2	- 10.8
Apr.	- 2.2	- 3.5	–	- 3.5	+ 1.3	+ 1.5	- 0.7	+ 0.2	+ 0.3
May	+ 1.3	- 0.2	–	- 0.2	+ 1.5	+ 2.0	- 0.8	+ 0.5	- 0.2
June	- 3.3	–	–	–	- 3.3	+ 1.0	- 0.0	- 2.5	- 1.7
July	+ 13.2	+ 18.9	–	+ 18.9	- 5.7	+ 1.1	- 0.9	- 5.8	- 0.1
Aug.	+ 44.2	+ 32.3	–	+ 32.3	+ 11.9	+ 1.7	- 1.4	+ 13.0	- 1.5
Sep.	- 32.7	- 22.0	–	- 22.0	- 10.6	+ 1.1	+ 0.5	- 11.5	- 0.8
Oct.	- 12.0	- 9.0	–	- 9.0	- 3.0	+ 1.1	- 0.6	- 2.1	- 1.4
Nov.	+ 2.0	–	–	–	+ 2.0	+ 1.7	- 0.5	+ 1.3	- 0.5
Dec.	+ 0.8	–	–	–	+ 0.8	+ 0.8	+ 0.5	- 0.6	+ 0.2
Total	- 35.8	- 4.8	–	- 4.8	- 31.1	+ 16.0	- 6.4	- 24.2	- 16.4
1994 Jan.	- 2.8	–	–	–	- 2.8	+ 1.2	+ 0.2	- 2.8	- 1.4
Feb.	- 1.4	–	–	–	- 1.4	+ 1.7	- 0.8	- 0.4	- 1.8

* Transactions recorded according to the date of entry. – 1 Including operations by other central banks, where they affect the external position of the Bundesbank. – 2 Debt settlement: Deutsche Mark repayments to the Bundesbank by EMS partners.

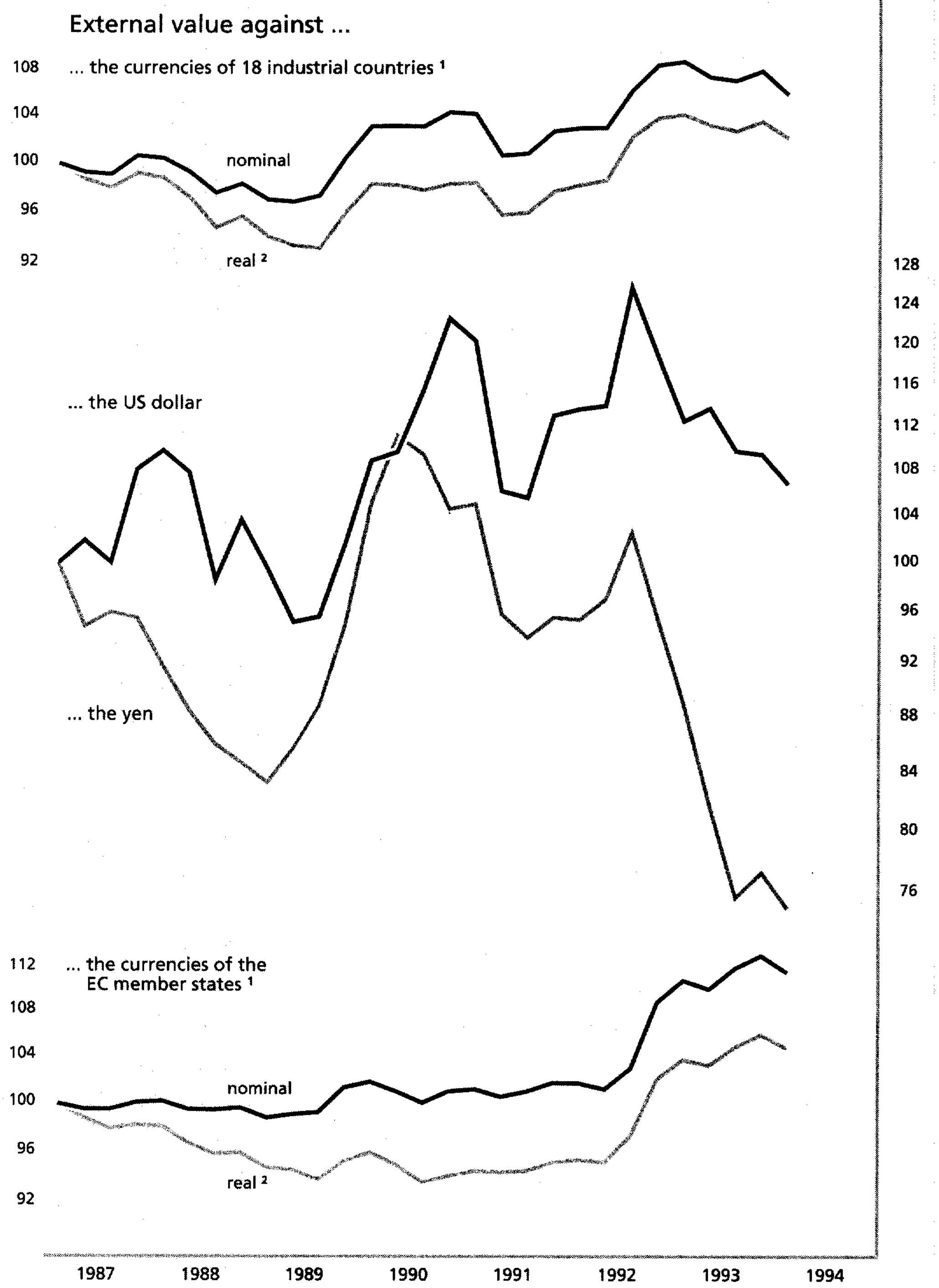
Deutsche Bundesbank

tion with the sales of Bundesbank Treasury discount paper (liquidity paper), or "Bulis", to non-resident investors, were the main reasons for this. The Bundesbank issued this paper for the first time in March 1993. At DM 16½ billion, foreign investors, particularly central banks, were holding approximately two-thirds of the Treasury discount paper issued by the Bundesbank by the end of the year. The Bundesbank's monetary reserves were subject to considerable fluctuations during 1993, which was a reflection of the rapidly growing tensions in the European foreign exchange markets. The somewhat more settled market situation enabled the European partner central banks in the spring of last year gradually to repay their liabilities from the autumn and winter of 1992. In connection with the exchange rate unrest in the summer of 1993, the Bundesbank's monetary reserves then increased sharply again (by DM 60 billion net in July alone). With the gradual stabilisation of exchange rates following the widening of the fluctuation bands in the EMS, however, the central banks concerned could again repay most their intervention liabilities by the end of 1993.

External value of the Deutsche Mark

Chart 6

1st qtr of 1987 = 100, log. scale



1 Weighted external value. — 2 External value after adjustment for the differing macroeconomic price movements (as measured by the prices of total sales).

Deutsche Bundesbank

Revaluation of the external position

As usual, the external position of the Bundesbank was revalued at the end of the year. Overall, however, there were no appreciable changes in the Bundesbank's foreign currency assets as a result of this. The US dollar holdings are still valued at DM 1.3870, but the ECU and SDR holdings were revalued and now stand at DM 1.89636 per ECU and DM 2.37527 per SDR.

Slight appreciation of the Deutsche Mark in the EMS

The exchange rate trend of the Deutsche Mark was marked by rather varying trends in 1993. The Deutsche Mark continued to appreciate against a number of EMS partner currencies right into the autumn as a result of the re-emergence of currency unrest in the European Monetary System. After speculative pressures had abated following the widening of the EMS fluctuation bands, however, most EMS currencies moved persistently in the opposite direction during the autumn and winter. As a result of these developments, the Deutsche Mark was being quoted 1 ½ % higher on average against the currencies participating in the EMS exchange rate mechanism in the first quarter of 1994 than it had been during the same period of 1993. This appreciation arose essentially from a pronounced strengthening of the Deutsche Mark against the Iberian currencies, which were under constant pressure to depreciate until last autumn, whereas the exchange rates against the EMS core currencies, which had been participating in the exchange rate mechanism within the normal 2¼ % fluctuation band for a long time, remained virtually unchanged overall.

Slight appreciation against other European currencies

Other European currencies had also benefited from the generally more relaxed conditions in the EMS since the autumn of 1993. For example, the currencies of the countries which are expected to join the EC were relatively stable against the Deutsche Mark. The exchange rate of the Deutsche Mark against the Austrian schilling was virtually constant, as it had been since the beginning of the eighties. This had more or less been true of the Norwegian krone and the Swedish krona since the spring of 1993, whereas the Finnish markka again appreciated against the Deutsche Mark (by 8 %) after depreciating heavily against the German currency during the previous two years. The performance of the Deutsche Mark against the currencies which had withdrawn from the exchange rate mechanism showed different trends. On average during the first quarter of 1994 the Deutsche Mark was being quoted 6 % lower against the pound sterling than a year earlier as the pound had been benefiting from the discernible economic revival in the United Kingdom, whereas it firmed (by 3 ½ %) against the Italian lira, which had generally been losing more ground owing to its exposure to particular economic and political disadvantages.

Record of domestic and external monetary policy measures

January 1, 1993

The Fourth Act Amending the Banking Act and the amendment of the "Principles Concerning the Capital and Liquidity of Credit Institutions" come into force; these measures translate into German law the EC Council Directives on banking coordination, on the own funds of credit institutions and on a solvency ratio for credit institutions.

February 1, 1993

The Irish pound is devalued by 10 % in the European Monetary System (EMS).

February 4, 1993

The Central Bank Council decides that in March the Bundesbank will sell by tender in the open market up to DM 25 billion of liquidity paper in the form of Treasury discount paper (under section 42 of the Bundesbank Act) in three tranches with maturities of three, six and nine months. The minimum reserve ratios for time liabilities and savings deposits are reduced to a uniform 2 % (from 4.95 % and 4.15 %, respectively) with effect from March 1. The lombard rate is lowered from 9½ % to 9 % and the discount rate from 8¼ % to 8 % with effect from February 5.

March 18, 1993

The Central Bank Council lowers the discount rate from 8 % to 7½ % with effect from March 19. By taking this measure, the Bundesbank continues its policy of gradual interest rate reductions.

April 22, 1993

The Central Bank Council lowers the discount rate from 7½ % to 7¼ % and the lombard rate from 9 % to 8½ % with effect from April 23. At the same time, it approves the annual accounts for the financial year 1992; DM 13.1 billion of the net profit is paid over to the Federal Government.

May 13, 1993

The Spanish peseta and the Portuguese escudo are devalued by 8 % and 6.5 %, respectively, in the EMS.

July 1, 1993

In continuation of its policy of cautiously lowering interest rates, the Central Bank Council reduces the discount rate from 7¼ % to 6¾ % and the lombard rate from 8½ % to 8¼ % with effect from July 2.

July 15, 1993

The Bundesbank reviews and reaffirms the monetary target for 1993, which provides for a 4½ % to 6½ % expansion of the money stock M3 between the fourth quarter of 1992 and the fourth quarter of 1993.

July 29, 1993

The Central Bank Council lowers the lombard rate from 8¼ % to 7¾ % with effect from July 30.

August 2, 1993

The finance ministers and central bank governors of the member states of the European Community decide temporarily to widen, with effect from August 2, the band for compulsory intervention by the states participating in the exchange rate mechanism of the EMS to ±15 % around the unchanged bilateral central rates (instead of ±2¼ %, and ±6 % for Spain and Portugal). On the basis of a bilateral agreement, only the Netherlands and Germany retain the old fluctuation margin of ±2¼ %. These measures were taken in response to developments in the EMS which had assumed crisis-like proportions, and were successful in curing tensions within the EMS that had lasted since the autumn of 1992.

August 19, 1993

On the occasion of an invitation to tender for new Bundesbank Treasury discount paper (liquidity paper), the Bundesbank announces – in order to promote the use of this liquidity policy instrument – that with immediate effect non-banks holding a giro account with a Land Central Bank can likewise submit bids direct, that the minimum denomination is raised to DM 500,000, and that it is planned to replace liquidity paper falling due from December 1993 exclusively by paper running for six months, until further notice.

September 9, 1993

The Central Bank Council lowers the discount rate from 6¾% to 6¼% and the lombard rate from 7¾% to 7¼% with effect from September 10.

October 21, 1993

The Central Bank Council lowers the discount rate from 6¼% to 5¾% and the lombard rate from 7¼% to 6¾% with effect from October 22. By taking these measures, the Bundesbank continues its policy of cautious interest rate reductions against the backdrop of discernible progress in the fight against inflation.

November 1, 1993

The Treaty on European Union comes into force in Germany upon the conclusion of the ratification process following the ruling by the Federal Constitutional Court.

December 16, 1993

The Bundesbank sets the monetary target for 1994. It provides that the Bundesbank will conduct its monetary policy in 1994 in such a way as to ensure that the pace of inflation continues to slacken and, at the same time, that the monetary conditions for durable economic growth remain in place. To this end, the Bank regards it as appropriate for the money stock M3 to expand by 4% to 6% between the fourth quarter of 1993 and the fourth quarter of 1994.

January 1, 1994

The second stage of the European economic and monetary union (EMU) commences. Its objective is to promote the convergence of the member states in order thereby to create the fundamental prerequisites for transition to the final stage of EMU. Moreover, in the second stage the legal, institutional and organisational foundations of a uniform European monetary policy in the final stage of EMU are to be laid. The European Monetary Institute will be set up in accordance with the Treaty; it will be domiciled in Frankfurt am Main. In keeping with the regulations governing the second stage of EMU, cash advances by the Bundesbank to the public sector (under section 20 of the Bundesbank Act) are prohibited. At the same time, the Bundesbank effectively releases the central and regional public authorities from their deposit requirements (under section 17 of the Bundesbank Act) by granting them or increasing their blanket quotas for the alternative investment of their liquid funds.

January 11, 1994

The Council of the European Monetary Institute convenes for its constituent meeting in Frankfurt am Main.

January 20, 1994

The Central Bank Council approves the restructuring and lowering of the minimum reserves with effect from March 1, 1994. The progressive reserve stages for the sight deposits of residents (of 6.6%, 9.9% and 12.1%) are abolished, and the reserve ratio for the sight deposits of both residents and non-residents is lowered to a uniform 5%. The reserve ratios for time liabilities and savings deposits remain unchanged at a uniform 2%. At the same time, the deductibility of credit institutions' cash in hand when complying with the minimum reserve requirements is limited to 25% (rather than 50%) of the required reserves. The primary aim of these decisions is to lessen the competitive drawbacks of the domestic financial markets vis-à-vis the Euro-markets, and thus to reduce the incentive to try to circumvent the minimum reserve requirements.

February 17, 1994

The Central Bank Council lowers the discount rate from 5¾% to 5¼% with effect from February 18. In this way, the Bundesbank takes due account of the fact that the decline in the inflation rate is persisting.

April 14, 1994

The Central Bank Council lowers the discount rate from 5¼% to 5% and the lombard rate from 6¾% to 6½% with effect from April 15. At the same time, it approves the annual accounts for the financial year 1993; DM 18.26 billion of the net profit is paid over to the Federal Government.

Record of general economic and fiscal policy measures

January 20, 1993

The coalition parties adopt benchmark figures for a Federal Consolidation Programme and for a supplementary Federal budget for 1993.

May 27, 1993

The Financial Planning Council declares that the current situation calls for the built-in stabilisers being allowed to take effect and, at the same time, for confidence being placed in the medium-term consolidation strategy. It says that it is imperative to limit the rise in the expenditure of the central, regional and local authorities – particularly that on consumption – to an average of 3 % in the years ahead by means of strict budgetary discipline.

May 28, 1993

The Bundesrat approves the Act Implementing the Federal Consolidation Programme – which was adopted following negotiations on a "solidarity pact". Primarily by means of tax increases, this package of measures aims to bring about a medium-term reduction in the central, regional and local authorities' deficit, and to lay a foundation for the reform of the distribution of revenue among the individual levels of government in reunited Germany, which will be necessary in 1995 and will include the settlement of the debts "inherited" from the former GDR.

June 18, 1993

The Bundestag approves a supplement to the Federal budget for 1993, which primarily takes account of the cyclically-induced additional burdens relative to previous expectations. Compared with the original budget, expenditure will rise by DM 22½ billion, whereas receipts will decrease by DM 2 billion on balance. Hence the deficit will grow by DM 24½ billion to DM 68½ billion.

July 9, 1993

The Bundesrat approves the Location Protection Act in the compromise wording agreed in the Mediation Committee. This second stage of the corporation tax reform focuses on reducing the rates of income and corporation tax on industrial profits. On the other hand, as part of this tax package – which in the longer run is intended not to affect revenue – some special tax concessions as well as possibilities of abuse are to be eliminated; depreciation allowances for investment in machinery and equipment are, however, left intact.

July 13, 1993

The Federal Cabinet approves the draft Federal budget for 1994, involving an expenditure volume of DM 478½ billion and a deficit of DM 68 billion, as well as the financial plan from 1993 to 1997. According to that plan, over the medium term the rise in expenditure is to be limited to an annual average of 2.3 %, and the deficit is to be reduced to DM 38½ billion by 1997. At the same time, the benchmark figures of a Retrenchment, Consolidation and Growth Programme are presented, which is intended to relieve the burden on the central, regional and local authorities' budgets by a total of DM 25 billion in 1994 – rising to DM 35 billion by 1996.

November 15, 1993

In its Annual Report for 1994, the Council of Economic Experts expects real GDP to decrease slightly in western Germany, and overall output to rise by 7½% in the new Länder. Economic policy will be successful in bringing down inflation. Owing to prior charges – as early as the end of 1993 the index will be 1½% above the annual average – the annual rate of inflation will come to about 3%. The rise in mineral oil tax has a very strong bearing on that. In eastern Germany the rise in consumer prices will reach about 4% because some prices administered by the government have not yet been fully adjusted.

December 17, 1993

The Bundestag approves the 1994 Federal budget and the associated retrenchment package after a compromise thereon has been reached in the Mediation Committee. The pressure on the central, regional and local authorities' budgets will be relieved by a good DM 14 billion in 1994 by means of statutory consolidation measures – which focus mainly on cuts in expenditure on social benefits and which, in addition, include some tax regulations to fight abuses, as well as a mineral oil tax increase to finance the reform of the railways. Inclusive of further cuts in budget management and envisaged additional receipts owing to administrative measures, the consolidation package for 1994 amounts to a total volume of nearly DM 26 billion, DM 21 billion of which is accounted for by the Federal Government. The deficit in the Federal budget for 1994 – with an expenditure volume of DM 480 billion – will thereby be confined to just under DM 70 billion; on account of cyclically-induced additional burdens – most of which, however, can be offset – it still exceeds that of the Government draft by DM 1½ billion.

January 1, 1994

Various financial policy measures come into force: major components of the Retrenchment, Consolidation and Growth Programme (for example, cuts in wage substitutes, increase in the mineral oil tax), the reform of the railways, some measures of the Federal Consolidation Programme (such as the reduction of the tax concessions granted on owner-occupied old buildings), as well as the main part of the Location Protection Act. In addition, the contribution rate to the pension insurance funds is raised by 1.7 percentage points to 19.2%.

January 27, 1994

In its Annual Economic Report for 1994, the Federal Government expects real GDP to grow by ½% to 1% in western Germany and by 6% to 8% in the new Länder. In the Federal Republic as a whole, this implies an increase in overall economic output of 1% to 1½%.

Depreciation against the dollar and the yen

In the course of last year the Deutsche Mark depreciated perceptibly against the US dollar in a period of considerable fluctuation against the US currency. This depreciation amounted to 5 %, compared with the first quarter of 1993. One reason for this was the generally firmer trend in the US dollar since the middle of 1993 when, after a period of renewed doubt and uncertainty about the future progress of the cyclical upturn in the United States, there were growing signs that the recovery in the US economy had, in fact, gained strength and momentum. Other reasons were that between the beginning of 1993 and March 1994 the interest rate advantage of short-term Deutsche Mark assets over dollar assets had more than halved and that the yield differential in favour of the Deutsche Mark which had prevailed in the capital markets for quite some time had virtually disappeared by the end of 1993. Yet another factor was that the Deutsche Mark – as had happened before – was temporarily under greater strain owing to the unpredictable shifts in political power in eastern Europe. The depreciation of the Deutsche Mark against the yen (– 15 1/2 %) was even greater than that against the dollar. However, this is not so much a countermovement to a previous strengthening of the Deutsche Mark as a reflection of a continual "autonomous" upward trend, which the Japanese currency, in view of the country's growing foreign trade surpluses, has been showing for some time.

Slight depreciation of the Deutsche Mark overall

Overall, i. e. as measured by the weighted external value against the currencies of 18 industrial countries, the Deutsche Mark depreciated by 2 1/2 % in the first quarter of 1994, compared with the same period last year. If the different rates of price rises between Germany and its partner countries are eliminated, the real external value of the Deutsche Mark was 2 % lower in the first quarter of 1994 than in the same period of 1993. It was therefore only 2 % above the level at the beginning of 1987, the time of the last comprehensive realignment within the EMS. It is therefore likely that the German economy, following the normalisation of the currency situation and the welcome progress in regaining stability, has become more price competitive again, whereas in the two preceding years sales of German products had been more difficult as a result of the real appreciation of the Deutsche Mark. If our international competitiveness is to be improved, however, gearing domestic cost trends permanently to stability will continue to be essential.

4. Monetary policy on the road to regaining price stability

(a) Monetary policy abides by its anti-inflationary stance, monetary conditions ease distinctly

Progressive, and ultimately marked, interest rate reduction

Last year the Bundesbank once again abided by its underlying stability-oriented monetary policy stance. As the outlook for price stability gradually brightened, this stance allowed a continuation of the easing of central bank interest rates initiated in the autumn of 1992. The macro-economic setting for the conduct of monetary policy remained difficult, however. Despite the sharp downturn in economic activity, visible progress in the fight against inflation was slow to materialise; monetary growth was buoyant and actually accelerated temporarily in the latter part of the year, and in the foreign exchange markets confidence in the Deutsche Mark weakened at times. In these circumstances the Bundesbank therefore had to act particularly cautiously, so as to maintain market confidence in the future, too, by means of a credible policy geared to continuity, and not to risk any major setbacks with respect to the capital market rate and the exchange rate. It was consistent with this cautious approach that the Bundesbank lowered its interest rates in small steps, and sometimes sought to stabilise interest rate movements and reassure the financial markets if it considered the underlying conditions to be overly unsettled. In such periods of "going straight ahead", the Bundesbank, when offering its weekly securities repurchase agreements, frequently gave preference to fixed-rate tenders, whereas in periods when interest rates were on the decline it used variable-rate tenders in order to explore the scope available for cutting interest rates. On balance, short-term interest rates fell sharply. The discount and lombard rates were lowered six times in 1993. In February this year the discount rate was reduced further, and in April both the discount rate and the lombard rate were lowered again; at 5 % and 6 1/2 %, respectively, these rates are now 3 3/4 and 3 1/4 percentage points, respectively, lower than in the early autumn of 1992. Securities repurchase rates and day-to-day money market rates have dropped by almost 4 percentage points since then, to a level of around 5 3/4 %, and time deposit rates in the money market have fallen even more steeply. The yield on domestic bonds outstanding has likewise been easing further, and has settled down most recently at a decidedly low level (just under 6 1/4 %).

Rejection of accelerated interest rate cuts motivated by business cycle and exchange rate considerations

By maintaining a stable environment and confidence in the currency, monetary policy also promotes the objectives of economic growth and full employment. A strategy of accelerated interest rate cuts motivated by business cycle and exchange rate considerations, on the other hand, would involve the risk of exerting a counter-productive impact on the economy as a whole. Interest rate reductions in the money market which are incompatible with anti-inflation policy could trigger inflation expectations, and hence a setback in the capital market as well as in the field of long-term interest rates, which are of particular significance for investment decisions and construction projects. A strategy of devaluation based on interest rate policy measures would be downright disastrous. It would markedly impede the restoration of price stability via the import side and involve the danger of a price-wage spiral and higher risk premiums in the capital market. On the export side, hardly anything is to be gained by competitive devaluation, especially as such a move might easily prompt counteraction abroad.

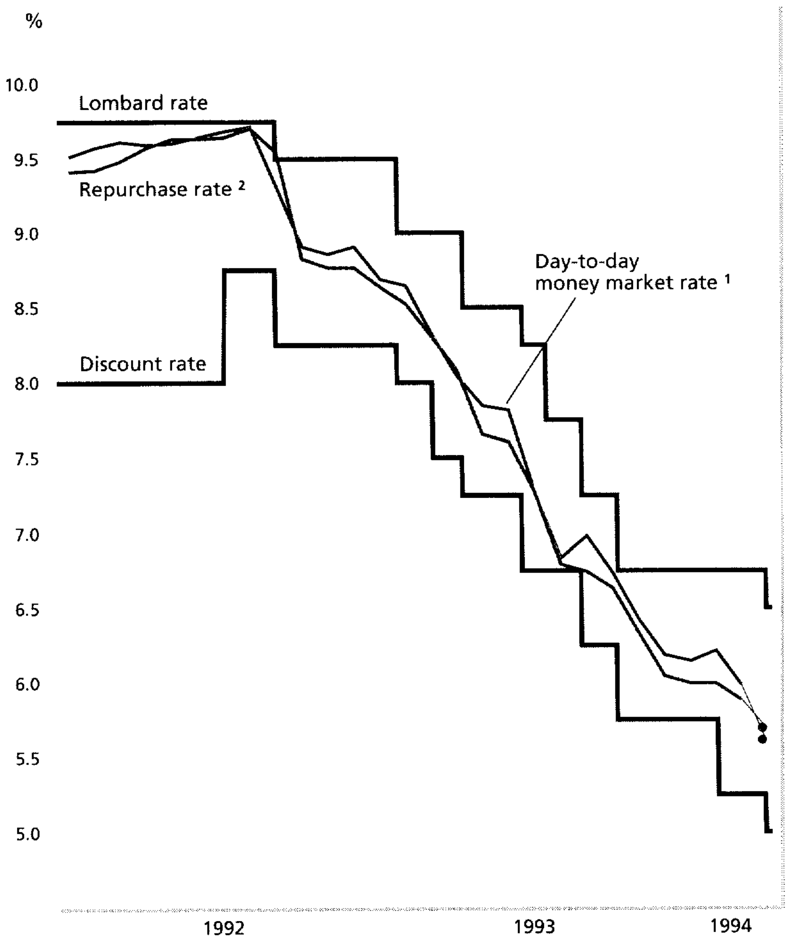
Restructuring of, and radical reduction in, the minimum reserves

The Bundesbank has slightly modified the deployment of its monetary policy instruments recently; in particular, it restructured the minimum reserves and lowered them markedly in two steps in March 1993 and 1994. The Bundesbank's primary aim in doing so was to lessen the incentive to evade the minimum reserve requirements provided by a high level of minimum reserve ratios, while at the same time reducing the competitive disadvantages suffered by Germany as a financial centre. With effect from March 1, 1993 the reserve ratios for time liabilities were lowered from 4.95 % and those for savings deposits from 4.15 % to a uniform 2 %. To supplement this change, the progressive reserve stages for sight liabilities to residents (of 6.6 %, 9.9 % and 12.1 %) were abolished, and the ratios applied to domestic and external liabilities were lowered to a uniform 5 % with effect from March 1, 1994. The deductibility of credit institutions' cash holdings when meeting the minimum reserve requirements was reduced from 50 % to 25 % of the required reserves.[1] As a result of these measures the required minimum reserves decreased by DM 33 billion in March last year, and by about DM 30 billion gross or around DM 19 billion net (i. e. inclusive of the effect of the reduced deductibility of cash holdings) in March this year. The Bundesbank's basic attitude towards the minimum reserves, which it sees as an instrument which in the long run is important for the efficacy of monetary policy and hence ultimately also indispensable in any future European monetary policy, is not affected by the lowering and restructuring of the minimum reserves; in the final analysis, the reduction of the reserve ratios actually strengthens the position of the minimum reserves among the range of monetary policy instruments because it lessens the incentive to circumvent that instrument. The essential function of the minimum reserves as a monetary policy instrument, viz. that of creating stable

1 For further details of recent minimum reserve measures, see Deutsche Bundesbank, The restructuring and lowering of the minimum reserves, Monthly Report, February 1994, page 13 ff.

Bundesbank interest rates and day-to-day money market rate

Chart 7



1 Monthly averages. — **2** Average rate during month applied to securities repurchase agreements with one-month or, from October 1992, with two-week maturities; uniform allotment rate (fixed-rate tender) or weighted allotment rate („US-style" variable-rate tender). — • = Latest position: April 14, 1994.

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demand on the part of banks for central bank balances and at the same time acting as a liquidity buffer in the money market, is preserved even at their present, lower, level. The increase in liquidity resulting from the two reserve cuts has been offset in different ways. In March 1993 the Bundesbank primarily took advantage of the extended scope for selling liquidity paper (pursuant to section 42 of the Bundesbank Act) provided by the amendment of the Bundesbank Act, and sold a total amount of DM 25.0 billion of such paper in the open market.[1] The objective

1 See Deutsche Bundesbank, Annual Report 1992, page 57.

pursued at the same time of putting open market policy on a broader footing by granting non-banks access to such transactions could, however, be attained to only a very limited extent. By contrast, the liquidity released by the latest minimum reserve cut was absorbed in full by a corresponding reduction in the amount of securities repurchase agreements outstanding. Altogether, it thus implied over DM 1 billion in cost relief for the banking industry, with the combined effect of the two moves providing the banks with not inconsiderable scope for lowering the lending rates and raising the deposit rates applied in transactions with their customers.

Renewed EMS crisis at mid-year resolved by widening the fluctuation margins

After the EMS turmoil in the autumn of 1992, the background to the Bundesbank's money market management had largely returned to normal by the middle of last year. In the course of July, however, conditions in the EMS once again started to assume crisis-like proportions. Towards the end of that month, foreign exchange equivalent to almost DM 30 billion flowed to the Bundesbank on a single day, as a result of support operations for partner currencies; in July as a whole the inflows came to nearly DM 60 billion. The Bundesbank counteracted the associated sharp rise in the liquidity of the domestic banking system by means of a rapid reduction in the amount of securities repurchase agreements outstanding and by managing liquidity "at sight". However, massive inflows of funds from abroad, whose impact is virtually uncontrollable, not only impede the management of the money market but also jeopardize the control of monetary growth, which is indispensable for combating inflation. The widening of the fluctuation margins in the EMS on August 2, which terminated the crisis of confidence that in the end had been self-sustaining (see also page 87), was therefore unavoidable from the point of view of the Bundesbank in order to regain room for monetary policy manœuvre and to be able to stick to a counter-inflationary monetary policy. In our partner countries, too, it provided monetary policy makers with a greater degree of freedom.

Money market management back in calmer waters since the autumn

Since last autumn money market management by the Bundesbank has been moving in comparatively calm waters again. This has enabled the emphasis of the ongoing provision of funds to be shifted back unequivocally to the revolving weekly conclusion of securities repurchase agreements. Between the end of November 1993 and the end of February 1994 the Bundesbank resorted to fixed-rate tenders to provide guidance to the financial markets in conditions which had become more difficult. Moreover, from mid-November onwards all the securities transactions were offered with two-week maturities. By stabilising interest rate trends in the money market – and at times announcing the terms of several securities repurchase tenders in advance – the Bundesbank sought, in particular,

Monetary developments*

Table 8

Change during year[1]

Item	1990	1991	1992	1993
	DM billion			
I. Central bank money requirements of banks and liquidity policy measures by the Bundesbank[2]				
1. Provision (+) or absorption (–) of central bank balances by:				
Rise in central bank money[3] (increase: –)	– 29.6	– 20.2	– 38.7	– 21.5
Foreign exchange movements (excluding foreign exchange swaps)	+ 9.9	+ 1.1	+ 63.6	– 16.6
Cash transactions of the central and regional authorities (including shifts of Federal balances under section 17 of the Bundesbank Act)	– 16.2	+ 9.7	+ 10.9	– 9.2
Transfer of the Bundesbank's profit to the Federal Government	+ 10.0	+ 8.3	+ 14.5	+ 13.1
Other factors	– 15.0	– 19.0	– 19.1	– 18.9
Total 1	– 40.8	– 20.1	+ 31.1	– 53.1
2. Liquidity policy measures:				
Change in minimum reserves[4]	– 0.2	– 0.1	– 0.9	+ 32.6
Change in refinancing facilities	+ 25.2	– 7.6	– 15.5	+ 0.1
Open market operations in liquidity paper and in the bond market	– 0.3	+ 1.5	+ 3.3	– 26.5
Securities repurchase agreements	+ 13.3	+ 29.8	– 16.0	+ 46.6
Other assistance measures in the money market[5]	+ 1.0	+ 0.8	– 2.6	+ 3.6
Total 2	+ 39.0	+ 24.3	– 31.7	+ 56.3
3. Remaining deficit (–) or surplus (+) (1 plus 2)	– 1.8	+ 4.2	– 0.6	+ 3.2
met or absorbed by:				
Recourse to unused refinancing facilities (reduction: +)	– 0.5	– 2.0	+ 2.0	– 4,2
Changes in lombard loans (increase: +)	+ 2.3	– 2.3	– 1.4	+ 1.1
	%			
II. Key monetary indicators				
Money stock M3[6]	+ 5.6	+ 6.1	+ 8.4	+ 8.7
Money stock M3 extended[7]	+ 7.9	+ 7.4	+ 9.5	+ 12.8
Lending by the banking system to domestic non-banks	+ 7.4	+ 9.9	+ 9.4	+ 9.5
	DM billion			
III. The money stock and its counterparts				
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 66.9	+ 95.7	+117.1	+186.2
Counterparts in the balance sheet				
1. Volume of credit[8]	+223.1	+286.1	+299.9	+334.1
of which				
Lending by credit institutions to domestic non-banks	+223.3	+286.0	+294.3	+340.0
– to enterprises and individuals[9]	+181.7	+259.3	+247.9	+243.7
– to public authorities	+ 41.6	+ 26.7	+ 46.4	+ 96.3
2. Net external assets[10]	+ 48.4	– 7.4	– 40.7	– 5.5
3. Monetary capital	+161.3	+154.4	+101.5	+ 98.2
of which				
Savings deposits at over three months' notice and bank savings bonds	+ 37.4	+ 10.3	+ 12.3	+ 10.2
Time deposits for four years and over	+ 33.1	+ 32.1	+ 26.3	+ 32.4
Bank bonds outstanding[11]	+ 76.9	+ 92.1	+ 41.0	+ 32.0
4. Central bank deposits of public authorities	+ 12.3	– 6.4	– 12.3	+ 13.1
5. Other factors	+ 31.1	+ 35.1	+ 52.9	+ 31.2

* New territorial definition of the Federal Republic of Germany, for items I and III from July 1990, for item II from 1991. – **1** Unless otherwise indicated, based on end-of-month figures. – **2** Based on daily averages of the last month of the period. – **3** Currency in circulation (excluding credit insitutions' currency holdings, which are deductible from the required minimum reserves) and required reserves on domestic liabilities at current reserve ratios; but excluding changes in the required reserves due to changes in the reserve ratios. – **4** Including changes in minimum reserves due to the growth of reserve-carrying external liabilities. – **5** Sales of short-term Treasury bills, foreign exchange swaps, foreign exchange repurchase agreements, quick tenders and shifts of Federal balances under section 17 of the Bundesbank Act. – **6** Currency in circulation plus sight deposits, time deposits for less than four years and savings deposits at three months' notice held at domestic credit institutions, computed as a monthly average. – **7** Money stock M3 extended to include deposits abroad and short-term bank bonds held by domestic non-banks. – **8** Credit institutions and the Bundesbank; including lending against securities. – **9** Including housing loans. – **10** Credit institutions and the Bundesbank. – **11** Excluding banks' portfolios.

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Changes to the institutional framework in the money market at the beginning of 1994

to ease the banks' end-of-year liquidity management operations, as well as the transition to a new "system" in the money market after the virtual abolition of the public authorities' obligation to deposit their funds at the Bundesbank. This move was related to the entry into the second stage of the European economic and monetary union on January 1, 1994.[1] Since then, central bank lending to the government, which in Germany at any rate has hitherto been permissible only within very narrow limits, has been completely prohibited. In the light of this change, and in anticipation of a subsequent statutory regulation, the Bundesbank has granted the Federal Government and the Länder Governments what are known as blanket quotas, within which they are allowed to invest their liquid funds "elsewhere", i. e. outside the Bundesbank (or it has increased such quotas). At the same time it declared itself opposed to an investment of such funds in the Euro-market. Owing to the abolition of the deposit requirement, public sector cash transactions are now no longer accompanied by corresponding changes in credit institutions' central bank balances, they only affect their distribution among the banks. The "typical" pattern of central bank balances during a month, which hitherto was dominated by public sector cash transactions and marked by a high degree of advance compliance with the minimum reserve requirements in the first half of each month, has thus disappeared; central bank balances are now likely to fluctuate more closely around the level of required reserves. This has necessitated modifications both of the ongoing provision of funds by the Bundesbank and of the banks' liquidity management. In the event, the banks have adjusted to the new situation smoothly; some adjustment problems occurred at the end of January only, when the banks had to take up lombard loans on a relatively large scale. Some liquidity management problems and heavy lombard borrowing were also seen in the wake of the sharp cut in minimum reserves at the end of March/beginning of April. For the first time this year, the Bundesbank therefore resorted to a fine-tuning measure in the money market at the beginning of April, granting the banks liquidity assistance for one week by means of a "quick tender".

(b) Monetary target overshot again in 1993

Setting the 1993 monetary target impeded

Last year the Bundesbank stuck to its policy of setting and announcing a monetary target. The money stock M3 was to grow by 4 1/2 % to 6 1/2 % between the fourth quarter of 1992 and the fourth quarter of 1993. Setting this target was hampered by various factors. Firstly, the money stock had grown at an exceptionally rapid

1 See Deutsche Bundesbank, The second stage of European economic and monetary union, Monthly Report, January 1994, page 23 ff.

pace in 1992, with the monetary target being overshot by a wider margin than ever before. Liquidity was therefore very ample at the beginning of the new target period. Secondly, monetary growth was influenced by a number of special factors which were not easy to quantify. Notably towards the end of the year, the underlying monetary trend was obscured by various irregular factors stemming from the EMS currency turbulence and the introduction of the tax on interest income; they hampered the assessment of longer-term monetary trends. Overall there was no doubt, however, that a counter-inflationary policy stance geared to medium-term objectives called for a distinct moderation of the pace of monetary expansion in the further course of the year.

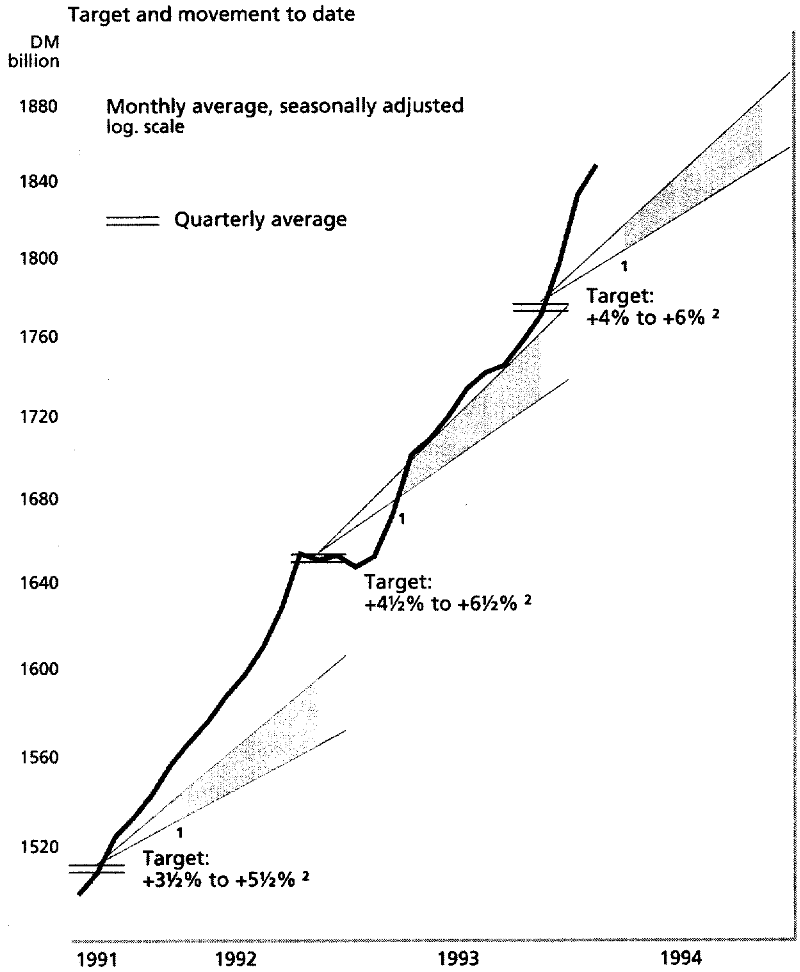
Monetary growth still buoyant in 1993

M3 growth decelerated slightly in 1993, it is true, but it remained buoyant. The monetary target was again overshot, albeit less so than a year before. In the fourth quarter of 1993 the money stock M3 was 7.4 % up on the fourth quarter of 1992. Over the year, the pace of monetary expansion was fairly unsteady under the changing impact of special factors. At the beginning of the year, when the inflows of funds in the aftermath of the EMS turmoil reversed, money balances actually declined. Subsequently, the pace of monetary growth accelerated for a while, but slackened again from the summer onwards. At that time, there seemed to be a good chance of the growth rate of the money stock M3 returning to the target corridor by the end of the year. Towards the end of 1993 monetary growth picked up again, specifically for reasons which were mainly attributable to special factors. Tax law changes are one of the influences to be cited first in this connection. In addition to the pronounced special factors, however, monetary growth last year also reflects macro-economic trends. Thus, monetary expansion was fostered by higher public deficits and the associated heavy government borrowing from banks. Moreover, the general public's low propensity to invest in long-term assets also contributed to the strong monetary growth. Against the backdrop of low long-term interest rates and investors' uncertainty about future trends, the latter initially tended to show a preference for liquid bank deposits that are counted towards the money stock M3. The trend of the various money stock components likewise reflects the adjustment of money holdings to the fall in interest rates and the flattening of the yield curve. Shorter-term time deposits, which carry market-related rates, and which had grown at a disproportionately fast pace in the preceding years, were now temporarily reduced. Non-interest-bearing sight deposits and currency in circulation, by contrast, were built up strongly, with special movements (some of which were caused by domestic factors, and some by external ones) playing a major part in the case of currency in circulation. Last year an even steeper rise was registered by savings deposits at three months' notice, which

Growth of the money stock M3 *

Chart 8

Target and movement to date



* Average of five bank-week return days; end-of-month levels included with a weight of 50 %. — 1 The target corridor has not been shaded until March because M3 is normally subject to major random fluctuations around the turn of the year. — 2 Between the 4th quarter of the preceding year and the 4th quarter of the current year.

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had been completely eclipsed by time deposits in the preceding years in view of the high level of money market rates. One contributory factor was that – especially after the entry into force of the new provisions governing savings at mid-year – credit institutions offered more attractive, higher-yielding savings facilities in this maturity range. Another factor was a reorientation on the part of savers in connection with the changes in interest income taxation, which triggered sizeable portfolio switching out of bank savings bonds and other long-term forms of saving into short-term savings deposits. Residents increased not only their money balances held at domestic banks, but also their cash holdings in the Euro-markets, even though funds were repatriated temporarily to domestic accounts at the end of the year. Over the past year as a whole, the growth of the money stock M3, extended to include Euro-deposits and short-term bank debt securities, markedly outstripped that of traditional M3. Money holdings in the Euro-markets now amount to about one-seventh of domestic money holdings. They must not be disregarded when assessing the overall liquidity situation in the non-bank sector. If they are shifted temporarily between Germany and abroad, moreover, they constitute a considerable potential source of disruption of domestic monetary growth, to which the Bundesbank primarily gears its policy action.

Monetary relationships broadly stable

The experience that in the past year money balances responded to macroeconomic and interest rate trends in a fashion which was broadly consistent with the normal pattern bears out the notion that in Germany the longer-term links between monetary growth and price performance are still intact. This is also reaffirmed by some recent empirical studies carried out within and outside the Bundesbank. These suggest that (while German unification, the currency crises in the EMS, the introduction and modification of the tax on interest income, the inverse yield curve and other disruptive factors destabilised shorter-term monetary growth, and in the short run adversely affected the indicator function of the money stock) they failed to have a major impact on the long-term relationships between the money stock, interest rates, aggregate demand and, last but not least, prices. The money stock M3 therefore remains a suitable nominal anchor for an anti-inflation policy. For the rest, last year the growth of money balances in all other statistical definitions actually exceeded that of the money stock M3, which is used as an intermediate target. This argues against any specific indicator problems on the part of this monetary aggregate and in favour of an ample supply of liquidity in the German economy. In the debate on the strategy of monetary targeting, the weaknesses of other indicators must not be overlooked, either. This applies, for example, to the gap between money market rates and capital market rates, which quite recently has been proposed as an alternative intermediate monetary target by various commentators. It does not seem suitable for a policy primarily committed to the target of price stability, since no particular interest rate pattern can be related to this target. A monetary policy geared to that gap would lack a clear anchor, while the long-term links between monetary growth and price movements are undisputed.

Potential-oriented monetary target in 1994, too

The Central Bank Council therefore set a target for the growth of the money stock M3 in the current year, too. Hence it continued its anti-inflation policy, which is geared to the medium term. Judging by the target, the Bundesbank wishes to see the money stock M3 expand by 4 % to 6 % between the fourth quarter of 1993 and the fourth quarter of 1994.[1] The reason why the target corridor is slightly lower than last year is that the growth of all-German real production potential this year, at 2 1/2 %, must be put at a somewhat lower figure than in 1993. This is due to the trend in western Germany, where the capital stock is growing at a slower pace at present on account of the persistent sluggishness of investment activity. The projected expansion of production potential is, however, distinctly above the foreseeable rate of actual economic growth. Hence the slight lowering of the target corridor does not signal a restrictive stance of monetary policy, but allows scope even for an unexpectedly strong economic recovery. The inflation norm was set at 2 %, as in previous years. Finally, in deriving the target due account was taken of the fact that the trend growth in the money stock is outpacing that of production potential at current prices. In the light of the experience gained after German unification, and especially of the persistently high level of cash holdings in eastern Germany, the adjustment for the trend velocity of money, at 1 percentage point, is slightly higher than in preceding years.

Difficult start to the new target period

The start to the new target period was severely hampered by a number of special factors associated in particular with changes to the tax framework at the beginning of 1994. The extension of the tax on interest income to foreign growth investment funds as from 1994, which was foreseeable from the autumn onwards, prompted a repatriation of funds on a considerable scale to domestic liquid bank accounts, notably in December 1993, as did corporate window-dressing operations. At the same time, demand for housing loans soared, as the reduction after the turn of the year in the depreciation allowances granted on the acquisition of owner-occupied old buildings triggered a spate of accelerated purchases of dwellings. The boost given to the money stock by the special factors mentioned caused the money supply to rise in December far above its average level in the fourth quarter of 1993, and thus created a large "overhang" at the start of 1994. In January, another factor which contributed to the buoyancy of monetary growth was that the propensity to invest funds at longer term dropped markedly in view of the rise in long-term interest rates. These special factors are waning only slowly; in February, the money stock M3 exceeded its level in the fourth quarter of 1993 by 4.1 %, corresponding to an annualised rate of 17.5 %.

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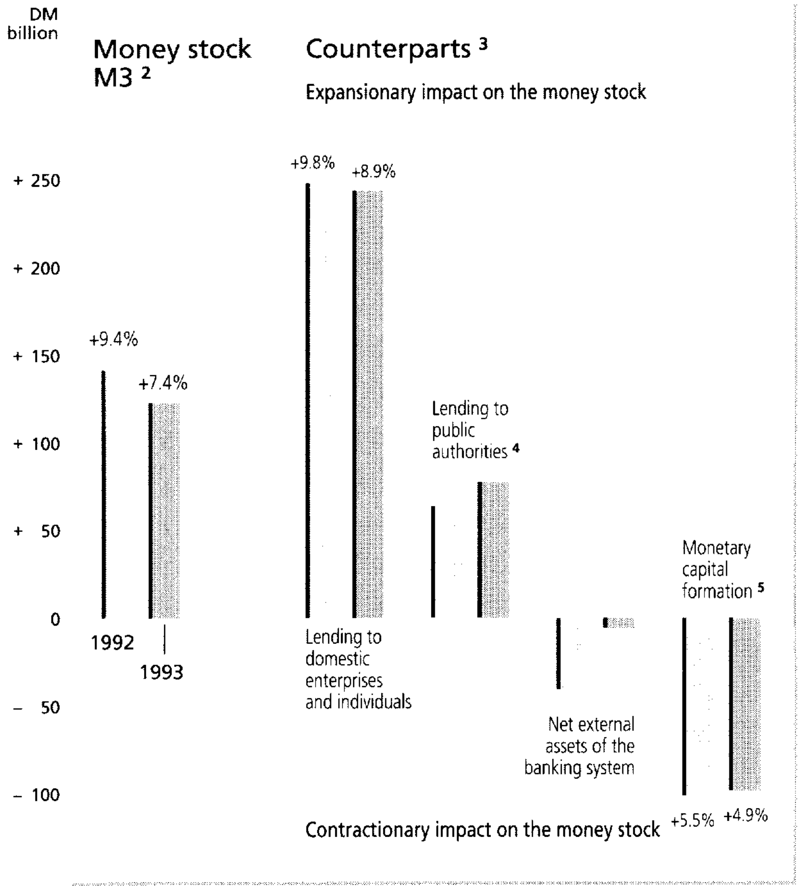
1 This year's monetary target is expressed in terms of a money stock M3 whose definition has been slightly changed from that used hitherto. This statistical change has been necessitated by the effective abolition of the central and regional authorities' obligation to deposit their funds at the Bundesbank (see Deutsche Bundesbank, The second stage of European economic and monetary union, Monthly Report, January 1994, page 23 ff.).

The money stock and its principal counterparts

Chart 9

Change during year in DM billion or % [1]



1 Money stock M3: change during 4th qtr of 1993 from 4th qtr of 1992; counterpart: change in December 1993 from December 1992. — 2 Calculated on the basis of monthly averages. — 3 Calculated on the basis of end-of-month levels. — 4 Less public sector deposits at the Bundesbank. — 5 Monetary capital formation of domestic non-banks at domestic credit institutions.

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(c) Determinants of monetary growth

Slight deceleration of lending to the private sector

Last year, too, lending to the private sector remained the principal determinant of the strong monetary growth. Lending to enterprises and individuals went up by DM 244 billion or 9 %. It thus increased somewhat more slowly than in 1992 and 1991, when it had expanded by 10 % and 11 1/2 %, respectively. Against the backdrop of the west German economy slipping into recession, this rapid pace of credit expansion at first comes as a surprise. However, it was primarily fuelled not by enterprises but by housing construction and reconstruction in eastern

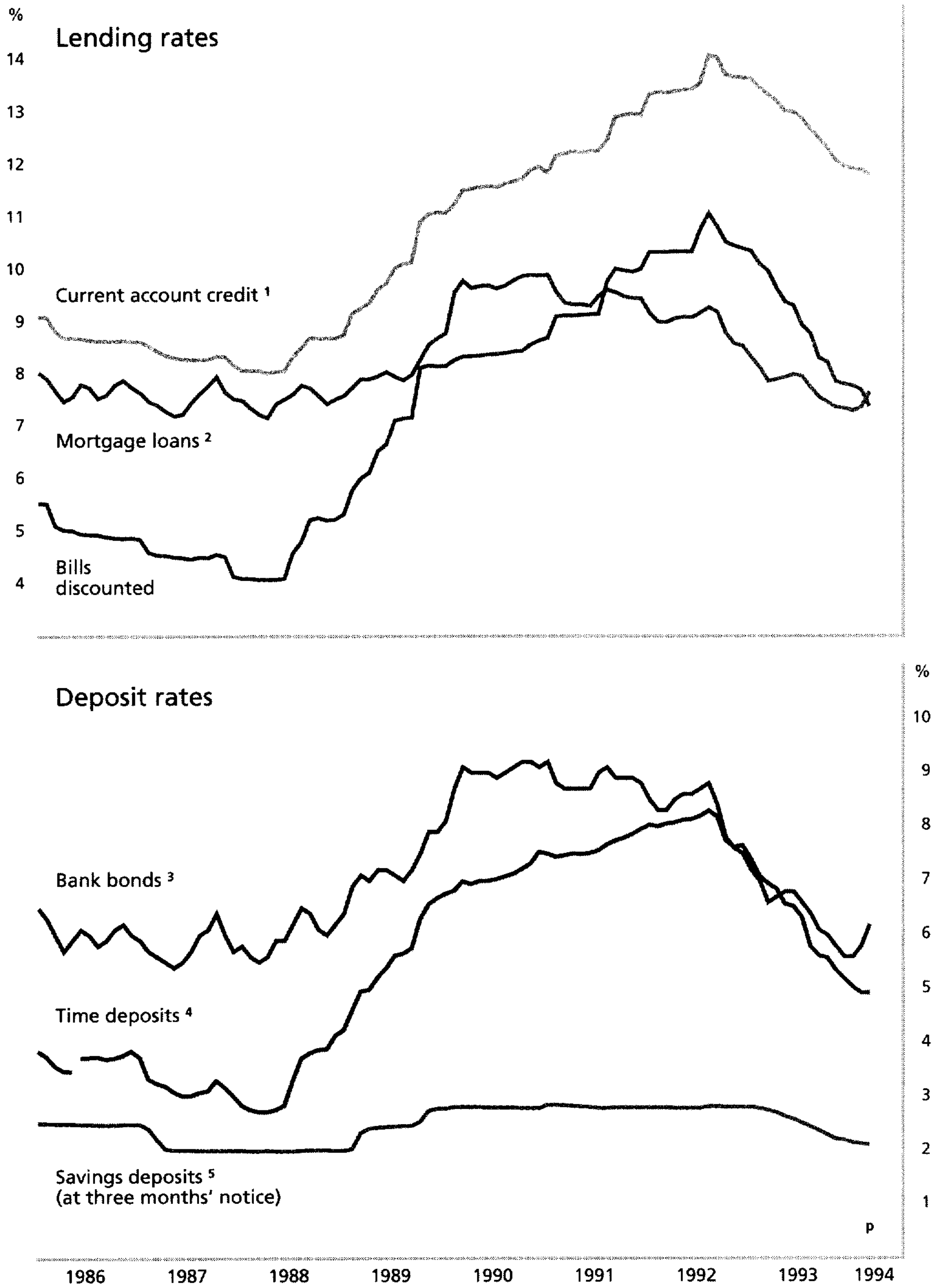
Germany. Housing loans increased by 11.8 % in 1993, compared with 8.3 % in 1992. This owed something not only to immigration and the associated shortage of housing, but also to the low level of long-term interest rates and the aforementioned reduction in tax concessions as from the new year. On balance, over one-half of enterprises' and households' direct borrowing from banks was applied to housing. Reconstruction in eastern Germany, which was broadening last year, obviously continued to impart a marked stimulus to lending. Borrowing by enterprises (excluding housing), by contrast, declined appreciably against the background of the slowdown in business activity in western Germany. Lending to enterprises and self-employed persons increased by 4.8 %, and thus only half as fast as in the preceding year. Manufacturing actually reduced its debt. Demand for consumer credit likewise slackened in the light of the more gloomy outlook for incomes. In view of the low level of long-term interest rates, all the demand for credit was for long-term loans, on balance, last year. Both longer-term lending (DM 215 billion) and lending against securities (DM 37 1/2 billion), which normally is likewise at longer term and granted in particular to Federal enterprises – railways, post office, Treuhand agency – grew vigorously. In contrast to that, enterprises and individuals reduced their short-term debt (by DM 9 billion). This pattern of borrowing was strengthened by the fact that, among the groups of borrowers, those traditionally borrowing primarily at longer term (like housing) predominated. There was also some large-scale funding of short-term debt.

High level of lending to the public sector

Public sector borrowing imparted a major stimulus to monetary expansion in 1993. Lending by credit institutions to public authorities increased by over DM 96 billion or 13 %, and thus much more strongly than in 1992 (just over 7 %). The sharp rise in government debt to banks offset the somewhat slower increase in lending to the private sector, so that total bank lending to non-banks, at almost 10 %, actually expanded at a slightly faster pace than in 1992. The high level of government borrowing is qualified to only a small extent by the fact that the public authorities at the same time added DM 13 billion to their cash balances at the Bundesbank, which are not counted towards the money stock, and reduced the amount of their cash advances outstanding. This was mainly due to the structural and cyclical rise in the budget deficits. Borrowing from banks by public enterprises (such as the railways, post office and the Treuhand agency), which in particular takes the form of purchases of securities, also rose steeply. Inclusive of such borrowing, the public sector accounted for about two-fifths of all bank loans granted to residents in 1993.

Movements in selected bank interest rates *

Chart 10



* Since January 1991, including the rates in the new Länder. — **1** Under DM 1 million. — **2** Average effective rate for fixed-rate mortgage loans secured by residential real estate with interest locked in for 10 years. — **3** Yield on bonds outstanding. — **4** With agreed maturities of 1 month to 3 months inclusive and sums of DM 100,000 and over but less than DM 1 million; up to and including May 1986, under DM 1 million and maturities of 3 months. — **5** Until the end of June 1993, savings deposits at statutory notice; excluding bonus-carrying savings deposits and special savings schemes.

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Non-banks' external payments largely cancel out

The inflows and outflows generated by domestic non-banks' external payments largely cancelled out in the statistics last year. The net external assets of the banking system, which reflect such payment transactions, decreased by a total of DM 5 1/2 billion. This statistical result is, however, distorted by the shifting abroad of domestic capital formation, which continued into the autumn of 1993, and by the associated indirect purchases of domestic bank debt securities through Luxemburg investment funds. In the balance sheet context of the monetary analysis, this led to a fall in the net external assets of the banking system and restrained domestic monetary capital formation. In the course of 1993 outflows initially outweighed inflows from non-banks' external payments; towards the end of the year, by contrast, net inflows were registered. The latter were due in particular to the changes in tax provisions mentioned above. This strongly fuelled domestic monetary growth, especially in December 1993. The exchange rate tensions in the EMS, by contrast, which prompted heavy intervention by the Bundesbank last summer, had a comparatively minor effect on monetary growth, because the associated inflows of funds were mostly to the banking sector and less than, say, in the autumn of 1992 to the non-bank sector.

Monetary capital formation sluggish against the backdrop of low capital market rates

Last year monetary capital formation was once again sluggish and failed to provide a sufficient counterweight to the expansionary impact of bank lending on monetary growth. At DM 98 billion, or a growth rate of no more than 5 %, it was about as moderate as in 1992, whereas in the two preceding years it had amounted to some DM 150 billion each. This primarily reflects non-banks' low propensity to lock in funds at longer term, given the sharp fall in long-term interest rates in the course of the year, and some uncertainty about future interest rate movements. This assessment of the propensity to invest is not radically changed if one bears in mind that statistically recorded domestic capital formation is understated because of the redirection of the flows of investible funds via foreign banking centres mentioned above. Finally, the longer-term funds accruing failed to respond visibly to the reflux of funds from Luxemburg setting in towards the end of the year or to the increasing normalisation of the yield curve; maturing time deposits tended to be switched into short-term savings deposits rather than long-term assets. Accordingly, not only savings deposits at three months' notice but also savings deposits at over three months' agreed notice, which are included in monetary capital formation, increased strongly last year (by DM 23 1/2 billion). In terms of maturity, which is no doubt mostly one year or less, the latter tend to constitute shorter-term assets. Long-term assets proper, by contrast, grew only slightly. Thus the amount of bank debt securities held by the non-bank sector went up only moderately; the volume of bank savings bonds actually dropped sharply in connection with the above-mentioned tax-induced portfolio switching to short-term savings deposits.

5. The financial system demonstrates its efficiency

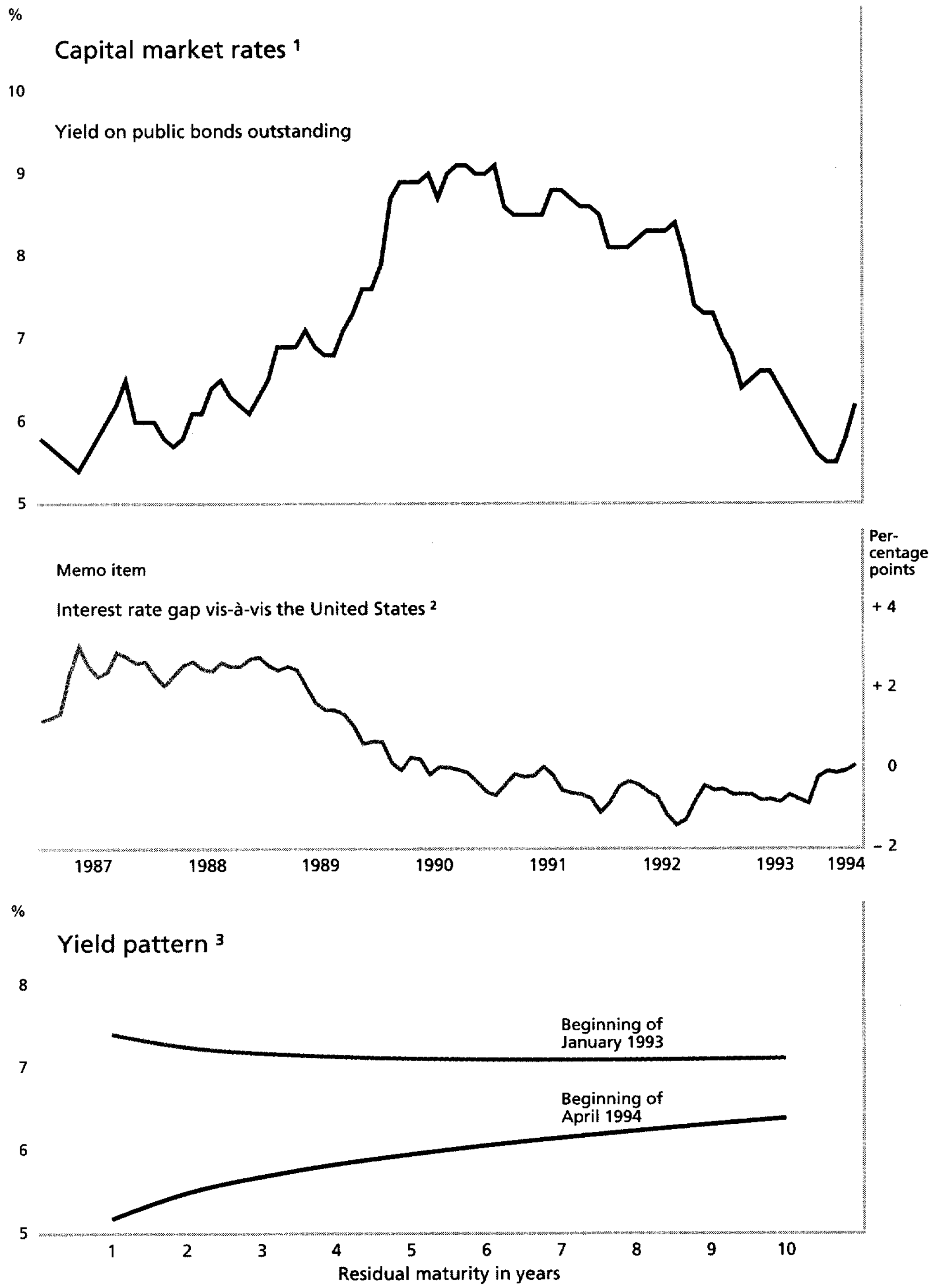
(a) Historically low interest rates and an issuing record in the bond market

Low capital market rates an asset in a difficult economic setting

In 1993 the German bond market, with interest rates at a historically low level, provided a major basis for improving general economic conditions in Germany. In the course of the year the yield on domestic bonds outstanding declined by just over 1½ percentage points, and reached its lowest level since mid-1987 at the end of December, at 5½ %. After the turn of 1993-4 the German bond market was increasingly affected by the interest rate uncertainty stemming from the international financial markets. Since then, interest rates have risen again slightly, while the fluctuations have increased. However, the yield on domestic bonds outstanding, at just under 6¼ % in mid-April, has remained at a relatively low level by historical standards. In the second half of 1993 the real rate of interest, roughly computed as the capital market yield less the current rate of inflation of consumer goods, dropped below the level of 2 % for the first time since the mid-seventies. Hence last year real capital market rates, computed in the same way, also reached a very low level, by historical and international standards alike. The heavy demand for housing loans with interest rates locked in for long periods, the pronounced trend towards rescheduling shorter-term loans and the issuing of fixed-interest securities with maturities of 30 years show that borrowers consider the terms for raising long-term outside funds to be highly favourable. The continuous decline in yields last year, which only faltered temporarily in the spring, took place against a background of globally falling capital market rates and was fostered by foreign investors' massive bond purchases. Their buying in the German bond market reflects their unabated high regard for the Deutsche Mark and their pronounced expectations of interest rate cuts. By contrast, the great significance of foreign investors, who usually tend to lodge funds at short term, poses certain risks to developments in the capital market. Like other institutional investors, they respond very sensitively when exposed to expectations of falling interest rates, on the one hand, and burgeoning expectations of a devaluation or of inflation, on the other. It is therefore all the more important to maintain confidence in the Deutsche Mark, and to strengthen domestic private investors' propensity to invest at long term, which has hitherto been weak.

Interest rate movements in the bond market

Chart 11



1 Monthly averages. — 2 Yields on US Treasury paper with a maturity of approx. 10 years less yields on public bonds with a residual maturity of over 9 up to and including 10 years. — 3 Regression figures for listed Federal securities.

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Decline in yields fostered by monetary policy

The Bundesbank paved the way for the decrease in capital market rates by consistently adhering to its counter-inflationary monetary policy stance and cautiously exploring the scope for lowering interest rates. With money market rates declining sharply, the inverse pattern of the yield curve flattened out in 1993, and the general interest rate level dropped at the same time. The interest rate advantage of the money market over the capital market narrowed from approximately 1½ percentage points at the end of 1992 to approximately ½ percentage point at the end of last year. Following the increase in interest rates in the capital market at the beginning of this year, early in April the three-month rate in the money market was ½ percentage point lower than the yield on domestic bonds outstanding. Monetary policy continues to contribute best to buoyant sentiment in the bond market when it credibly counteracts new expectations of devaluation and inflation. In terms of business cycle policy, too, nothing would be gained if declining short-term interest rates were accompanied by higher risks of inflation and rising long-term interest rates. Durably low capital market rates and a buoyant bond market call not only for a credible monetary policy stance but also – domestically speaking – for a lasting consolidation of public finance and a continuation of the circumspect wage rate policy. Interest rate uncertainties, which have recently proliferated in a global context, should increase awareness of this.

Record levels of funds raised and of turnover

The amount raised and turnover in the German bond market, which had already reached peak levels in earlier years, recorded a further steep increase in 1993. Net sales of domestic and foreign bonds came to just under DM 400 billion, which is approximately DM 100 billion more than in 1992 (both figures including the allotment of bonds of the Currency Conversion Equalisation Fund, which did not involve any direct recourse to the market). The sales proceeds continued to accrue almost entirely to domestic issuers. This meant that an increasing part of overall financial flows was being channelled through the bond market. This is primarily due to the substantial borrowing requirements of the public sector, which in the past few years has increasingly resorted to raising securitised outside funds. In addition, borrowers have been very interested in long-term loans at fixed interest rates, which are mainly granted by mortgage banks. In 1993 the public sector met four-fifths of its new borrowing requirements in the capital market. The Federal Government and the Treuhand privatisation agency transformed a large amount of existing liabilities and old debt into securities. At the end of 1993 just over one-half of public sector debt was securitised in the form of listed securities, compared with just under two-fifths in 1987. In the financial sector, the proportion of funds raised by issuing debt securities increased to approximately one-third in 1993.

This is mainly because the banking system was more heavily involved in financing public sector deficits by means of loans refinanced in the bond market. By contrast, Deutsche Mark commercial paper was comparatively little used in 1993 for direct securitised fund-raising by enterprises.

Strong increase in public sector bonded debt

Public authorities drew on the bond market to the market value of DM 222 billion in 1993 by issuing their own bonds; this was nearly DM 100 billion more than in the previous year (not counting the bonds of the Currency Conversion Equalisation Fund). Besides the Federal Government, the Treuhand agency was the most important issuer; they sold debt instruments amounting to DM 94 billion and DM 81 billion (net), respectively, while the Länder Governments sold paper worth DM 26½ billion. In March the Treuhand agency added special bonds with a maturity of five years to the maturity range of the listed paper it issues. Moreover, a medium-term-note programme was arranged for it and the post office last year. As part of such a programme, large-scale investors can be offered specially tailored bonds in terms of maturities and amounts, thus greatly easing the terms of financing for the issuer. The very long end of the maturity range in the bond market was also revitalised last year. In autumn 1993 several Länder Governments issued bonds with maturities of up to 30 years, and the Federal Government increased its issue dating from 1986 with the same maturity. The Federal Government's traditional New-Year's-Eve bond issue was likewise launched with a maturity of 30 years. By introducing, in March 1994, a futures contract on very long-dated bonds issued by the Federal Government and the Treuhand agency, the German Financial Futures and Options Exchange (DTB) responded to issuers' aim of durably establishing, in this market segment, a liquid market which is attractive primarily to institutional investors.

Communal bonds remain in the ascendant

In 1993 sales of bank bonds were likewise affected by rising public borrowing requirements. Sales of communal bonds, at DM 112½ billion (net), made up nearly three-quarters of the total amount of funds raised by issuing bank bonds (DM 152 billion); compared with the previous year, they more than doubled. Loans to public debtors, particularly to Länder Governments and local authorities, and also loans from issuing institutions to public credit institutions, were refinanced by issuing such paper. Owing to heavy demand for housing loans with interest rates locked in for long periods, sales of mortgage bonds likewise increased sharply (from DM 12 billion to DM 20 billion). Sales of other bank bonds amounted to DM 25½ billion; here, too, long maturities predominated.

Sales and purchases of bonds

Table 9

DM billion

Period	Sales				
		Domestic bonds[1]			
			of which		
	Total	Total	Bank bonds	Public bonds	Foreign bonds[2]
1985	103.5	76.1	33.0	42.7	27.5
1990	244.8	220.3	136.8	83.6	24.5
1991	232.0	219.3	131.7	87.0	12.6
1992	291.8	284.1	106.9	177.4	7.7
1993	396.3	382.6	151.8	230.6	13.7
1993 1st qtr	127.2	118.0	49.1	68.7	9.3
2nd qtr	85.6	79.5	27.3	52.0	6.1
3rd qtr	71.2	74.1	38.8	35.2	- 2.9
4th qtr	112.3	111.0	36.6	74.7	1.2
	Purchases				
			Non-banks[4]		
	Total	Banks (incl. the Bundesbank)[3]	Total	Memo item Foreign investment fund units	Non-residents[2]
1985	103.5	32.8	39.3	- 0.1	31.5
1990	244.8	91.8	133.3	- 0.7	19.8
1991	232.0	45.8	126.5	12.6	59.7
1992	291.8	133.5	27.7	58.6	130.6
1993	396.3	160.5	9.8	15.8	226.0
1993 1st qtr	127,2	51,9	0,8	24,6	74,5
2nd qtr	85.6	24.7	- 0.6	15.0	61,5
3rd qtr	71.2	25.3	7.1	8.3	38.8
4th qtr	112.3	58.6	2.5	- 32.0	51.2

1 Net sales at market values plus/less changes in issuers' holdings of their own bonds. — **2** Transaction values. — **3** Book values; statistically adjusted. — **4** Residual.

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Large-volume issues in the market for foreign Deutsche Mark bonds

Last year the Deutsche Mark further increased in significance as a currency of issue for foreign debtors. With gross sales of foreign Deutsche Mark bonds amounting to the record sum of DM 87 billion, that currency came second only to the US dollar among international currencies of issue. A number of countries, as well as international and supranational institutions, launched large-volume foreign Deutsche Mark bond issues; they accounted for approximately 40 % of the total amount raised. For the first time, they included a Deutsche Mark issue which was simultaneously floated in Germany and in several other financial centres abroad. Even though the compulsory listing of foreign Deutsche Mark bonds on a German stock exchange was abolished from August 1, 1992, the greater part of these securities continues to be quoted in Germany.

Foreign purchases skyrocket for speculative and tax reasons

In 1993 turmoil in the EMS and the introduction and subsequent modification of taxation of interest income again affected the buyers' side of the German bond market. Foreign investors were the principal group of buyers; they purchased German bonds to the value of DM 226 billion (against DM 130½ billion in 1992), thus accounting for more than one-half of the total funds raised in the German bond market. Foreign demand was mainly fuelled by institutional investors' operations. In view of renewed tensions in the EMS in the early summer, motives for currency speculation played an important role here. However, even after the widening of the fluctuation margins in the EMS at the beginning of August, Deutsche Mark assets evidently remained attractive to non-residents. Pronounced expectations of interest rate reductions, in particular, were significant factors here. A quite considerable part of these heavy foreign purchases, however, seems to have consisted of return flows of German savings. Such funds were transferred to foreign financial centres, from which they flowed back to the German bond market as tax-free "foreign" financial assets in order to evade the tax on interest income, e.g. by means of shifting safe custody accounts or purchasing foreign investment fund units.

Reversal in foreign investment fund units

In the course of last year there was a reversal in the portfolio operations of domestic private investors and in "indirect" purchases through foreign financial intermediaries. In the early summer of 1993 purchases of foreign investment fund units slackened noticeably; apparently, the original portfolio shifts to evade the taxation of investment income, which was not levied at that time on income from foreign investment funds, were largely completed. From mid-year the shares of distributing foreign funds were, for the time being, likewise included in the taxation of investment income by means of "amendments". Evidently, this resulted in extensive shifts from special distributing funds to special growth funds. Since the beginning of 1994 the tax on interest income has been payable on income from foreign growth funds, too, if it is being realised by domestic investors. When this new provision became foreseeable in the final months of 1993, domestic savers resold a large quantity of foreign investment fund units. In the fourth quarter of 1993 the holdings of such paper in domestic safe custody accounts fell by DM 30½ billion, that is, by approximately one-quarter; the proceeds of sales of such paper were lodged temporarily in liquid bank accounts in Germany, thus fuelling monetary expansion. These shifts, which were primarily tax-induced, underline the need for an international harmonisation of the taxation of interest income that is as far-reaching as possible.

Low propensity of non-banks to invest in the domestic market

Domestic non-banks' direct purchases in the German bond market, at DM 11½ billion, ran at a low level, just as they had done during earlier periods of low interest rates. They did not rise significantly, either, upon the increasing normalisation of the interest rate pattern and the resales of foreign investment fund units. Instead, non-banks strongly increased their liquid deposits at banks. In 1993 credit institutions' bond portfolios went up by DM 160½ billion; this figure included DM 8½ billion of bonds of the Currency Conversion Equalisation Fund, the allocation of which did not involve any provision of funds by credit institutions. During periods of falling interest rates, credit institutions usually buy bonds on a larger scale. On the one hand, this owes something to the prospect of short-term price gains; on the other hand, some banks consider securities purchases to be a substitute for short-term lending to trade and industry, which is slackening owing to the slowdown in business activity.

(b) Boom in the share market

Steep rise in share prices

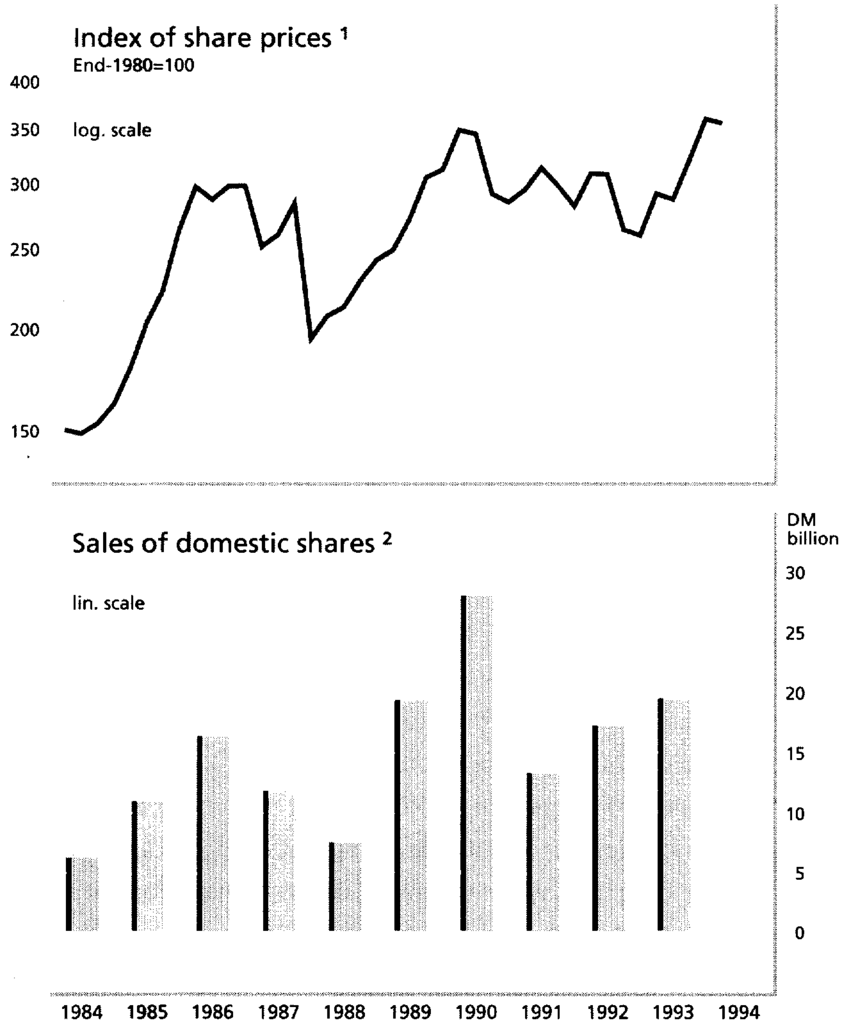
Prices in the German share market rose steeply in 1993, and reached an all-time high after the turn of 1993-4. In the course of the year German shares – as measured by the Federal Statistical Office's index – increased in value by 40 % on average; individual sectors recorded even stronger increases (e.g. the motor industry, at just under 60 %, and the insurance industry, at 50 %). At the beginning of April 1994 prices were again almost 40 % higher than at the start of 1993, following a lengthy period of consolidation. Thus, after the cyclical low in 1992, German equities caught up with the upward trends in major foreign share markets. This bullish mood was greatly stimulated by falling money and capital market rates worldwide, which made shares an attractive alternative to fixed-rate forms of saving. Moreover, the German economy saw far-reaching retrenchment and restructuring efforts and associated expectations of rising corporate profits; for instance, improved earnings prospects were probably the key factor in the abovementioned increase in share prices in the motor industry. Finally, the Location Protection Act, which was passed in the summer, ensured that investments in shares were more attractive, especially to foreign investors, by lowering the tax rate on dividends.

Growing amount of funds raised

In 1993 issuing activity in the German share market, at DM 19½ billion, caught up with that of the late eighties. New shares were issued primarily by way of capital increases by credit institutions. In contrast, major new issues by trade and industry – with a few exceptions – played a comparatively minor role, as did the stock exchange listing of enterprises. At nine, the number of companies newly

Conditions in the share market

Chart 12



1 Quarterly averages; source: Federal Statistical Office. — 2 At issue prices.

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listed on the stock exchange remained low. There is still a distinct discrepancy in Germany between the share market's importance as a source of liable capital, on the one hand, and as a turntable for trading in shares, on the other. In its function as a secondary market, the German share market is one of the front runners by international standards; by contrast, the capitalisation of enterprises via stock exchanges in Germany continues to be rather low.

Foreign investors in the forefront

Foreign investors' pronounced interest was the paramount factor in the dynamic upsurge in the German share market in 1993; they increased their holdings of

German shares by DM 8½ billion in all, after they had run down their portfolios by DM 8 billion a year before. Apart from the tax concessions already mentioned, foreigners evidently took advantage of the falling interest rates and improved economic prospects in Germany to give more room to German shares in their portfolios. Residents' interest in German shares, by contrast, slackened; on balance they purchased such paper to the value of only DM 11 billion, against DM 25 billion in 1992. On the other hand, domestic investors considerably stepped up their buying in foreign share markets (DM 17 billion), as they had already done a year before; their portfolio investment, at just under DM 8½ billion, increased distinctly in significance compared with their direct investment. In 1993 indirect share purchases via purchases of corresponding investment fund units made a comeback. The amount raised by share-based funds (the number of which increased by 15 in 1993), at DM 9 billion, more than tripled compared with 1992. Apart from tax advantages over bond-based funds, the fact that many credit institutions advertise share purchases through affiliated fund companies may have been a major reason for the increased interest in the units of share-based funds. In this way investors gain access to diversified share portfolios with smaller amounts, too, particularly since direct share purchases have become unattractive to investors in many cases on cost grounds.

(c) Favourable business and profit performance of credit institutions

Credit demand benefits mortgage banks and regional giro institutions

Last year the heavy demand for long-term housing loans at fixed interest rates and the huge borrowing requirements of public authorities mainly benefited regional giro institutions and mortgage banks. The growth rates of their domestic credit volume, at 15.1 % and 17.8 %, respectively, were much stronger than the average rate of all credit institutions (+ 9.8 %). Regional banks (+ 11.1 %), credit cooperatives (+ 10.8 %) and savings banks (+ 10.1 %) likewise stepped up their lending to non-banks at slightly above-average rates, owing to their comparatively strong position in long-term lending to trade and industry. Big banks were able to offset the decline in short-term lending to trade and industry (– 5.4 %) only in part by a sharper expansion of longer-term loans and lending against securities; hence their domestic lending business expanded at a below-average pace, at 5.8 %, albeit more strongly than a year before. Even stronger was the impact of the decline in short-term lending on credit cooperatives' regional institutions, whose total credit volume remained unchanged on balance. The credit volume of credit institutions with special functions actually declined, though this owed something to institutional changes in eastern Germany that led to write-offs of corporate loans.

Favourable profitability trend

Overall, according to the information available at present, the profitability of the German banking industry in the financial year 1993 was relatively good. Interest income appears to have been favourably affected, in particular, by the heavy demand for longer-term loans and the falling interest rates in the money and capital markets, which, as usual, were passed on more swiftly in deposit business than in lending business. In addition, developments in the bond and share markets presented exceptional earning opportunities in the context of a bank's own financial operations, and also in connection with commissions received in securities business on behalf of customers. This enabled credit institutions to take precautions against risks, which were rising on cyclical grounds, particularly in the field of domestic lending.

Adjustment to new institutional regulations

Following the revision of the provisions governing savings transactions in mid-1993, credit institutions increasingly offered more attractive savings facilities with clearly-defined maturities. Against this background, savings deposits at savings banks increased sharply in 1993, while savings deposits at three months' notice at credit cooperatives and those with longer periods of notice at big banks expanded vigorously. Furthermore, credit institutions adjusted quickly to the capital adequacy regulations, which were amended at the beginning of 1993. They were tightened in line with international and European standards on the occasion of the revision of Principle I; at the same time, as part of the amendment of the Banking Act, the definition of "additional capital components" was broadened. Credit institutions responded to this by significantly increasing their "subordinated liabilities" to DM 48 billion, more than half of which was raised in the form of subordinated debt securities. Big banks and regional banks together accounted for a share of just over two-fifths, the savings bank sector for just over one-third. The addition of approximately DM 5.4 billion to participation rights capital, to a total of DM 22.8 billion, by contrast, was roughly in line with the increase in the two previous years, although since 1993 participation rights capital has no longer been restricted to one-quarter of the "core capital" under the Banking Act.

(d) The "financial centre Germany", considered in terms of competition policy and monetary policy

Further measures to enhance efficiency and competitiveness

Owing to the increasing internationalisation and globalisation of financial services, the German financial market has been exposed to mounting competitive pressure in recent years. Financial market supervisory authorities, the Bundesbank and private market participants have taken up this challenge and further enhanced the efficiency and competitiveness of the financial centre Germany by means of a number of measures. At the moment, public financial market policy is focused on creating an up-to-date and efficient supervisory authority for securities transactions and stock market trading. Under the Second Financial Market Promotion Act, which is due to come into effect in mid-1994, the supervisory system for securities transactions will be adjusted to conform to international standards. Its focal points are the establishment of a Federal Supervisory Office for Securities Trading and the introduction of an effective market and securities trading supervision system on the stock exchanges. Among the major tasks of the new Federal Supervisory Office will be protection against and, where necessary, disclosure of insider trading, which will be made a criminal offence, and monitoring the transparency of the participatory relationships with listed enterprises. These measures are aimed at safeguarding the viability of the capital market and improving investors' protection. In addition, changes in stock exchange law are designed to guarantee that different trading systems, such as on-the-floor trading and computerised trading, can meet market criteria in a competitive environment without state aid or a survival guarantee. Moreover, market participants themselves have paved the way for the improved viability and greater international attractiveness of the German securities markets by means of a variety of organisational measures – in particular, the concentration of stock market activities in the Deutsche Börse AG. By further lowering the minimum reserve ratios for time liabilities and savings deposits (to a uniform 2 %) with effect from March 1, 1993 and those for sight deposits (to 5 %) with effect from March 1, 1994, the Bundesbank, for its part, has lessened the incentive to evade minimum reserve requirements by switching to the Euro-markets, and has reduced the competitive disadvantages of the domestic markets. The effectiveness of the minimum reserve regulations as a monetary policy instrument of a regulatory nature which serves above all to create favourable conditions for the deployment of the other monetary policy instruments was not adversely affected by those measures.

Principles of German financial market policy

German financial market policy is aimed at creating conditions which ensure the allocation of scarce financial resources in fair competition as efficiently and cost-effectively as possible. In competitively organised financial markets, participants should have sufficient incentive and latitude constantly to develop the market structures, instruments and techniques further on their own responsibility in response to changes in underlying conditions. A low degree of regulation at the "macro" level helps to ensure that the markets' creative potential is not largely absorbed by efforts to evade existing restrictions on business operations. Against this background, the early and extensive deregulation and liberalisation of the German finacial sector and the continuous and cautious adjustment of basic conditions to the changed environment have proved successful. State intervention in the free play of market forces is justified from a regulatory point of view if it serves to safeguard functioning competition and the stability of the financial system. Sufficient, risk-weighted, competitively neutral capital adequacy standards and suitable transparency provisions are appropriate points of departure for this. Such indirect forms of state intervention in market participants' freedom of action should, in principle, be given preference over direct requirements and prohibitions, even though detailed regulations on supervision and implementation are virtually unavoidable, given the increasing complexity of financial products, particularly in the area of derivatives and derivative operations. A set of rules that are balanced in this sense – such as has existed in Germany for a long time – is increasingly being perceived to be a token of a financial centre's quality. At the same time, it bolsters the effectiveness of the Bundesbank's monetary policy. Both the efficiency of the financial system and the efficacy of monetary policy are major preconditions for steady growth and high employment.

Correlation between safeguarding monetary stability and financial market policy

There is a longer-term correlation between safeguarding monetary stability and financial market policy. Any conflict between them is only on the surface, if it exists at all; after all, a stable currency is a mainstay of an efficient financial system. Thus, it comes as no surprise that the private ECU, as an "artificial currency" without an autonomous foundation of stability, has not assumed much importance in Germany so far, either among investors or among borrowers. Creating and maintaining a stable financial system by means of a consistent anti-inflationary policy stance is in the best interest of monetary policy, too. A monetary policy which is geared to continuity has a reassuring and confidence-building effect on the financial markets and fosters long-term financial relations. This, in turn, grants the central bank scope to maintain a stability-oriented policy over the longer term, and lessens the danger of its policy getting towed along by market expectations and cyclical considerations, which, judging by past experience, is almost always to the detriment of monetary stability in the longer run. Savers' and borrowers' long-term orientation, together with major structural features of the German financial system (such as the stability of the banking sector and comparatively low interest rate volatility), are the basis for safeguarding monetary stability, which has been carried on successfully for years by means of a Bundesbank monetary targeting policy geared to production potential. Conversely, monetary policy, by its consistent anti-inflationary stance, makes the best contribution to a successful financial market policy – not least in its own interest. It gives a worldwide reputation to the Deutsche Mark securities traded in the financial markets, and, at the same time, prevents temporary exaggerations in the financial markets that might give rise to significant social costs in the longer run.

III. International monetary policy cooperation

1. Widening of the fluctuation margins in the EMS

System of narrow fluctuation margins ruptured by renewed currency turbulence

In the middle of 1993, following the preceding crises, the EMS was once more subjected to massive speculative attacks which could no longer be fended off using the available range of monetary and intervention policy measures. As in autumn 1992, the currency turbulence once more threatened to undermine German monetary policy in particular, which was again confronted with high inflows of funds from abroad. The finance ministers and central bank governors of the EC countries, meeting at Germany's request following a preparatory session of the EC Monetary Committee, therefore decided to widen the existing margins of exchange rate fluctuations from ± 2 1/4 % and ± 6 %, respectively, to a single corridor of ± 15 % with effect from August 2, 1993. The Netherlands and Germany alone have since then maintained the previous narrow fluctuation band between their currencies on a bilateral basis. The special agreement concluded to this end takes account of the fact that the exchange rate between the two currencies had remained remarkably stable even at the peaks of the repeated EMS crises.

Loss of credibility of the original EMS rules

The renewed currency crisis clearly showed that the EMS had suffered a severe loss of credibility which, in the eyes of the financial and foreign exchange market players, could not be restored by merely reaffirming the existing rules and obligations. The primary cause of the 1992 crisis was that it did not prove possible to bring about in a timely and orderly fashion the exchange rate changes which were necessary in terms of the key macroeconomic variables. Thus in 1992, and again at the start of 1993, market pressure forced the monetary authorities to belatedly undertake long due, but hitherto neglected, exchange rate adjustments. The United Kingdom and Italy even felt obliged to withdraw altogether from the exchange rate mechanism of the EMS. This appeared to eliminate for the time being one of the incentives to speculate in exchange rate changes. However, the situation remained unstable as it was presumed in the markets that, in view of the general deterioration in the business cycle and the level of employment, some individual partner countries that had already made substantial progress in combating inflation might opt for a policy of unilateral interest rate reductions, even if this were to entail a depreciation of their own currency. For the financial and foreign exchange market players, headed by the increasingly important institutional investors, doubts concerning the durability of the monetary policy stance of individual EMS partners sufficed in this situation for them to also fiercely assail the currencies of those countries whose fundamental economic data did not warrant any enduring exchange rate change.

Restricted scope for countervailing monetary policy measures against the speculative waves

Once exchange rates, buffeted by a welter of diverse macroeconomic problems, had well and truly come under pressure by the middle of 1993, the monetary authorities had relatively little chance of stabilising exchange rates again if they were to avoid jeopardising other key aims of their policy. In Germany, at least, the scope for lowering interest rates was severely restricted by the financial problems of the public sector and the pressure exerted by wage costs, which was easing only slowly. On the other hand, in countries with somewhat weaker currencies it was clearly apparent that any move to raise short-term market interest rates with a view to stabilising exchange rates would prove difficult to sustain, given the attendant problems of growth and employment.

Excessive foreign exchange market interventions

Attempting to stabilise exchange rates by force in such highly fraught situations through increased intervention in the foreign exchange market likewise held out little prospect of success, as earlier currency crises had demonstrated. Countries suffering an outflow of foreign currency can very soon come up against financial limits which are hard to conceal from the markets. And indeed the French and Danish monetary reserves were quickly exhausted in the course of the crisis of July 1993. Seeking to solve such problems by stepping up reciprocal assistance, as was repeatedly called for – including in the most recent EMS crisis – appears questionable, however. For one thing, such arrangements increase the temptation to leave the stabilisation of exchange rates primarily to the central banks. For another, such demands ignore the monetary policy problems which interventions in the foreign exchange markets impose on countries with strong currencies. The central bank of such a country – regardless of whether it intervenes itself or makes its currency available for interventions by other countries – is faced with an expansion of bank liquidity and hence aggravated conditions for money market management. Thus the official sales of Deutsche Mark in the EMS in July 1993 totalled DM 107 billion, of which DM 59 billion represented a corresponding increase in German bank liquidity. What is more, interventions in the foreign exchange market are often accompanied by money and capital flows to non-banks and in this way directly contribute to expanding the money stock. And the greater the room for financial manœuvre on the part of the countries with weak currencies, the less the central bank, besieged by capital inflows, can expect a relatively rapid reversal of disruptive capital movements which would relieve monetary policy accordingly.

Deutsche Mark interventions in the EMS *

Table 10

DM billion

Year		Compulsory	Intramarginal	Total	**Memorandum item** Effect on liquidity in Germany 1
1990	Purchases	1.5	32.5	34.1	- 1.6
	Sales	–	12.3	12.3	–
	Balance	1.5	20.2	21.8	- 1.6
1991	Purchases	–	6.4	6.4	–
	Sales	–	21.9	21.9	–
	Balance	–	- 15.5	- 15.5	–
1992	Purchases	–	75.1	75.1	- 51.3
	Sales	63.7	199.7	263.4	110.6
	Balance	- 63.7	- 124.6	- 188.3	59.4
1993	Purchases	–	92.0	92.0	- 63.7
	Sales	25.1	168.8	193.9	58.9
	Balance	- 25.1	- 76.8	- 101.9	- 4.8
Selected periods, net					
June 3, 1992 to September 25, 1992		- 63.7	- 120.4	- 184.2	92.0
Increasing strength of the Deutsche Mark in the EMS; devaluations of partner currencies and withdrawal of the pound and the lira					
September 26, 1992 to November 17, 1992		- 0.0	47.7	47.7	- 43.2
Reversal of exchange rate movements in the EMS					
November 18, 1992 to July 7, 1993		- 0.4	- 32.8	- 33.1	- 14.5
Deutsche Mark again firm within the EMS; devaluations of several partner currencies					
July 8, 1993 to August 1, 1993		- 24.7	- 82.4	- 107.0	58.6
Further strengthening of the Deutsche Mark in the EMS, followed by widening of the fluctuation margins					
August 2, 1993 to end-March 1994		–	15.9	15.9	- 38.4
Initial weakening of partner currencies gradually rectified					

* Deutsche Mark interventions of other central banks participating in the exchange rate mechanism plus the EMS interventions of the Bundesbank; based on the transaction date. – **1** Shows to what extent Deutsche Mark interventions in the EMS plus the settlement of intervention debts influenced the Bundesbank's net external position and hence the supply of central bank money to the banks; + = expansionary liquidity effect through Deutsche Mark sales; – = contractionary liquidity effect through Deutsche Mark purchases.

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Widening of fluctuation margins in accord with German notions

In order to overcome the problems that had arisen in the EMS and, in particular, to forestall further intervention obligations, a substantial widening of the fluctuation margins between most of the participating currencies (with the exception of the bilateral relationship between the Deutsche Mark and the guilder) finally became inevitable. The suggestion made by one partner country to let the Deutsche Mark alone float temporarily (just as the pound and the lira had been floating since September 1992) elicited, by contrast, no support from Germany's other partners. The subsequent decision to temporarily widen the fluctuation bands was basically consistent with the view which the Bundesbank had already been expressing for some time in the internal discussions. The agreed solution has several advantages. On the one hand, substantially expanded fluctuation bands can largely protect the monetary policy of countries with strong currencies against disruptive inflows of funds. At the same time, they discourage currency speculation, as the market participants have to pay greater heed to the possibility of counterswings in exchange rate movements leading to corresponding losses. On the other hand, continuation of the system of central rates – in conjunction with an enlarged fluctuation corridor – offers a point of reference in terms of economic policy to those countries whose monetary policy stance is geared towards the goal of exchange rate stability. In maintaining the previous central rates, the member states also clearly manifested their conviction that lasting exchange rate adjustments within the EMS were not currently called for. As regards the rate of exchange between the French franc and the Deutsche Mark, this was reaffirmed in July 1993 in a joint statement of the governments and central banks of the two countries. There were certainly differences of opinion on the extent to which the fluctuation margins should be widened. The relatively broad fluctuation corridor that was finally agreed was determined less by requirements of German monetary policy than by the concern of those countries that were intent on avoiding as far as possible in future excessive intervention debts resulting from multilateral or bilateral support measures, after it had become apparent that a sharp decline in the net monetary reserves of a country impairs the credibility of its intervention policy.

No fundamental reorientation of exchange rate policy

All this shows quite clearly that the enlargement of the fluctuation margins in no way amounts to a reorientation of exchange rate policy in Europe. On the contrary, following the decision of August 1993, the EC countries reaffirmed their determination to do their utmost to adhere to the timetable laid down in the Treaty on European Union for the establishment of the European economic and monetary union (EMU). Yet quite apart from that, a satisfactory functioning of the single European market presupposes a high degree of exchange rate stability – albeit not in terms of nominal exchange rates but rather as regards the real exchange relationships (the constancy of which results from limiting exchange rate changes to the inflation differential).

Expansion of fluctuation margins also takes account of the changed realities in the financial markets

The decision to widen the fluctuation margins also takes due account of the fact that, with the emergence of efficient and closely integrated financial markets, new realities have arisen both within the Community and in transactions with third countries and of the need to take these into consideration. Under such circumstances, a system of fixed but adjustable exchange rates always runs the risk of being tested by the markets. On the other hand, ensuring that capital transactions are free from artificial constraints and obstacles is an integral and indispensable part of the single market. This was, right from the start, one of the most pressing concerns of the German side, and – inasmuch as this lay in the power of the German policy makers to decide – it was implemented as soon as possible. In the meantime our European partner countries have, without exception, likewise recognised the advantages of the free movement of capital and have taken corresponding measures, as was also laid down by the internal market programme and explicitly reaffirmed by the EU Treaty. However, the free flow of capital, especially that of the industrial countries, is also advantageous on a global scale. It is a precondition for the optimum utilisation of capital and the full development of international trade and service transactions. This precludes any return to capital controls as a means of ensuring fixed exchange rates; such controls would, moreover, have no prospect of success given today's highly sophisticated and tightly integrated financial markets. A clear distinction needs to be made, however, between such restrictions on capital movements and prudential supervisory rules which aim to ensure that financial market players only assume such risks as they are actually capable of bearing even under unfavourable circumstances. Inasmuch as the international discussions being held on this matter lead to tougher regulatory measures, this may help to dampen the scope and volatility of international capital movements. Yet such developments would in no way noticeably ease the conditions in which exchange rate policy operates in the EMS.

Exchange rate stability now even more reliant on progress towards convergence

Since the potential for instability in the foreign exchange markets has increased considerably with the changes in the financial markets, this must be seen as a spur to systematically tackle the underlying causes of such instability. For, following the general widening of fluctuation margins, the aspired stability of exchange rates is now more heavily dependent than before on member states aiming at and achieving a large measure of stability-oriented convergence in their economic policies and economic performance. At the same time, exchange rate movements within the wider fluctuation bands mean that convergence deficiencies of the member states can be identified more easily and more quickly, since within this modified system the political influencing of exchange rate movements recedes in favour of market forces. Extended phases of stable exchange rates therefore assume a higher quality than was previously the case in respect of the resultant implications for the fundamental cohesion of the Community.

Harmonisation of the "financial culture" also desirable

Over and above the creation of the requisite macroeconomic convergence conditions, an effort should be made to achieve the maximum harmonisation of the underlying conditions in the financial sector – with the aim of promoting a convergence of the "financial culture" in Europe. From the point of view of monetary policy, it would be useful to gradually eliminate existing differences in the financial structures of EMS members in the wake of the progressive integration of the European financial markets. One outstanding example of such persisting differences is the prevalence in the United Kingdom of floating-rate loans as opposed to the preference in Germany for longer-term locked-in interest rates. For this reason changes in short-term interest rates that are subject to central bank influence have a comparatively large impact on disposable incomes in the United Kingdom where households moreover have a relatively high level of indebtedness; this may well have implications for the deployment of the central bank's set of instruments, as was demonstrated by the events of the EMS crisis in 1992. Clearly, this could give rise to problems for monetary policy cooperation in the EMS and for the later single monetary policy. The greater the success in curbing inflation and inflation expectations on a durable basis, the sooner the harmonisation of the financial structures, e.g. through the spread of longer-term forms of financing, can be implemented.

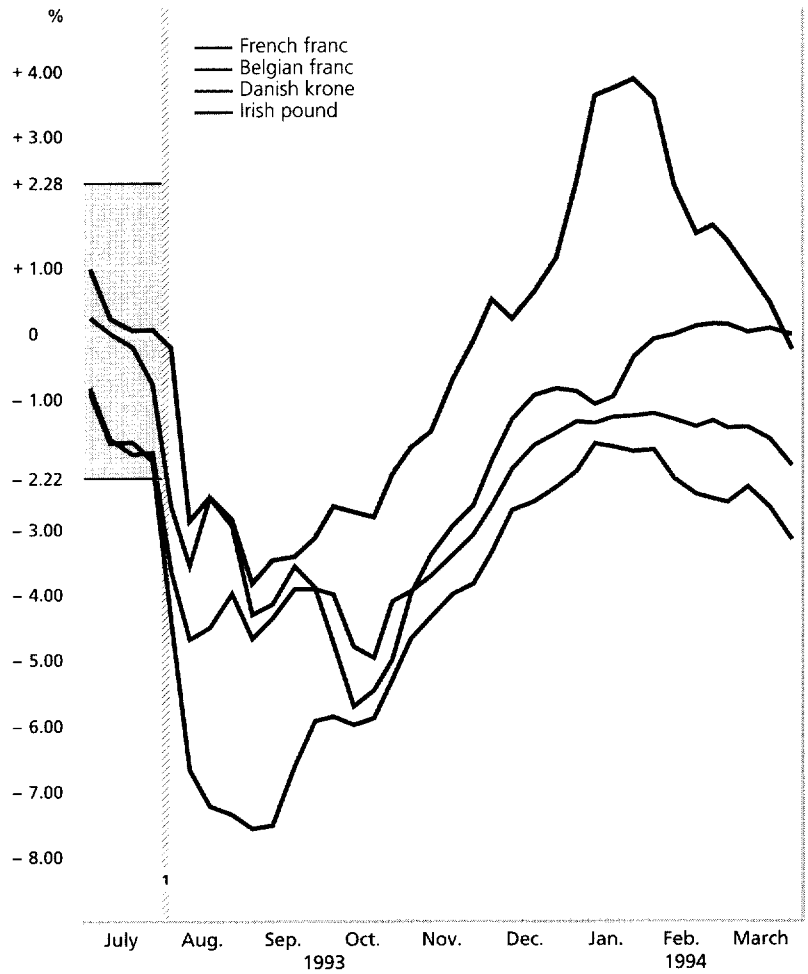
Exchange rates relatively stable despite the widening of fluctuation margins

Experience to date following the expansion of the fluctuation bands has, moreover, shown that exchange rate volatility can be checked much better than many people expected if national policy decisions are, of themselves, geared to the objective of exchange rate stabilisation. By contrast, problems would undoubtedly have arisen if in those EMS countries that have made further progress than Germany in combating inflation, the money market rates had been unilaterally lowered, under the impact of political pressure, more rapidly than the joint mechanism with other currencies, and in particular their pegging to the Deutsche Mark, would have actually allowed. For a time, recommendations to that effect were indeed forthcoming from foreign and international sources. According to such thinking, a (possibly only temporary) depreciation of the national currency would have had to be tolerated or even striven for as an additional stimulus to the economy. To date, however, Germany's remaining partners

Movements of selected EMS currencies against the Deutsche Mark *

Chart 13

Deviations from the central rate in %, weekly averages



* Partner currencies which in July 1993 maintained the previous normal fluctuation margin of ± 2¼%. — 1 Fluctuation margin widened to ±15%.

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in the exchange rate mechanism have not heeded such suggestions. To the extent that the enlargement of the fluctuation margins initially depressed partner countries' exchange rates, the lost ground has in the meantime largely been recovered. The countries concerned rightly assumed that any strategy which neglects the exchange rate is bound to engender mistrust within the markets and could ultimately lead to higher rather than lower interest rates. They were also mindful of the danger that neglecting the exchange rate could easily lead to a round of competitive devaluations. At the moment it is impossible to tell whether or when this situation, and the responsibly conceived exchange rate policy which underlies it, could justify a general return to narrower fluctuation bands. For the moment it is more important to observe developments over a longer period and to wait and see how the market rates develop in the absence of relatively narrow "guide rails". Furthermore, it would be wrong to underestimate the danger of renewed turbulence if market participants were once again offered an incentive to mount speculative assaults which, given the obligation to intervene within a system of narrow fluctuation margins, is to be feared. Another question which arises is whether a formal narrowing of fluctuation bands is at all necessary in order to meet the contractually agreed preconditions for transition to monetary union. The actually perceived stability of exchange rates on the basis of a high degree of convergence would appear to be more important than formal compliance with narrow fluctuation margins. At any rate, the advantages and risks of a return to narrower bands must be very carefully assessed before corresponding steps are taken.

2. Institutional progress on the road to EMU

EU Treaty now in force

The coming into force of the Maastricht Treaty on November 1, 1993 imposed on the signatories the binding objective of ensuring that the European Communities evolve in stages into an economic and monetary union and, to a certain degree, also into a political union. The European Communities accordingly now designate themselves as the European Union (EU) in matters in which the emphasis is on the comprehensive cooperation between the member states. It should be noted, though, that the United Kingdom and Denmark have negotiated certain derogation provisions which, in particular, give those countries the right of opting out of participation in the monetary union. Denmark has meanwhile already announced that it will not participate. All countries that join the European Union in future will, however, have to accept the European Treaty provisions in full. Austria, Finland, Norway and Sweden, which are scheduled to join as of January 1, 1995, have duly noted this stipulation, subject to the referendum that is to be held in each of the four countries.

Creation of the EMI

The conclusion of the ratification process in the course of 1993 – originally the end of 1992 was envisaged as the latest possible deadline – enabled the Union to inaugurate the second stage on the road to EMU, as envisaged in the amended EC Treaty, on January 1, 1994. The clearest manifestation of this is the setting-up of the European Monetary Institute (EMI). It replaces the previous Committee of EC Central Bank Governors and the European Monetary Cooperation Fund as the organ of cooperation of the central banks, whose responsibility for national monetary policies remains unimpaired. In addition, the EMI is entrusted, above all, with the task of creating the conceptual and the technical preconditions for a single internal and external monetary policy for the European System of Central Banks (ESCB) that is to be established at the beginning of the third stage. Those preconditions notably include the harmonisation of monetary policy strategies and instruments as well as the coordination of statistics and payment systems. The Bundesbank welcomes the choice of Frankfurt am Main as the location of the Institute as well as of the later European Central Bank (ECB), the headquarters of the ESCB, due to be established in the third stage, since this underscores the concurrence on the priority of maintaining monetary stability that has emerged ever-more clearly within the framework of the EMS.

Reform of some national central bank constitutions

Important institutional progress has been made in some other EC countries in the form of adjusting the national central bank statutes in line with the requirements of the EMU. Three countries whose central banks were hitherto dependent on the instructions of their government have now granted their central banks a higher degree of freedom (Belgium, France and Spain). Whether this is sufficient to meet the stipulations of the EC Treaty is something that still has to be assessed. But the fact that the movement towards independence of the national central banks has been embarked on at an early stage would certainly appear to be significant. Adjusting as rapidly as possible to the conditions of the third stage offers the countries concerned the chance to accustom themselves in timely fashion to the rather different relationship between governments and the central banking system obtaining in the EMU. The initial phase of the EMU could run all the more smoothly on account of that.

Special procedure for avoiding excessive budget deficits

The start of the second stage also saw the coming into force of institutional precautions aimed specifically at buttressing the budgetary discipline of the member states. Since in the EMU, budgetary policy – unlike monetary policy – is to remain a matter of national jurisdiction but could also be the source of significant dangers for monetary policy, the member states are obliged to avoid excessive public deficits in the third stage. They must seek to do so already in the second stage, for a sound budgetary situation is one of the prerequisites for the transition to EMU. The criteria defined in the EC Treaty for identifying excessive deficits are oriented both towards the level of current deficits and towards the level of public indebtedness; the ceilings of 3 % and 60 % of GDP, respectively, which are stipulated as a precondition for entry into the EMU, will trigger a special assessment and adjustment procedure as defined in the Treaty. It will be applied the moment a member state fails to satisfy one of the criteria. The procedure can also be triggered if there is merely a risk of non-fulfilment of the criteria. The basis for assessing a critical budgetary situation will be a report by the Commission which will contain all the relevant factors, including a comparison of the deficit with capital expenditure. The EMI will also be able to put forward its comments. If the Council concludes that an excessive deficit exists, it will make recommendations to the member state concerned coupled with a deadline by which the overshooting of the particular criterion must be rectified. If effective measures are not taken within the set time frame, the Council can also make public its recommendations and thus exert greater pressure. More far-reaching sanctions, which could include the imposition of financial penalties, are not envisaged until the third stage.

Ban on central bank lending to the public sector

Another means of strengthening budgetary discipline and simultaneously safeguarding the autonomy of the future European central banking system is the ban on central bank lending to the public sector, which likewise became effective with the beginning of the second stage. This regulation prohibits the national central banks (and later the ECB) both from granting new book credit to public authorities and from purchasing public debt instruments (except for transactions forming part of monetary policy open market operations). This ban forces governments and public bodies to finance their expenditure within the limits of tax receipts and borrowings in the money and capital markets, and thus concurrently also increases the disciplinary impact of the market mechanisms. At the same time, the measure prevents governments from gaining access to money creation and hence from directly jeopardising monetary policy. The precise details of the ban on central bank lending to public authorities are set out in a Council Regulation. This defines, in particular, which aspects of central bank business are not subject to the lending ban, such as notably the open market operations mentioned above, the limited take-over of coins in circulation and transactions associated with membership of the IMF; for the duration of the second stage the acquisition of tradable public debt instruments issued by another member country is also permitted as an investment vehicle for monetary reserves. The Council Regulation further stipulates that all central bank claims on the public sector existing at the end of 1993 must be given a fixed final maturity. In Germany, the corresponding changes to the Bundesbank Act necessitated by the lending ban have meanwhile been initiated.[1]

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1 See Deutsche Bundesbank, The second stage of European economic and monetary union, Monthly Report, January 1994, page 23 ff.

Ban on privileged public sector access to financial institutions

A further ban, which is closely associated with the ban on lending to public authorities and which likewise came into effect at the beginning of 1994, concerns granting the public sector privileged access to financial institutions. This proscribes not only measures compelling financial institutions to make certain investments in public bonds, but also those measures which seek to do the same by means of tax or other incentives that are inconsistent with market conditions. Exceptions to this rule are, in principle, only permissible in the interests of investor protection. A further Council Regulation contains the finer details and also lists some exceptions (for example, measures concerning the promotion of publicly assisted housing construction). It was made clear that, among other things, financial institutions can be compelled for monetary policy reasons to immobilise liquid resources at the respective central bank (or later at the ECB). It may reasonably be expected that the ban on privileged access to financial institutions will further reinforce the pressure to pursue a strict budgetary policy.

Exclusion of liability of the Community and member states for the debts of a partner country

With the coming into force of the EU Treaty, another provision became effective according to which neither the Community shall be liable for the obligations of the member states, nor shall any member state be responsible for the liabilities of another member state. Since, even within the EMU, responsibility for budgetary policy will remain with the parliaments and governments of the member states, this exemption from liability is designed to make public authorities and market participants acutely aware that the burdens ensuing from excessive budget deficits will have to be borne in the future, too, by each member country alone. Only if awareness of this fact is perpetually maintained can the market forces generate a disciplining effect. While past experience admittedly shows that markets usually take a long time to react to fiscal problems of public authorities, their delayed reactions are sometimes all the more intense.

3. Intensification of economic policy cooperation in the EC

Presentation of convergence programmes

The EC countries will only be able to achieve their objective of setting up an EMU before the end of the century if they succeed in comprehensively approximating their economic policies and economic performance towards a maximum degree of domestic economic stability. The aspired exchange rate stability in the EMS with enlarged fluctuation margins likewise depends more heavily than it did before on a high degree of anti-inflation convergence among the member states. Yet irrespective of the fact that, according to Article 103 of the EC Treaty, member states' economic policy is to be regarded as a matter of common concern, it is to remain a national preserve both in the second stage and also in the EMU. The common concern is therefore to be ensured through procedures aimed at coordinating economic policies and economic developments. In this context the amended EC Treaty commits member states, wherever convergence deficits arise, to elaborate multi-annual reform programmes in order to guarantee that the requisite progress is made, especially as regards price stability and sound public finances. These programmes are not to be seen as informal declarations of intent but rather constitute international obligations by which the progress made by a given country towards convergence will be gauged.

Disappointing development of public finances

In order to gain an early overview of the progress towards convergence and integration made on the road to EMU, the Council – as demanded by the amended EC Treaty – evaluated (even prior to the inauguration of the second stage at the beginning of 1994) the current state of economic convergence and the progress made towards translating Community law on the single market into national legislation. On the basis of a report presented by the Commission, the Council noted that the progress made towards convergence was rather disappointing. And indeed the situation in respect of public finances in all member countries has worsened substantially. In 1993 only a few EC countries managed to keep the public budget deficits as well as aggregate public indebtedness below the ceilings of 3 % and 60 % of GDP, respectively, which will later determine the start of an EMU and define the range of countries that are eligible to participate, and which are already now the criteria which trigger the aforementioned special budget assessment procedure. This unpropitious development was connected to some extent with the sharp slump in economic activity which curbed tax receipts and resulted in higher public spending. In a number of countries this led to such a critical financial situation, owing to existing structural budget deficits, that even the effects of "automatic stabilisers" inevitably came up against reservations and limits. In many cases, therefore, much more far-reaching retrenchment efforts are required. The convergence programmes that have so far been submitted by eleven member states are predominantly in need of improvement in this respect. It certainly needs to be ensured that, in a situation in which – as shown by the table on page 99 – an excessive budget deficit probably exists in eleven of the twelve member states, the special budget surveillance procedure is able to play an additional disciplining role.

Advances in combating inflation

By contrast, gratifying progress towards convergence has been made in the field of combating inflation. It should be noted in this connection that the EC Treaty does not precisely define how a country's progress towards convergence is to be

Progress in convergence in the EC

Table 11

EMU criterion fulfilled

Country	Change in consumer prices from previous year in %				Financial balance of the public sector as % of GDP[1]	
	1992		1993		1992	1993
EMU threshold value[2]	3.6	3.9	2.8	3.1	– 3	– 3
Belgium	2.4	2.4	2.8	2.8	– 6.9	– 7.4
Denmark	2.1	2.1	1.3	1.3	– 2.6	– 4.4
France	2.4	2.4	2.1	2.1	– 3.9	– 5.9
Germany	[3] 4.0	[3] 4.0	[3] 4.2	[3] 4.2	– 2.6	– 3.3
Greece	15.9	15.9	14.4	14.4	– 13.2	– 15.4
Ireland	3.1	3.1	1.4	1.4	– 2.2	– 3.0
Italy	5.1	5.1	4.5	4.5	– 9.5	– 10.0
Luxemburg	3.2	3.2	3.6	3.6	– 2.5	– 2.5
Netherlands	3.7	3.7	2.1	2.1	– 3.5	– 4.0
Portugal	8.9	8.9	6.5	6.5	– 5.2	– 8.9
Spain	5.9	5.9	4.6	4.6	– 4.6	– 7.2
United Kingdom	3.7	3.7	1.6	1.6	– 5.9	– 7.6

Country	Yield on long-term public bonds in %				Gross indebtedness of the public sector as % of GDP[1]	
	1992		1993		1992	1993
EMU threshold value[2]	10.6	10.9	9.2	9.5	60	60
Belgium	8.7	8.7	7.2	7.2	131.9	138.4
Denmark	8.9	8.9	7.2	7.2	73.4	78.5
France	8.6	8.6	6.8	6.8	39.2	44.9
Germany	7.9	7.9	6.5	6.5	44.8	48.9
Greece	[4] 21.7	[4] 21.7	[4] 21.2	[4] 21.2	106.7	113.6
Ireland	9.1	9.1	7.7	7.7	91.6	92.9
Italy	13.4	13.4	11.4	11.4	108.0	115.8
Luxemburg	7.9	7.9	6.9	6.9	7.3	10.0
Netherlands	8.2	8.2	6.3	6.3	79.7	83.1
Portugal	[5] 15.4	[5] 15.4	[5] 12.5	[5] 12.5	63.5	69.5
Spain	12.2	12.2	10.2	10.2	48.8	55.6
United Kingdom	9.1	9.1	7.5	7.5	47.3	53.2

Sources: European Commission and national statistics. — **1** In the definition of the national accounts (including social security funds). — **2** The rate of inflation must not exceed that of the – at most three – best-performing countries by more than 1.5 percentage points. The yield on long-term public bonds must not exceed that of the – at most three – best-perfoming countries by more than 2 percentage points. The following threshold values for the inflation rate and the yield relate to the best-performing and the third best-performing member country, respectively. Fulfilment of the criteria is measured in terms of both threshold values. — **3** Western Germany. — **4** One-year Treasury bills. — **5** Yield on public floating-rate bonds outstanding.

Note: The Treaty is likely to presume that the threshold values for the inflation rate and the yield are normally to be calculated in terms of the best-performing member country. Hence it follows that deviations from that rule would only be justified if the stability achieved by the best-performing country were due to extraordinary circumstances (such as extreme differences in the course of business activity). In such cases a threshold value geared to the third best-performing country could represent the softest alternative conceivable.

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measured. The Treaty merely states that the convergence criteria for participating in the start of the EMU, regarding both price and interest rate trends, will be the inflation rate of the – at most three – best-performing member states in terms of price stability. The wording indicates that the inclusion of all three stability criteria in the definition of the threshold values should be regarded rather as the exception. The calculation of the threshold values – in keeping with the aim of ensuring a high degree of price stability for the EMU – should, therefore, be geared, in principle, to the country with the most stable prices. Calculating the threshold values on the basis of the third best-performing country alone – i. e. the softest alternative conceivable – which the European Commission is apparently considering, should, by contrast, provoke grave misgivings. In practice, these definitional differences could, it is true, prove increasingly insignificant should the differential in the rate of price increases of the three best-performing countries narrow further. For example, in 1993 the price stability criterion was fulfilled by half the EC countries, regardless of which method of calculation is used.

Implementation of the internal market programme advanced further

Progress has likewise been made in implementing the internal market programme in respect of harmonising technical regulations, the award of public orders and ensuring the free movement of goods, services and capital. By December 1993, the Community had adopted around 95 % of the measures envisaged in the Commission's White Paper of 1985 and had put the requisite acts into force almost in their entirety. The member states, on the other hand, have fallen somewhat further behind in translating those Community acts into national legislation; on an EC-wide basis they have enacted only 85 % of all the necessary national implementation measures. One of the principal single market provisions still outstanding is the failure so far to eliminate passport controls at international borders. Another unsatisfactory point is that the provisional internal market arrangements for the collection of value-added tax (initially set to remain in force up to the end of 1996), which is still based on the destination principle, places a considerable administrative burden on the fiscal authorities and, more especially, on enterprises. For this reason it would appear sensible to effect an early change-over to a procedure based on the origin principle.

Further development of cooperation through common "broad guidelines of the economic policies"

The coming into force of the EU Treaty has committed the member states not only to submit convergence programmes but also to foster sound economic developments in Europe by agreeing each year on Community recommendations on the "broad guidelines of the economic policies" of the member countries. The "broad guidelines" for 1994, the first to be issued by the Council, are primarily concerned with reducing the high level of unemployment in the Community. The key requirement, in the Council's view, is to pursue a credible medium-term strategy for lowering budget deficits and for promoting growth by stimulating private investment and by concentrating public resources on capital spending. Labour market policy is also to include efforts aimed, among other things, at lowering wage costs and non-wage labour costs. In order to bolster the effect of the "broad guidelines", the Council will, as part of a "multilateral surveillance" function, check twice yearly – on the basis of Commission reports – whether member states' economic policy stance fully accords with the Community's guidelines. If national policy is not in harmony with the Community's "broad guidelines", the Council can make economic policy recommendations to the member countries concerned and also – so as to further strengthen the efficacy of those proposals – may make them public.

Action plan for combating unemployment

In connection with the growth initiative adopted by the European Council back in December 1992, which envisages both national measures and a number of Community programmes, the Commission was called on by the European Council in July 1993 to develop medium and long-term strategies for reviving the economy and for combating unemployment. The White Paper which the Commission subsequently issued in December 1993 ("Growth, Competitiveness, Employment – Challenges and Ways Forward into the 21st Century") was made the basis of an action plan by the European Council that same month. The core elements of this plan affirm strategies directed towards moderating pay settlements, lowering non-wage labour costs, rendering working conditions more flexible and improving training and further training, as likewise defined in the above-mentioned "broad guidelines of the economic policies". More extensive proposals from the Commission to step up the Community funding of trans-European infrastructural and environmental projects were, however, accepted by the European Council only in part. Such projects are to be confined initially to the financial resources which are either already available within the framework of the Community's medium-term budget planning or else can be provided by the European Investment Bank and the newly established European Investment Fund that is to be administered by the European Investment Bank. In particular, the European Council did not approve the proposal made in this connection to launch "union bonds". Such bonds could weaken the disciplinary precautions built into current EC budget law, even if the resources raised in this way are used for lending, i. e. not for current Community spending. If this were to open the door in the longer run to the financing of the EC budget through borrowing, it could undermine the budgetary discipline which is so crucially needed both in the member states and in the Community as a whole. As a result, the objective of establishing a monetary union in Europe in the foreseeable future would be seriously jeopardised.

Operations of the Deutsche Bundesbank

I. Processing cash payments and cashless payments

1. Cash payments

Banknotes and coins in circulation

The amount of banknotes in circulation at December 31, 1993, at DM 224.3 billion, was DM 11.0 billion (or 5.1 %) larger than at the end of 1992. The amount of coins in circulation, by contrast, rose by only 2.7 %. At the end of 1993 about 94 % of all currency in circulation consisted of banknotes, and 6 % of coins.

Currency in circulation

Table 12

Trends over time

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
1989	162,144	150,548	11,596
1990	179,690	166,909	12,781
1991	194,615	181,300	13,315
1992	227,285	213,355	13,930
1993	238,641	224,341	14,300

Pattern at the end of 1993

Banknotes in circulation			Coins in circulation		
Notes of DM	DM million	Percentage of total	Coins of DM	DM million	Percentage of total
1,000	68,486	30.5	10.00	1,984	13.9
500	24,287	10.8	5.00	5,433	38.0
200	11,632	5.2	2.00	2,079	14.5
100	86,849	38.7	1.00	2,232	15.6
50	20,312	9.1	0.50	1,068	7.5
20	7,747	3.5	0.10	922	6.5
10	4,695	2.1	0.05	291	2.0
5	333	0.1	0.02	135	0.9
			0.01	156	1.1
Total	224,341	100	Total	14,300	100

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Of the almost 2.4 billion notes which were in circulation at the end of 1993, more than 2.1 billion belonged to the new series. In the denominations between DM 10 and DM 100, the new notes account for shares of between 87 % (DM 10) and 93 % (DM 100) of the respective total amounts in circulation.

Although they are only of minor significance in cash payments, the notes of the old series will remain unrestricted legal tender for the time being. Even after their withdrawal from circulation, such banknotes will not become worthless because the Bank will go on replacing them at their face value.

Destruction of banknotes

The following banknotes were destroyed as being no longer fit for circulation or after having been called in:

	1989	1990	1991	1992	1993
Number (millions)	719	506	1,099	1,697	914
Value (DM billion)	27.4	25.8	62.6	97.5	120.0

The decline in the number of destroyed banknotes, despite the simultaneous increase in the overall amount, is attributable to the fact that during the period under review larger numbers of DM 500 and DM 1,000 banknotes of the old series which flowed back to the Bank from payment operations and stocks of these denominations held by the Bank were destroyed. The volume of notes of the new series sorted out still remains small.

Coins

The stock of German coins held by the Bank at the end of 1993 amounted to DM 2,067 million (end-1992: DM 1,661 million). In 1993 DM 804 million was credited to the Federal Government in respect of coins received from the mints and DM 28 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1993 the Bank – acting for account of the Federal Government – received coins amounting to DM 18,247 million and redeemed coins which were no longer fit for circulation or which had been called in to the value of DM 1,879 million. At the end of 1993 coins totalling DM 14,300 million were in circulation, equivalent (given 81 million inhabitants) to DM 177 per head of the population. The DM 10 commemorative coin "1,000th anniversary of the foundation of Potsdam" was put into circulation in 1993.

Counterfeits

Both the number and the amount of the counterfeit DM banknotes detained in payments and appraised by the Bank also increased during the year under review.

Counterfeits detained in payments, as recorded by the Bundesbank — Table 13

	Banknotes		Coins	
Year	Number	DM thousand	Number	DM thousand
1989	3,425	304	8,324	31
1990	4,120	327	12,132	49
1991	6,632	754	4,412	16
1992	14,057	2,520	21,257	103
1993	41,838	5,732	8,086	39

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DM 100 note forgeries predominated, accounting for almost 80 % of the total. Some 60 % of all counterfeits were colour photocopies. The counterfeiting of Federal coins decreased perceptibly, the DM 5 coin being almost the only one forged.

2. Cashless payments

Number of payments presented declines slightly

In 1993 the number of credit transfer and collection orders channelled through the Bank declined slightly. Altogether, 3.1 billion payments, totalling DM 202,654 billion, were submitted in local and intercity transfer operations; this represented a decline of 0.5 % in the number of payments. By contrast, the amount involved increased by 21 %, the major part of it (88 %) once again being settled under the local transfer system; some large credit transfers deriving from interbank transactions were processed, especially in the field of clearing operations. This applies particularly to Electronic Clearing with File Transfer ("EAF") in Frankfurt – a system which, in terms of the amount, accounted for about 73 % of the local transfer operations channelled through the Bank.

Cashless payments — Table 14

		Credit transfers presented			Collection orders presented		
			of which: passed on			of which: passed on	
Year	Total	Total	in local transfers	in intercity transfers	Total	in local transfers	in intercity transfers
	Millions						
1989	2,449	750	249	501	1,699	44	1,655
1990	2,695	848	220	628	1,847	40	1,807
1991	3,197	1,128	378	750	2,069	46	2,023
1992	3,118	1,149	404	745	1,969	59	1,910
1993	3,101	1,146	386	760	1,955	96	1,859
	DM billion						
1989	123,245	119,337	110,522	8,815	3,908	701	3,207
1990	134,111	129,768	118,880	10,888	4,343	728	3,615
1991	144,500	139,634	126,176	13,458	4,866	798	4,068
1992	167,467	162,488	146,707	15,781	4,979	944	4,035
1993	202,654	197,792	177,479	20,313	4,862	957	3,905

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Effects of levying charges

The levying of transaction charges since mid-1991 probably also affected operations in the year under review and contributed to the decrease in the number of payments presented, because since that time the banking industry has increasingly routed payments through internal networks or stepped up the exchange of payments on a bilateral basis. In addition, the differing levels of charges for paper-based procedures (DM 0.05 per credit transfer, and DM 0.10

per collection item) and paperless procedures (DM 0.01 per data record, at least DM 10 per data medium) have fostered the transformation of paper-based payments into paperless transactions.

Retail payments processed via the computer centres

The above-mentioned greater transition to efficient and cost-effective paperless procedures is particularly noticeable in the field of retail payments via the eight computer centres of the Bank. In the year under review, the proportion of credit transfer and collection orders processed by paperless exchange of data media (EDM procedures) rose from 78 % to 82 %.

Credit transfers

The share of paperless credit transfers increased from 60 % to 68 %. This trend probably owes very much to the obligation incumbent on credit institutions since the beginning of 1992 to convert paper-based intercity transfers of amounts from DM 10,000 upwards into data records, and to transmit them in the form of electronic payments (EZÜ obligation). In the meantime, the banking industry, on grounds of efficiency, has also started to transform credit transfers below this ceiling into paperless payments without distinguishing between local and intercity transfers. In addition, the paperless cash inpayment credit transfer system (BZÜ system) has probably also made itself felt – a procedure whereby the particulars of the coding line of a specially designed credit transfer voucher or credit voucher are recorded by means of machine-optical reading and transmitted by the paperless exchange of data media. The corresponding agreement – to be applied on a voluntary basis – came into force on January 19, 1993; the computer centres of the Bank have been actively involved in the transformation of such vouchers since October 7, 1993.

Collection orders

In the case of collection operations, the share of paperless orders increased from 85 % to 88 % in the year under review. In this context, it was primarily the amendment of the Agreement on the truncated cheque collection procedure (BSE Agreement) that made itself felt. Since April 7, 1993 it has been possible, on a voluntary basis, for all cheques for less than DM 5,000 (previously, less than DM 2,000) to be transformed into data records and transmitted by the EDM system. The introduction of a general obligation for credit institutions to convert all direct debits into data records and to collect them by the electronic funds transfer system (EZL obligation) from November 18, 1993 will foster paperless payments even more. For the rest, in anticipation of this obligation, the banking industry has already started to convert paper-based direct debits on an increasing scale.

Intercity transfers

Table 15

Millions

Year	Credit transfers presented: Total	of which: passed on: in direct operations between branch offices	via computer centres: in automated paper-based operations	via computer centres: through the paperless exchange of data media	Collection orders presented: Total	of which: passed on: in direct operations between branch offices	via computer centres: in automated paper-based operations	via computer centres: through the paperless exchange of data media
1989	501	4	290	207	1,655	3	346	1,306
1990	628	6	353	269	1,807	7	324	1,476
1991	750	6	347	397	2,023	5	320	1,698
1992	745	3	297	445	1,910	2	292	1,616
1993	760	4	242	514	1,859	2	221	1,636

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Direct operations between branch offices

The functions of the express electronic intercity and local credit transfer system (EIL-ZV), which processes telegraphic transfers and express transfers (express large-value credit transfers amounting to DM 10,000 or – since October 1, 1993 – DM 50,000 and more), were supplemented by an automated routing system as from August 20, 1993. This routing system permits a transmission and settlement of credit transfers that depart from the indicated bank code number (for instance, via the head office of a multiple-branch bank or via a central institution of the savings bank or cooperative bank sectors). By introducing this procedure, the Bank has complied with a request made by the banking industry and brought the control and settlement facilities of the telegraphic and large-value transfer system into line with its procedures for retail payments processed via the computer centres. Since the introduction of this system, payments submitted by participants in the Electronic Counter (ELS) scheme in the form of data telecommunication or by diskette no longer have to be submitted separately, broken down into local transfers, on the one hand, and intercity transfers, on the other.

Risk reduction in large-value payment operations

In line with international agreements to review national net settlement systems so as to identify systemic risks, the Bank continued its discussions with the banking industry on the restructuring of its settlement procedures and took a number of measures in this connection. First of all, a binding time-scheme was introduced for all settlements, together with better information of the participants on the state of settlement. Moreover, in view of the marked concentration of settlement turnover on the Frankfurt banking centre, uniform standards were devised there for the level of the collateral to be provided, but without having the latter blocked exclusively for settlement purposes. In the light of the experience gained in Frankfurt, this procedure will also be introduced, if appropriate, in the other local settlement systems. In addition, it was decided to develop the EAF concept further, instead of resorting to measures for limiting risks in net systems by imposing limits and loss-sharing arrangements, such as are customary abroad. The future Electronic Clearing System (EAF-2) has been designed to make do with relatively low liquidity requirements during the day – comparable to the existing net settlement procedure – and at the same time to achieve early finality of the individual payments, as is typical of gross settlement systems. The Bank is convinced that in this way it can satisfy both what are known as the „Lamfalussy criteria" for limiting systemic risk and the calls for an efficient interbank settlement system at the financial centre Frankfurt.

3. Special trends in cross-border payments

Cooperation at EC level

Since the introduction of the single European market and in the course of the implementation of the European monetary union, cross-border payments have attracted more and more attention. In 1993 the "Working Group on EC Payment Systems" set up by the central bank governors of the EC member states prepared a detailed study ("Minimum common features for domestic payment systems") which highlighted the common features of the payment systems of the countries of the European Union. This was intended to ensure that payment transactions are executed, as far as possible, with the same high degree of efficiency and security in all the countries concerned. Moreover, since internationally operating credit institutions have a number of different possibilities of participating directly in foreign payment systems, any undesirable dodging to the less regulated, but risk-prone, systems of other countries (risk arbitrage) is to be avoided. The envisaged harmonisation encompasses, in particular, central bank policy with regard to access conditions, risk management, legal provisions, technological standards, prices and opening hours. The targets relate to all kinds of payment systems. However, central banks' interest is focused on large-value payment systems, since that is where interbank payment transactions, involving possible risks to the entire money economy, take place, and where central banks conduct their monetary policy.

On behalf of the EC central bank governors, the above-mentioned Working Group started preparatory work on a large-value payment system which, in stage III of the economic and monetary union, is to be able to implement the monetary policy formulated in the European System of Central Banks smoothly and on a real-time basis. This system will be based on the gross payment systems which will have to be installed everywhere (in Germany, for instance, on the Bank's Eil-ZV).

Cooperation among the G-10 countries

As a member of the "Committee on Payment and Settlement Systems" of the Group of Ten countries at the Bank for International Settlements (BIS) in Basle, the Bank was involved in preparing the report on central bank payment services for cross-border transactions involving several currencies, which was published in September 1993. That report presents some new ideas with regard to cutting risks and enhancing efficiency, particularly in the case of those international payments which have to be executed in order to settle foreign exchange contracts.

II. The Bank's international transactions

Foreign exchange spot deals

The Bank's turnover in foreign exchange spot deals diminished in the year under review as a result of lower support purchases of EMS currencies. Compulsory and intramarginal Deutsche Mark sales by EMS partner central banks are not included in the turnover statistics; although they are financed by the Bank, they are transacted in other financial centres. Foreign exchange purchases decreased to DM 8.4 billion, compared with DM 25.4 billion a year before. By contrast, foreign exchange sales amounted to DM 32.3 billion, compared with DM 21.3 billion a year earlier; the increase is primarily due to the fact that foreign exchange which had increasingly accrued to the Bank from repayments of foreign currency loans by European central banks was returned to the market.

Other foreign exchange deals

For purposes of money market management, the Bank effected foreign exchange swaps totalling DM 40.2 billion and foreign exchange repurchase transactions amounting to DM 3.9 billion. The volume of cross deals (foreign currency against another foreign currency) increased in the year under review to DM 2.2 billion, compared with DM 1.1 billion a year before. In addition, US dollar inter-centre switch transactions totalling US$ 125 million were entered into, against US$ 113 million in 1992.

Foreign bill of exchange and cheque deals

In the context of refinancing operations, the Bank bought foreign bills of exchange totalling DM 63 billion in 1993 (see page 111). Moreover, it sold 28,892 foreign cheques payable to order amounting to DM 112 million in 1993 (compared with 27,477 cheques totalling DM 203 million a year before). Another 58,055 cheques, to the value of DM 145 million, were presented in 1993 under the simplified collection procedure for foreign cheques; in 1992, 66,454 cheques worth DM

321 million had been so presented. For the rest, in 1993 the Bank accepted 13,829 items bought on a commission basis (mainly bills and cheques) for realisation in foreign commission business; a year earlier, 14,404 such items had been bought. In addition, transactions in foreign notes and coins were effected on a small scale.

III. The Bank's money market deals and refinancing operations

Discount credit

In 1993 the Bank again granted credit institutions basic refinancing by providing central bank money on the basis of the discount credit facility. The volume of rediscount quotas fixed (not counting the special rediscount facilities to finance export orders) came to DM 65.3 billion at December 31, 1993 (1992: DM 64.4 billion). On the occasion of the regular updating of the rediscount quotas at the beginning of November 1993, the method of calculation was brought into line with the new banking supervision regulations incorporated in the Fourth Amendment of the Banking Act. The modifications took account of the new definition of the liable funds of credit institutions and the introduction of the EC passport for the branch offices of foreign banks from EC member states. In addition, for the first time the recalculation was effected on a common basis for west and east German credit institutions alike, with the result that the adjustment of the refinancing conditions for east German banks is now really concluded.

Purchases of domestic bills of exchange

The utilisation of the rediscount quotas was subject to major fluctuations in the course of the year, owing to the changing interest rate conditions and interest rate expectations in the money market. Altogether, 1.4 million domestic bills of exchange totalling DM 262 billion were purchased under the rediscount quotas, or under the special rediscount facilities (ceiling B) granted to the AKA Ausfuhrkreditgesellschaft mbH; in 1992 1.5 million such domestic bills of exchange had been purchased, amounting to DM 261 billion. In the absence of payment, 6,998 bills totalling DM 196 million (1992: 5,486 bills totalling DM 161 million) were returned and charged to the parties presenting them for discount.

Purchases of foreign bills of exchange

Purchases of foreign bills of exchange, which are counted towards the rediscount quotas, numbered 107,275 in 1993, and totalled DM 63 billion (1992: 131,199 bills totalling DM 73 billion). The share of foreign bills denominated in foreign currencies came to 1.4 % (1992: 1.9 %). The decline in foreign bill purchases is partly attributable to the abolition of German bill tax from January 1, 1992, which eliminated the cost advantage of foreign bills of exchange (which were formerly not, or only partly, liable to bill tax).

Securities repurchase agreements

The most important instrument of central bank money provision was open market transactions in securities under repurchase agreements ("securities repurchase agreements"). In 1993 52 such transactions were conducted in all, 19 of which were in the form of "double-deckers", i. e. consisted of two tranches of differing maturities. The standard maturities of such transactions are two or four weeks. The "double-deckers" were suspended several times in the second half of the year: in August and September, when the volume of repurchase agreements declined sharply as a result of heavy foreign exchange inflows, and in December, when long tranches did not seem to be appropriate, against the background of pronounced expectations of falling interest rates. The outstanding volume of securities repurchase agreements at the end of 1993 was DM 184.5 billion, against DM 124.1 billion at the end of 1992.

Liquidity management portfolios

The range of securities that can be used for open market operations was extended as a result of modifications of business policy provisions under the Fourth Amendment of the Bundesbank Act. Now all debt securities eligible as collateral for lombard loans that are officially listed or traded in the regulated market (Treasury discount paper is included, even if unlisted) may be purchased. At the end of 1993, securities amounting to DM 436.5 billion were deposited by credit institutions at Land Central Banks for securities repurchase agreements and for lombard purposes.

Quick tenders

In response to sudden sharp changes in the money market situation, the Bank four times entered into what are known as "quick tenders" in 1993. These are securities repurchase agreements which, in contrast to the normal transactions, are processed within about one hour and for which only a few dozen banks (ones active in the money market) are invited to submit tenders. The amounts involved in such quick tenders were between about DM 4 billion and DM 18 billion, and their maturities ranged from two to ten days; they were carried out in the form of fixed-rate tenders.

Shifts under section 17 of the Bundesbank Act

To bolster the money market's short-term liquidity, the Bank shifted Federal Government balances lodged with it into the market on 48 days. Since January 1, 1994 such shifts have become impossible, since no Federal funds are available any longer. In anticipation of the Amendment of the Bundesbank Act, which provides for the repeal of the deposit obligation under section 17 of the Act, the Federal Government was granted what is known as a blanket quota, with the result that it is now able to place its liquid funds in the market.

Foreign exchange transactions

In 1993 the Bank again effected foreign exchange swaps and foreign-exchange-based repurchase transactions in order to stabilise the money market (see also page 111).

Dealings in money market paper

In order to fine-tune the money market, the Bank sold liquidity Treasury bills totalling DM 15.7 billion on four days in 1993, on the basis of section 42 of the Bundesbank Act; their maturities were one to three days. In addition, the Bank issued several tranches of Bundesbank Treasury discount paper with maturities of three, six and nine months in the period under review. All in all, DM 53.2 billion of such paper was issued, and DM 24.9 billion was in circulation at the end of the year.

Lombard loans

Throughout 1993 recourse to lombard loans was available to banks to meet their short-term liquidity needs. In the main, this facility was used to offset unforeseeable debit balances arising in payments in the form of "giro overdraft loans". Substantial lombard loans were recorded on only a few days; the heaviest recourse was registered in the wake of end-of-year transactions on December 30, 1993, at DM 21.3 billion.

Note

The Bank is publishing the current monetary policy regulations in a booklet appearing parallel to the Annual Report: Deutsche Bundesbank, Monetary policy regulations, Frankfurt am Main, April 1994. This publication is available to interested parties free of charge.

IV. The Bank's participation in issues of Federal securities

Issues of bonds

In 1993 the Bank was again involved on a growing scale in the issuing and placing of securities launched by public borrowers at the Federal level. All in all, the Bank participated in the floating of 19 bond issues totalling DM 129.0 billion, among which were seven increases in previously launched issues. DM 91.4

billion (including tender allotments) was issued via the Federal Bond Consortium, which is under the direction of the Bank, while DM 37.6 billion was reserved for market-smoothing purposes. In 1993 the Treuhand agency drew on the capital market in the form of six bond issues totalling DM 54.0 billion, which was almost as much as the Federal Government took up (DM 56.0 billion). The other issuers – the "German Unity" Fund, the German Federal Post Office, the German Federal Railways and the ERP Special Fund – launched bond issues totalling DM 19 billion.

Issuing procedures

The method of launching bonds by a combined syndicate and tender procedure again proved to be effective. If one includes the increases, which were launched by the tender procedure, the credit institutions belonging to the Federal Bond Consortium bought bonds totalling DM 33.5 billion by the syndicate procedure; a further DM 57.9 billion was allotted to those institutions under the tender procedure. In November 1993 the quotas in the consortium were once again brought into line with the placement potential, taking due account of the allotments under the tenders. At the end of the year, the Federal Bond Consortium comprised 109 credit institutions in all, including 53 foreign-owned institutions.

30-year bonds issued again

At the end of 1993, for the first time since 1986, the Federal Government again issued bonds with a maturity of 30 years; previously, this very long maturity category had been tested successfully by increasing a bond issue dating from 1986 with a residual maturity of 22 1/2 years. On the one hand, the issue of this 30-year bond, which is due to be followed by other bonds of the Federal Government and the Treuhand agency, was intended to meet the demands of national and international investors. On the other hand, it enlarged the range of maturities of Federal securities. The issuing of the 30-year bond also owed something to the decision taken by the German Financial Futures and Options Exchange (DTB) to start trading in a 30-year "bund futures" contract in the first quarter of 1994.

Issues of other Federal securities

In 1993 the Bank also took over the tendering and placing of Treasury notes of the Federal Government and the Federal Post Office, as well as of Treuhand special five-year bonds. Federal Treasury notes and special Treuhand bonds were offered regularly at intervals of three months. Furthermore, the Bank, acting for the account of the Federal Government, was involved in the selling (settlement of sales via credit institutions as well as its own sales) of Treasury financing paper, Federal savings bonds and five-year special Federal bonds (which were launched on tap).

Bond issues by the Federal Government, its special funds and the Treuhand agency in 1993

Table 16

Issuer	Issue amount (DM billion)				Terms				
		of which							
	Total	Syndicate amount	Allotment amount by tender procedure	Market regulation amount	Nominal interest rate (% p.a.)	Maturity (years/ months)	Issue price or average allotment rate (%)	Yield on the issue price or average allotment rate (% p.a.)	Date of issue
Federal Railways - increase -	1.0	–	1.0	0.0	7.500	9/10	–/ 101.85	–/ 7.22	Jan. 8
"German Unity" Fund - increase -	2.0	–	–	2.0	8.000	9/0	–	–	Jan. 13
Treuhand agency	10.0	3.0	4.8	2.2	7.125	10/0	100.50/ 99.80	7.05/ 7.15	Jan. 26
Treuhand agency - increase -	4.0	–	3.3	0.7	7.125	9/11	–/ 102.12	–/ 6.82	Feb. 25
Federal Government - increase -	2.0	–	–	2.0	7.125	9/9	–	–	Mar. 3
Federal Government - increase -	2.0	–	–	2.0	7.125	9/8	–	–	Apr. 6
Treuhand agency	10.0	3.0	4.5	2.5	6.500	10/0	100.30/ 99.36	6.46/ 6.59	Apr. 20
Federal Government	10.0	3.0	4.5	2.5	6.750	10/0	100.55/ 99.90	6.67/ 6.76	May 4
ERP Special Fund	6.0	2.0	2.0	2.0	6.750	10/0	99.80/ 98.99	6.78/ 6.89	May 17
Treuhand agency	10.0	3.0	5.1	1.9	6.875	10/0	100.45/ 99.81	6.81/ 6.90	June 7
Treuhand agency	10.0	3.0	4.2	2.8	6.625	10/0	100.00/ 99.49	6.63/ 6.70	July 6
Federal Government	10.0	3.0	3.5	3.5	6.500	10/0	100.90/ 100.52	6.38/ 6.43	Aug. 3
Federal Government - increase -	6.0	–	4.0	2.0	6.500	9/10	–/ 102.73	–/ 6.12	Sep. 8
Federal Post Office	5.0	2.0	2.1	0.9	6.250	10/0	100.50/ 99.78	6.18/ 6.28	Sep. 28
Federal Government	10.0	3.0	4.1	2.9	6.000	10/0	100.90/ 100.72	5.88/ 5.90	Oct. 12
Federal Railways	5.0	2.5	2.1	0.4	6.125	10/0	100.55/ 99.69	6.05/ 6.17	Oct. 25
Treuhand agency	10.0	3.0	4.0	3.0	6.000	10/0	100.45/ 100.31	5.94/ 5.96	Nov. 9
Federal Government - increase -	6.0	–	4.4	1.6	6.000	22/6	–/ 97.10	–/ 6.24	Dec. 8
Federal Government	10.0	3.0	4.2	2.8	6.250	30/0	100.40/ 99.71	6.22/ 6.27	Dec. 28

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Issues of five-year special Federal bonds in 1993

Table 17

Designation of series	Start of sales	Amount issued (DM million) Sales[1]	Market regulation amount	Total	Terms Nominal interest rate (% p.a.)	Issue price (%)	Yield (% p.a.)	Date of stock exchange listing
S. 103 of 1992 (1997)	Jan. 4[2]	[3] 3,717	3,283	7,000	7.250	101.35	6.91	Jan. 13
S. 104 of 1992 (1997)	Jan. 6				7.000	100.80	6.80	
	Jan. 8					101.00	6.75	
	Jan. 19					101.30	6.67	
	Feb. 4					101.50	6.62	
	Feb. 5	3,838	6,162	10,000		101.70	6.57	Feb. 23
S. 105 of 1993 (1998)	Feb. 15				6.625	100.40	6.52	
	Feb. 19					100.80	6.42	
	Feb. 23					101.40	6.28	
	Feb. 24	2,603	3,397			101.70	6.21	Mar. 9
			[4] 2,000					
			[4] 2,000	10,000				
S. 106 of 1993 (1998)	Mar. 2				6.000	99.60	6.09	
	Mar. 9					99.80	6.04	
	Mar. 16	881	3,119			100.00	6.00	June 8
			[5] 2,000					
			[5] 2,000	8,000				
S. 107 of 1993 (1998)	June 2				6.375	100.20	6.32	
	June 14					100.60	6.22	
	June 22					100.80	6.17	
	June 30					101.10	6.10	
	July 12					101.40	6.02	
	July 14					101.60	5.97	
	Aug. 4					102.00	5.87	
	Aug. 5					102.20	5.82	
	Aug. 9					102.40	5.77	
	Aug. 17	4,377	1,623	6,000		102.60	5.72	Sep. 6
S. 108 of 1993 (1998)	Aug. 30				5.750	100.20	5.70	
	Sep. 1					100.40	5.65	
	Sep. 7					100.60	5.61	
	Oct. 6					100.80	5.55	
	Oct. 7					101.00	5.50	
	Oct. 14					101.10	5.48	
	Oct. 19					101.30	5.43	
	Oct. 20					101.70	5.33	
	Oct. 21	2,288	2,712	5,000		102.00	5.26	Nov. 23
S. 109 of 1993 (1998)	Nov. 15				5.250	100.30	5.18	
	Nov. 16					100.50	5.13	
	Nov. 18					100.70	5.08	
	Dec. 9					100.90	5.03	
	Dec. 28	550	[6] ...	[6] ...		101.20	4.95	[6] ...

1 Cumulative from the first day of sale. – 2 Start of sales on October 20, 1992. – 3 Sales from October 20, 1992 to December 31, 1992 = DM 801 million – 4 Increase as from April 21, 1993 and June 3, 1993. – 5 Increase as from September 8, 1993 and November 2, 1993. – 6 Sales not completed on December 31, 1993.

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Issues of Treasury notes by the Federal Government and its special funds and issues of five-year special Treuhand bonds in 1993

Table 18

Issuer	Amount issued (DM million)			Terms				
	Total	of which						
		Allotment amount by tender	Market regulation amount	Nominal interest rate (% p.a.)	Maturity (years/ months)	Average allotment rate (%)	Average yield (% p.a.)	Date of issue
Federal Post Office	3,500	2,871	629	6.750	6/0	98.84	6.99	Jan. 13
Federal Government	4,000	2,173	1,827	6.500	4/0	99.93	6.52	Feb. 19
Treuhand agency	6,000	4,328	1,672	6.125	5/0	99.24	6.31	Mar. 24
Federal Government	5,000	2,700	2,300	6.375	4/0	99.74	6.45	May 25
Treuhand agency	6,000	4,337	1,663	6.125	5/0	99.24	6.31	June 23
Federal Government	5,000	3,592	1,408	5.750	4/0	99.80	5.81	Aug. 25
Treuhand agency	5,000	4,039	961	5.625	5/0	99.55	5.73	Sep. 22
Treuhand agency - increase -	2,000	–	2,000	5.625	4/10	–	–	Nov. 9
Federal Government	4,000	2,609	1,391	5.250	4/0	100.43	5.13	Nov. 24
Treuhand agency	6,000	4,867	1,133	5.000	5/0	99.67	5.08	Dec. 15

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Issues of Federal savings bonds in 1993

Table 19

Issue	Sales period 1993	Gross sales (DM million)			Nominal interest rates (% p.a.)	Final yield (% p.a.)	
		Total	Federal savings bonds type A	Federal savings bonds type B		Type A	Type B
1992/15+16	Jan. 4 – Jan. 8[1]	1,678[2]	1,354	324	6.00 – 8.00	7.30	7.46
1993/ 1+ 2	Jan. 11 – Feb. 12	1,418	1,195	223	6.00 – 7.75	7.02	7.18
1993/ 3+ 4	Feb. 15 – Feb. 23	459	400	59	6.00 – 7.50	6.87	7.00
1993/ 5+ 6	Feb. 24 – June 1	1,721	1,497	224	5.75 – 7.00	6.50	6.61
1993/ 7+ 8	June 2 – July 23	1,434	1,228	206	5.75 – 7.25	6.70	6.82
1993/ 9+10	July 26 – Aug.11	848	733	115	5.75 – 7.00	6.50	6.61
1993/11+12	Aug.12 – Sep. 1	691	613	78	5.50 – 6.75	6.21	6.32
1993/13+14	Sep. 2 – Oct. 13	2,005	1,812	193	5.50 – 6.50	6.09	6.18
1993/15+16	Oct. 14 – Nov. 19	1,770	1,591	179	5.25 – 6.50	5.88	6.00
1993/17+18	Nov.19 – Dec. 28	2,079	1,917	162	5.00 – 6.25	5.59	5.71
1994/ 1+ 2	Dec. 28 [3] –	119	108	11	4.75 – 6.25	5.49	5.64

1 Start of sales on November 24, 1992. — **2** Sales from November 24, 1992 to December 31, 1992: DM 1,086 million, of which FSB/A DM 924 million and FSB/B DM 162 million. — **3** Sales not completed on December 31, 1993.

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Issues of Treasury discount paper by the Federal Government and its special funds in 1993

Table 20

DM million

Type of paper	1992 Outstanding at December 31	1993 Issued	Redeemed	Outstanding at December 31
Treasury discount paper of the Federal Republic of Germany types "B" and "BN" [1]	27,944	15,359	17,311	25,992
of which: "Treasury financing paper"	(27,414)	(14,944)	(16,781)	(25,577)
Treasury discount paper of the Debt-Processing Fund type "KAF N" [1]	13,305	3,823	10,902	6,226
Treasury discount paper of the east German Railways type "RBa N" [1]	387	–	387	–
Treasury discount paper of the Federal Republic of Germany, "Germany Unity" Fund type "FDE" [1]	–	2,073	–	2,073
Total	41,636	21,255	28,600	34,291

1 The Bundesbank has not undertaken to buy securities distinguished by the letter "N" before maturity.

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Issuing schedule

In July 1993, the Bank for the first time announced the issuing plans of the Federal Government and the Treuhand agency for a whole quarter. This approach – i. e. publishing an issuing schedule for each quarter – has been adopted since that time, and represents a further step towards the modernisation of the instruments and techniques of public borrowing, a policy pursued by the Bank and the Federal Ministry of Finance over the past few years. This approach is designed to offer national and international investors better resource management possibilities.

Market-smoothing and price-support operations

The market regulation amounts retained on the issue of listed Federal securities, which the Bank sells on the stock exchanges by order and for the account of the issuer concerned, once again facilitated market-oriented, flexible and continuous financing in 1993. Federal issuers continued to avail themselves of the option of increasing their issues for sale through the stock exchanges, and thus built up large-scale and highly liquid issues, which satisfy the needs of national and international investors alike.

Besides selling the market regulation amounts, in the year under review – as in previous years – the Bank conducted (for the account of the issuers) price-support operations on the German stock exchanges for the officially listed securities issued by the Federal Government, its special funds and the Treuhand agency, as well as for securities issued by the Reconstruction Loan Corporation, the German Equalisation Bank and the State Bank, Berlin.

V. The Bank's participation in banking supervision, and changes in banking supervision legislation

1. International harmonisation of banking supervision

In 1993 the Bank again participated in the relevant international bodies engaged in harmonising banking supervision legislation.

Basle Committee on Banking Supervision

On April 30, 1993 the "Basle Committee" on Banking Supervision presented consultative proposals for the supervisory treatment of netting, market risks and exposure to interest rate risk, and invited the interested public to comment:

- The proposal on the supervisory recognition of netting for capital adequacy purposes takes due account of the arrangements for the netting of mutual claims arising from pending transactions (bilateral netting). In addition to netting by novation, which has been recognised in the past, netting arrangements where the netting is subject to the occurrence of particular events (such as the institution of bankruptcy proceedings) – "netting by close-out" – is also to be recognised. In view of the strong global growth of derivative transactions, wider use of netting arrangements is desirable as it reduces counterparty risks. The crucial problem posed by the supervisory recognition of netting arrangements is, however, the extent to which these are legally effective in the event of bankruptcy. Under current German law this is not always the case.

- The consultative paper on the supervisory treatment of market risks arising from position-taking in the trading portfolio of internationally operating banks deals with the risks arising from movements in market prices, including interest rates, equity prices and exchange rates. The price risks posed by trading in derivative instruments (such as swaps, futures, options) are also duly taken into account.

Major parts of the individual provisions of the market risk paper correspond to the EC Capital Adequacy Directive, as the technical solutions included in that Directive were worked out jointly with the Basle Committee. What poses problems, however, is the fact that some major points of the Basle paper do not tally with the Capital Adequacy Directive, but contain more restrictive regulations. The differences between the two sets of rules are mainly attributable to the fact that no agreement with securities supervisors could be reached among the G-10 countries – unlike the conditions in the European Community. International banks in the EC countries with a universal bank system would therefore, if a consensus was not reached after all, be faced with differing rules which would increase the work-load involved in preparing reports, and would also give rise to competitive disadvantages.

- Unlike the market risk paper, which only takes account of the trading portfolio, the proposal on the measurement of the banks' exposure to interest rate risk deals with the banks' total exposure to interest rate risk. All the interest-rate-responsive assets, liabilities and off-balance-sheet positions of a bank are included in a system for measuring the interest rate risk. The measuring system is designed to identify banks with an overly large exposure to interest rate risk. According to the current state of the paper, however, the national supervisory authorities concerned are free to adopt appropriate supervisory measures. After the final adoption of this proposal by the Governors of the G-10 central banks, the question of how to translate this regulation into national law will arise for the German banking supervisory authorities.

At the end of 1993 the associations of the German banking industry indicated their agreement in principle to these three proposals by the Basle Committee, but at the same time they pointed out that the necessary equal treatment of banks and securities firms is not yet guaranteed. The Basle Committee on Banking Supervision is currently discussing the comments on its consultative papers received from all over the world.

As far as the European Communities are concerned, the adoption of the aforementioned Capital Adequacy Directive in March 1993 was of particular significance. Like the market risk paper of the Basle Committee on Banking Supervision, the Capital Adequacy Directive contains capital standards for, in particular, the market risks posed by credit institutions' trading portfolios. In contrast to the Basle paper, however, it is also addressed to securities firms, which were granted the freedom to set up in business and to provide services throughout the EC countries

European Communities

under the EC Investment Services Directive, which was likewise approved in March 1993. EC member states are now required to translate the directives into national law by the end of 1995. This will, among other things, necessitate another amendment of the Banking Act and of the Principles Concerning Credit Institutions' Capital.

The Second Banking Coordination Directive, which was adopted as long ago as 1989, granted EC banks EC-wide freedom of establishment and of providing investment services with effect from January 1, 1993. In this connection, the Federal Banking Supervisory Office, with the Bank's participation, agreed on "common positions" with almost all banking supervisory authorities of the EC member states, primarily during 1993; these positions regulate in detail the form of bilateral cooperation through extensive information and consultation procedures.

Draft "BCCI Directive"

In 1993 the banking supervisory authorities continued to concern themselves with the conclusions to be drawn from the closure of the Bank of Credit and Commerce International (BCCI). The European Commission presented a proposal for a Directive ("BCCI Directive") designed to close some gaps in the supervision of the financial services industry. This proposal relates to credit institutions, investment firms and insurance undertakings, where they are part of a group, and essentially comprises the following points:

- The group structure should be sufficiently transparent to enable the financial undertaking to be supervised effectively.

- The head office of a financial undertaking should remain within the same member state as the registered office, so that the appropriate home member state authorities can be identified easily.

- The possibility of exchanging confidential information subject to professional secrecy should be improved by extending the list of those bodies and persons between whom such an exchange of information may take place.

- Statutory auditors engaged in the preparation of financial undertakings' annual accounts should communicate to the competent authorities any irregular circumstances which come to their notice in the course of carrying out that activity.

Deposit protection

On October 25, 1993 the Council of the European Union agreed on a common position concerning the proposal for a Council Directive on deposit protection schemes. Germany was the only member state to vote against the adoption of such a directive. Following a suggestion by the European Parliament, the minimum amount to be protected has been raised to ECU 20,000. The proposed mandatory membership of all credit institutions in a deposit protection scheme and the inclusion of the EC branches of these institutions in the protection scheme of their country of origin (home-country principle) were retained, with these branches being eligible in addition to join a host-country deposit protection scheme; moreover, the ban on exports of deposit protection by a country of origin providing a higher level of deposit protection than that in the host country is to be maintained. The directive is expected to have to be translated into national law by January 1, 1995. The existing German deposit protection schemes, which have proved their worth, should, if at all possible, continue to operate.

2. Amendments of national banking supervision legislation

Government draft of a Fifth Act Amending the Banking Act

On January 13, 1994, the Federal Cabinet approved a Draft Fifth Act Amending the Banking Act and passed it on to Parliament for further deliberation. The amendment is intended to translate the EC Consolidation Directive and the EC Large Exposures Directive into German law. The Fifth Act Amending the Banking Act is expected to be passed before the end of the current legislative period.

Principles Concerning the Capital and Liquidity of Credit Institutions

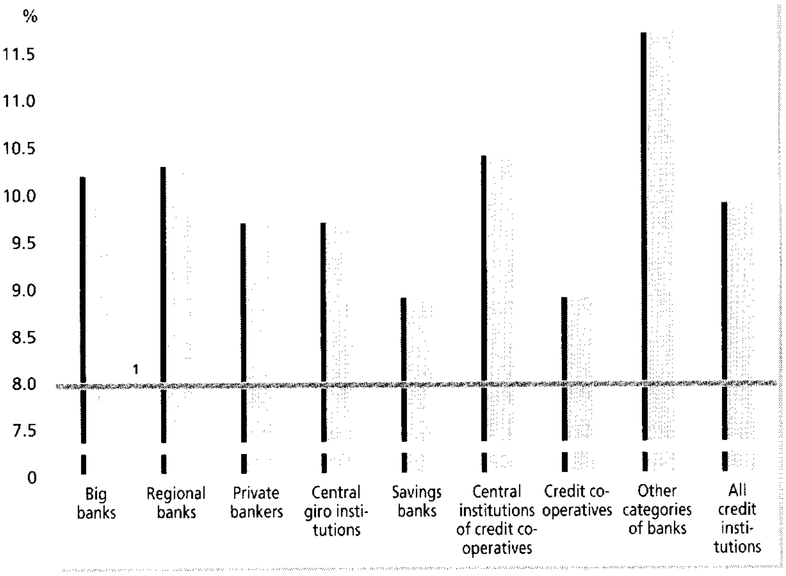
After the amendment of Principle I as from January 1, 1993, in the wake of the translation of the Solvency Ratio Directive into national law, credit institutions had to file reports in accordance with the amended Principle for the first time as at June 30, 1993. The amended Principle provides that the risk assets of banks and savings banks must be backed by a minimum 8 % (previously 5.56 %) of liable capital. Meeting the standard, which is the key criterion for the assessment of capital adequacy, does not now pose any problems for most credit institutions. As is evident from the chart opposite, the required minimum standard of 8 % was markedly exceeded by all categories of banks at the end of December 1993. At December 31, 1993, the average capital ratio of all of the roughly 3,900 German credit institutions was 9.9 %.

At the end of December the ratios of all credit institutions under Principle Ia, which limits the risk positions involving price risks (including the risks posed by derivative instruments) for the risk categories foreign currency risks, interest rate risks and other price risks, amounted to 4.2 %, 2.8 % and 1.4 %, respectively.

Capital ratio of credit institutions filing Principle I reports

Chart 14

End of December 1993



1 The Principle I minimum capital ratio is 8%.

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They were thus distinctly below the limits, which were reduced to 21 %, 14 % and 7 %, respectively, from January 1, 1993.

No changes were made in 1993 to the Liquidity Principles II and III. Here the average ratios at December 31 were 88.5 % for Principle II and 70.6 % for Principle III.

Other regulations

The draft Auditor's Report Regulation pursuant to section 29 (3) of the Banking Act, whereby the Federal Banking Supervisory Office will issue more detailed provisions governing the contents of auditor's reports on the annual accounts of credit institutions, was the subject of a hearing by the associations representing the banking industry on December 21, 1993. An early adoption of that regulation is being sought. It will supersede the audit guidelines issued by the Federal Banking Supervisory Office in 1968.

On October 13, 1993, the Federal Ministry of Justice, in agreement with the Federal Ministry of Finance and in consultation with the Deutsche Bundesbank, issued the Regulation governing the notes to the annual accounts of credit institutions that are registered cooperative societies or savings banks (Federal Law Gazette I, page 1705). It came into force on October 21, 1993, and contains specimens of the notes by means of which credit cooperatives and savings banks must elucidate their annual accounts to banking supervisors.

3. Ongoing banking supervision operations

At the end of 1993, 4,080 credit institutions (3,695 institutions in the old Länder and 385 in the new ones) were covered by banking supervision. That was 154 institutions fewer than in the preceding year. In the period under review most of this reduction was once again due to mergers in the credit cooperative sector (130, including 17 east German institutions); in the savings bank sector there were only 27 mergers (including 15 in eastern Germany).

Ongoing banking supervision operations

Table 21

Number of operations conducted

Item	1990	1991	1992	1993
Individual reports pursuant to section 13 of the Banking Act	60,793	69,593	72,267	68,542
Borrowers included in the lists submitted in accordance with section 13 of the Banking Act	70,411	73,012	82,626	75,996
Reports on loans of DM 1 million[1] or more pursuant to section 14 of the Banking Act	1,683,592	1,875,105	2,116,425	2,001,923
Reports pursuant to section 16 of the Banking Act	10,068	23,755	24,503	14,376
Reports pursuant to section 24 of the Banking Act	12,124	16,905	16,781	19,828
Monthly returns pursuant to section 25 of the Banking Act	53,306	53,147	54,776	49,514
Reports on the volume of external lending	953	983	973	998
Annual accounts of credit institutions	4,811	4,652	4,837	4,338
Auditor's reports on annual accounts	2,767	2,317	2,454	2,294
Reports on the auditing of safe custody accounts	471	393	527	407
Routine, special and deposit guarantee fund auditor's reports	693	738	489	463
Audits commissioned by the Federal Banking Supervisory Office pursuant to				
section 44 (1) of the Banking Act	15	33	27	33
section 44 (2) of the Banking Act	117	117	128	122
Reports under the Capital Accord of the Basle Committee on Banking Supervision	112	106	104	102

1 DM 3 million as from July 1, 1993

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Credit register for "Millionenkredite"

Table 22

3rd qtr	Volume of loans of DM 1 million[1] or more: DM billion	Change (%)	Number of loans of DM 1 million[1] or more reported: Number	Change (%)	Number of reporting credit institutions	Number of reporting insurance enterprises
1989	1,651	+ 7.5	404,569	+ 4.3	3,279	498
1990	1,889	+ 14.4	439,565	+ 8.7	3,264	520
1991	2,414	+ 27.8	494,950	+ 12.6	3,654	537
1992	2,593	+ 7.4	547,486	+ 10.6	3,608	518
1993[1]	2,444	− 5.8	275,691	− 49.6	2,403	403

1 Reporting threshold raised from DM 1 million to DM 3 million as from the reporting date September 30, 1993.

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The scale of Land Central Banks' participation in banking supervision operations is apparent from the table on page 124. The fall in the number of reports to be processed was a consequence of various changes. In addition to the mergers already mentioned, which reduced the number of institutions to be supervised and caused the reporting thresholds for the merged institutions to rise, a particularly important factor was the discontinuation of numerous reports from branches of foreign banks from EC countries, which are now subject to home-country supervision as a result of the Second Banking Coordination Directive.

Credit register for "Millionenkredite"

In addition, in the wake of the raising of the reporting threshold for "Millionenkredite" from DM 1 million to DM 3 million from July 1, 1993, the number of such loans reported under section 14 of the Banking Act dropped by just over one-half to about 275,000 in the third quarter of 1993. It thus regained the level of 1985. In contrast to the number of reports, the total credit volume reported declined by DM 270 billion, or almost 10 %, to about DM 2,500 billion as a result of the raising of the reporting threshold.

At the reporting date September 30, 1993 – the first reporting date after the raising of the reporting limit to DM 3 billion – 2,806 institutions were reporting to the credit register. That was a year-on-year fall of about one-third in the number of participating lenders. The number of borrowers notified to institutions decreased by just over one-half, from 447,000 to 200,000. Two-thirds of these borrowers were combined in 41,000 borrower units, as defined in section 19 (2) of the Banking Act. Of these borrowers, 34,000, or some 25 %, had raised loans from more than one lender (multiple borrowing), whereas only 15 % of the borrowers not combined in borrower units were indebted to more than one lender. At the end of September, 71 borrower units accounted for debts under section 14 of the Banking Act amounting to more than DM 2 billion; the overall debt of these borrowers had risen by DM 50 billion against the previous year, to a total of DM 290 billion. At DM 1,683 billion, loans to borrowers domiciled in Germany accounted for almost 70 % of the total volume of loans of DM 3 million or more.

The table on page 125 shows the effect of the raising of the reporting limit. It reflects the position as at September 30, as that reporting date brings out the changes particularly clearly.

A total of 1,541 insolvent enterprises and individuals, for whom "Millionenkredite" under section 14 of the Banking Act were reported at the date when the insolvency became known, were recorded by the credit register in 1993. There was thus a year-on-year increase of 290 (+ 23.2 %) in the number of insolvencies. The outstanding amount of loans of DM 3 million or more taken up by insolvent enterprises and individuals rose by DM 2.7 billion to a total of DM 10 billion; an amount of DM 2 billion was accounted for by 309 insolvent borrowers in the new Länder.

VI. Authorisations under monetary law

Value guarantee clauses

Decisions on the authorisation of value guarantee clauses are taken by the Bank in accordance with its "Principles Governing Decisions on Applications for Authorisations Pursuant to Section 3 of the Currency Act (No. 2c of the Currency Regulation for Berlin)".[1]

Under article 3 of Annex I of the Treaty of May 18, 1990 between the Federal Republic of Germany and the German Democratic Republic Establishing a Monetary, Economic and Social Union, the authorisation requirement of section 3 of the Currency Act was extended to cover the new Länder; the general author-

1 Deutsche Bundesbank Notice No. 1015/78 of June 9, 1978, published in Federal Gazette No. 109 of June 15, 1978. For the Bundesbank's policy in granting such authorisations, see also Deutsche Bundesbank, Value guarantee clauses – synopsis of the Bundesbank's policy in granting permits, Monthly Report, April 1971, page 24 ff. Regarding the incurrence of liabilities denominated in the European Currency Unit (ECU) or the special drawing right of the International Monetary Fund (SDR), see Deutsche Bundesbank Notice No. 1002/90 of January 5, 1990, published in Federal Gazette No. 3 of January 5, 1990.

Applications for authorisations pursuant to section 3 sentence 2 of the Currency Act, and the decisions taken Table 23

Year	Applications	Authorisations	Certificate of non-applicability of authorisation requirement	Applications rejected
1970	33,796	24,999	6,585	2,212
1971	40,884	31,189	7,554	2,141
1972	42,964	33,254	7,583	2,127
1973	49,033	36,747	10,045	2,241
1974	44,975	33,830	8,813	2,332
1975	39,686	29,712	7,778	2,196
1976	38,529	29,189	7,494	1,846
1977	39,344	30,145	7,323	1,876
1978	40,002	30,617	7,555	1,830
1979	41,761	32,231	7,632	1,898
1980	43,375	33,237	8,032	2,106
1981	45,375	35,129	7,960	2,286
1982	44,036	34,096	7,798	2,142
1983	43,078	33,654	7,293	2,131
1984	42,526	32,997	7,416	2,113
1985	46,629	37,343	7,312	1,974
1986	40,064	30,998	7,367	1,699
1987	37,083	28,069	7,523	1,491
1988	37,812	29,899	6,313	1,600
1989	38,633	30,349	6,448	1,836
1990	42,552	33,232	7,123	2,197
1991	48,806	37,837	8,197	2,772
1992	54,129	41,689	8,840	3,600
1993	57,155	44,949	8,231	3,975

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isations and authorisation principles under section 3 of the Currency Act were put into effect in the new Länder by Notice No. 1006/90.[2]

VII. The Bank's activities in the field of UN embargo measures

Financial sanctions

The efforts of the United Nations (UN) to solve conflicts in various parts of the world have been not without an impact on the Bank's operations, namely where the implementation of financial sanctions is concerned. Although there have been no restrictions on payments and capital movements for external monetary policy reasons in the Federal Republic of Germany since 1973, there

2 Deutsche Bundesbank Notice No. 1006/90 of June 13, 1990, published in Federal Gazette No. 114 of June 23, 1990, page 3215.

have been some restrictions under the External Trade and Payments Act by virtue of resolutions adopted by the United Nations, i. e. on foreign policy grounds (in respect of Southern Rhodesia, lifted in 1980; in respect of Iran, lifted in 1981). Such restrictions are translated into German law by the Federal Government on the basis of the Foreign Trade and Payments Act by a corresponding amendment of the Foreign Trade and Payments Regulation.

After a break of several years, the UN Security Council resorted to the instrument of financial sanctions once again in August 1990 after Iraqi troops had invaded Kuwait. At present, financial sanctions are being applied in Germany against the following countries:

Iraq	since August 1990 (sections 52 and 69 e of the Foreign Trade and Payments Regulation),
Serbia/Montenegro	since June 1992 (section 69 k of the Foreign Trade and Payments Regulation),
Haiti	since July 1993 (section 69 o of the Foreign Trade and Payments Regulation),
Libya	since December 1993 (section 69 n of the Foreign Trade and Payments Regulation).

Blocking of accounts and payment restrictions

Essentially, the sanctions comprise the blocking of accounts and safe custody accounts and of claims on non-banks, as well as payment restrictions. The blocking of accounts applies to the aforementioned assets of the states concerned, of all official agencies and of resident and non-resident enterprises controlled by these states.

The payment restrictions apply to payments to these states, agencies and enterprises as well as, in part, to some other persons staying in these states. As laid down in the Foreign Trade and Payments Act, the granting of exemptions from restrictions is the responsibility of the Deutsche Bundesbank; specifically, decisions on authorisations are taken by the Land Central Banks and, in the case of credit institutions performing central functions, the Central Office of the Bundesbank.

The authorisation principles have substantially been defined in the Foreign Trade and Payments Regulation. Authorisations may be granted, in particular, for the sake of processing old transactions and for humanitarian purposes. Specific issues are settled, if only because of the primacy of foreign policy considerations, in close cooperation with the Federal Cabinet.

Moreover, the Deutsche Bundesbank monitors credit institutions and insurance enterprises to ensure compliance with the financial sanctions.

Under the Treaty on European Union, the Council of the European Union has been empowered since January 1, 1994 to take measures affecting payments and the movement of capital on foreign policy grounds (Article 73 g EC Treaty). The Council took advantage of this authorisation for the first time by adopting measures vis-à-vis Libya (Council decision of November 22, 1993; an EC regulation which is also intended to regulate financial sanctions is currently being prepared).

VIII. The Bank's organisational structure and staff level

Restructuring the Bank's branch office policy

Owing to structural changes in the banking industry which have a direct bearing on the business handled by the branch offices, the Central Bank Council of the Deutsche Bundesbank agreed on a strategy for a review of the branch office network. Under that strategy, within a period of approximately ten years the number of branch offices is to be reduced from 183 at present to about 120. The impact of these structural changes on the Bank's staff will be cushioned by social-welfare adjustment measures.

Downward trend in staff figures

The decrease in the volume of business of the branch offices also had repercussions on the number of staff working there. The number of employees at the Bank's branches fell by 319 (or 3.2 %), and thus contributed materially to the overall decline of 362 in the number of staff.

Trends in staff figures

Table 24

Beginning of 1993

Employed persons	Central Office of the Deutsche Bundesbank	Land Central Banks	Total[1]	of whom male	of whom female
Civil servants	1,058	6,021	7,079	6,189	890
Other salaried staff	1,600	8,205	9,805	4,466	5,339
Wage earners	242	868	1,110	222	888
Total	2,900	15,094	17,994	10,877	7,117

Beginning of 1994

Employed persons	Central Office of the Deutsche Bundesbank	Land Central Banks	Total[1]	of whom male	of whom female
Civil servants	1,060	5,960	7,020	6,108	912
Other salaried staff	1,551	7,976	9,527	4,377	5,150
Wage earners	217	868	1,085	221	864
Total	2,828	14,804	17,632	10,706	6,926

1 The following are included in the total number of employed persons:	Start of 1993	Start of 1994
Trainee civil servants and other trainees	1,086	883
Part-time employees	1,708	1,743
Persons seconded to work abroad	31	33
The following are not included in the staff figures: members of the Bank's staff released without pay	475	546

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Training and further training programmes intensified

In the past three years the Bank's training and further training capacities have been mainly occupied in transferring knowledge and skills to the new Länder. A focal point of a new training and further training strategy is preparing staff members for assignments in the international, and especially in the European, arena. This is being done not least in view of the fact that the European Monetary Institute is due to commence operations in Frankfurt later this year.

Staff exchange with other EC central banks

Within the framework of the staff exchange scheme between EC central banks agreed in 1992, staff members of other central banks were received by the Bundesbank for stays extending over several months. The Bank, for its part, also availed itself of this opportunity, and seconded a number of its employees to work abroad, where they gained valuable experience and enhanced their skills during their stays at the various central banks.

Technical assistance to countries in transition

Since 1991 the Bundesbank has been helping, in particular, a number of the countries in transition in central and eastern Europe to set up modern central bank and financing systems by means of selective consultancy and training measures.

The scale of these activities increased further last year. In a number of cases gratifying progress is already discernible with regard to monetary stabilisation policy and the institutional reorientation of the monetary system.

So far, technical assistance has mainly been extended to central and east European countries in transition. In future, however, the central banks of developing countries which are faced with similar problems could also be included in such schemes. Advisory services are offered along decentralised lines both by the Land Central Banks and by the Central Office of the Bundesbank, and these activities are coordinated by a unit set up specially for this purpose at the Bank's Central Office. Technical assistance takes many and varied forms. It ranges from consultations with Bundesbank experts on the site of a specific project to general commitments of continuous care and attention. In addition, the Bundesbank offers training to selected executives and specialists of the respective central banks at the Land Central Banks and the Central Office of the Bundesbank; such training is supplemented by special courses abroad. Moreover, the Bundesbank participates in the multilateral aid programmes of the International Monetary Fund, the World Bank and the Bank for International Settlements.

Annual accounts of the Deutsche Bundesbank for 1993

I. Balance sheet of the Deutsche Bundesbank as at December 31, 1993

Assets

			DM	31. 12. 1992 DM million
1 Gold			13,687,518,821.70	13,687
2 Reserve position in the International Monetary Fund and special drawing rights				
2.1 Drawing rights within the reserve tranche		6,832,720,551.–		(6,842)
2.2 Loans under special borrowing arrangements		–		(–)
2.3 Special drawing rights		1,663,034,725.29		(1,357)
			8,495,755,276.29	8,199
3 Claims on the European Monetary Cooperation Fund (EMCF) in connection with the European Monetary System				
3.1 ECU balances	43,662,758,367.97			
less Difference between the ECU value and the book value of the gold and dollar reserves contributed to the EMCF	11,786,810,373.–			
		31,875,947,994.97		(26,786)
3.2 Other claims		4,300,114,010.64		(6,833)
			36,176,062,005.61	33,619
4 Balances with foreign banks and money market investments abroad			61,761,872,472.26	85,825
5 Foreign notes and coins			21,851,147.71	20
6 External loans and other external assets				
6.1 Loans in connection with EC medium-term balance of payments assistance		–		(–)
6.2 Other loans to foreign monetary authorities		–		(–)
6.3 Loans to the World Bank		2,411,509,000.–		(2,418)
6.4 Other external assets		208,050,000.–		(190)
			2,619,559,000.–	2,608
7 Lending to domestic credit institutions				
7.1 Securities bought in open market transactions under repurchase agreements		184,530,935,000.–		(124,099)
7.2 Domestic bills of exchange		47,586,414,382.89		(50,037)
7.3 Foreign bills of exchange		10,548,993,068.28		(13,150)
7.4 Lombard loans		14,835,435,400.–		(1,643)
			257,501,777,851.17	188,929
8 Cash advances				
8.1 Federal Government		–		(4,354)
8.2 Equalisation of Burdens Fund and ERP Special Fund		–		(–)
8.3 Länder Governments		–		(188)
			–	4,542
9 Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			8,683,585,988.93	8,684
10 Lending to the Federal Railways and Federal Post Office				
10.1 Cash advances		–		(–)
10.2 Treasury bills and Treasury discount paper		–		(–)
			–	–
11 Securities			4,728,953,601.74	6,066
12 German coins			2,067,176,829.59	1,661
13 Balances on postal giro accounts			451,456,460.03	299
14 Land and buildings			3,175,486,082.26	2,819
15 Furniture and equipment			238,211,046.–	281
16 Items in course of settlement			2,962,951,430.59	7,705
17 Other assets			2,506,462,363.21	3,344
18 Prepayments			488,269,239.06	51
			405,566,949,616.15	368,339

Liabilities

			DM	31. 12. 1992 DM million
1	Banknotes in circulation		224,341,120,275.–	213,355
2	Deposits of credit institutions			
	2.1 Deposits on giro accounts	73,344,909,046.07		(88,844)
	2.2 Other	32,828,125.41		(28)
			73,377,737,171.48	88,872
3	Deposits of public authorities			
	3.1 Federal Government	13,024,835,634.38		(80)
	3.2 Equalisation of Burdens Fund, ERP Special Fund, "German Unity" Fund	21,823,111.90		(14)
	3.3 Länder Governments	386,801,071.13		(302)
	3.4 Other public depositors	62,720,196.73		(33)
			13,496,180,014.14	429
4	Deposits of other domestic depositors			
	4.1 Federal Railways	5,253,083.58		(5)
	4.2 East German Railways	6,051,088.76		(14)
	4.3 Other depositors	769,585,828.47		(774)
			780,890,000.81	793
5	Liabilities arising from liquidity paper sold		26,207,400,000.–	2,011
6	Liabilities arising from external transactions			
	6.1 Deposits of foreign depositors	22,032,537,637.79		(24,637)
	6.2 Other	19,108,141.43		(16)
			22,051,645,779.22	24,653
7	Counterpart of special drawing rights allocated		2,875,881,905.20	2,687
8	Provisions			
	8.1 for pensions	2,665,000,000.–		(2,554)
	8.2 for other purposes	8,643,373,322.50		(7,266)
			11,308,373,322.50	9,820
9	Other liabilities		560,088,685.32	596
10	Accruals		485,199,902.93	753
11	Capital		290,000,000.–	290
12	Reserves			
	12.1 Legal reserves	10,667,700,000.–		(9,065)
	12.2 Other reserves	290,000,000.–		(290)
			10,957,700,000.–	9,355
13	Unappropriated profit		18,834,732,559.55	14,725
			405,566,949,616.15	368,339

II. Profit and loss account of the Deutsche Bundesbank for 1993

Expenditure

			DM	1992 DM million
1	Interest expenditure		3,390,967,321.34	3,354
2	Staff costs			
	2.1 Wages and salaries	1,039,244,036.67		(1,008)
	2.2 Social security contributions, spending on retirement pensions and on maintenance payments	460,178,124.56		(499)
			1,499,422,161.23	1,507
3	Other operating expenditure		392,000,844.49	505
4	Banknote printing		236,440,556.60	290
5	Depreciation			
	5.1 of land and buildings	233,232,182.79		(243)
	5.2 of furniture and equipment and of other assets	154,375,425.98		(159)
			387,607,608.77	402
6	Write-downs of monetary reserves and other foreign currency positions		–	6,868
7	Other expenditure		259,711,416.41	67
8	Profit for the year (= unappropriated profit)		18,834,732,559.55	14,725
			25,000,882,468.39	27,718

Receipts

		DM	1992 DM million
1	Interest	24,519,609,903.34	27,468
2	Fees	111,926,531.39	116
3	Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	58,862,989.35	–
4	Other receipts	310,483,044.31	134
		25,000,882,468.39	27,718

Frankfurt am Main, February 16, 1994

Deutsche Bundesbank
The Directorate

Dr Tietmeyer Gaddum
Hartmann Prof. Dr Issing Meister Schieber Dr Storch

According to the audit we have carried out in line with our mandate, the bookkeeping and annual accounts comply with German law. The annual accounts conform to the principles of orderly bookkeeping, and present a picture of the Bank's assets, liabilities, financial position and profitability which is consistent with the actual state of affairs.

Frankfurt am Main, March 18, 1994

C & L TREUARBEIT
DEUTSCHE REVISION
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

WOLLERT-ELMENDORFF
DEUTSCHE INDUSTRIE-TREUHAND GMBH
Wirtschaftsprüfungsgesellschaft

Windmöller
Certified Auditor

Langen
Certified Auditor

Thoennes
Certified Auditor

Flaig
Certified Auditor

III. Notes on the annual accounts for 1993

1. Legal basis

Legal basis

Irrespective of its public-law status, the Deutsche Bundesbank is a trader within the meaning of section 1 (2) number 4 of the Commercial Code *(Handelsgesetzbuch – HGB)* because it conducts banking operations. Hence it is likewise subject to the principles of orderly bookkeeping. Specifically, the legal basis for its accounts is provided by section 26 and section 27 of the Bundesbank Act *(Gesetz über die Deutsche Bundesbank)*, in the wording of October 22, 1992. In accordance with those provisions, the layout of, and the notes on, the annual accounts must take due account of the Bundesbank's functions. Regarding valuation, the provisions of the Commercial Code relating to corporations are to be applied as appropriate.

In particular, the current assets (which include, first and foremost, the monetary reserves) are to be shown in the balance sheet in keeping with the strict lower value principle (section 253 (3) of the Commercial Code). Furthermore, write-downs may be effected in order to obviate the need to change the valuation in future on account of fluctuations in value. Such a lower valuation may, moreover, be retained in the following years (section 253 (5) of the Commercial Code). The creation of liability items in respect of general hazards encountered in domestic and external transactions is regulated by section 26 (2) of the Bundesbank Act.

In accordance with section 27 of the Bundesbank Act, 20 % of the net profit, but not less than DM 20 million, is to be transferred to the legal reserves until these reserves have reached 5 % of the amount of banknotes in circulation. Up to 10 % of the residual amount of the net profit may be used to create other reserves, which must not exceed the amount of the capital stock. DM 30 million must be transferred to the Fund for the Purchase of Equalisation Claims. The balance is to be paid over to the Federal Government.

Auditing and approval of the annual accounts

The annual accounts of the Bundesbank for 1993 were audited by C&L Treuarbeit Deutsche Revision AG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft of Frankfurt am Main, and Wollert-Elmendorff Deutsche Industrie-Treuhand GmbH Wirtschaftsprüfungsgesellschaft of Düsseldorf, whom the Central Bank Council had appointed to be auditors in accordance with section 26 (3) of the

Bundesbank Act. In their certificate of audit the auditors confirmed without qualification that the annual accounts for 1993 and the Bank's bookkeeping comply with German law and present a true picture of the Bank's assets and liabilities, financial position and profitability. The Central Bank Council approved the annual accounts for 1993, along with the profit distribution, on April 14, 1994.

2. Assets

Gold

The balance sheet value of the Bank's total gold reserves is about DM 17 billion. However, since the establishment of the European Monetary System (EMS) in 1979, the item "Gold" has included only 80 % of the gold holding, because 20 % of the gold and dollar reserves has been transferred to the European Monetary Cooperation Fund (EMCF) in the form of three-month revolving swaps. The item "Gold" comprises 95 million ounces of fine gold with a balance sheet value of DM 13,688 million. As in the previous year, the gold is valued at its purchase price; the average value per ounce therefore works out at DM 144.

Reserve position in the International Monetary Fund and special drawing rights

This item contains the claims on the International Monetary Fund (IMF) financed and held by the Bank and arising from Germany's membership of the IMF. The drawing rights within the reserve tranche correspond to the amounts actually paid to the IMF under the German quota in gold, special drawing rights and Deutsche Mark. At December 31, 1993 their level came to DM 6,833 million (= SDR 2,877 million), compared with DM 6,842 million (= SDR 3,083 million) at the end of 1992. It represents the difference between the German quota of SDR 8,242 million and the Deutsche Mark balances equivalent to DM 12,743 million (= SDR 5,365 million) at the disposal of the IMF at the end of the year. Owing to Deutsche Mark drawings and Deutsche Mark repayments by other member countries, the holding of drawing rights decreased by SDR 207 million net in 1993.

During the year under review the Bank did not grant any new loans to the IMF under special borrowing arrangements. At present only one credit line in favour of the IMF amounting to SDR 2.4 billion is outstanding under the General Arrangements to Borrow (GAB), but the IMF can utilise it only subject to certain conditions.

Special drawing rights, by means of which convertible currencies can be obtained at any time, were originally allocated free of charge to the extent of SDR 1,211 million. A counterpart thereof is shown on the liabilities side. The amount of special drawing rights held at the end of 1993 came to DM 1,663 million (= SDR 700 million). Increases totalling SDR 113 million due to interest received were accompanied by decreases amounting to SDR 24 million due to interest payments and freely agreed SDR transactions.

Claims on the European Monetary Cooperation Fund (EMCF)

This item comprises the Bank's ECU balances and the claims denominated in ECUs arising from recourse by other central banks to the very short-term financing mechanism. The ECU balances, amounting to DM 43,663 million, result mainly from the contribution of 20 % of the Bank's gold and dollar reserves to the EMCF. In addition, these balances include the reserve ECUs (DM 14,242 million) transferred to the Bank by other central banks participating in the EMS. The gold and dollar reserves contributed to the EMCF under the terms of the EMS against the crediting of ECUs were transferred at market prices and therefore at values higher than those shown in the balance sheet. The resulting difference of DM 11,787 million is deducted from the ECU balances. At the end of 1993 other claims denominated in ECUs totalling DM 4,300 million were outstanding as a result of lending under the very short-term financing mechanism.

Balances with foreign banks and money market investments abroad

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 61,762 million at the end of 1993, against DM 85,825 million at December 31, 1992 (excluding the dollar reserves contributed to the EMCF). This asset item, which increased sharply in 1992 and 1993 owing to foreign exchange market interventions in the EMS, has declined distinctly again in the meantime. The assets and liabilities denominated in US dollars were valued at the balance sheet rate of US $ 1 = DM 1.3870, which represents the all-time lowest level of the dollar on September 2, 1992.

External loans and other external assets

The main constituents of this item are loans to the World Bank (which were mostly granted against borrowers' notes denominated in Deutsche Mark). No loans under the EC medium-term balance-of-payments assistance arrangement or other loans to foreign monetary authorities were outstanding in the year under review. The other external assets constitute limited investments with foreign institutions. Because of their lower liquidity, external loans and other external assets are not counted among the monetary reserves.

Lending to domestic credit institutions

This item reflects the volume and pattern of domestic credit institutions' refinancing. Most of it is composed of the securities repurchase agreements used as part of the flexible money market management arrangements. In this context, the Bank buys securities eligible as collateral for lombard loans on condition that the sellers repurchase them forward. At the end of the year the claims deriving from these transactions amounted to DM 184,531 million; the increase of DM 60,432 million against the previous year owes something to the fact that these claims had dropped to a comparatively low level owing to liquidity-boosting foreign exchange inflows at the end of 1992. The portfolio of domestic and foreign bills of exchange which the Bank purchases within the rediscount quotas at the discount rate decreased by DM 5,052 million compared with December 31, 1992. Lombard loans, by means of which the Bank provides central bank money against the collateral of securities and Debt Register claims, serve to meet short-term liquidity needs on the part of credit institutions. At the balance sheet date they amounted to DM 14,835 million.

Cash advances

Hitherto, the item "Cash advances" has comprised advances to the Federal Government, the Equalisation of Burdens Fund, the ERP Special Fund and the Länder Governments. These advances were used solely to meet a temporary financial need. They were limited in scale (credit ceilings pursuant to section 20 of the Bundesbank Act) and interest was payable on them at the lombard rate. Not only cash advances but also Treasury bills which the Bank bought were to be counted towards these credit ceilings. Cash advances ceased to exist on December 31, 1993; as a consequence of article 104 of the Maastricht Treaty, direct lending by the central bank to the public sector is not allowed from 1994 onwards.

Equalisation claims

Equalisation claims on the Federal Government and the non-interest-bearing debt certificate in respect of Berlin both date back to the currency reform of 1948. They form the balance sheet counterpart of the amounts paid at that time in cash per capita and per enterprise, and of the initial provision of credit institutions and public corporations with central bank money. Equalisation claims yield interest at the rate of 1 %. In conformity with Article 104 of the Maastricht Treaty, it has been laid down that equalisation claims are to be redeemed in ten annual instalments, starting in the year 2024.

Lending to the Federal Railways and Federal Post Office

To date, "Lending to the Federal Railways and Federal Post Office" (excluding the Postbank) has not been shown in the balance sheet under "Public authorities". It has been shown in separate items, because these special funds of the Federal Government are usually assigned to the enterprise sector. No cash advances to the railways or the post office were outstanding on the balance sheet date; nor did the Bank hold any Treasury bills or Treasury discount paper issued by those borrowers. Lending of that kind, too, was discontinued from the beginning of 1994, because of the need to comply with Article 104 of the Maastricht Treaty.

Securities

During the year under review the Bank's portfolio of securities, which chiefly comprises bonds issued by the Federal Government, the Federal Railways and the Federal Post Office, decreased from DM 6.065 million to DM 4.729 million on account of transactions in the open market.

German coins

The Bank's portfolio of coins is held as a reserve for use in payments. The Bank, acting for the account of the Federal Government (which holds the coinage prerogative), receives new coins from the public mints at face value. At the end of 1993 the amount of coins in the Bank's portfolio was equivalent to about 14.5 % of the volume of coins outstanding; the maximum level permissible under the Coinage Act *(Münzgesetz)* is 15 %.

Land and buildings

In 1993 the balance sheet value of land, bank offices and residential buildings increased by DM 356 million on balance. Additions of DM 590 million were accompanied by depreciation amounting to DM 233 million.

Furniture and equipment

In the year under review the value of the furniture and equipment of the Bank fell by DM 43 million, after additions of DM 101 million and depreciation amounting to DM 144 million.

Items in course of settlement

The "Items in course of settlement", the volume of which is influenced by return-date effects, in particular, mainly consist of the cheques, direct debits and credit transfers in transit within the Bank at the end of the year. The balance of these items stood at DM 2,963 million at December 31, 1993, against DM 7,705 million at the end of 1992.

Other assets

"Other assets" primarily comprise the interest income from external assets and securities transactions not due until 1994 but assignable to the profit and loss account for 1993. This item also includes participating interests in the Bank for International Settlements, Basle, the cooperative society S.W.I.F.T., La Hulpe (Belgium) and the Liquiditäts-Konsortialbank GmbH, Frankfurt am Main. The 30 % interest in the Liquidäts-Konsortialbank GmbH entails for the Bank a maximum commitment of DM 558 million.

Prepayments

The prepayments consist mainly of interest payments booked in the year under review, but relating to 1994, for liquidity paper sold.

3. Liabilities

Banknotes in circulation

Compared with the end of 1992, the amount of banknotes in circulation rose by DM 10,986 million to DM 224,341 million, representing an increase of 5.1 %. In the preceding year the increase came to 17.7 %.

Compared with the previous year, the amount of currency in circulation went up by DM 11,356 million to DM 238,641 million; DM 14,300 million of this sum was accounted for by coins.

Deposits of credit institutions

Credit institutions' deposits on giro accounts, totalling DM 73,345 million (1992: DM 88,844 million), mainly consist of the minimum reserves to be held at the Bank. The subitem "Other" contains the deposits of domestic credit institutions and of the branches of foreign banks on US dollar accounts (DM 33 million).

Deposits of public authorities

This item comprises the balances of the Federal Government, the Equalisation of Burdens Fund, the ERP Special Fund and the Länder Governments, which are required to deposit their liquid funds with the Bank in accordance with section 17 of the Bundesbank Act. In the case of the Länder Governments and the Federal Government's special funds, the Bank admits exceptions, so that they are able to invest some of their liquid funds at interest outside the Bank. In addition, this item includes some deposits of the "German Unity" Fund. The deposits of other public depositors constitute balances of the social security funds and local authorities. At December 31, 1993 such deposits amounted to DM 13,496 million (1992: DM 429 million).

Deposits of other domestic depositors

This balance sheet item contains the deposits of the Federal Railways and east German Railways and the deposits of enterprises and individuals. At the end of 1993 they totalled DM 781 million, against DM 793 million a year before.

Liabilities arising from liquidity paper sold

"Liabilities arising from liquidity paper sold" relate to Treasury bills and Treasury discount paper issued by the Federal Government. At the end of 1993 they amounted to DM 26,207 million (1992: DM 2,011 million). Of late, the vast bulk thereof has been made up of Bundesbank liquidity paper with maturities of six and nine months, which is being sold to interested parties at home and abroad. At December 31, 1993 the amount of such paper outstanding came to DM 24,913 million. Furthermore, Treasury bills were sold to credit institutions as part of the money market management operations to mop up liquidity at short notice. They also serve public authorities, foreign monetary authorities and international organisations as a means of investing such balances as they do not require for payment purposes in an interest-bearing manner. DM 1,288 million of Treasury bills were outstanding at the end of 1993.

Liabilities arising from external transactions

This balance sheet item, totalling DM 22,052 million (1992: DM 24,653 million), consists primarily of Deutsche Mark deposits by foreign monetary authorities, resulting in the main from their Deutsche Mark interventions in the foreign exchange markets. Specifically, DM 21,933 million (1992: DM 24,457 million) was accounted for by the balances of foreign banks and DM 118 million by other deposits.

Counterpart of special drawing rights allocated

The counterpart of the special drawing rights allocated by the IMF free of charge and shown in item 2 on the assets side corresponds to the allocations of SDRs to the Federal Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,211 million.

Provisions for pensions

After an increase of DM 111 million, the provisions for pensions amount to DM 2,665 million; they are in line with the actuarially computed requirements.

Provisions for other purposes

On December 31, 1993, DM 1,377 million net was added to the provisions for other purposes, which serve primarily to cover general risks inherent in domestic and external operations and doubtful liabilities; this was mainly in order to provide for the risks posed by the external position. Since then, these provisions have amounted to DM 8,643 million (see also the notes below on the items "Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions" and "Other operating expenditure").

Other liabilities

The other liabilities, amounting to DM 560 million (1992: 596 million), constitute amounts not yet passed on and interest expenditure falling due in 1994 but relating to 1993.

Accruals

Accruals amounted to DM 485 million at December 31, 1993 (1992: DM 753 million). This item comprises the interest received during the year under review, but relating to the following year, from domestic and foreign bills of exchange and US Treasury notes.

Reserves

In accordance with the decision taken by the Central Bank Council on April 22, 1993, the legal reserves were increased by DM 1,603 million out of the unappropriated profit for 1992. Since that increase, the legal reserves have totalled DM 10,668 million; they have thus reached the maximum level permissible by law of 5 % of the amount of banknotes in circulation, which was DM 213,355 million at the end of 1992. The other reserves reached the statutory ceiling of DM 290 million as long ago as the end of 1980.

Unappropriated profit

See the notes on "6. Profit for the year" on page 146 of this Report.

4. Expenditure

Interest expenditure

Interest expenditure increased slightly during the year under review, to DM 3,391 million. The interest paid on liquidity paper rose strongly (DM 1,454 million) on account of the Bundesbank liquidity paper, which was sold for the first time. By contrast, the interest expenditure on external transactions declined.

Staff costs

Staff costs fell by 0.5 % in 1993 to DM 1,499 million. The influences at work here include, on the one hand, the negotiated pay increase (3 %); in addition, the incomes of government employees in the new Länder were raised from 74 % to 80 % of the levels applying in the west. On the other hand, the staff level of the Bank at the beginning of 1994 was 2.0 % lower than a year before. DM 309 million (1992: DM 353 million) of the staff costs was accounted for by retirement pensions. This sum includes the increase of DM 111 million in the provisions for pensions, as well as the payments made to staff members of the former Deutsche Reichsbank and to 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.

Payments to serving members of the Central Bank Council and the Directorate of the Bank amounted to DM 9,394,949.46 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 of the Executive Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 13,066,924.36.

Other operating expenditure

The other (non-staff) operating expenditure decreased by DM 113 million compared with 1992, and amounted to DM 392 million. This reflected, in particular, the smaller increase than in previous years in the provisions for doubtful liabilities, which affected the other operating expenditure.

Banknote printing

In the year under review expenditure on banknote printing declined by DM 53 million to DM 236 million. This is attributable to the high level recorded in the previous year in connection with the issue of the new banknote series, which was completed in 1992.

Depreciation of fixed assets

Depreciation both of land and buildings and of furniture and equipment was discussed in connection with the respective balance sheet items. Further depreciation relates to computer software, which is shown on the assets side under other assets.

5. Receipts

Interest

In the year under review the interest received, at DM 24,520 million, was DM 2,948 million lower than in 1992. The crucial factor here was interest income from lending to domestic credit institutions; it fell by DM 2,647 million owing to the decline in central bank interest rates, with the higher average refinancing volume being more than offset. Interest income from securities and cash advances, at DM 409 million and DM 46 million, respectively, had only a minor impact on total interest receipts. Interest income from external transactions decreased by DM 165 million against the previous year. In this case, interest receipts from foreign exchange swaps went up while less interest was earned on dollar investments owing to smaller dollar holdings and declining average yields.

Fees

Fees accrue first and foremost in connection with payments; this factor has increased in significance in recent years in the light of the Bank's more cost-oriented fee policy. In 1993 such receipts came to DM 112 million.

Receipts and valuation losses deriving from the monetary reserves

This item comprises the gains and losses arising from purchases and sales of foreign currencies and the outcome of the valuation of the monetary reserves and other foreign currency positions; the amount also includes the changes in the provisions likewise affecting the external position. Altogether, net receipts totalling DM 59 million were recorded. Specifically, there were realised price gains in the case of the dollar reserves, which were accompanied by losses on the ECU position as a result of exchange market interventions and increases in the other provisions.

6. Profit for the year

The profit and loss account for 1993 records a profit for the year of DM 18,834,732,559.55, which is shown in the balance sheet as unappropriated profit (net profit). In accordance with section 27 of the Bundesbank Act, DM 549,400,000.00 of this sum will be transferred to the legal reserves and DM 30,000,000.00 to the Fund for the Purchase of Equalisation Claims. The balance, amounting to DM 18,255,332,559.55, will be paid over to the Federal Government. After this appropriation, the legal reserves will total DM 11,217,100,000.00; they will thus once again come up to the statutory ceiling of 5 % of the amount of banknotes in circulation.

IV. Fund for the purchase of equalisation claims

The fund for the purchase of equalisation claims as at December 31, 1993 was audited by C & L Treuarbeit Deutsche Revision AG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft of Frankfurt am Main and Wollert-Elmendorff Deutsche Industrie-Treuhand GmbH Wirtschaftsprüfungsgesellschaft of Düsseldorf. In their certificate the auditors confirmed without qualification that the purchase fund had been properly managed. The Central Bank Council approved the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1993 on April 14, 1994.

During the year under review the purchase fund again received DM 30 million from the profit of the Deutsche Bundesbank for the preceding year. In addition, DM 390 million of interest and redemption payments from the debtors of equalisation claims and DM 9 million of interest from the temporary investment of available resources accrued to the fund. Together with the DM 197 million carried forward from the financial year 1992, DM 626 million was at the fund's disposal.

A total of DM 408 million was disbursed in 1993 on the purchase and the general acquisition of equalisation claims in accordance with section 9 of the Act on the Redemption of Equalisation Claims. Of that sum, DM 6 million in all was accounted for by purchases and the acquisition of minor equalisation claims in accordance with section 9 (2) number 2 and section 9 (3). DM 403 million was disbursed in the 20th acquisition round on the general acquisition of 34 % of all remaining equalisation claims on the Federal Government and ten Länder Governments. Emergency purchases of equalisation claims in accordance with section 9 (1) were effected on only a small scale.

Total fund assets amounted to DM 2,672 million at December 31, 1993. DM 218 million of this sum (mainly comprising interest and redemption payments due at the end of the year) was not yet invested in equalisation claims, but was temporarily lodged in Federal Government money market paper.

Equalisation claims in the purchase fund
Changes in 1993

Deutsche Mark

Interest rate %	Initial capital[1]				Remaining capital[2]
		Additions			
	Holding at Dec. 31, 1992	Purchases	General acquisition[3]	Holding at Dec. 31, 1993	Holding at Dec. 31, 1993
3	4,129,151,400.67	4,169,956.85	766,094,719.52	4,899,416,077.04	1,469,154,277.26
3 ½	3,796,857,928.34	87,004.92	691,797,812.90	4,488,742,746.16	977,523,223.71
4 ½	398,008,336.37	–	48,509,999.65	446,518,336.02	7,426,695.46
Total	8,324,017,665.38	4,256,961.77	1,506,402,532.07	9,834,677,159.22	2,454,104,196.43

1 Amounts entered in the Debt Registers of the Federal and Länder Governments. – **2** Initial capital less the redemptions effected by debtors since 1956. – **3** Including minor equalisation claims where transferred to the Fund in the event of general acquisition.

Fund for the purchase of equalisation claims in 1993

Deutsche Mark

	Equalisation claims (remaining capital)	Available resources	Liabilities	Fund assets, total
Holding at December 31, 1992	2,356,010,480.47	197,328,322.27	63,942.49	2,553,274,860.25
Transfer from the profit of the Deutschen Bundesbank in 1992	–	30,000,000.–	–	30,000,000.–
Purchases and general acquisition of equalisation claims	408,238,160.59	–408,238,160.59	–	–
Redemption	–310,144,444.63	310,144,444.63	–	–
Interest income from equalisation claims	–	80,102,645.31	–	80,102,645.31
temporary investment of the Fund's cash resources	–	8,788,042.91	–	8,788,042.91
Holding at December 31, 1993	2,454,104,196.43	218,125,294.53	63,942.49	2,672,165,548.47

Frankfurt am Main, February 16, 1994

Deutsche Bundesbank
The Directorate

Dr Tietmeyer Gaddum
Hartmann Prof. Dr Issing Meister Schieber Dr Storch