Report of the Deutsche Bundesbank

for the Year 1986

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Members of the Directorate of the Deutsche Bundesbank and the Managing Boards of the Land Central Banks

Members on April 1, 1987

of the Directorate of the Deutsche Bundesbank

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

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

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Part A: General part

The currency and the economy in 1986

I. Economic developments and central bank policy

In 1986 the Bundesbank's monetary policy was confronted with some unusual challenges. In the fourth year of an upswing in the Federal Republic of Germany that had been relatively free of tensions until then, a steep fall in the prices of major sources of energy and the marked depreciation of the US dollar profoundly changed economic conditions world-wide. Although these changes were generally beneficial to the Federal Republic of Germany (the terms of trade improved and thus raised income throughout the economy in real terms), Germany, like most other countries, came under strong external pressure to adjust. The fall in import prices – especially those for oil, petroleum products and natural gas – led to a steep rise in the German current account surplus despite the impediments to exports. The difficulties besetting German exports were in large part the debit side of global economic changes which in other respects were favourable to Germany, since countries exporting oil and natural gas now had to exercise great restraint in their imports for balance of payments reasons. The non-oil developing countries, especially those which have long been heavily in debt to non-residents and can hardly manage their debt service on their own, were likewise obliged to cut down their imports. German exporters therefore suffered their heaviest losses in trade with developing countries, but their losses in trade with centrally planned economies were also considerable. An additional factor that became significant in the course of the year was that signs of a reduction of the external disequilibria emerged via a fairly abrupt depreciation of the US dollar. Although the volume of German exports to the United States hardly diminished at all to begin with, the dollar depreciation led to a narrowing of profit margins and finally to a downturn in new orders as well.

These changes in underlying world economic conditions also restricted the Bundesbank's room for manoeuvre in the field of monetary policy. In 1986, as in some other years of the past decade (e.g. 1978 and 1973), massive inflows of money and capital from abroad, coupled with an appreciation of the Deutsche Mark, exercised a dominating influence on developments in the German financial markets. In that year the influx of funds from abroad derived not only from the massive current account surplus (DM 76.5 billion) but also in part from sizeable inflows in the field of long-term capital transactions (DM 38 billion net). In the light of the sustained expectation, which was largely borne out by the actual course of events, that the Deutsche Mark would continue to appreciate against the US dollar and most other currencies, the Deutsche Mark became a particularly attractive investment currency. The inflows of funds stemming from current and capital transactions contributed to an expansion of the money stock in Germany that was far in excess of its envisaged growth, and in themselves tended to depress interest rates or to prevent rudimentary interest rate increases from developing further. In these circumstances strict limits were set to the Bundesbank's efforts to resist the strong monetary expansion by taking monetary policy measures, and it had to put up with the fact that in 1986 – for the first time since 1978 – the monetary target was considerably overshot.

The risks posed by an ample supply of money to the German economy – judged by the usual standards – were all the easier to accept as the external changes were highly conducive to price stability in Germany. The falls in energy prices and cheapening of imports due to the appreciation of the Deutsche Mark even led at times to a slight decline in prices. This, as well as the tax cuts which came into force at the beginning of 1986, strengthened consumers' purchasing power; this constituted the strongest stimulus to the growth of domestic demand, which was supported at the same time by investment activity. Until the late summer of 1986 the expansion of domestic demand was so strong that it not only offset but actually outweighed the retarding effects which external influences were exerting on domestic production; as late as the third quarter of 1986 real GNP (adjusted for seasonal and working-day variations) was growing

Key data on overall economic trends

Period	Gross national product 1	Employed persons 2		Unemployment rate 3	Consumer prices; 4 annual change	Balance on current account
	Annual change					
	in %		in thousands	in %	in %	in DM billion
1970 to 1973 5	+ 4.2	+ 0.5	+ 140	0.8	+ 5.3	+ 5.3
1974 to 1979 5	+ 2.3	− 0.5	− 150	3.5	+ 4.6	+10.5
1980 to 1986 5	+ 1.4	− 0.1	− 40	6.8	+ 3.5	+17.9
1975	− 1.4	− 2.8	− 760	4.0	+ 5.9	+10.0
1976	+ 5.6	− 0.8	− 220	4.0	+ 4.4	+ 9.9
1977	+ 2.7	− 0.2	− 40	3.9	+ 3.6	+ 9.5
1978	+ 3.3	+ 0.6	+ 150	3.8	+ 2.7	+18.0
1979	+ 4.0	+ 1.4	+ 350	3.3	+ 4.2	−11.0
1980	+ 1.5	+ 1.1	+ 280	3.3	+ 5.4	−28.5
1981	+ 0.0	− 0.7	− 180	4.8	+ 6.3	−11.7
1982	− 1.0	− 1.7	− 440	6.7	+ 5.3	+ 9.9
1983	+ 1.8	− 1.5	− 380	8.1	+ 3.3	+10.6
1984 p	+ 3.0	+ 0.1	+ 30	8.1	+ 2.4	+23.9
1985 p	+ 2.5	+ 0.7	+ 180	8.2	+ 2.2	+44.6
1986 p	+ 2.4	+ 1.0	+ 250	7.9	− 0.2	+76.5

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

at an annual rate of just over 4% — even faster, that is, than the trend rate of the preceding years.

But the pressure to adjust increased further. Shortfalls in demand in foreign markets of importance to Germany and the persistent appreciation of the Deutsche Mark increasingly impaired the export prospects of German producers; at the same time they found themselves faced on the domestic market with stronger competition from foreign manufacturers. The dampening effect which is naturally associated with a reduction in the real trade surplus became so marked in the fourth quarter of 1986 that the increase in domestic demand was no longer strong enough to outweigh it. The dampening external influence and the associated, partly precipitous downturn in exporters' profit expectations had a distinct impact on corporate decisions. This is why enterprises started to lower the level of their planned investment in the last three months of 1986, although they continued to keep it expansionary.

Under the influence of these factors, the overall economic performance in Germany fell short of earlier expectations; in 1986, viewed as a whole, real GNP went up by only 2½%. Even so, last year's economic record was quite favourable in many respects: overall capacity utilisation remained high, the labour force grew by over a quarter of a million during the year and the number of unemployed fell, for the first time since the beginning of the sustained upswing. Thanks also to the decline in the prices of energy and other imports, these developments were accompanied by an exceptional degree of price stability.

In view of the stable price situation and the absence of cyclical tensions, the Bundesbank was able last year to take due account of domestic and external requirements by adopting a policy stance which tended to be expansionary. Not only did it foster the stimulating external influences on the money stock in the course of the year by taking some measures of its own; a glance at the overly rapid pace of currency appreciation also prompted the Bundesbank to buy foreign exchange on several occasions. At times — as in the spring of 1986 — it was obliged to do so in the light of its commitments under the European

Monetary System (EMS); this applied even more to the period immediately before the renewed realignment of exchange rates within the EMS in mid-January 1987. Following this fresh adjustment of central rates within the EMS and the accord on coordinated economic policy measures, including measures to stabilise exchange rates, reached among the major industrial countries in Paris in February 1987, the tensions eased. A stabilisation of conditions in the foreign exchange markets would in general be of significance for future economic trends, both in Germany and in its partner countries, and would in particular facilitate the tasks of monetary policy.

By setting a monetary target for 1987 which provides for an expansion of the central bank money stock by 3 % to 6 % between the fourth quarter of 1986 and the fourth quarter of 1987, the Bundesbank has demonstrated that it wishes to make economic growth possible from the monetary angle while keeping prices stable. Recent developments warrant the hope that this objective can be attained, even though the room for manoeuvre has been seriously restricted by external constraints. In addition to its particular function of maintaining price stability, monetary policy can, however, make only a limited contribution to solving Germany's pressing domestic and external economic problems. Government financial policy and the pay policy of management and labour are likewise required to pay due regard to the domestic and external exigencies of the current situation. Germany cannot evade the external adjustment process that is now under way. Hence it is imperative for the upswing in domestic economic activity to continue without new sources of inflation emerging. Germany is endeavouring in this way to bear its share of the responsibility for the world economy. It is doing so in the belief that its principal trading partners will also play their part in overcoming the disequilibria in the world economy and stabilising the global financial system.

1. The Federal Republic of Germany under external pressure to adjust

Favourable overall economic result in the face of unexpectedly strong external influences

The economic upswing in the Federal Republic of Germany continued in 1986; last year was thus the fourth year of the upswing, after the stagnation in the period from 1980 to 1982. Looking at the year as a whole, output and employment went up strongly and unemployment fell for the first time since the beginning of the upswing, even if only slightly. The goal of zero inflation was attained and extreme external influences even led temporarily to small price falls. On trend, the domestic performance last year can thus be described as being good. Global economic events played a role in this, admittedly not always to the benefit of Germany's economy. Of the external influences, one to mention is the strong fall in the price of oil, which began around the turn of 1985-86. Whereas, shortly beforehand, North Sea oil had cost almost US$ 30 per barrel in the Rotterdam spot market, its price had dropped to only US$ 9.50 by July 1986. Later, it rose again slowly and in December 1986 reached US$ 15.50 (in March 1987 it was just under US$ 18). Taking the average of 1986, imported crude oil, free German border, was almost 60 % cheaper than a year before for domestic importers, whose business was additionally favoured by the fall in the US dollar against the Deutsche Mark. In the final analysis, in 1986 Germany's external energy bill cost it nearly 50 % or approximately DM 40 billion less than in 1985. A factor tending to have the same effect was that much other work done at previous stages of production and imported from foreign countries cheapened under the influence of the Deutsche Mark strongly appreciating against the US dollar and – to a lesser extent – against other major currencies.

Stimulating and restraining external influences

The fall in the price of oil and the marked changes in exchange rates had significant effects not only on underlying conditions in Germany but on the world economy as well. The fall in the price of oil and the cheapening of other imports generated an expansion in domestic income scope in Germany of 3 % to 3½ %

Key economic variables in the Federal Republic of Germany

Item	Unit	1983	1984	1985	1986	1983	1984	1985	1986
						Change from previous year in %			
Aggregate demand									
Private consumption	DM billion	964.2	1,002.8	1,041.8	1,081.1	+ 5.0	+ 4.0	+ 3.9	+ 3.8
Public consumption	DM billion	336.2	350.2	365.7	383.1	+ 3.1	+ 4.2	+ 4.4	+ 4.8
Fixed capital formation	DM billion	343.8	354.6	359.3	375.9	+ 5.2	+ 3.1	+ 1.3	+ 4.6
Machinery and equipment	DM billion	135.6	137.6	153.9	162.2	+ 8.6	+ 1.5	+ 11.8	+ 5.4
Construction	DM billion	208.2	217.1	205.5	213.7	+ 3.1	+ 4.2	– 5.3	+ 4.0
Increase in stocks	DM billion	– 1.8	+ 5.1	+ 7.5	+ 2.6	.	.	.	.
Domestic expenditure	DM billion	1,642.4	1,712.8	1,774.3	1,842.6	+ 5.3	+ 4.3	+ 3.6	+ 3.9
Foreign balance **1**	DM billion	+ 36.9	+ 50.3	+ 72.7	+ 106.4	.	.	.	.
Exports	DM billion	524.6	588.0	647.3	634.8	+ 1.4	+ 12.1	+ 10.1	– 1.9
Imports	DM billion	487.7	537.7	574.6	528.5	+ 1.6	+ 10.2	+ 6.9	– 8.0
GNP at current prices	DM billion	1,679.3	1,763.1	1,847.0	1,949.0	+ 5.1	+ 5.0	+ 4.8	+ 5.5
Memorandum items									
Orders received by the manufacturing sector	1980 = 100	107.9	118.2	127.8	127.9	+ 4.4	+ 9.6	+ 8.1	+ 0.1
Domestic orders	1980 = 100	103.1	109.5	116.4	119.1	+ 4.9	+ 6.2	+ 6.3	+ 2,4
Foreign orders	1980 = 100	118.3	137.1	152.3	146.9	+ 3.4	+ 15.9	+ 11.1	– 3.5
Orders received by the construction industry	1980 = 100	94.4	88.9	87.4	95.3	+ 10.0	– 5.8	– 1.7	+ 9.1
Distribution of income									
Wage and salary income	DM billion	920.7	953.4	989.4	1,039.1	+ 2.0	+ 3.5	+ 3.8	+ 5.0
do. as a percentage of national income	%	71.6	70.5	69.5	68.6	.	.	.	.
Entrepreneurial and property income	DM billion	364.4	398.2	433.9	475.1	+ 13.5	+ 9.3	+ 9.0	+ 9.5
Memorandum items									
Gross income of producing enterprises	DM billion	277.4	305.2	339.2	379.8	+ 19.1	+ 10.0	+ 11.1	+ 12.0
do. as a percentage of national income	%	21.6	22.6	23.8	25.1	.	.	.	.
National income	DM billion	1,285.1	1,351.6	1,423.3	1,514.2	+ 5.0	+ 5.2	+ 5.3	+ 6.4
Production									
GNP at 1980 prices	DM billion	1,497.8	1,542.4	1,580.8	1,618.4	+ 1.8	+ 3.0	+ 2.5	+ 2.4
Productivity **2**	1980 = 100	106.7	109.9	112.6	115.1	+ 3.7	+ 3.0	+ 2.5	+ 2.2
Output in the producing sector (excluding construction) **3**	1980 = 100	96.4	99.6	104.5	106.6	+ 0.9	+ 3.3	+ 4.9	+ 2.0
Construction output **3**	1980 = 100	89.0	89.5	83.7	87.1	+ 0.6	+ 0.6	– 6.5	+ 4.0
Employment									
Employed persons	Millions	25.3	25.4	25.5	25.8	– 1.5	+ 0.1	+ 0.7	+ 1.0
Wage and salary earners	Millions	22.1	22.1	22.3	22.5	– 1.7	+ 0.2	+ 0.8	+ 1.1
Memorandum item									
Total number of man-hours worked	1980 = 100	94.5	94.5	94.5	94.7	– 1.8	– 0.0	+ 0.0	+ 0.2
Unemployed persons	Thousands	2,258.2	2,265.6	2,304.0	2,228.0	+ 23.2	+ 0.3	+ 1.7	– 3.3
do. as a percentage of									
the total labour force	%	8.1	8.1	8.2	7.9	.	.	.	.
the dependent labour force	%	9.1	9.1	9.3	9.0	.	.	.	.
Prices									
GNP deflator	1980 = 100	112.1	114.3	116.8	120.4	+ 3.3	+ 2.0	+ 2.2	+ 3.1
Memorandum item									
Unit labour costs in the economy as a whole **4**	1980 = 100	108.5	109.1	110.3	113.0	+ 0.4	+ 0.5	+ 1.2	+ 2.5
Cost of living index for all households	1980 = 100	115.6	118.4	121.0	120.7	+ 3.3	+ 2.4	+ 2.2	– 0.2
Producer prices of industrial products	1980 = 100	115.8	119.2	121.8	118.2	+ 1.5	+ 2.9	+ 2.2	– 3.0
Overall construction price level	1980 = 100	109.9	112.5	113.5	115.5	+ 1.7	+ 2.4	+ 0.9	+ 1.8
Index of import prices	1980 = 100	115.8	122.8	124.6	101.0	– 0.3	+ 6.0	+ 1.5	– 18.9

1 Balance of transactions in goods and services with other countries (including the GDR). — **2** GNP at 1980 prices per man-hour worked; calculated by the Bundesbank. — **3** Results for kinds of activity units. — **4** Index of gross wages and salaries per employee divided by index of real GNP per employed person. — The figures from the national accounts from 1984 onwards are provisional. BBk of real GNP. The oil-exporting countries, however, experienced a loss in foreign currency receipts and so their real purchasing power fell; these nations were forced to cut back on imports. This also applies to a lesser extent to countries which do not export oil but invoice their exports largely in dollars. These thus suffered a decline in their export proceeds in real terms in 1986 and therefore had to limit their imports where, unlike the United States, they could not incur more foreign debt or did not want to do so. As the Deutsche Mark strengthened, moreover, domestic suppliers lost competitiveness. This change in external economic factors was associated for the German economy with a strong shift within the "upswing forces". The external side had a retarding effect on economic growth in Germany. The only factor which was still able to stimulate growth was domestic demand; in 1986 it increased in real terms by a good 3½ %, and thus far more than in any of the preceding six years.

Private consumption most important engine of domestic demand

It was households' consumption demand, in particular, which fuelled domestic economic activity in 1986. At current prices, consumption expenditure last year rose by just under 4 %; thanks to falling prices, real consumption in fact increased somewhat more. Consumers' real purchasing power was strengthened particularly by energy becoming cheaper. At first, uncertainty as to the further trend in heating oil prices made many households fill up their fuel stocks earlier and more than usual. Consumers' savings on energy expenditure nevertheless ran to 1½ % of their disposable income, calculated over the year as a whole. Households used the extra purchasing power largely for other purchases. Passenger cars were subject to very heavy demand. New registrations by private persons in 1986 rose by almost 30 % and reached a record level. Considerably more than before was spent on services, too. In 1986, they accounted for an estimated 40 % of all consumption expenditure; five years before the figure had been just under 37 % and ten years earlier only 35 %. On the other hand, demand for everyday requisites showed relatively little dynamism.

Good sales prospects for foreign consumer goods

Foreign suppliers of consumer goods, whose price competitiveness improved as a result of the appreciation of the Deutsche Mark, profited considerably from the strength of consumption in Germany. Imports of consumer goods and consumer durables rose by volume in 1986 by as much as 13 %. In addition to foreign textiles and clothing manufacturers, who are traditionally strongly represented in the German market, foreign automobile producers especially were able to gain noteworthy market shares; almost 30 % of newly registered passenger cars in Germany last year were imported vehicles (after a good 27 % in 1985). In this way, the growth in consumers' purchasing power spread to Germany's major trading partners, though usually only to those who themselves proved competitive and capable of adjusting.

Strong growth in private income

Consumption propensity received strong support from income in 1986. Total gross wages and salaries increased by 5 %, i.e. by about 1½ percentage points more than in 1985. Firstly, negotiated wage settlements were on average much higher than in the wage round of the preceding year and, secondly, the number of employees grew even more sharply than in 1985. In addition, the first stage of the tax cuts went into force in 1986. With the relief it afforded of about DM 11 billion, it was possible – in general – for net wages and salaries to rise even more strongly than gross earnings. Moreover, government current transfers, which primarily benefit lower income groups, went up more strongly than in 1985. By contrast, growth in receipts from financial assets was slowed by the fall in interest rates. In total, households had over 4½ % more income in 1986 than in 1985. As there was a small decline in consumer prices, the rise in their real income was about 5 %.

Heavy saving by households, particularly in liquid forms

A marked growth in income – unexpected on this scale – naturally favours saving. The share taken by saving in households' disposable income – the "saving ratio" – rose to a good 13% in 1986; this was ½ percentage point more than in 1984 and 1985. It was liquid financial assets that were particularly strongly built up, i.e. holdings of cash and sight deposits as well as savings deposits at statutory notice. Forms of contractual saving at attractive rates of interest, some of which enjoy tax privileges, including saving through insurance enterprises, were second most favoured by the public. Private investors' interest in acquiring securities, by contrast, decreased markedly. In 1986 households put only about half as many funds into the domestic bond market as a year before. Savers' restraint had an even stronger effect on foreign bonds, which had previously experienced heavy demand. Households increased their debt for consumption purposes relatively little last year because they were in a favourable income and liquidity situation and because lending rates in this sector were relatively high. At about DM 10 billion, households borrowed about one-fifth fewer additional funds than in 1985.

Pump-priming effect of government expenditure

At a good 4%, the rise in total expenditure by the central, regional and local authorities and the social security funds (in the definition of the national accounts) was as high as the rise in domestic demand at current prices. As a percentage of the latest domestic GNP expenditure, the public sector's spending ratio last year – unlike that in the preceding three years – thus did not fall any further. Government consumption went up fairly strongly, namely by 5%. This figure includes both the increase in staff costs for government employees, the number of whom grew further in 1986, and higher operating expenditure by the central, regional and local authorities and the social security funds. Public sector capital spending rose much above average, by 9% in all, with construction expenditure going up by 8%.

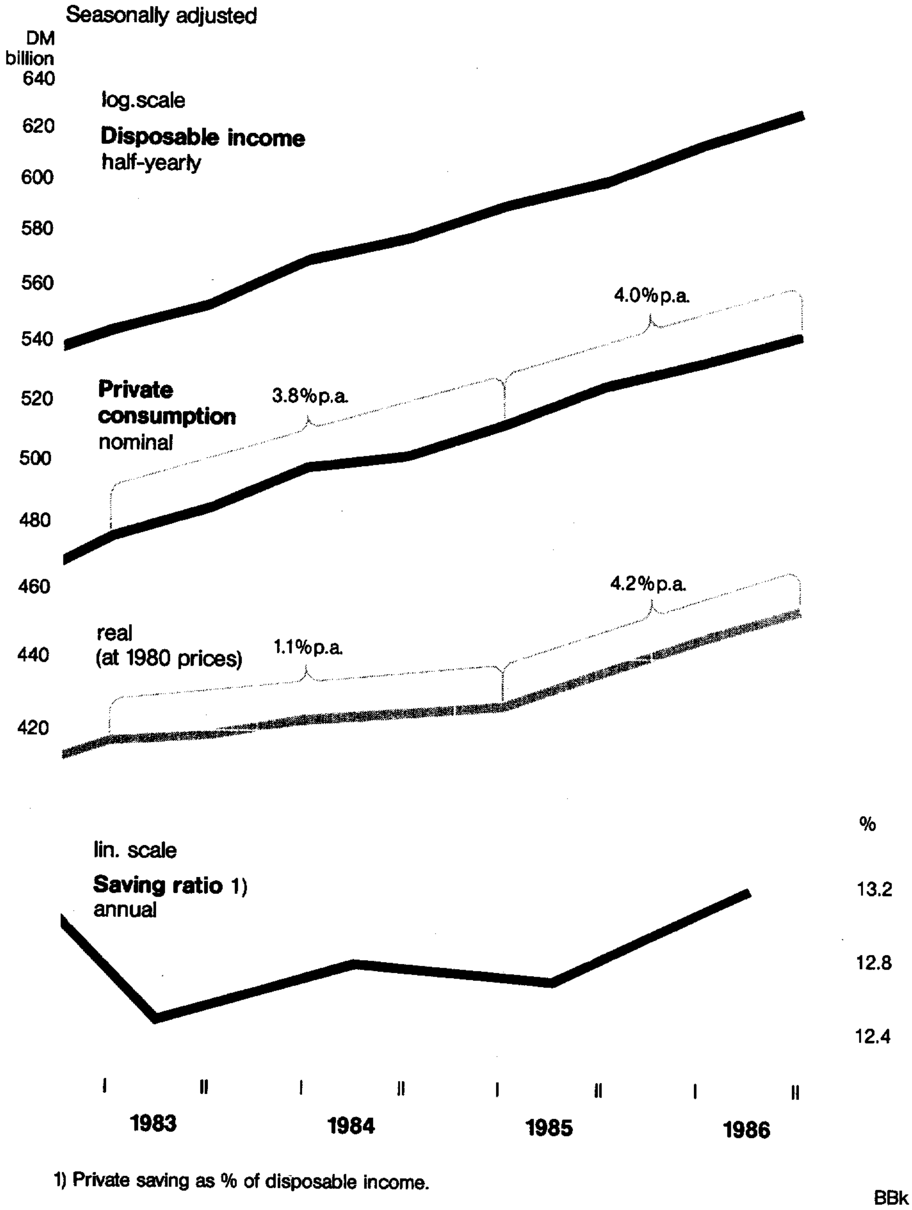
Better situation in the construction sector, particularly in industrial construction

The situation in the construction market improved last year. Overall demand for construction work rose sharply; in the construction industry, which accounts for about half of the value added in the whole construction sector, a good 9% more orders were received in 1986 than a year before. Construction activity, which had been severely restricted in 1985, expanded again. Construction expenditure increased by 4% at current prices and by 2½% at 1980 prices. This positive overall picture admittedly masks considerable differences in the individual areas of construction. Industrial construction (including the Federal Railways and Federal Post Office) proved to be the most important buttress of construction activity in 1986. The orders received by construction firms in this area over the whole year were almost a fifth up on those of 1985. However, this high growth rate overstates the basic cyclical tendency to the extent that it is inflated by large-scale orders placed in the summer months. However, even without this surge of orders, industrial construction demand registered strong growth. Construction in this area will have benefited, firstly, from final demand having shifted more towards services, with additional construction demand thus having been generated in the economic sectors concerned. Secondly, and particularly in the first half-year, the fact that industry was more prepared to expand its production capacity stimulated demand for industrial buildings. In addition, investment in environmental protection grew in importance.

Higher demand in public construction, too

The central, regional and local authorities also increased their demand for construction work more strongly in 1986 than in the two preceding years. The orders they placed with the construction sector in 1986 were about 8% up on the year. The local authorities, in particular, used the financial scope they had gained from the preceding budget consolidation to launch new building projects. In the areas falling within the competence of the local authorities, namely environmental protection, waste disposal and urban renewal, and in road building, too, more capital projects were started again. Order placement was,

Households' income, consumption and saving



1) Private saving as % of disposable income.

however, uneven over the year. It focused on the spring and summer months. As the orders planned for 1986 had apparently largely been placed by the autumn, public construction demand weakened again towards the end of the year.

Demand for housing construction stays at a low level

Housing construction was in the doldrums once again in 1986. After a steep fall in 1984 and 1985, housebuilding orders to the construction industry in the year under review dropped again (in spite of temporary increases), viz. by about 5%. The particular weakness, as already for a long time, was in apartment house construction. Here, construction of new buildings was probably braked especially by the fact that in many areas of the rented housing market apartments on offer did not meet with corresponding demand. In view of the difficulties in marketing accommodation, even the favourable construction conditions — low mortgage rates, low construction price rises, short periods to completion — were not able to motivate potential investors to commit themselves more strongly, especially as increasing numbers of existing residential buildings were being put on the market — often at relatively low prices. Distortions in the housing market which are due not least to the many government promotion measures of the last few decades are disappearing only slowly. Apparently the discrepancy between cost-covering rentals for newly completed dwellings and the rental which the market will bear is still too large, even when looked at over the long term, for commercial landlords to go into building on a large scale. With the ongoing withdrawal by the government from promoting rented housing construction, these "distortions" will probably unwind over the long term; for the time being, however, the problems rental accommodation has in adjusting to free-market conditions have not yet been overcome and the construction of new buildings remains subdued.

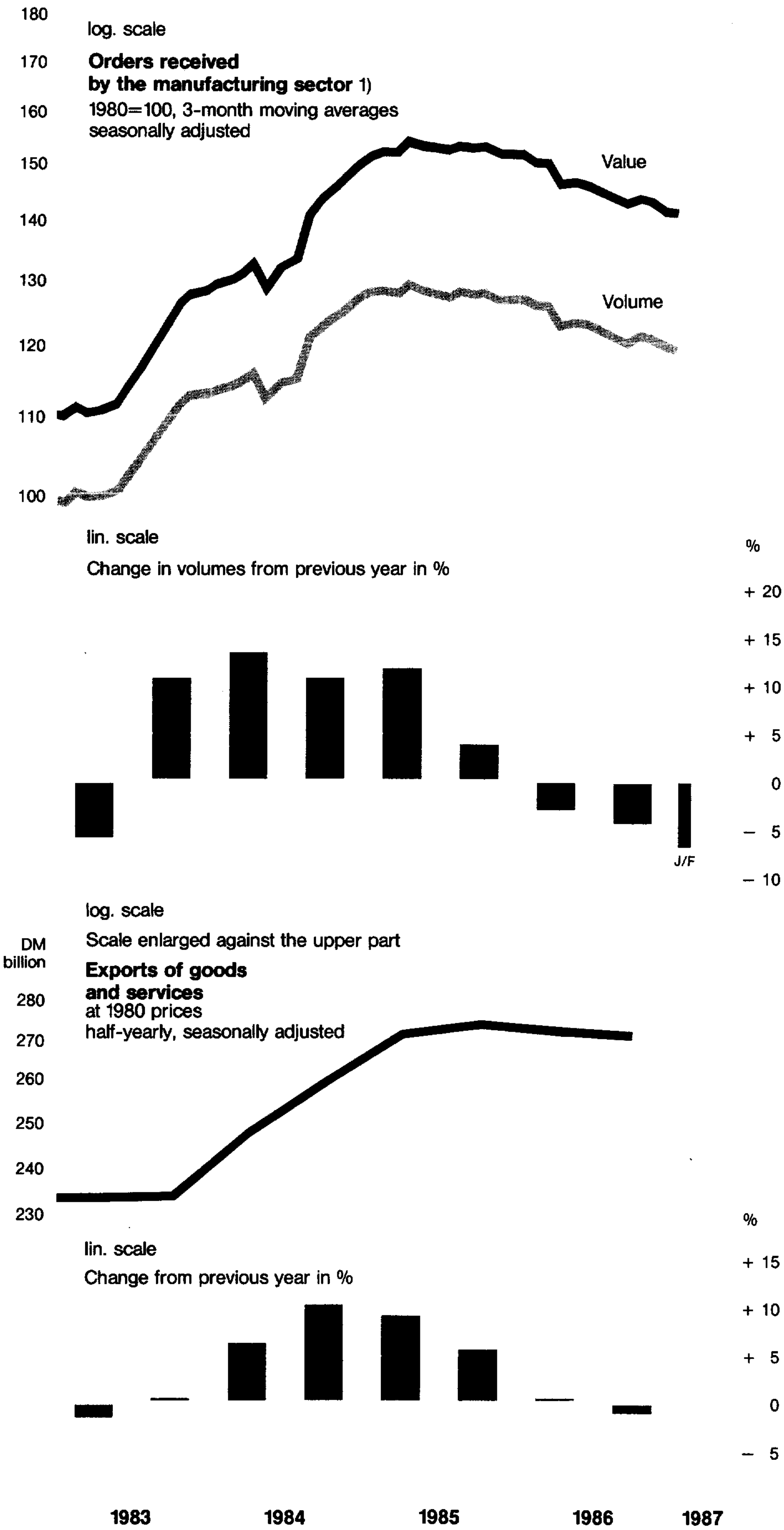
Markedly fewer completions of dwellings

However, housing construction demand for one and two-family houses, largely destined for owner-occupation, reached the previous year's level in 1986, as measured by building permits. This may have owed something to the fact that the fiscal promotion of owner-occupied residential property has been subject to new legislation. It is not impossible that this may also have involved projects being brought forward – namely two-family houses, for which tax provisions were more favourable if they were finished by the end of 1986. In spite of this positive impulse, the dwellings completed in 1986 fell to a level of about 250,000 (after 312,000 in 1985) – the lowest figure registered since the beginning of the fifties. In 1986 the construction industry will have found partial compensation for the shrinking volume of construction of new buildings in higher output tied to the rehabilitation and modernisation of existing residential buildings. Expenditure here, at any rate, has been pointing steeply upwards for several years, but is statistically classifiable only to a limited extent.

Strong expansion in enterprises' capital formation

In 1986 enterprises strongly expanded their capital formation; they spent 5% more than in 1985 on machinery and equipment or, including construction, 6% more. Over the whole year, investment was strong but, given improved corporate profitability, not exceptional. In total, the gross income of producing enterprises last year was 12% up on the previous year. The return on fixed assets was thus higher than in 1985. At the same time, the long-term interest rate, as measured by the yield on bonds outstanding, continued to fall, to 6%. This shows that, at least arithmetically, the gap between the (higher) return on fixed assets and the long-term interest rate has widened. However, enterprises probably did not see their improved profitability as lasting. Firstly, they could not count on the relief from energy costs remaining at the level it was at till summer 1986. Secondly, the ongoing upward trend in the Deutsche Mark cut export earnings. In not a few cases German exporters had to lower their Deutsche Mark prices to retain competitiveness, especially in dollar markets. The fall in commodity and energy prices was not always enough of a counterbalance here, particularly as domestic cost increases intensified. In addition, import-induced price pressure in domestic markets also strengthened or, at any rate, it proved more and more difficult to raise prices. The improvement of corporate profitability which went on until summer 1986 did not continue after that time. Both this fact and recently subdued sales expectations will have contributed to enterprises' demand for capital goods having lost steam in the course of last year. Whereas in the first three quarters of 1986 the capital goods sector (excluding vehicle manufacture) received 8½% more domestic orders than a year before, in the last quarter of 1986 new orders showed a year-on-year fall of about 1½%. Earnings prospects which were not as good as before were arguably the main reason why enterprises' plans to expand their investment were not realised. As late as last autumn producing sector enterprises were telling the Ifo Institute that they would be expanding their investment, on average, by 13% in 1986. Several negative factors have remained at work since the beginning of 1987. These include the initially fairly strong appreciation of the Deutsche Mark and uncertainty as regards the outcome of negotiations on wage rises and reductions in working hours. Investment propensity has thus been dampened further for the time being, although the basic state of the German

Foreign demand



1) Excluding food, drink and tobacco industry.

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economy and the expected improvement in the underlying data, e.g. in the tax area, could strengthen optimism.

Further slackening of foreign demand

Foreign demand for German products constituted an element with a strongly retarding effect on economic trends in 1986. This was mainly because of lower import demand on the part of oil-producing countries and other countries supplying commodities on world markets, as well as those countries which, although not typical suppliers of raw materials, also had to cut back on their imports because they had got into balance of payments difficulties (e.g. the centrally planned economies). Orders from the industrial countries, which in most cases were profiting from falling energy and commodity prices, offered a certain but insufficient compensation. These trends, which obtained in many areas of the world economy, were supplemented for German exporters by the braking effect of the Deutsche Mark appreciation; as from the end of 1985 only the Japanese yen appreciated somewhat more strongly than the Deutsche Mark (calculated in relation to the weighted external value). In total, on an annual average for 1986, the value and volume of foreign customers' orders to domestic industry were about 3½ % down on the year. Capital goods producers were hit hardest by the sluggishness of foreign business; excluding vehicle manufacture, they booked 5 % fewer foreign orders on an average last year than in 1985. Mechanical engineering in particular — and within it, plant construction, which is traditionally heavily engaged in foreign business — was faced with severe cuts in demand, while export orders in the electrical engineering industry ran at the preceding year's level. Manufacturers of tools and finished metal goods and specialised steel processing enterprises fared relatively well on markets abroad. The basic and producer goods sector also did much less foreign business; in this area the value of export orders in 1986 fell by 8½ %. Owing to considerable price cuts, which enterprises were able to implement because this sector, in particular, was enjoying relatively high external cost relief, the fall in demand volume, at 2½ %, was admittedly much smaller. Domestic vehicle manufacturers and the consumer goods sector, by contrast, clearly profited from the high level of consumer spending in other countries in 1986. Last year, foreign customers ordered more passenger cars from the vehicle manufacturing industry than in 1985. The consumer goods sector registered an increase in foreign orders of 2½ %; furniture manufacturers and the clothing industry had particular success in international markets.

Weaker economic growth as a result of falling real surpluses on transactions in goods and services with the rest of the world

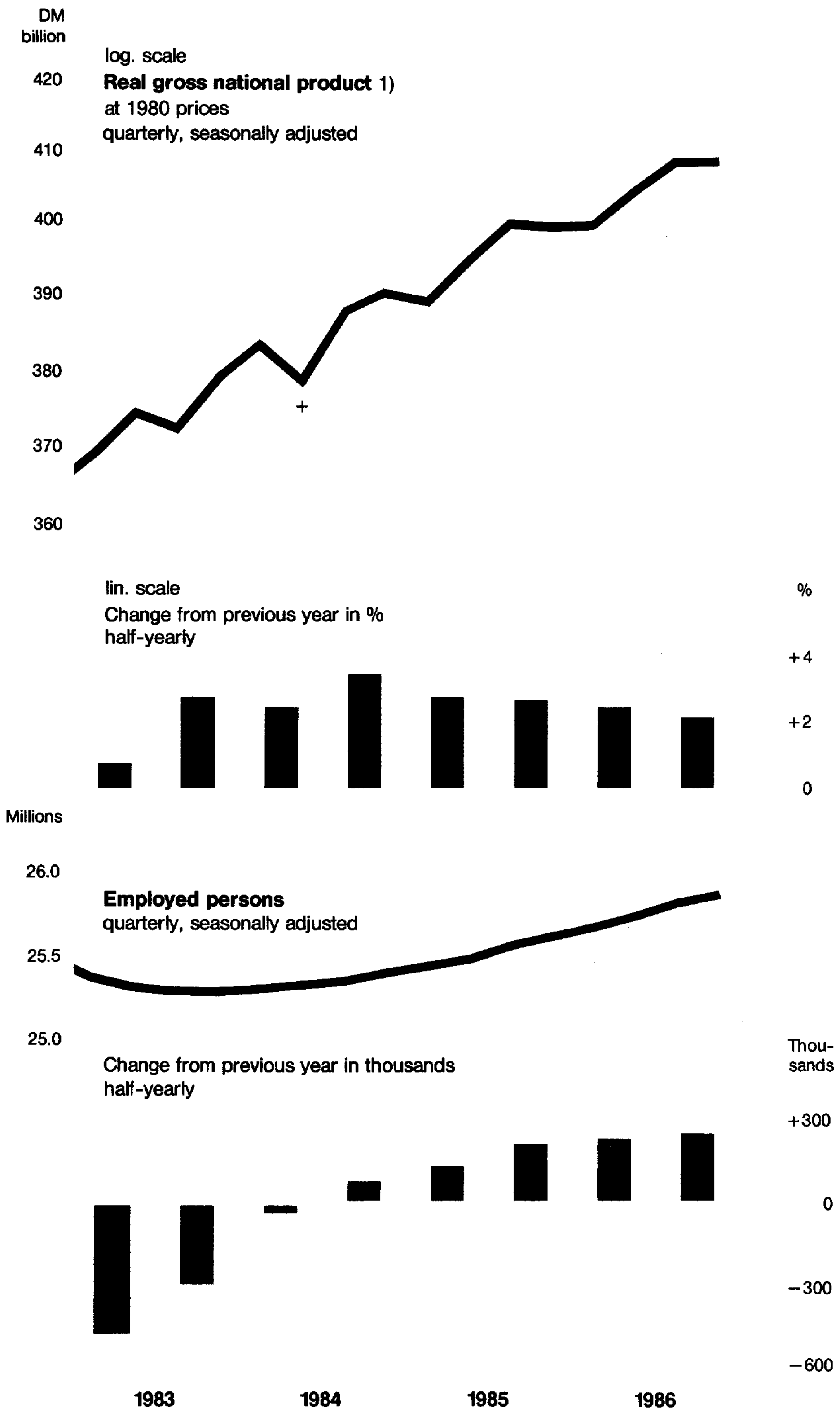
Slackening foreign demand made deliveries to foreign countries fall in the course of 1986. Exports of goods and services (in the definition of the national accounts) were ½ % down on 1985, in real terms. The fact that external transactions were braking economic trends in Germany becomes more apparent if one takes a look at imports, too. In total, over 3 % more goods and services were imported in 1986, at constant prices, than in the previous year. Foreign competitors were able to strengthen their toehold on domestic markets for industrial finished goods, in particular. As a consequence of import prices dropping while export prices fell only slightly, it is true that Germany's external surpluses hit a record level in 1986. However, if price changes are eliminated to highlight the "real" processes determining domestic output and employment, it can be seen that the trade surplus (goods and services) last year fell by DM 18 billion or 1 % of real GNP; this was — and currently still is — the counterweight, retarding overall economic growth, to the upward trend of domestic demand.

Further rise in real GNP ...

In 1986, as in the year before, real GNP grew by 2½ %.[1] Overall output will thus have gone up to about the same extent as production capacity, which also grew by an estimated 2½ % in 1986. The capital stock increased somewhat more than

1 The growth rate published by the Federal Statistical Office, on the basis of what are still provisional calculations, is 2.4 %.

Output and employment



1) Adjusted for working-day variations.- + Affected by labour disputes.

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in 1985 on account of higher net fixed capital formation. In addition, the labour potential grew partly for demographic reasons and partly because there was an influx to the labour market owing to improved employment prospects. However, as in 1985, 1986 saw the reductions in working hours acting as a definite brake on the increase in the potential number of man-hours worked which had been caused by the rise in the number of employees.

... with a shift in focus within the growth of output

With the shift in expansionary forces from foreign to domestic demand, the focus of the growth in output shifted at the same time from industry to other sectors of the economy (like the services sector and the construction industry) as industry was, of course, particularly exposed to the external pressure to adjust in view of its high share of exports and the considerable inroads of imported industrial finished products on domestic markets. Growth in industrial production thus lost a good deal of momentum in the course of 1986; while in 1986 as a whole output of goods in the producing sector (excluding construction) was about 2% up on 1985, a year-on-year growth of only 0.4% was registered in the fourth quarter. In the capital goods sector, which depends particularly on exports, this trend was even stronger; there output (excluding vehicle manufacture) rose on an annual average by 4½%, but in the fourth quarter only by 0.7%. Mechanical engineering suffered not only from weak foreign demand but of late also from the fall in domestic orders. Output in road vehicle manufacture, which depends very strongly on demand from households, was still growing sharply in the last few months of last year. Because of the high level of domestic demand, the automobile industry hit a record in 1986: in total, about 4.3 million passenger cars were produced, 3½% more than in 1985. Admittedly, certain last-minute purchases before the expiry of deadlines for claiming full tax relief on low-pollutant vehicles played a role. The consumer goods sector also registered strong expansion in production (+ 2%) in the buoyant consumption climate. By contrast, output in the basic and producer goods sector fell by ½%; sales were particularly hampered by exchange rate changes and consequent lower competitiveness in domestic and foreign markets (with EEC market problems also being in evidence, e.g. in the steel industry).

Strong increase in output in construction and the tertiary sector

For the first time since the end of the seventies, construction output, which is determined almost solely by the home market, grew strongly again in 1986. After losses during the long period of sub-zero temperatures in winter 1985-86, construction output increased steadily as a consequence of the positive course of demand; over the whole year, it was 4% up on 1985. The other non-industrial economic sectors also contributed considerably to output growth in the year under discussion. This is true primarily of the private services sector, which put up its real value added by 3½%. The banking and insurance industries were the front-runners in expansion. Telecommunications and the industries providing services to enterprises also generated considerable growth impulses.

Improved situation on the labour market owing to considerable rise in the number of employees

The situation on the labour market improved in 1986, with the continued upward trend in the economy and the shift in emphasis towards the "tertiary" sector. The number of employed rose considerably over the year; the end of 1986 saw about 260,000 more employed in the economy as a whole than twelve months before. This represented the strongest increase since the start of the eighties, with over half of the rise in employment being attributable to the tertiary sector. Trends in the producing sector were very mixed. In the construction industry, the average number of employed fell again in 1986; in the course of the summer, seasonally adjusted reductions in staff levels came to a halt, however. In the manufacturing sector, the number of personnel went up strongly until late summer 1986; but as growth in demand and output slowed in major areas of the capital goods industry, the expansion in employment in the manufacturing sector ceased. In spite of a further increase in employment in the services area, employment

Conditions in the labour market

Item	1983	1984	1985	1986	1985	1986
Item	in thousands, annual average				Change from previous year in thousands	
Employment						
Employed **p**	25,331	25,358	25,534	25,786	+ 176	+ 252
of whom						
Wage and salary earners **p**	22,057	22,092	22,268	22,515	+ 176	+ 247
Short-time workers	675	384	235	197	– 149	– 38
Vacancies	76	88	110	154	+ 22	+ 44
					Unemployment rate in % **3**	
Unemployed	2,258	2,266	2,304	2,228	9.3	9.0
Structure of unemployment						
by Länder labour exchange district						
Schleswig-Holstein/Hamburg	180	189	207	209	11.6	11.7
Lower Saxony/Bremen	353	373	386	366	12.5	11.9
West Berlin	84	82	81	85	10.0	10.5
North Rhine-Westphalia	706	717	733	725	11.0	10.9
Hesse	172	168	165	155	7.2	6.8
Rhineland-Palatinate/Saarland	170	172	178	172	9.7	9.4
Baden-Württemberg	231	217	210	199	5.4	5.1
Northern Bavaria	183	173	166	150	8.7	7.8
Southern Bavaria	179	175	179	166	6.9	6.4
	in thousands, at end-September				Percentage of total	
Unemployed, total	2,134	2,143	2,151	2,046	100	100
by sex						
male	1,145	1,155	1,132	1,040	52,6	50.8
female	989	988	1,019	1,006	47.4	49.2
by vocational qualification						
qualified **1**	895	925	883	821	41.1	40.1
unqualified **2**	1,239	1,218	1,268	1,224	58.9	59.8
by length of time unemployed						
less than 6 months	1,079	1,061	1,039	978	48.3	47.8
6 months to less than 1 year	524	464	446	414	20.7	20.2
1 year and more	532	617	666	654	31.0	32.0
by age						
up to 24 years	623	582	564	503	26.2	24.6
25 to 44 years	961	959	951	919	44.2	44.9
45 to 64 years	549	601	636	624	29.6	30.5

1 Skilled workers and salary earners of equivalent status. — **2** Unskilled workers and salary earners of equivalent status. — **3** Unemployed as % of the dependent labour force, annual average. — **p** As from 1984 provisional.
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growth in the economy as a whole was affected by this. In the first two months of 1987 the seasonally adjusted number of employed increased, even though much less than before; the year-on-year rise in February 1987 was about 240,000.

Growth in part-time employment and more placements by labour exchanges

In line with the growing significance of the services sector the number of part-time employees, for whom the tertiary sector provides jobs on a larger scale than do other sectors of the economy, rose strongly in 1986. Currently about every tenth employee will have a part-time job. The labour exchanges were particularly successful in placements for this type of jobs in 1986. Generally speaking, there was more mobility in the labour market last year. At 1.8 million, almost one-fifth more new vacancies were registered with the labour exchanges than in 1985 and job placements increased accordingly. The seasonally adjusted number of positions vacant was on the rise until the autumn of 1986; at the end of March 1987, at 165,000, it was just over 20,000 up on the year. Moreover, the increase in registered vacancies continued to be larger than a year before, as was the number of job placements.

Fall in unemployment

The strong increase in employment led in the course of 1986 to a fall in unemployment, but not nearly to the extent to which the number of employed went up, because the labour supply rose. On an annual average for 1986 the number of unemployed dropped by about 75,000 to 2.23 million; this was 9.0 % of the dependent and 7.9 % of the total labour force. Labour market policy measures (inter alia, increased further training and retraining) contributed to this fall in unemployment. The seasonally adjusted number of unemployed reached its low point in November 1986, at 2.16 million; after that it went up again slightly. Following a long period of sub-zero temperatures extending well into March 1987, 2.23 million unemployed were registered at the labour exchanges, or 35,000 fewer than a year before. As the annual special survey carried out by the Federal Labour Office every September reveals, the structure of unemployment is still not conducive to a far-reaching improvement of the labour market situation in Germany. While the number of unemployed without any completed vocational training declined in 1986, the share they represented in the total of registered unemployed increased to more than one-half. Unemployed with completed vocational training had much better chances of being found a job, as had younger unemployed. In September 1986 unemployed under 25 were jobless on average for just under six months, while those 45 years of age and older were without work for 19 months. A good tenth of those registered as unemployed, almost exclusively women, were looking only for part-time work. Regional differences did not lose any of their weight and in fact in some cases they intensified. In 1986 employment rose more strongly in the south of Germany[1] than in the north; at the same time, the number of unemployed declined less in the northern Länder — with the exception of Lower Saxony — than in the southern ones. About half of all registered vacancies were carried by labour exchanges in southern Germany, but only 30 % of the unemployed. In certain districts the discrepancy between north and south was even more marked, this largely reflecting differences in the economic and sectoral structure of the regions, i.e. the differences are largely due to causes which cannot be removed using demand management instruments — including those of the monetary policy type.

Halt to inflation inter alia owing to strong fall in import prices

After the rise in prices had slowed down more and more in the preceding years of the upswing, overall prices remained stable in 1986, for the first time for many years. In some areas prices in fact fell. Imported cost relief, generated by the fall in the price of oil, sinking world market prices for numerous other commodities and the appreciation of the Deutsche Mark, contributed directly here. In addition, "home-made" inflation seems to have weakened further, by and large, last year. The drop in import prices reveals the whole extent of the price-restraining influences originating abroad. On an average for 1986 they were 19 % down on 1985, this being largely due to the fall in oil prices. Calculated in Deutsche Mark, crude oil was almost 60 % cheaper in 1986 than in 1985 and petrol and heating oil were 55 % cheaper. In the course of 1986 oil price trends went into reverse, however. After the OPEC decisions of August and December 1986 oil prices went up again. On the other hand, the price for imported natural gas, which follows that of oil with a time-lag, has fallen further in the last few months (over the whole of 1986, by 28 %). Import prices for other internationally-traded commodities have also dropped on account of the decline in the dollar rate. Finally, exchange rate trends depressed prices for imported finished and semi-finished goods, albeit to a much lesser extent.

Fall in export prices partly a consequence of external cost relief

In 1986 German exporters lowered their Deutsche Mark selling prices on foreign markets (by an average of 2 %) so as to counteract worsened sales prospects abroad stemming from the rising value of the Deutsche Mark against other currencies. The considerable cost relief on imported work done at previous

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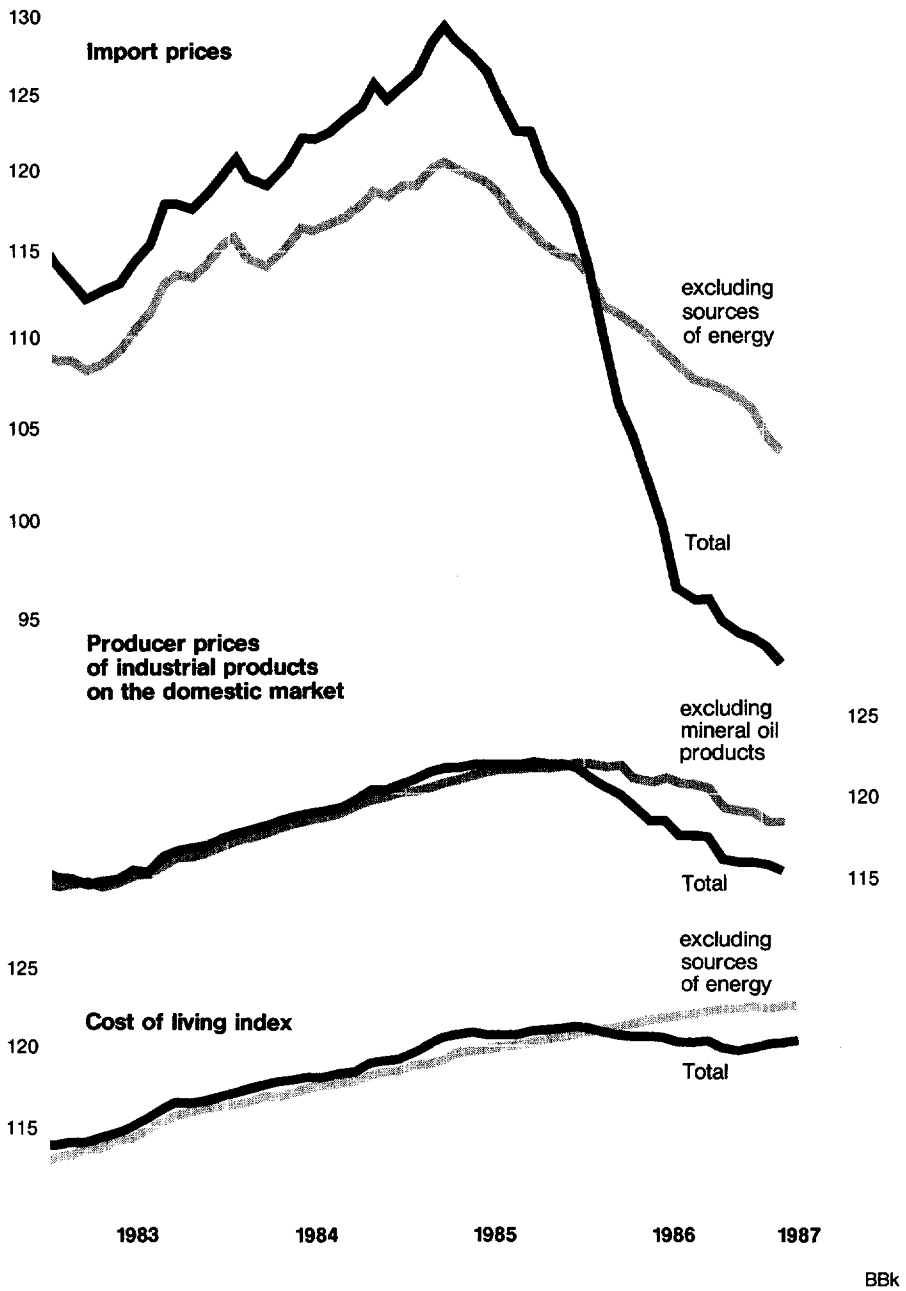
1 Baden-Württemberg, Bavaria and Hesse.

Prices

1980=100, seasonally adjusted, log. scale



stages of production constituted a sizeable counterweight to the loss in earnings associated with the reduction in selling prices, although the relief was anything but uniform in the cost accounting for individual goods. Thus the fall in export prices was particularly marked for products of the basic and producer goods sector. The export prices of capital goods, however, went up further.

Prices in domestic markets under pressure

In domestic markets, too, industrial producer prices in 1986 decreased overall, namely by an annual average of 3%. But price movements here varied fairly strongly, too: finished products for investors and consumers (excluding mineral oil products) continued to become more expensive, but basic goods and primary products (again, excluding mineral oil products) cheapened. Agricultural producer prices fell even more strongly than industrial selling prices in 1986, as a consequence of an ample supply of agricultural products and the restrained price policy of the European Communities. In the construction market, by contrast, prices went up again last year, in fact more than in 1985, at just under 2%. At the consumer stage, the price level in 1986 did not change much; the cost of living index on an annual average was 0.2% down on the year. The sharp decline in energy prices made a strong impact here. Rentals and the prices of industrial goods (excluding energy) did rise further, but less than in 1985. By contrast, services increased in price in 1986 to the same extent as in both preceding years. After the price of oil and, in its wake, the prices of mineral oil products went up strongly towards the end of 1986, price trends at the consumer level have been pointing slightly upwards again recently; however, the prospects for a high degree of price stability in 1987 are good.

2. Large current account surpluses and first countermovements

Record surpluses on current account

The global price and exchange rate shifts which occurred last year not only left perceptible marks on economic activity in the Federal Republic of Germany, but also led at the same time to fundamental changes in the German balance of payments, both in current and capital transactions. The current account surpluses expanded owing to the fall in oil prices and the sharp depreciation of the US dollar, i.e. to this extent as a result of exogenous factors. In 1986 Germany had to spend approximately DM 40 billion on its external energy bill alone, i.e. roughly 50% less than a year previously. It is clear that setbacks of this type cannot be offset in the short term by movements in the opposite direction in the current account of the German balance of payments. A rapid expansion in Germany's current account surplus was inevitable in 1986, and the surplus on current transactions, at DM 76.5 billion, was DM 32 billion up on 1985. The trade surplus alone – on an f.o.b./f.o.b. basis[1] – rose from DM 86 billion to DM 124 billion. Of course, this rise does not reflect a corresponding growth in Germany's structural disequilibrium, but is primarily the result of the naturally disparate rates at which prices and volumes adjust in foreign trade and payments. Whereas the decline in oil prices in the world markets and the exchange rate shifts rapidly worked through to import prices, export and import volumes were appreciably slower to react.

Gradual reduction of the surpluses initiated in the interim

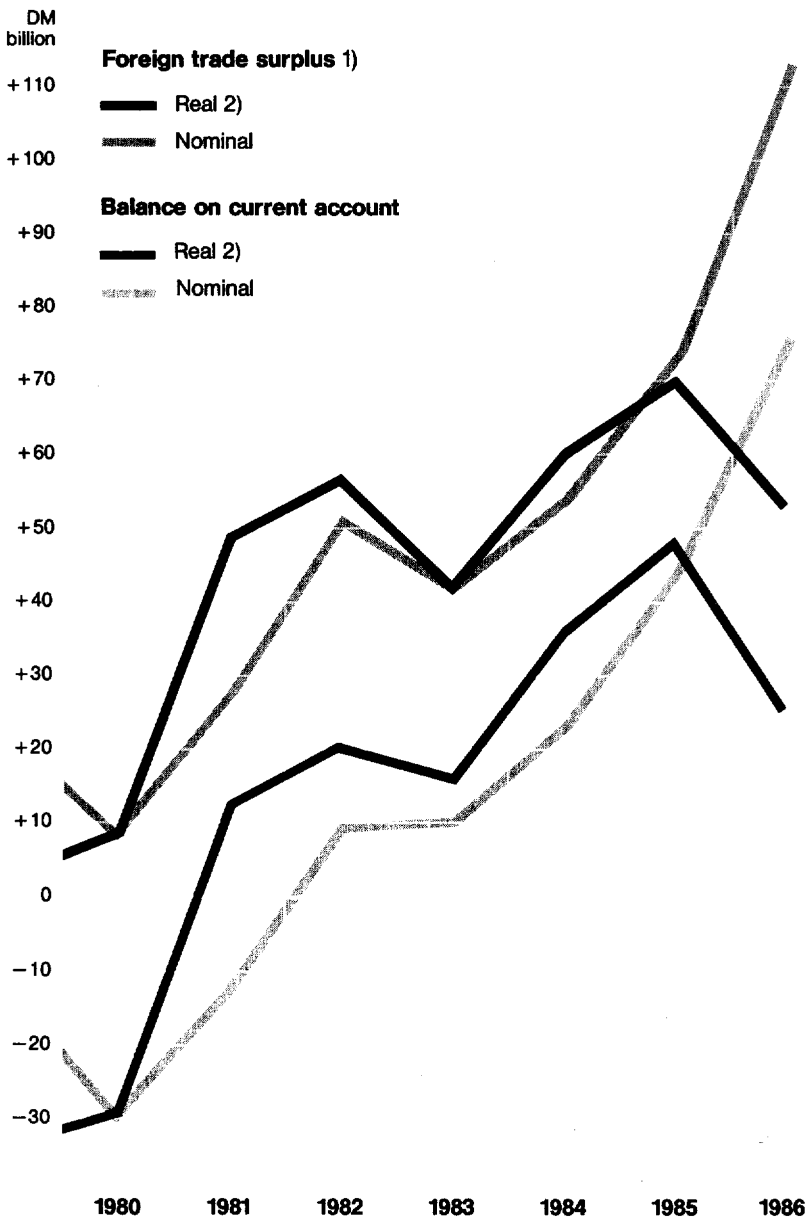
A more detailed analysis shows, moreover, that the requisite countermovement got under way at the beginning of 1986. For example, imports of goods rose unusually sharply in volume – at 6½%, a good 2½ times more than real GNP – while exports of goods increased only a little. The trade surplus, calculated at 1985 prices, decreased by more than DM 20 billion, while it rose by close on DM 40 billion at current prices (as mentioned above). As the gap between import and export prices did not widen towards the end of 1986, the seasonally adjusted trade and current account surpluses have declined in recent months, at both constant and current prices. A steep fall in the surpluses is expected in 1987, too. However, in view of the magnitude of the surpluses it will take some time to achieve normalisation, especially since an abrupt reversal in the exogenous factors, i.e. the trend of oil prices or exchange rates, is not likely in the foreseeable future.

Sharp growth in real imports, particularly of finished products

In 1986 the rapid growth in surpluses not only received a fillip from the import side, because of the decline in import prices; in addition, the first signs of a correction were soon apparent here. The real rise in imports of a good 6% was mainly attributable to the buoyant domestic economy. It was also significant that the competitiveness of goods offered by non-residents, especially of industrially

1 In contrast to the official foreign trade statistics, both exports and imports are recorded here on an f.o.b. basis, i.e. excluding the transport and insurance costs payable on imports, which are included in services transactions in accordance with international balance of payments practice. The current account balance is not affected by this "transfer". On an f.o.b./c.i.f. basis, i.e. including the transport and insurance costs payable on imports, the foreign trade surplus increased from DM 73 billion to DM 113 billion.

Foreign trade and current account



1) On an f.o.b./c.i.f. basis.- 2) At 1980 prices.

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produced finished goods, increased with the appreciation of the Deutsche Mark. Imports of electrical engineering products rose by 7½% in volume, while imports of mechanical engineering products and foreign road vehicles increased by more than 9% and 16½%, respectively. Imports of consumer goods, particularly of textiles and clothing, also showed two-digit growth rates. In 1986 the main beneficiaries here were the developing countries, which, in real terms, supplied just over 9% more to Germany than in the preceding year. However, most other partner countries, too, considerably stepped up their supplies to Germany. Hence Germany had an appreciable expansionary effect on the economies of its partner countries, which is not adequately reflected in the import values. (Volume figures are only available for particular groups of countries, not for individual countries.)

Sluggish exports as a result of shortfalls in demand and increased price competition

The reduction in the current account surplus was, however, initiated on the export side as well. In 1986 the expansion of Germany's export volume lagged behind the growth in real world trade. If real exports nevertheless increased by 1½%, this was not least due to the fact that German exporters lowered their sales prices. These price concessions were, of course, made considerably easier by the cost savings on energy and raw materials. In particular those buying countries which were suffering from an acute lack of foreign exchange on account of the decline in oil prices or their high foreign indebtedness had to cut back on their imports. In 1986 exports to the OPEC countries dropped by almost 30% in value, while exports to the other developing countries and the centrally planned economies diminished by just over 8% and 7%, respectively. German exports held their own comparatively well in the markets of the industrial countries. Admittedly, the appreciation was limited in relation to the major industrial countries in Europe. In real terms (i.e. taking into account the price and cost differentials vis-à-vis these countries), the Deutsche Mark scarcely appreciated at all vis-à-vis the partner currencies in the European Monetary System (EMS) between the spring of 1985 (the peak of the dollar appreciation) and the end of 1986; nor was it valued appreciably higher, in real terms, if Austria, Switzerland and Sweden are included. On the other hand, the appreciation against the United States and Canada came to a real 58%. Exporters responded to this with price concessions and accepted cuts in profits, so that the losses in market shares have up to now remained moderate, even in relation to the United States. As the sluggish inflow of orders from abroad to industry reveals, however, exporting has become more difficult of late. As well as the pressure of competition from the United States, in particular the competition from suppliers from threshold countries in East Asia, which benefited from both the depreciation of the dollar and their specific cost advantages, intensified considerably. To make matters worse, economic activity slackened in a number of major industrial countries. Nevertheless, in spite of the current tendency for exports to stagnate, the comparatively gratifying position of German industry in world markets has not fundamentally been put at risk.

Increasing deficit on services account

The decline in the dollar rate also adversely affected some of the receipts from services transactions. In 1986 they declined by a total of DM 6 billion to DM 139 billion. The Bundesbank's interest income from the investment of its monetary reserves alone fell by DM 2 billion to DM 7 billion; this was due not only to the exchange rate but also to the lower interest rate level in the United States. There was also a reduction in the Deutsche Mark equivalent of the foreign currency exchanged by foreign troops stationed in Germany. In addition, tourists from the United States spent only half as much in Germany as a year earlier. On the other hand, German expenditure on services (including the transport and insurance costs payable on imports of goods) rose slightly, i.e. by DM 2 billion to DM 157 billion. This was primarily ascribable to the fact that German tourists again spent more on foreign travel. The overall deficit on services account almost doubled in 1986 (to DM 18 billion), though it continued to be smaller than between 1979 and 1983, not least because net external assets expanded for a period of five years. The transfer payments account – i.e. unilateral payments to the EEC, transfers to members of families living abroad, etc. – ran a large deficit in 1986, as it had done in the preceding years (DM 28 billion against DM 30 billion in 1985), so that this side continued to form a substantial counterweight to the surplus on foreign trade.

Sizeable long-term capital imports

In the light of past experience, increased outflows of long-term capital would have been likely in view of the rise in Germany's current account surplus last year. However, there were in fact substantial inflows of long-term funds into Germany; on balance, they came to DM 38 billion. Given the interest rate level in Germany, which was low by international standards, the motive of foreign investors must be sought in the expectation that the Deutsche Mark would

Major items of the balance of payments

DM billion

Item	1979	1980	1981	1982	1983	1984	1985	1986
A. Current account								
1. Foreign trade								
Exports (f.o.b.) 1	314.5	350.3	396.9	427.7	432.3	488.2	537.2	526.4
Imports (f.o.b.) 1	282.7	331.4	357.3	365.2	378.5	421.4	451.1	402.9
Balance	+ 31.8	+ 18.9	+ 39.6	+ 62.6	+ 53.8	+ 66.8	+ 86.0	+ 123.5
2. Supplementary trade items 2 and merchanting trade	+ 0.0	– 0.6	+ 0.6	+ 1.5	+ 3.2	– 1.7	– 1.3	– 1.3
Balance of trade	+ 31.8	+ 18.3	+ 40.2	+ 64.1	+ 57.0	+ 65.1	+ 84.7	+ 122.2
3. Services								
Receipts	78.0	89.7	106.9	118.5	120.8	135.3	144.5	138.5
Expenditure	101.3	114.0	134.5	147.2	141.9	146.4	154.8	156.7
Balance	– 23.3	– 24.2	– 27.6	– 28.7	– 21.1	– 11.1	– 10.3	– 18.1
4. Transfer payments	– 19.6	– 22.6	– 24.3	– 25.5	– 25.3	– 30.1	– 29.8	– 27.6
of which								
Remittances of foreign workers	– 7.0	– 7.5	– 7.7	– 7.7	– 7.7	– 8.4	– 7.6	– 7.0
Net transfers to the European Communities	– 4.0	– 4.4	– 6.5	– 7.5	– 6.1	– 7.5	– 8.2	– 7.9
Balance on current account	– 11.0	– 28.5	– 11.7	+ 9.9	+ 10.6	+ 23.9	+ 44.6	+ 76.5
B. Capital account								
1. Long-term capital transactions								
(a) German investment abroad (increase: –)	– 20.3	– 28.4	– 27.4	– 29.1	– 36.5	– 45.1	– 61.9	– 49.8
Direct investment	– 8.2	– 7.6	– 9.3	– 6.8	– 8.1	– 12.5	– 14.3	– 16.2
Foreign securities	– 3.0	– 7.7	– 6.0	– 11.4	– 10.4	– 15.7	– 31.5	– 21.5
Advances and loans to non-residents	– 7.8	– 11.1	– 9.6	– 8.7	– 14.7	– 14.3	– 13.1	– 9.3
Other investment abroad	– 1.3	– 2.0	– 2.5	– 2.3	– 3.3	– 2.6	– 3.0	– 2.9
(b) Foreign investment in Germany (increase: +)	+ 32.5	+ 33.9	+ 35.3	+ 14.2	+ 29.5	+ 25.2	+ 51.9	+ 87.7
Direct investment	+ 3.2	+ 0.8	+ 0.8	+ 2.0	+ 4.6	+ 2.1	+ 2.2	+ 2.9
Domestic securities and official domestic borrowers' notes	+ 6.2	+ 23.4	+ 23.3	+ 12.2	+ 25.5	+ 21.7	+ 40.1	+ 68.6
Securities	+ 5.9	+ 0.9	+ 1.0	+ 2.8	+ 13.6	+ 17.4	+ 42.1	+ 73.7
Borrowers' notes	+ 0.3	+ 22.6	+ 22.3	+ 9.4	+ 11.9	+ 4.3	– 2.0	– 5.1
Advances and loans to residents 3	+ 23.2	+ 9.9	+ 11.2	+ 0.1	– 0.4	+ 1.4	+ 9.8	+ 16.2
Other investment in Germany	– 0.0	– 0.2	– 0.0	– 0.1	– 0.2	– 0.0	– 0.1	– 0.1
Balance of long-term capital transactions	+ 12.2	+ 5.5	+ 7.9	– 14.9	– 7.0	– 19.8	– 10.0	+ 37.9
2. Short-term capital transactions (net capital exports: –)								
(a) Banks	+ 4.1	– 8.9	– 10.3	+ 8.1	+ 1.8	+ 0.1	– 27.7	– 58.8
Assets	– 1.7	– 7.1	– 11.2	+ 4.3	+ 5.3	– 17.8	– 33.4	– 65.8
Liabilities	+ 5.8	– 1.8	+ 0.9	+ 3.8	– 3.6	+ 17.8	+ 5.7	+ 7.0
(b) Enterprises and individuals	– 6.7	+ 5.5	+ 6.1	+ 1.7	– 7.3	– 15.5	– 13.3	– 42.8
Financial relations with foreign banks	– 3.1	+ 9.8	+ 10.2	+ 5.7	– 0.3	– 1.7	– 8.7	– 36.2
Financial relations with foreign non-banks	– 2.0	+ 1.4	+ 0.7	– 2.0	– 0.6	– 4.0	– 1.0	– 1.3
Trade credits	– 1.7	– 5.7	– 4.8	– 2.1	– 6.5	– 9.7	– 3.7	– 5.2
(c) Official	– 0.3	– 0.4	+ 2.8	+ 0.7	– 3.3	– 1.8	+ 0.1	– 1.2
Balance of short-term capital transactions	– 2.9	– 3.7	– 1.4	+ 10.5	– 8.8	– 17.2	– 40.9	– 102.8
Balance on capital account	+ 9.3	+ 1.8	+ 6.5	– 4.4	– 15.8	– 37.0	– 50.9	– 64.9
C. Balance of unclassifiable transactions (balancing item)	– 3.2	– 1.2	+ 3.0	– 2.4	+ 1.1	+ 10.0	+ 8.1	– 5.6
D. Balancing item for the external position of the Bundesbank 4	– 2.3	+ 2.2	+ 3.6	– 0.4	+ 2.4	+ 2.1	– 3.1	– 3.2
E. Change in the net external assets of the Bundesbank (increase: +) (A plus B plus C plus D)	– 7.3	– 25.7	+ 1.3	+ 2.7	– 1.6	– 1.0	– 1.3	+ 2.8

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

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appreciate. Compared with dollar investments the exchange rate gains on Deutsche Mark investments for foreign investors were, from the present perspective, indeed greater than the interest rate disadvantage. Moreover, expectations, which were predominantly geared to a further reduction in interest rates in Germany (and thus to price gains in the bond market), would appear to have prompted "arbitrage transactions" in which short-term Euro-DM were taken up and invested in Deutsche Mark bonds. Both factors, the exchange rate and the interest rate expectations alike, shared the same real background, namely the internationally outstanding stability of the internal purchasing power of the Deutsche Mark, the large surplus on current account and the complete freedom of cross-border capital transactions which exists in the German financial market. However, these long-term capital movements did not contribute to squaring the current account surplus. The large inflow of long-term capital was focused on Deutsche Mark bonds of German issuers, of which non-residents purchased on balance almost DM 60 billion (though it is, of course, debatable to what extent non-resident purchasers are really striving for a long-term commitment and to what extent "speculative" considerations and thus short-term purchases were uppermost). In addition to the inflows through the bond market there were also increased foreign purchases of domestic shares (excluding participations), which, at DM 15 billion net, attained a volume which was very considerable for the German share market.

Decline in long-term capital outflows ...

While overall imports of long-term capital in 1986, at DM 88 billion, were two-thirds up on 1985, exports of long-term capital from Germany last year, at DM 50 billion, were appreciably lower than in the preceding year (DM 62 billion). German enterprises again invested a record amount (DM 16 billion) in foreign subsidiaries and operating plants, almost half of this total being accounted for by direct investment in the United States, but the conspicuous exchange rate risks caused residents to show restraint, particularly with respect to purchases of foreign currency bonds. In addition, the banks reduced their external lending, not least because the risks entailed by claims on a number of already heavily-indebted countries were still regarded as being high. Since, on balance, long-term capital transactions did not offset the current account surplus but further increased the inflows of funds from abroad, Germany ran a record surplus of about DM 115 billion in its "basic balance" in 1986. Relative to this, the rise in the net external assets of the Bundesbank, at DM 6 billion (at transaction values), remained insignificant.[1]

... but large exports of short-term funds

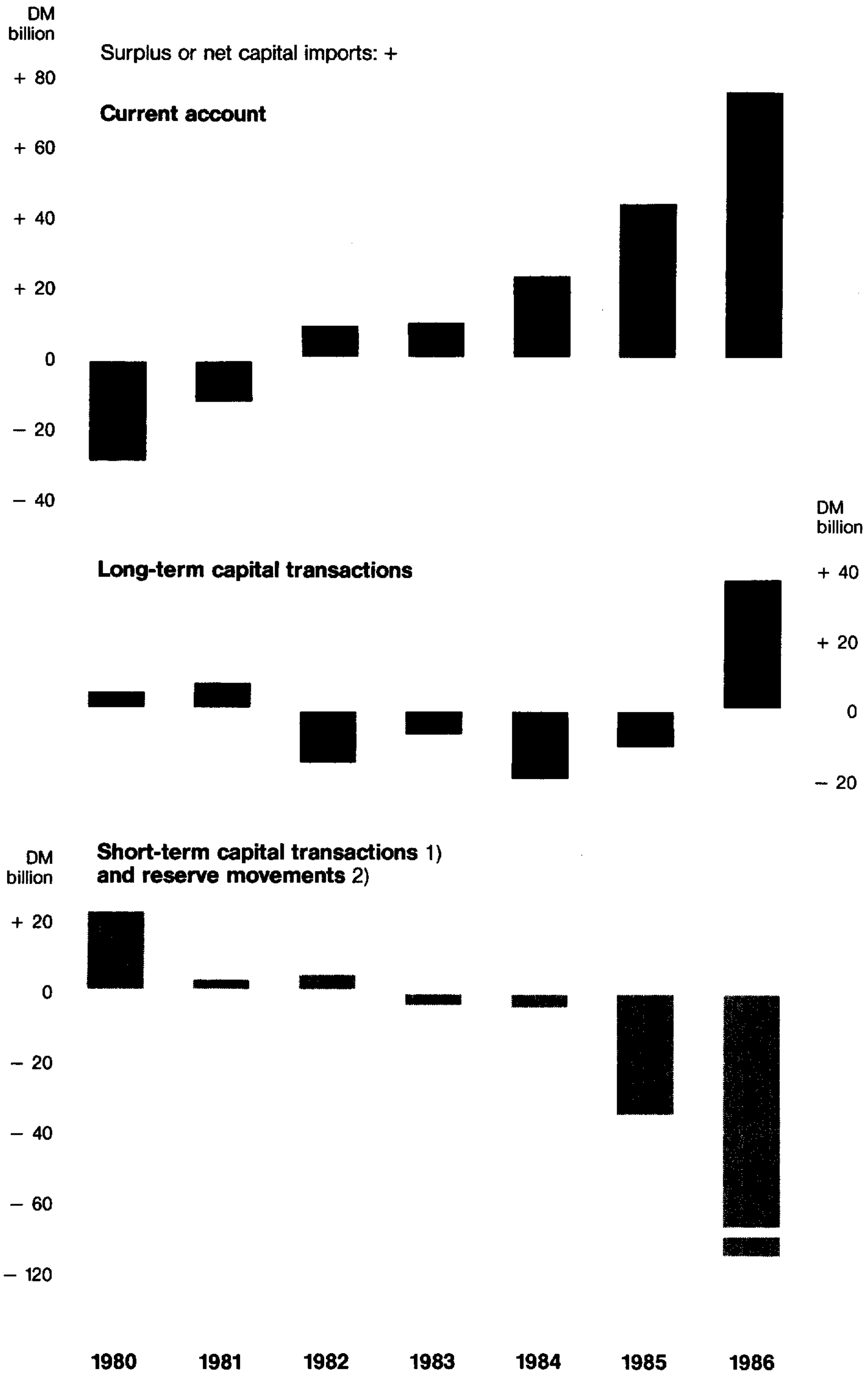
The surplus on the basic balance was predominantly reflected in an increase in the short-term claims of German banks and non-banks on non-residents. The short-term net asset position of domestic banks vis-à-vis foreign banks (including the foreign establishments of German banks) alone went up by DM 55 billion and thus almost tripled in the course of last year. At the same time, German non-banks, primarily business enterprises, increased the liquid funds they held outside Germany by DM 25 billion. Furthermore, in view of their very good liquidity position, enterprises exported short-term funds totalling DM 11 billion through repayments of Euro-loans to foreign banks.

Short-term capital exports create some problems for monetary policy

This unusually large outflow of short-term funds — mainly to the Euro-market — was equivalent to the Deutsche Mark requirements for financing other countries' current account deficits vis-à-vis Germany and the "longer-term" investments of non-residents in Germany. This is, of course, not merely a problem-free outflow

1 The aforementioned growth in the net external assets was concentrated in the second half of the year after the monetary reserves had initially declined sharply following the realignment in the European Monetary System (with effect from April 7, 1986). At end-1986 the Bundesbank's monetary reserves, valued at balance sheet rates, at DM 91.6 billion, again virtually reached the record level of the end of 1979. However, the reserve assets were accompanied by a sharp increase in external liabilities to the amount of DM 23.6 billion, so that the net monetary reserves came to DM 68.0 billion. Moreover, at end-1986 the Bundesbank held DM 2.4 billion worth of less liquid external loans and other external assets.

Main payments balances



1) Including the balancing item of the balance of payments.- 2) Change in the net external assets of the Bundesbank resulting from transactions; increase: –.

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"squaring" the balance of payments. As is explained in more detail on page 38, the short-term funds flowing out from the non-bank sector were reflected to a considerable extent in balances of German non-banks at banks abroad (mainly in Deutsche Mark). These cash holdings outside Germany — primarily at foreign establishments of German banks in Luxembourg and London — should be seen in economic terms as part of the domestic money stock, even though this is not recorded in the traditional monetary aggregates, just as the demarcation between Germany and other countries is formally correct and necessary at a time when the international links between banks are becoming increasingly closer, but does not do full justice to the actual economic conditions.

3. New emphases in public finance

After the first tax cuts, new rise in the central, regional and local authorities' deficit, contrary to expectations

The government's financial policy entered a new phase last year: the first stage of the income tax cuts approved in 1985 marked the beginning of the reduction in the tax and levy burden which is to be continued in a second stage entering into effect in 1988. The precondition for this reduction was that the central, regional and local authorities' budget deficits were lowered substantially from 1982 onwards by pursuing a policy of deliberately restrained expenditure increases. To gain the financial scope for tax cuts, the rise in government spending had to be strictly limited in 1986 as well. This requirement, to which the Financial Planning Council (on which the Federal and Länder Governments and the central associations of the local authorities are represented and in whose deliberations the Bundesbank regularly participates) repeatedly drew attention, was in fact largely taken into account when planning the budgets for 1986. Ultimately, however, overall expenditure by the central, regional and local authorities rose more sharply in 1986 than intended. In view of the economic situation last year, when it was necessary to strengthen domestic demand in order to offset the retarding external influences described above, this was no doubt justifiable. But it was no help in achieving the longer-term objective of lowering the government spending ratio (see below) and creating more scope for private income and demand. In 1986 not only did expenditure go up more steeply, but tax revenue grew less than estimated as well, so initial expectations that the first stage of the tax cuts could be managed without a new increase in the deficits were not fulfilled. Instead, the deficit of the central, regional and local authorities climbed again last year, for the first time since 1981; it amounted to DM 42.5 billion compared with DM 39.5 billion in 1985.

Better results by the social security funds

In the social security sector, by contrast, the surpluses grew in 1986, mainly as a result of measures to consolidate the pension insurance funds' finances. Hence the deficit of all public authorities (i.e. central, regional and local authorities and social security funds combined) in 1986, at DM 36 billion, was some DM 1 billion lower than in 1985; it amounted to 1.8 % of GNP. However, the implications of the higher deficits for the central, regional and local authorities are not neutralised by the social security funds' better results: the renewed deterioration in the budget situation of the central, regional and local authorities tends to limit the freedom of action of financial policy in the future, while the surpluses of the social security funds do not provide any additional room for manœuvre because in 1986 they were used for the necessary replenishment of the cash reserves, which had fallen too far.

More rapid rise in public sector expenditure

The expenditure of the public sector (including the social security funds) rose by 4 % in 1986; this was almost 1 percentage point more than in 1985. As in the preceding three years, it thus grew less than nominal GNP, and the government spending ratio – i.e. public expenditure as a percentage of GNP – declined further by ½ percentage point last year, to 48½ %; in 1982 it had amounted to 52 %.[1] With an overall spending increase of 4¼ %, however, the central, regional and local authorities substantially overshot the limit of 3 % which the Financial Planning Council had recommended for the annual growth in expenditure. The Länder Governments' spending rose in 1986 by nearly 4½ %, and that of the local authorities by as much as 5½ %; on top of this, there was a sharp

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

Finances of the public authorities*

Item	1983	1984	1985 **pe**	1986 **pe**	1983	1984	1985 **pe**	1986 **pe**
	DM billion				Change from previous year in %			
A. Budgetary trend								
Central, regional and local authorities								
Expenditure								
Personnel expenditure	183.9	186.7	193.6	202.5	+ 2.8	+ 1.6	+ 3.7	+ 4.5
Other operating expenditure	89.0	93.2	97.4	101	+ 4.1	+ 4.8	+ 4.5	+ 3.5
Transfers **1**	158.2	160.8	165.8	172.5	− 1.5	+ 1.7	+ 3.1	+ 4
Interest	51.4	53.6	56.0	58	+13.8	+ 4.2	+ 4.5	+ 3.5
Fixed capital expenditure	50.4	49.4	51.6	55.5	− 7.1	− 2.0	+ 4.5	+ 7.5
Financial aid **2**	37.7	41.0	39.8	40.5	− 2.1	+ 8.6	− 3.0	+ 2
Total expenditure **3**	570.5	584.9	604.1	630	+ 1.4	+ 2.5	+ 3.3	+ 4.5
of which								
Federal Government	248.7	253.9	259.4	263	+ 0.9	+ 2.1	+ 2.2	+ 1.5
Länder Governments	228.3	234.3	243.9	254.5	+ 1.8	+ 2.6	+ 4.1	+ 4.5
Local authorities	151.7	154.7	163.4	172.5	− 0.9	+ 2.0	+ 5.6	+ 5.5
Receipts								
Tax revenue	396.6	414.7	437.2	452.5	+ 4.7	+ 4.6	+ 5.4	+ 3.5
Other receipts	119.8	124.7	129.7	134.5	+ 3.8	+ 4.1	+ 4.0	+ 4
Total receipts **3**	515.2	538.5	564.4	587.5	+ 4.5	+ 4.5	+ 4.8	+ 4
of which								
Federal Government	216.8	225.2	236.7	240	+ 3.8	+ 3.9	+ 5.1	+ 1.5
Länder Governments	206.9	216.1	226.8	237	+ 3.6	+ 4.4	+ 5.0	+ 4.5
Local authorities	150.3	155.8	163.7	170.5	+ 3.1	+ 3.7	+ 5.1	+ 4
Surplus (+) or deficit (−)	− 55.3	− 46.3	− 39.7	− 42.5	.	.	.	.
of which								
Federal Government	− 31.9	− 28.6	− 22.8	− 23.5	.	.	.	.
Länder Governments	− 21.4	− 18.2	− 17.1	− 17.5	.	.	.	.
Local authorities	− 1.3	+ 1.1	+ 0.3	− 2	.	.	.	.
Social security funds								
Expenditure	316.9	331.1	341.1	354	+ 2.1	+ 4.5	+ 3.0	+ 3.5
Receipts	315.7	328.2	343.6	360.5	+ 0.2	+ 4.0	+ 4.7	+ 5
Surplus (+) or deficit (−)	− 1.2	− 2.8	+ 2.4	+ 6.5	.	.	.	.
Public authorities, total								
Expenditure	848.4	877.3	905.1	942.5	+ 2.4	+ 3.4	+ 3.2	+ 4
Receipts	791.9	828.1	867.8	906.5	+ 3.7	+ 4.6	+ 4.8	+ 4.5
Deficit (−)	− 56.4	− 49.2	− 37.3	− 36	.	.	.	.
	Level at end of year in DM billion				Change from previous year in DM billion			
B. Indebtedness of the central, regional and local authorities								
Borrowers' note loans	474.5	490.0	497.7	487	+25.1	+15.5	+ 7.7	−10.5
Securities	175.7	205.1	243.4	293	+33.3	+29.4	+38.3	+49.5
Other debt	21.5	22.4	19.1	21.5	− 1.5	+ 0.9	− 3.3	+ 2.5
Total indebtedness	671.7	717.5	760.2	802	+56.9	+45.8	+42.7	+41.5
of which								
Federal Government	341.4	367.3	392.4	415.5	+32.4	+25.9	+25.1	+23
Länder Governments	212.0	230.6	247.4	264	+21.4	+18.5	+16.9	+16.5
Local authorities	104.1	104.8	105.6	108	+ 2.3	+ 0.7	+ 0.8	+ 2.5

* 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 participations. — **3** This aggregate — unlike the figures below for the Federal and Länder Governments and local authorities — does not include transfers between the various levels of government (apart from differences in clearing transactions). — **pe** Partly estimated. Discrepancies in the totals are due to rounding.

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expansion in expenditure for the purposes of the European Communities. The Federal Government, on the other hand, again exercised marked restraint, with an increase of just over 1½% in expenditure.

Sharper expansion of the central, regional and local authorities' current expenditure

Of the central, regional and local authorities' current expenditure, which is mostly on consumption, both personnel spending and current transfers to the private sector grew more sharply in 1986 than a year previously. Personnel expenditure increased by 4½% in 1986. The main reason for this was the pay settlement in the public service, which led to income increases averaging about 4% last year. In addition, the recruitment of extra staff apparently continued, especially at local authority level. The social expenditure of the central, regional and local authorities also grew rather sharply (by 5%). Heavier spending in this context was necessitated, firstly, by the increase in housing allowances and the introduction of a baby allowance. Secondly, expenditure on social assistance, most of which is effected by the local authorities, went up considerably, mainly because of the rise in the number of those unemployed or seeking asylum and the relatively steep increase in basic rates in the middle of 1985. Current transfers by the government to the enterprise sector were also distinctly higher last year than in 1985. In addition to the sharp upturn in expenditure on the coking coal allowance, which rises as the US dollar depreciates, it was mainly supplementary benefits paid to farmers that were an important factor here. Other operating expenditure, by contrast, grew slightly less than in 1985, i.e. by 3½%; a pent-up demand for measures to maintain buildings was partly offset by sharp falls in the cost of mineral oil products. For the rest, the virtual stagnation of price rises had hardly any effect on public sector spending because important expenditure categories (personnel and social spending) are geared primarily to the general increase in nominal income; in real terms, wage and salary payments and current transfers by the government therefore went up considerably in 1986. Interest expenditure no longer grew as sharply as before; nevertheless, as new borrowing by the government was substantial again, 3½% more than in 1985 had to be spent on this despite the decline in interest rates.

Upturn in capital formation by the public sector

The central, regional and local authorities' expenditure on capital formation increased sharply in 1986. Their capital spending was 7½%[1] higher than in 1985, when this expenditure item had started to rise again after several years of decline. It was above all the local authorities which invested larger sums again (after many of them had consolidated their finances), a further stimulus being provided by the Federal and Länder Governments increasing the funds available for urban renewal. The shifts observable in the past few years in the pattern of capital spending appear to have persisted: for instance, public sector investment in environmental protection schemes seems to have risen at an above-average rate, while spending on school buildings grew only a little.

Diverging expenditure trends among the social security funds

The social security sector's expenditure did not increase as sharply as that of the central, regional and local authorities; in 1986 it was 3½% up on the year. Spending by the statutory pension insurance funds rose by 2%. A moderating influence here was the fact that pensioners had to assume a greater share of the cost of their health insurance in the form of a contribution they had to pay themselves. Expenditure by the Federal Labour Office, by contrast, increased markedly (+ 7%), because much higher sums than in 1985 had to be spent on vocational assistance and job creation measures. The situation of the statutory health insurance institutions remains critical because they did not succeed in curbing the cost increases caused primarily by expenditure on in-patient treatment and medicaments and spending on therapeutical treatment and aids; the health insurance institutions' expenditure grew by 5% last year and thus roughly as much as in 1985.

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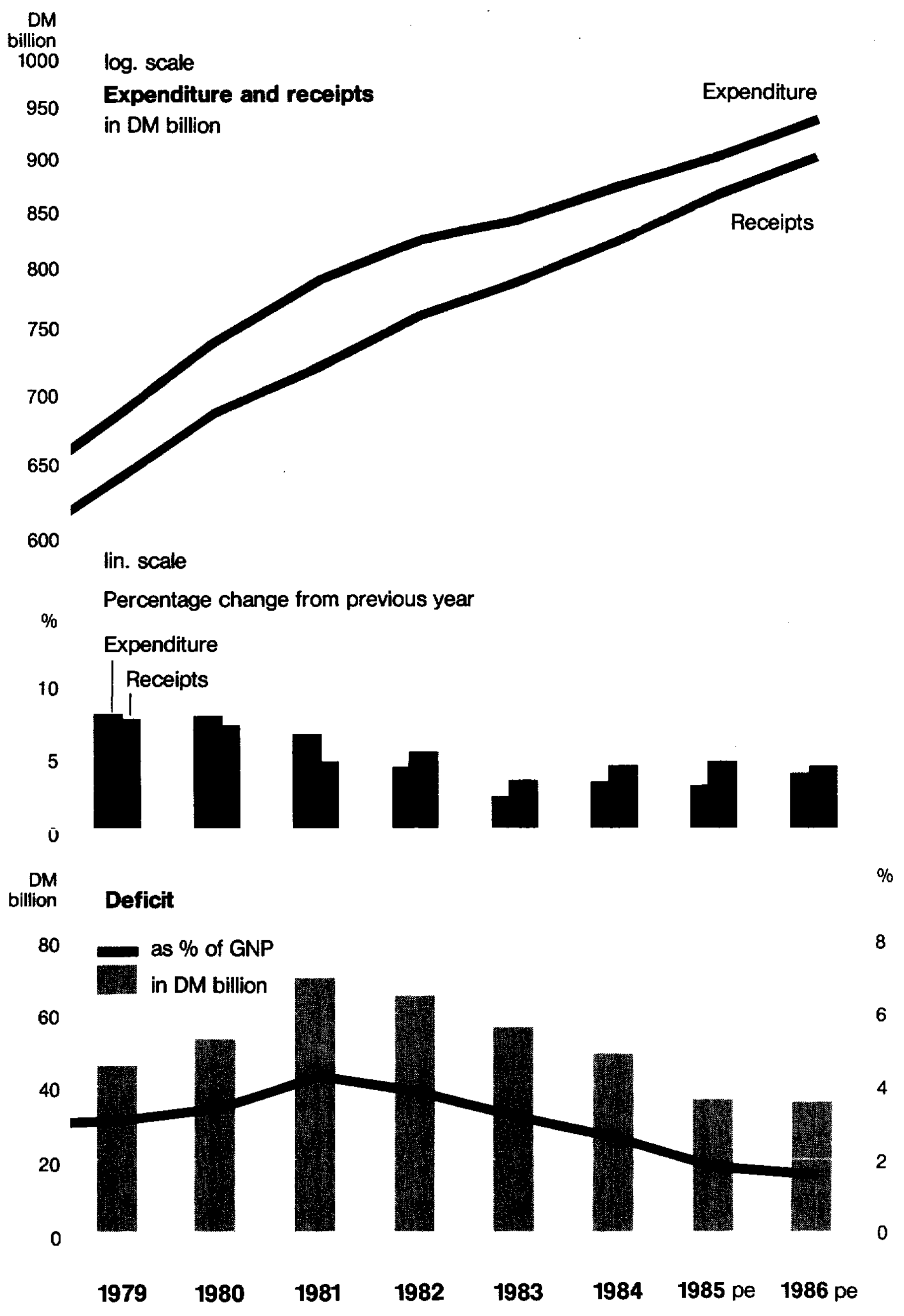
1 Budget expenditure on public sector capital projects thus went up somewhat less than the production figures as given in the national accounts (see p. 6).

Finances of the public authorities*



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

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Weaker growth of tax revenue owing to tax cuts and lower import prices

The total receipts of the central, regional and local authorities in 1986 were only 4% higher than a year previously, including a rise of 3½% in tax revenue; in 1985, by contrast, they had grown by 5% and 5½%, respectively. This was mainly because of the entry into force, at the beginning of 1986, of the first stage of the income tax cuts, which lowered receipts by approximately DM 10 billion (over 2% of tax revenue), although the fall in import prices likewise curbed the growth of tax income. All in all, tax receipts, at DM 452.5 billion, fell almost DM 5 billion short of the official estimate of November 1985, on which the budgets for last year were largely based. In 1986 the tax yield thus rose 2 percentage points less than nominal GNP, so that the overall tax ratio diminished from 23.7% in 1985 to 23.2%. This was the lowest level recorded since the beginning of the seventies.

Turnover tax and corporation tax revenue lower than expected

Turnover tax revenue was sluggish in 1986 although it depends chiefly on private consumption, which climbed strongly in real terms. The insignificant increase in turnover tax revenue of just over 1 % owed much to the fact that the value of imports (which are subject to turnover tax on imports) was far lower in 1986 than it had been in 1985 (− 8 %) as a result of the fall in petroleum prices and the decline in the US dollar, while the value of exports (on which the value-added tax charged in advance must be refunded) decreased only a little. Moreover, investment in housing construction, which is subject to value-added tax, was smaller again in 1986. Receipts from corporation tax, which had grown by approximately one-fifth in 1985, also fell far short of expectations. The sharp decline in the final tax payments for earlier years had not been foreseen. In addition, some enterprises seem to have obtained a reduction of their advance payments in the course of last year by drawing attention to their lower profits from export business.

More favourable results for assessed income tax and wage tax

The assessed income tax yield, by contrast, grew relatively vigorously (+ 4½ %) in 1986 despite the tax cuts. The receipts from this tax were augmented by the rise in self-employed persons' income. Moreover, one-off additional receipts flowed in owing to the sale of a major industrial concern, and finally, as in the case of corporation tax, receipts were lowered noticeably less than in 1985 by the disbursement of the investment grant approved in 1982, which was paid on a temporary basis for additional capital projects. On the other hand, the refunds to employees liable to assessment, which are to the debit of assessed income tax, again went up considerably, and this slowed down the growth of revenue. (As long ago as 1983 roughly one-half of those liable to wage tax were assessed for income tax.) The revenue from wage tax, which is deducted at source from wages, salaries and civil servants' pensions, and is the tax bringing the highest yield, reflected the relief (mainly the raising of the basic tax allowance and the children's allowance) far more sharply than the receipts from assessed income tax, the more so since in the latter case some of the relief only takes effect later, i.e. at the time of the assessment. Nevertheless, the revenue from this tax deducted at source grew by 3 % as a result of the rises in wages and salaries and in the number of employees.

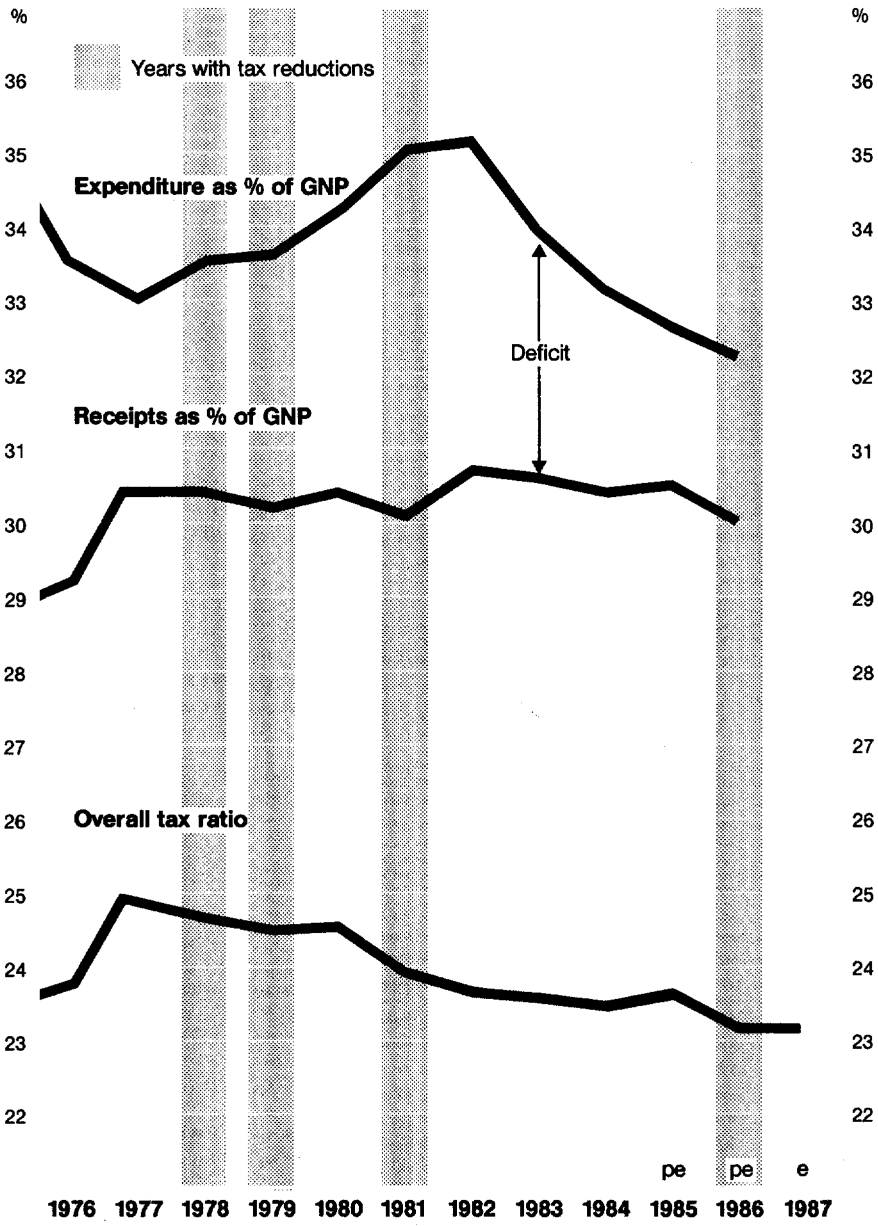
Further rise in the burden of social security contributions

In 1986 the total burden imposed on income by government levies declined less, however, than would have been possible as a result of the tax cuts alone, because the burden of social security contributions relative to wages and salaries went up further. The contribution rate for pension, health and unemployment insurance taken together, at 35.4 %, was again higher (by almost ½ percentage point) than in the preceding year. The main reason was the cost-induced increase in contributions to the statutory health insurance institutions. The raising of the pension insurance contribution, limited until the end of 1986, by contrast, was largely offset by the lowering of the contribution rate for unemployment insurance. Yet the problem of stabilising the contribution rates has been solved neither for statutory health insurance nor, over the longer term, for pension insurance. Some of the efforts to reduce the burden of government levies on wage and salary income will be frustrated if the rise in contribution rates, which is already the decisive factor in the growth of the relative burden, cannot be stopped by stabilising the outflow of social security benefits.

Additional tax cuts in 1988 and more extensive tax reform in 1990

The course of public finance in the next few years was mapped out on the receipts side in earlier years, and further tax cuts are outlined in the programme of the new Federal Government which took office on March 12, 1987. Pursuant to the Act approved in 1985, the second stage of the income tax cuts will go into force at the start of 1988, with a volume of DM 8.5 billion. The Federal Cabinet decided at the beginning of April that this tax relief will be supplemented by a further rise in the basic tax allowance, a flattening of the progressive tax scale

Expenditure and receipts of the central, regional and local authorities



pe Partly estimated.- e Estimated.

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and specific measures favouring families and small and medium-sized enterprises totalling just over DM 5 billion. Even greater weight will be attached to the measures envisaged for 1990, if the tax reform, as planned by the Federal Cabinet, has fully come into force by then. These measures propose raising the basic allowance for income tax further and lowering the tax threshold from 22 % to 19 %. They also envisage narrowing the lower proportional zone of the tax scale, having the marginal tax rate rise evenly in the progressive zone, and reducing the top marginal rates – which, however, will apply in future from a lower level of income onwards – from 56 % to 53 %. In addition, the corporation tax rate for retained earnings is to be lowered from 56 % to 50 %. Together with a number of other measures, these plans (including the above-mentioned tax reductions of just over DM 5 billion envisaged for 1988) will cause tax shortfalls of DM 44 billion in 1990. Some of these are to be offset by other financial policy measures, though this still requires more precise definition; on balance, the tax burden is expected to be eased by DM 25 billion.

Record of economic policy measures

I. Domestic and external monetary policy

1986 March 6	With effect from March 7 the discount rate is lowered from 4% to 3½%. By taking this decision the Bundesbank pays due regard to the tendency towards relaxation in the German financial markets. At the same time the Bundesbank decides to reduce the banks' rediscount quotas by DM 5 billion with effect from May 1. This will offset the greater part of the release of liquidity resulting from the changes in the reserve ratios and in the Bundesbank's "Minimum Reserves Order" already approved with effect from that date.
April 6	The central rates in the European Monetary System (EMS) are realigned. The Deutsche Mark and the Dutch guilder are revalued by 3%, the Belgian franc, the Luxembourg franc and the Danish krone are revalued by 1%, and the French franc is devalued by 3%.
April 10	The Bundesbank approves the annual accounts for 1985; DM 12.7 billion of its net profit is to be transferred to the Federal Government. It has been agreed with the Federal Minister of Finance that the profit is again to be transferred in instalments, with the first immediately payable instalment being raised to DM 8 billion – compared with DM 5 billion in the two preceding years – in the light of the drains of liquidity in the wake of the EMS realignment. Two further instalments of DM 2.3 billion each will be disbursed at the end of May and the end of June.
May 1	The revision of the minimum reserve regulations enters into force. The object of the revision is, in particular, to alter the pattern of reserve ratios and to authorise the issue of bonds denominated in Deutsche Mark which have the characteristics of certificates of deposit. At the same time bank bonds with maturities of less than two years are made subject to minimum reserve requirements. The change in the minimum reserve regulations reduces the banks' required reserves by DM 7.5 billion.
July 3	Following its regular review of the monetary target, the Bundesbank decides to retain the target range of 3½% to 5½% envisaged for the growth of the central bank money stock in 1986 (from the fourth quarter of 1985 to the fourth quarter of 1986).
August 2	In the EMS the Irish pound is devalued by 8% against all the other currencies participating in the exchange rate mechanism.
December 18	The Bundesbank announces its monetary target for 1987. The envisaged 3% to 6% expansion of the central bank money stock (between the fourth quarter of 1986 and the fourth quarter of 1987) is gauged in such a way as to permit strong economic expansion consistent with the longer-term productive capacity of the economy while maintaining virtually stable prices. The monetary target is derived on the basis of an average annual growth in overall production potential of about 2½% at constant prices and 4½% at current prices.
1987 January 12	In the 11th exchange rate realignment within the EMS the Deutsche Mark and the Dutch guilder are revalued by 3% and the Belgian and Luxembourg francs are revalued by 2%.
January 22	The Bundesbank decides to lower the rediscount quotas granted to banks (including a number of minor special credit lines) by DM 8 billion in February and to raise the minimum reserve ratios across the board by 10%. These measures will in effect siphon off DM 12 billion from the banking system and thus neutralise part of the very large influx of foreign exchange registered ahead of the EMS realignment of January 12. This will enable the Bundesbank to use securities repurchase agreements once again as a major instrument for controlling the money market and thus to make clear its interest rate policy stance in the markets. By lowering the discount and lombard rates by ½ percentage point each to 3% and 5% respectively (with effect from January 23) at the same time, the Bundesbank takes account of the changed domestic and external economic outlook after the turn of the year. Moreover, the Treasury bill selling rate is reduced from 4% to 3½% and the Bundesbank announces its intention of adjusting the interest rate level in the money market downwards in line with the cut in the discount and lombard rates.

II. Economic and financial policy

1986 January 1	Numerous tax, family and social policy measures come into force, notably: – the first stage of the Tax Reduction Act, including the raising of the basic tax allowance, the children's allowance and education allowances and, as a first step, the lowering of the tax scale in the progressive zone; – the reduction, for 1986, of the contribution rate to the Federal Labour Office by 0.1 percentage point to 4.0%, and the lengthening of the period of entitlement to unemployment benefit for elderly jobless persons; – the raising of the housing allowance; – the introduction of a baby allowance.

January 30	In its 1986 Annual Economic Report the Federal Cabinet points out that the economic upswing gained perceptible momentum in 1985, and that the German economy therefore came significantly closer to the attainment of the objectives of the Economic Stability and Growth Act. For 1986 the Federal Cabinet expects an average annual growth of approximately 3% in real GNP and an increase of about 300,000 in the number of employed persons. On an annual average, a distinct reduction in the unemployment rate (to some 7½% of the total labour force) and a slowdown in the pace of consumer price rises to between 1½% and 2% are likely.
March 21	The Bundestag approves the Act to Reorganise the Tax Promotion of Owner-Occupied Dwellings, which comes into force on January 1, 1987. Taxation of the rental value of a dwelling occupied by the owner is discontinued. As from 1987 the acquisition of housing is to be promoted via a deduction from income tax under the heading "special expenses" (a maximum of DM 15,000 annually for eight years) and via what is known as "children's allowances for house-owners", to be deducted from the tax liability (DM 600 per year, beginning with the first child).
May 13	The Federal Cabinet approves the payment of grants towards the cost of lower-income farmers' social security contributions and payments by the Federal Government to offset losses caused by the Chernobyl reactor disaster.
June 18	The Federal Minister of Finance, in view of unavoidable additional expenditure, orders budget freezes. 2% of non-personnel administrative expenditure and 8% of current transfers and grants (not subject to statutory or international commitments) are blocked.
July 1	The Federal Cabinet approves the draft Federal budget for 1987 and the financial plan for the period from 1986 to 1990. The budget volume in 1987 amounts to DM 271 billion (2.9% more than the estimate for 1986) and the deficit to just over DM 24.5 billion. In the medium term expenditure is to grow by almost 3% a year. Primarily on account of the second stage of the tax reduction approved for 1988, the Federal Government's deficits will remain high until 1989; they will not decline (to DM 22.5 billion) until 1990.
October 23	The Bundestag approves the Act to Improve the Underlying Conditions for Institutional Investors and the Act on Risk Capital Investment Companies. These two acts pave the way for the smoother provision of equity capital to enterprises and the indirect participation of a wide range of investors in small and medium-sized firms.
November 14	The Federal Cabinet approves the Second Personal Assets Participation Act, which, from 1987 onwards, extends employees' scope for participating in productive assets and improves the promotion thereof by the government.
November 21	The Financial Planning Council reaffirms that the policy of budgetary consolidation still remains the indispensable basis for a positive trend in growth and employment in our economy. As the reduction in the deficits has not continued in 1986, the efforts to accelerate the progress of consolidation should be reinforced. The Financial Planning Council repeats its recommendation that the overall growth rate of central, regional and local authority spending should be limited to an average of 3% a year.
November 25	In its Report for 1986-87 the German Council of Economic Experts comes to the conclusion that the economic upswing in Germany continues to rest on a solid foundation. The Council expects a consistently satisfactory course of domestic economic activity, fuelled by rising capital and consumption spending and accompanied by a further increase in employment at a virtually stable level of costs and prices. The Council considers it unlikely that the sharp appreciation of the Deutsche Mark will jeopardise this trend. Furthermore, it forecasts that the decline in foreign demand will soon give way to a rise. Altogether, the Council expects real GNP to grow by 2% in 1987.
November 28	The Bundestag approves the 1987 Federal budget, with an expenditure volume of DM 268.5 billion (+ 1.9% compared with the estimate for 1986) and a financial deficit of just over DM 22.5 billion.
1987 January 1	The contribution rate to the pension insurance funds is lowered from 19.2% to 18.7% of eligible income; the contribution rate to the Federal Labour Office is raised from 4.0% to 4.3%.
January 15	In its 1987 Annual Economic Report the Federal Cabinet notes that the salient feature of economic conditions is the shift in the expansionary forces from foreign demand to domestic demand. Private consumption and corporate capital formation are the driving forces behind overall expansion. For 1987 the Federal Cabinet expects an average annual real GNP growth of around 2½% or more, accompanied by an increase of 1% in employment; the unemployment rate will probably decline to approximately 8½% of the dependent, or some 7½% of the total, labour force. In the opinion of the Federal Cabinet, the rise in consumer prices can be limited to an average of distinctly less than 1% in 1987.
February 10	The Federal Cabinet approves bills concerning the extension of the period of entitlement to unemployment benefit and the granting of a financial benefit for child-rearing to mothers born before 1921.
February 24	The coalition parties agree on the basic features of the tax reform which is to enter into force in 1990. The tax relief will have a volume of just over DM 44 billion. The amendments include: – the raising of the basic tax allowance, the lowering of the lowest and highest marginal rates of income tax to 19% and 53% respectively, with a linear progressive scale between these two rates, and the raising of the children's allowance; – the lowering from 56% to 50% of the rate of corporation tax on retained earnings; – the extension of special depreciation for small and medium-sized enterprises. Over DM 19 billion of the tax relief is to be financed by running down tax concessions and subsidies and/or by raising indirect taxes.
March 8	In the negotiations between the coalition parties it is decided that, in addition to the second stage of the tax cuts due to enter into force in 1988, tax relief to the amount of over DM 5 billion should be brought forward from 1990 to 1988.

Ambitious targets set for tax cuts

The two-stage tax reduction in 1986-88 and the subsequent tax reform aim at a general reduction of the direct tax burden as well as the possible mitigation of the progressive effect of the income tax scale. A cut in direct taxes may well positively influence the calculations of economic agents by raising performance incentives and, not least, increasing participation in the "official" economy while curbing the activities of the "black" economy. This applies in particular to the large number of middle-income earners who are already faced with high marginal tax rates and most of whom are also required to pay social security contributions. Experience shows, however, that a tax reduction is not self-financing (the expectation of an increase in economic activity as a result of the tax cuts is justified, but the consequent rise in tax receipts cannot be rated as very high in the short term). Hence the question of how to finance the residual shortfall in receipts is left open. The Federal Cabinet's plans for special measures to make good some of this shortfall were not yet finalised when this Report went to press. Limiting some tax advantages and grants, and raising some indirect taxes are both under discussion.

Tax cuts should mainly be offset via the expenditure side

Like the tax reform itself, the selection of these compensatory measures is a key financial policy task. It also has implications for the government's spending behaviour. The policy of containing new debt initiated in 1982 and adhered to fairly consistently thereafter was successful because the increase in the central, regional and local authorities' expenditure was kept to an annual average of about 3 % between 1982 and 1986. This was perceptibly below the growth rate of GNP and government receipts. In 1986, considered by itself, however, the 3 % limit was exceeded. Any longer-term deviation from this containment strategy, which continues to be the objective of the Financial Planning Council, would involve the danger of a repetition of the adverse experience of the years in which taxes were cut but no parallel measures were taken on the expenditure side, so that the gap had to be filled by additional borrowing. The present favourable state of the capital market, characterised as it is by an all-time low in the interest rate level, should not obscure the fact that particularly advantageous factors, especially the massive inflows of funds from abroad, are currently at work here. This implies an element of uncertainty for future developments on the capital market. The situation here would become more difficult if the public sector borrowing requirement were to rise substantially; the stimulating effect which the tax cuts are expected to impart to the entire economy might then be called into question as a result of rising interest rates.

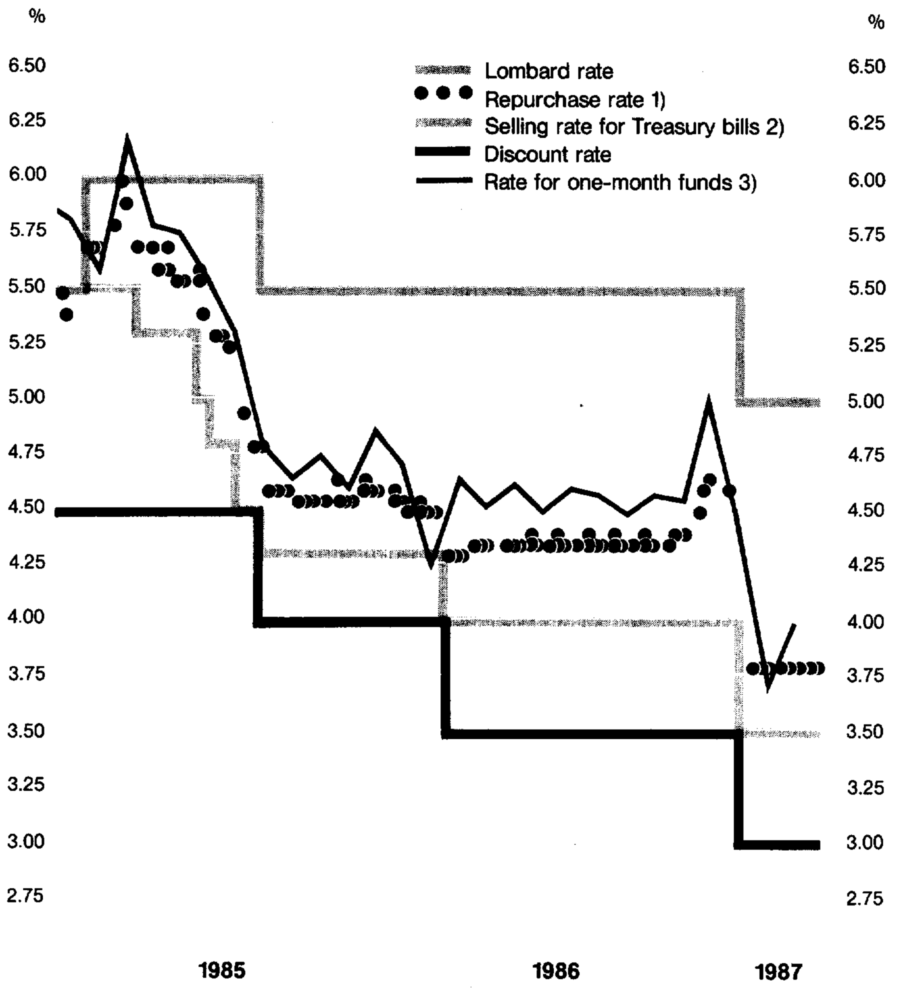
4. Monetary policy under external influences

(a) Money market management in a changed environment

Monetary policy room for manoeuvre restricted by external influences

In 1986 the monetary policy of the Bundesbank was exposed to strong external influences. The overall monetary picture was determined by upward pressure on the Deutsche Mark which persisted almost throughout the year, rapidly growing surpluses in non-banks' external payments and at times also by heavy inflows of foreign exchange to the Bundesbank which increased liquidity. In these circumstances the Bundesbank at first adopted a cautiously relaxing approach in its money market management and then maintained a consistently accommodating stance even when signs of an appreciable overshooting of the monetary target began to emerge in the late summer of 1986 (see also page 34). After the EMS realignment at the beginning of 1987 and the ensuing enhanced international cooperation in the foreign exchange markets in the wake of the "Louvre accord" between the major western industrial countries, the pressure on domestic monetary policy emanating from external monetary relations eased.

Interest rates of the Bundesbank and rate for one-month funds



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

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Easing of conditions in the financial markets and adjustment of central bank interest rates at the beginning of 1986

At the beginning of 1986 the fall in interest rates in the domestic financial markets, particularly at the longer end, at first continued. The Bundesbank followed this trend – which was also apparent world-wide – by lowering the allotment rates for its securities repurchase agreements and the rate applied to short-term Treasury bill sales to the banking system. Moreover, in the context of similar moves by a number of other central banks, it cut the discount rate from 4% to 3½% with effect from March 7, 1986, thus consolidating the easing of conditions which had been proceeding in the markets. The lombard rate, which has been of minor significance for the movement of money market rates since the shift to more flexible money market management at the beginning of 1985, remained unchanged at 5½%.

Heavy drains of liquidity in the wake of the EMS realignment

After the first few months of 1986 "interest rate optimism" in the domestic financial markets vanished rather abruptly. One of the main reasons for this was that the Deutsche Mark was rather weak for some time against the other European currencies in the wake of the realignment of exchange rates in the European Monetary System (EMS) with effect from April 7, 1986. After the marked change in central rates, the risk of devaluations of partner currencies – especially the French franc – seemed comparatively small for the time being, so that their interest rate advantage over the low-yielding Deutsche Mark came fully into play in the markets. This triggered massive outflows of funds abroad, and initially the Deutsche Mark could be kept at its lower intervention point against the franc only by sizeable support operations. The Bundesbank offset the resulting reduction in bank liquidity at short term chiefly by means of exceptionally large shifts of Federal funds into the money market (pursuant to section 17 of the Bundesbank Act). To this end, the first instalment of the Bundesbank profit for 1985 to be credited to the Federal Government in April was increased to DM 8 billion – compared with DM 5 billion in the two preceding years – in agreement with the Federal Government. In addition, the Bundesbank provided the banks with additional funds through securities repurchase tenders.

Revision of the minimum reserve regulations and accompanying measures

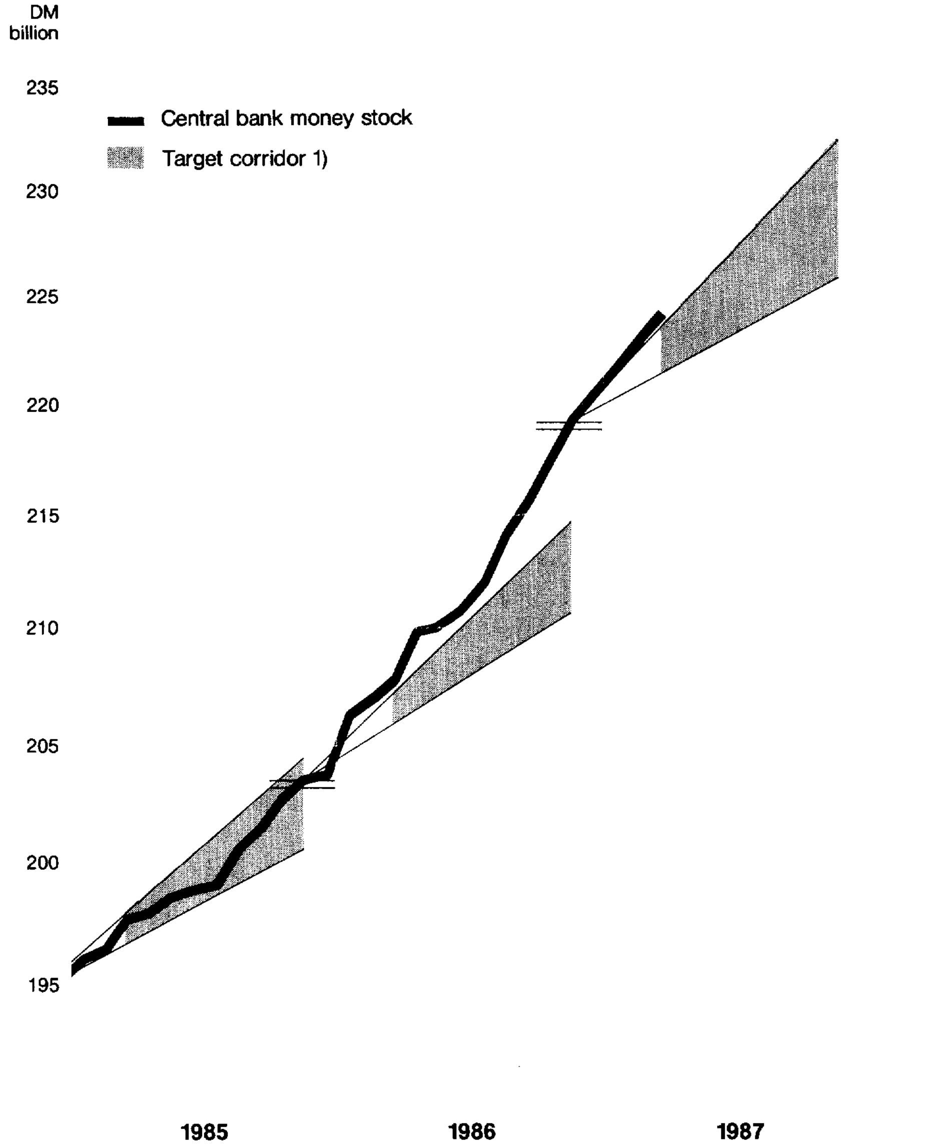
In May 1986 the revision of the minimum reserve regulations which the Bundesbank had approved in principle as early as December 1985 entered into force. The intention was to reduce the cost drawbacks and competitive disadvantages for German banks' international business associated with the minimum reserve requirements and to increase Germany's attractiveness as a financial centre. The reserve ratios for time liabilities and savings deposits were cut back markedly to a uniform lower level, i.e. the previous differentiation by stages on a progressive scale was dropped. In addition, banks' foreign currency liabilities to non-residents were largely exempted from reserve requirements by an extension of the offsetting arrangements. Finally, the authorisation of bonds denominated in Deutsche Mark that have the characteristics of certificates of deposit, which the Bundesbank announced simultaneously, was linked with the inclusion of bank bonds with original maturities of less than two years in the net, so as to prevent the minimum reserve requirements from being bypassed by deposit surrogates of this kind. This revision of the minimum reserve regulations reduced the banks' reserve requirements by DM 7.5 billion. Since no easing of monetary policy was intended thereby, the Bundesbank decided as early as the beginning of March 1986 to lower the banks' rediscount quotas by DM 5 billion to neutralise part of the "release effect". However, the compensating effect was in fact much smaller because of a lasting increase in the banks' utilisation of their rediscount quotas after the cut had become effective. The Bundesbank therefore reduced the volume of securities repurchase agreements concluded on a revolving basis with banks.

Accommodating stance of monetary policy in the further course of the year

In the second half of the year the Bundesbank maintained its policy stance in the money market virtually unchanged. Throughout the year the current central bank money requirements of the banking system were met at the lower rates of interest the central bank had been applying since the spring. In the light of the growing upward pressure on the Deutsche Mark from the middle of the year, the Bundesbank even tolerated a gradual relaxation in its ongoing management of bank liquidity. It did not offset the increase in the banks' central bank balances associated with the lasting inflows of foreign exchange by taking corresponding measures permanently siphoning off liquidity – such as raising the minimum reserve ratios or lowering the rediscount quotas – but rather allowed the banks to further run down their liabilities arising from securities repurchase agreements. Together with the above-mentioned "release effect" resulting from the revision of the minimum reserve regulations and the transfer of the Bundesbank profit (less the Bundesbank's current interest income), the banks were provided with funds to the amount of roughly DM 17 billion on a permanent basis last year. In the process, the volume of securities repurchase agreements outstanding fell in November 1986 to the relatively low level of DM 18 billion; the flexibility of money market management aimed at by using securities repurchase agreements would be more difficult to achieve if the requisite volume was always so low.

Growth of the central bank money stock*

Monthly, seasonally adjusted, log. scale



* Currency in circulation plus required reserves on domestic liabilities (calculated at constant reserve ratios, base: January 1974); excluding bank bonds subject to minimum reserve requirements.- 1) Increase in the central bank money stock between the fourth quarter of the preceding year and the fourth quarter of the current year; for 1985: 3% to 5%; for 1986: 3½% to 5½%; for 1987: 3% to 6%.

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Package of interest rate and liquidity policy measures at the beginning of 1987

A further substantial boost was given to the growth of bank liquidity as early as the turn of 1986-87, when the Bundesbank had to sell large amounts of Deutsche Mark in the course of interventions within the EMS — not only its own interventions but also those of other partner central banks — because of the persistent tendency of the Deutsche Mark to appreciate. These purchases of foreign exchange supplied the banks with additional central bank balances amounting to DM 17 billion within just under three weeks. Since in the wake of the realignment of January 12, 1987 there was comparatively little change in exchange rates between the EMS currencies in the market, there were initially no outflows of foreign exchange from the Bundesbank. Original plans to offer further securities repurchase agreements in the course of January had to be dropped. As the outlook was obscure, the Bundesbank endeavoured to secure greater scope for its open-market policy by taking measures to mop up liquidity. It lowered the banks' rediscount quotas by some DM 8 billion with effect from the beginning of February and increased the minimum reserve ratios across the board by 10%. These two measures absorbed DM 12 billion net. The fact that the sole purpose of the measures was to restore the instrument to the role it had played in the late autumn of 1986 rather than to tighten monetary policy is also illustrated by the simultaneous reduction of the discount and lombard rates by ½ percentage point each to 3% and 5% respectively with effect from January 23, 1987; new securities repurchase agreements were then concluded at a rate of interest which was more than ½ percentage point lower than in November 1986. By these interest rate policy decisions the Bundesbank hoped to help reduce external tensions and to moderate the rise of the Deutsche Mark against the US dollar; the changed economic situation also made this seem desirable, as already stated (page 2).

(b) 1986 monetary target missed — setting the target for 1987

Monetary target for 1986

Under the impact of external factors, in 1986 — for the first time since 1978 — the Bundesbank was unable to meet the monetary target, according to which the central bank money stock was to expand by 3½% to 5½% between the fourth quarter of 1985 and the fourth quarter of 1986. As in the previous year, the derivation of the monetary target was based on an expected average annual rise in production potential, calculated at current prices, of about 4½%. At some 2½%, the growth of real production potential was put at a slightly higher figure than in 1985 because of the expected more rapid expansion in the stock of utilisable fixed assets and the growing labour force, while the tolerated rise in the overall price level was assumed to remain unchanged at a maximum of 2%. This yielded a target corridor of 3½% to 5½% for four-quarter growth in the central bank money stock between the fourth quarter of 1985 and the fourth quarter of 1986, with the two-point width of the corridor being retained.

Sharp acceleration in growth of the central bank money stock

The growth of the central bank money stock was far above the target corridor even in the first few months of 1986. The expansionary underlying trend since the autumn of 1985 was reinforced by special factors such as the funds accruing from the sale of assets of a major industrial concern and the inflow of resources from abroad ahead of the EMS realignment of April 1986. By mid-year, though, these special movements had largely tailed off and the pace of central bank money stock growth had slackened distinctly, so that hopes of a normalisation of monetary expansion in the following months were not unwarranted. In the second half of the year, however, monetary growth speeded up yet again and the central bank money stock increased almost continuously from month to month at an annual rate of 9½%. In the fourth quarter of 1986 it was 7.7% up on the corresponding quarter of the preceding year and thus over 2 percentage points above the target range envisaged by the Bundesbank. A significant element in this was — as discussed in more detail on page 38 — the unusually rapid rise in German enterprises' deposits abroad last year. To this extent the expansion of the central bank money stock, which only reflects domestic money holdings, does not mirror the full scale of growth in the Deutsche Mark balances held by residents in 1986.

Overshooting of the target tolerated

The Bundesbank tolerated the overshooting of the monetary target, which emerged more and more clearly from mid-1986 onwards, chiefly because of the external constraints outlined at the beginning of this section. The Bundesbank's room for manoeuvre was reduced in particular by the sharp appreciation of the Deutsche Mark against the US dollar and the weak tendency of major EMS partner currencies — which was masked at times by interventions against the Deutsche Mark. Any attempt to restrain monetary expansion by interest and liquidity policy measures would presumably have further exacerbated the tendencies towards appreciation of the Deutsche Mark. Moreover, the 1986 monetary policy stance, which on balance had an expansionary impact, supported the desired shift of emphasis from foreign to domestic demand and

Monetary developments

Change during year 1

Item	1980	1981	1982	1983	1984	1985	1986
	DM billion						
A. Central bank money requirements of banks and liquidity policy measures of the Bundesbank 2							
1. Provision (+) or absorption (−) of central bank balances by							
Rise in central bank money **3** (increase: −)	− 6.5	− 2.7	− 7.5	− 10.1	− 7.1	− 6.6	− 13.1
Foreign exchange movements (excluding foreign exchange swaps and repurchase agreements)	− 24.6	− 3.1	+ 1.7	− 2.0	− 3.9	− 0.7	+ 8.7
Cash transactions of the central and regional authorities (including shifts of Federal balances under section 17 of the Bundesbank Act)	+ 0.3	+ 1.1	− 4.1	+ 1.7	+ 1.3	− 4.2	− 0.2
Transfer of the Bundesbank's profit to the Federal Government	—	+ 2.3	+ 10.5	+ 11.0	+ 11.4	+ 12.9	+ 12.7
Other factors	− 7.9	− 9.3	− 12.1	− 9.7	− 12.1	− 14.0	− 8.0
Total 1	− 38.8	− 11.8	− 11.4	− 9.0	− 10.6	− 12.5	+ 0.0
2. Liquidity policy measures							
Change in minimum reserves **4**	+ 10.5	+ 4.1	+ 5.4	− 0.2	− 0.4	+ 0.1	+ 7.4
Change in refinancing facilities	+ 12.1	+ 5.1	+ 7.7	− 0.7	+ 7.8	+ 3.3	− 5.6
Open market operations (with non-banks, in "N paper" − excluding short-term sales of Treasury bills − and in long-term securities)	+ 4.5	− 0.1	+ 1.5	+ 2.4	− 3.9	+ 0.1	+ 1.4
Securities repurchase agreements	+ 6.0	+ 4.4	− 1.4	+ 6.6	+ 7.7	+ 16.5	− 9.5
Other assistance measures in the money market **5**	+ 4.5	− 0.5	+ 1.6	− 3.4	± 0.0	+ 0.6	+ 1.5
Total 2	+ 37.6	+ 13.0	+ 14.8	+ 4.7	+ 11.3	+ 20.6	− 4.8
3. Remaining deficit (−) or surplus (+) (1 plus 2)	− 1.2	+ 1.2	+ 3.4	− 4.3	+ 0.7	+ 8.1	− 4.8
covered or absorbed by							
Recourse to unused refinancing facilities (reduction: +)	− 1.4	+ 1.3	− 3.5	+ 3.3	− 1.0	− 3.1	+ 4.2
Raising (+) or repayment (−) of lombard or special lombard loans	+ 2.6	− 2.5	+ 0.1	+ 1.0	+ 0.3	− 5.0	+ 0.6
	%						
B. Key monetary indicators							
Central bank money stock **2, 6**	+ 5.5	+ 3.2	+ 6.0	+ 6.8	+ 4.7	+ 4.4	+ 8.3
Memorandum item							
As an annual average	+ 4.8	+ 4.4	+ 4.9	+ 7.3	+ 4.8	+ 4.6	+ 6.4
M1 (= currency in circulation and sight deposits)	+ 4.2	− 0.8	+ 6.7	+ 8.1	+ 5.6	+ 5.2	+ 7.6
M2 (= M1 plus time deposits and funds borrowed for less than 4 years)	+ 8.8	+ 8.8	+ 5.0	+ 2.6	+ 5.0	+ 4.6	+ 6.1
M3 (= M2 plus savings deposits at statutory notice)	+ 6.1	+ 5.0	+ 7.1	+ 5.7	+ 4.6	+ 5.1	+ 6.8
Lending by banks and the Bundesbank to domestic non-banks	+ 9.4	+ 9.0	+ 6.5	+ 6.7	+ 5.9	+ 5.1	+ 4.1
	DM billion						
C. Money stock and its counterparts							
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 42.8	+ 36.1	+ 54.8	+ 45.3	+ 41.3	+ 45,4	+ 65.7
Counterparts in the balance sheet							
1. Volume of credit **7**	+ 126.3	+ 132.0	+ 104.4	+ 113.2	+ 108.1	+ 98.1	+ 81.7
of which							
Bank lending to domestic non-banks	+ 122.4	+ 129.9	+ 106.1	+ 111.3	+ 110.0	+ 100.6	+ 77.8
− to enterprises and individuals **8**	+ 56.3	+ 41.7	+ 30.0	+ 44.0	+ 47.4	+ 48.5	+ 40.4
− to the housing sector **9**	+ 44.5	+ 40.7	+ 36.1	+ 48.1	+ 43.5	+ 33.2	+ 33.2
− to public authorities	+ 21.6	+ 47.5	+ 40.0	+ 19.3	+ 19.1	+ 18.9	+ 4.2
2. Net external assets **10**	− 10.6	+ 11.9	+ 4.5	+ 1.2	+ 0.8	+ 30.0	+ 55.9
3. Monetary capital	+ 61.7	+ 86.0	+ 46.5	+ 67.1	+ 69.7	+ 75.0	+ 69.8
of which							
Savings deposits at agreed notice	− 1.9	− 2.1	+ 4.3	− 2.0	+ 6.0	+ 11.2	+ 15.3
Bank savings bonds	+ 17.8	+ 14.0	+ 11.9	+ 13.0	+ 16.3	+ 10.4	+ 9.9
Time deposits and funds borrowed for 4 years and over	+ 14.6	+ 13.8	+ 7.2	+ 27.2	+ 26.3	+ 34.5	+ 37.6
Bank bonds outstanding **11**	+ 26.7	+ 53.6	+ 14.1	+ 22.6	+ 13.2	+ 9.3	− 4.7
4. Central bank deposits of domestic public authorities	− 1.9	− 0.2	+ 0.5	+ 0.9	− 1.2	+ 1.3	− 1.1
5. Other factors	+ 13.2	+ 22.0	+ 7.2	+ 1.0	− 1.0	+ 6.5	+ 3.2

1 Unless otherwise indicated, based on end-of-month figures. — **2** Based on daily averages of the last month of the period and the last month of the previous period, respectively. — **3** Currency in circulation (excluding the banks' holdings of domestic notes and coins, which are deductible from the required minimum reserves) and required reserves on the banks' domestic liabilities at current reserve ratios; changes in the required reserves resulting from changes in the reserve ratios are shown in item A.2. — **4** Including changes in minimum reserves due to growth in reserve-carrying foreign liabilities. — **5** Open market operations under repurchase agreements in trade bills, foreign exchange swaps and repurchase agreements, shifts of Federal balances under section 17 of the Bundesbank Act and short-term sales of Treasury bills. — **6** Reserve component calculated at constant reserve ratios (base: January 1974); excluding reserve-carrying bank bonds. — **7** Banks and the Bundesbank; including credit based on the purchase of securities. — **8** Excluding housing. — **9** Excluding credit based on the purchase of securities. — **10** Banks and the Bundesbank. — **11** Excluding banks' portfolios.
Discrepancies in the totals are due to rounding.

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thus helped to reduce international trade imbalances. Toleration by the Bundesbank of the overshooting of the monetary target was facilitated by the fact that, with the fall in the oil price and the cheapening of imports owing to the appreciation of the Deutsche Mark, the ample supply of money presented no immediate threat to price stability. It was also evident that the unexpected increase in real income caused by import-induced falls in prices was initially leading to an unscheduled expansion of domestic money holdings. It will take some time for them to return to normal, if only because the opportunity cost of holding liquid assets is relatively small in view of the low level of interest rates.

Extension of distributional scope not permanent

Experience gained in 1978 and 1979, when the Deutsche Mark had also risen steeply and the terms of trade initially likewise changed in favour of Germany, makes it seem advisable, however, not to rely primarily on exchange rates for safeguarding price stability. Exchange rates and world market prices can change to Germany's disadvantage without this country taking any special action, as they did in the years mentioned above. At the beginning of 1987 there are signs of a slight upturn in prices. In 1987 the rise in unit labour costs is unlikely to be offset to any significant extent by a fall in other production costs. Even so, there will probably be no resurgence of inflationary tendencies this year. The causal connection between excessive money stock growth and the rekindling of inflation is only discernible in the longer run; it is for precisely this reason, however, that it must not be ignored by a central bank policy which is geared primarily to monetary stability (which can only be achieved over the somewhat longer term).

Large amount of excess liquidity and uncertain underlying conditions at the start to the 1987 target period

It was these considerations which guided the Bundesbank in setting its 1987 monetary target, too. As in the preceding years, it based the derivation of the target on the expected average annual expansion of nominal production potential (some 4½%). In translating this into the four-quarter growth rate envisaged for 1987 the Bundesbank had to pay due regard to the high level of money balances at the end of 1986, the starting point for assessing growth in the course of 1987 as a whole. The Bundesbank set a target corridor of 3% to 6% for growth between the fourth quarter of 1986 and the fourth quarter of 1987; meeting this target would imply that the expansion of the central bank money stock had again approximated to the "potential path" derived in a medium-term framework. The target corridor, which has been extended by ½ percentage point on either side compared with 1986, is intended to accommodate the special uncertainties affecting the outlook for central bank money stock growth. The lower part of the corridor would seem appropriate if a major part of the funds so far kept in liquid form were soon to flow into the acquisition of longer-term bank liabilities, public sector bonds or foreign securities. If, however, enterprises' and households' present strong liquidity preference were to persist or inflows of funds from abroad were to continue, growth could presumably only be kept near the upper limit mentioned. In the first three months of 1987 this upper limit has in fact been overshot, but there have been signs at the same time of a slackening of the pace of monetary growth – to some 7% at present against 9½% in the second half of 1986. The sooner the conflict situation between external constraints and domestic economic objectives is remedied – and there are some indications of this happening at the time this Report goes to press – the earlier will it be possible to do full justice again to the medium-term concept of monetary targeting.

(c) The money creation process in 1986

Faster growth of all monetary aggregates

Rather like the central bank money stock, money in the hands of domestic non-banks grew at a faster pace last year. A striking feature is that virtually all monetary aggregates expanded at a higher rate than is acceptable over the

Money stock M3 in traditional and extended definitions

Level at end of month and change; seasonally adjusted

Period	M3 traditional 1		Short-term bank bonds 2	Euro-deposits 3	M3 extended 4	
	DM billion	Change in % 5	DM billion	DM billion	DM billion	Change in % 5
1985 January	889.6	5.5	35.1	10.7	935.4	4.4
February	894.4	5.6	37.9	11.0	943.3	5.0
March	896,0	4.8	38.4	11.4	945.8	4.8
April	899.5	5.3	38.1	12.1	949.6	5.5
May	904.1	5.3	37.7	12.2	954.0	5.9
June	909.5	5.8	36.1	13.7	959.3	7.2
July	909.7	4.6	33.8	14.3	957.7	4.9
August	911.4	3.8	31.9	14.4	957.7	3.1
September	914.5	4.2	28.9	14.9	958.3	2.7
October	917.2	4.0	28.8	17.6	963.6	2.9
November	919.5	3.4	27.7	16.8	963.9	2.1
December 6	953.2	4.3	25.7	16.3	995.2	2.5
1986 January	961.2	6.0	24.4	20.4	1,005.9	5.0
February	963.4	6.1	21.8	20.9	1,006.1	5.1
March	967.1	6.2	19.0	25.4	1,011.5	6.0
April	967.5	5.7	17.2	30.2	1,015.0	5.6
May	971.9	6.1	15.5	30.5	1,017.9	6.3
June	980.8	5.9	13.8	32.1	1,026.7	6.6
July	985.6	5.3	11.9	36.3	1,033.8	5.8
August	993.8	6.5	11.9	38.4	1,044.2	7.9
September	998.8	6.8	10.4	41.4	1,050.5	8.1
October	1,006.1	8.3	9.0	44.0	1,059.1	9.1
November	1,017.6	9.7	6.1	47.2	1,070.9	10.8
December	1,017.9	7.8	5.2	49.9	1,073.0	9.3
1987 January	1,032.5	9.8	3.7	43.3	1,079.5	9.1
February p	1,035.1	8.5	3.1	41.4	1,079.6	7.0

1 Currency and sight deposits, time deposits for less than four years and savings deposits at statutory notice held by domestic non-banks at domestic banks. — **2** Bank bonds with maturities of up to one year in the hands of domestic non-banks; estimated. — **3** Short-term claims of domestic non-banks on foreign banks. — **4** M3 extended to include Euro-deposits and short-term bank bonds. — **5** Change in the last six months expressed as an annual rate. — **6** Statistical break because of extended coverage; eliminated in the changes. — **p** Provisional.
Discrepancies in the totals are due to rounding. BBk

medium term; the statement that the money supply tended to be superabundant would be correct even if a monetary indicator other than the central bank money stock was used as a yardstick. At the beginning of the year the special influences already mentioned made it difficult to assess the underlying trend in monetary growth correctly. When the effects of these factors had worn off, a more generalised pattern of strong monetary growth emerged as the year progressed. Between the fourth quarter of 1985 and the fourth quarter of 1986 traditional M3[1] increased by 7¼ %, or only a little less than the central bank money stock (7¾ %). Among the components of the money stock, both currency in circulation on the one hand and sight deposits and savings deposits at statutory notice on the other moved sharply ahead. Shorter-term time deposits and borrowed funds, by contrast, rose at a rather moderate rate. The expansion of the highly liquid components of the money stock, reflecting the marked liquidity preference, is typical of a period when deposit rates are low, as the "opportunity costs" associated with holding non-interest-bearing or traditionally low-interest-bearing money balances are not rated as high by enterprises and households. Last year the "basic savings rate" remained at 2½ %; not quite 3½ % was paid on average on three-month funds (under DM 100,000) from the spring onwards. Those money holdings which (in effect) do not earn interest — viz. currency and sight deposits (money stock M1) — thus rose more sharply, at 8¾ %, and the money stock M2 (M1 plus time deposits for less than four years) somewhat less, at 7 %, than broad money (M3) between the fourth quarter of 1985 and the fourth quarter of 1986.

1 The money stock M3 comprises currency, sight deposits held with domestic banks, time deposits and funds borrowed for less than four years plus savings deposits at statutory notice.

Surge in Euro-deposits

In addition, non-banks strongly built up their bank deposits held in the Euro-market (primarily short-term time deposits) in 1986. Large enterprises in particular accumulated new deposits – mostly denominated in Deutsche Mark – at the foreign offices of German banks on an unprecedented scale. Only a small part of these seem to have been "working balances", held for example in connection with increased German outward investment and hence not directly linked with capital expenditure in Germany. The surge in Euro-deposits would, rather, seem to be chiefly attributable to the fact that slightly higher interest rates were offered there than for comparable domestic deposits. One indication of this is that money market rates in the Euro-markets, which in the past tended to be below domestic rates, have approached these quite closely of late and at times have even exceeded them. The Euro-banks apparently had major funding needs in Deutsche Mark so that they were prepared to pass on a greater part of the interest rate advantage deriving from the absence of minimum reserve requirements in their deposit business. Demand for Euro-DM funds also increased because of substantial Deutsche Mark exchange market interventions at times by EMS member central banks to support their own currencies. In the process they sharply ran down their Deutsche Mark holdings in the Euro-market. In addition, internationally operating investors seem to have raised comparatively low-interest short-term Deutsche Mark loans or liquidated Euro-DM assets in order to purchase bonds in the German market for speculative reasons.

Euro-deposits as a substitute for domestic time deposits and short-dated bank paper

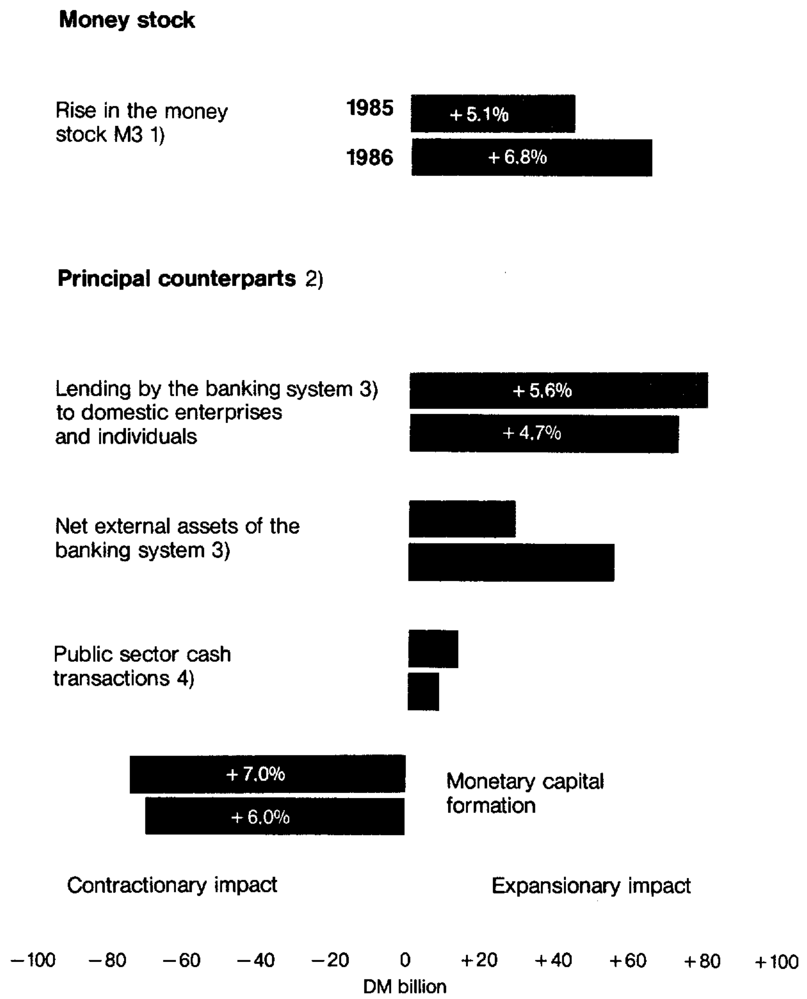
Large German enterprises which have ready access to the Euro-market apparently exploited even the smallest interest rate advantages to temporarily invest their surplus liquidity stemming not least from external sources there rather than in the domestic banking system. To this extent the funds shifted to the Euro-market are a close substitute for domestic time deposits and should in fact be counted towards the domestic money stock. In part, however, the funds enterprises invested in the Euro-market were redemption proceeds from short-dated bank bonds which they had found an attractive interim investment facility in the past, in particular when interest rates were fairly high. The amount of this paper outstanding has been falling dramatically since mid-1985. Upon its inclusion in the minimum reserve requirements as from May 1986 this tendency gathered pace; in other words, the Euro-market is increasingly being used to get round the minimum reserve requirements. If the money stock definition M3 is broadened to include the excess of short-term deposits at banks abroad over simultaneous reductions in domestic non-banks' short-dated bank bond portfolios, the growth of the aggregate M3 extended in this way between the fourth quarter of 1985 and the fourth quarter of 1986 works out at 7¾ % against – as mentioned before – 7¼ % for traditional M3 (see also the table on page 37). Non-banks' liquidity has thus increased even more sharply than is suggested by the traditional monetary aggregates.

Considerable inflows of funds from abroad

Inflows of funds from abroad were a major driving force behind the domestic money creation process in 1986. The net external assets of the banks and the Bundesbank, the rise in which reflects the influx of funds into the economy resulting from non-banks' external current and capital transactions, increased by DM 56 billion last year. This is almost twice as much as a year before and several times the amounts recorded in earlier years with large inflows of funds from abroad (1978 and 1973). The upsurge came from the rise in the current account surplus and the high level of net long-term capital imports. As already discussed elsewhere in this Report (see page 18 f.), the large net capital imports (instead of net capital exports, which would in fact have been desirable) were above all attributable to expectations of an appreciation of the Deutsche Mark and speculation on profits from interest rate arbitrage, i.e. from the funding of purchases of German bonds through short-term borrowing at the low interest rates ruling in the Euro-market. In all likelihood, the Bundesbank could have dampened the "mechanics" of the money creation process through non-banks'

The money stock and its principal counterparts

Change during year in DM billion or in %



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

BBk

external transactions only if it had engineered a rise in short-term interest rates in the domestic money market and at the same time accepted the consequence, i.e. an even more rapid and steeper appreciation of the Deutsche Mark. However, such a policy would have been consistent neither with domestic economic conditions nor with the part Germany is expected to play in the world economy. These considerations made it appear more appropriate to aim at a gradualist exchange rate adjustment through a deliberate policy of easy money market rates and temporary exchange market interventions by the Bundesbank, and to ride out the consequences of the strong impetus this would give, on past experience, to monetary growth.

Slower expansion of lending

The massive inflow of funds from abroad not only stimulated the growth of the money supply in 1986 but also — as is invariably the case in such periods — restrained domestic lending. As their external assets were "monetised", non-banks, especially enterprises, had less need to borrow from banks. Domestic borrowing was particularly sluggish in the second half of the year, especially when external payments generated an even stronger surge of funds.

Over 1986 as a whole, lending by the banking system (including the Bundesbank) to domestic non-banks increased by 4%, compared with 5% in 1985. In absolute terms it went up by DM 82 billion. If domestic credit expansion and the acquisition of external assets by the banking system are combined, the growth of overall assets-side business in 1986 (at DM 138 billion) outpaced that of the preceding year (DM 128 billion). While there was in fact some substitution of inflows of funds from abroad for domestic credit expansion, the banks' assets-side business on balance provided a strong stimulus to monetary growth.

Low level of public sector borrowing in Germany

It was domestic bank lending to public sector borrowers that slowed down most: in 1986 it went up at a rate of only 1½% (after 3½% in 1985). With the public sector deficit remaining largely unchanged, the main reason for this was that public sector funding needs were increasingly met by securities issues, the great bulk of which were purchased by foreigners. To this extent the public sector's "contribution" to monetary expansion in 1986, viewed in the balance sheet context of the monetary analysis, is reflected less in borrowing from banks than in an increase in the net external assets of the banking system, which also mirrors the inflow of funds to non-banks from borrowing abroad.

Moderate corporate and personal borrowing requirements

Bank lending to the private sector expanded by just under 5% in 1986 as against 5½% in 1985. Enterprises' demand for credit in particular was very subdued as firms' overall working fund requirements were low in view of their strong "cash flow" fed not least from external sources. In detail, however, the situation in the enterprise sector was rather mixed. Thus bank credit to the sectors which were at the centre of the economic upswing grew particularly sharply. Bank lending to households slackened in 1986 despite the steep rise in private consumption and very buoyant demand for passenger cars, which are mostly financed by means of consumer credit. The marked relief brought to family budgets by the fall in oil prices apparently allowed new borrowing to be cut down. The expansion of housing loans, by contrast, which had slowed down noticeably in the two preceding years, did not decline much further in 1986. The lower level of interest rates and the dullness of the real property market contributed to some flattening in demand for credit in this context. At the end of 1986 "consumer credit" was 5½%, lending to the housing sector 5% and lending to enterprises 4% up on the year.

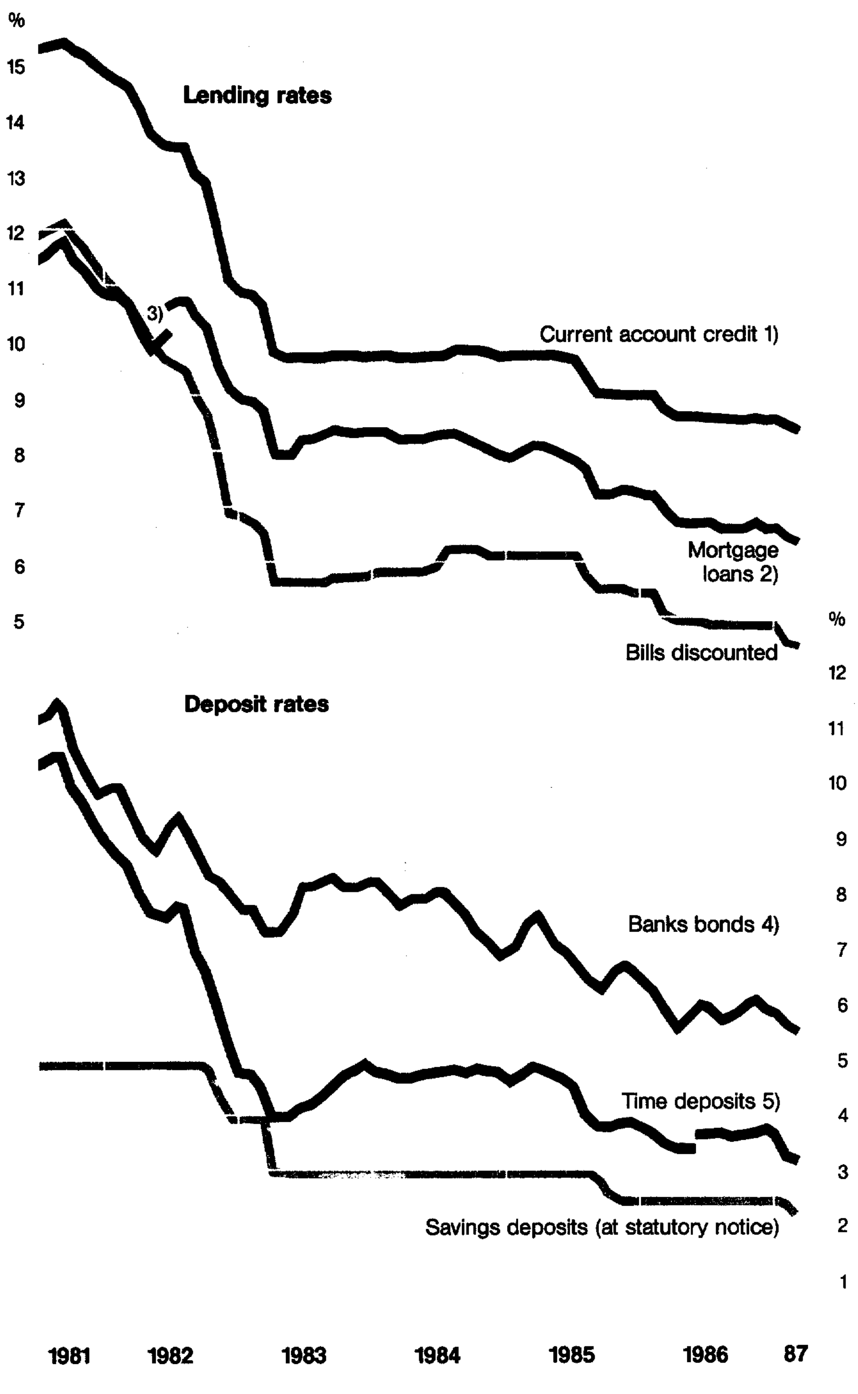
Buoyant demand for long-term credit for interest rate reasons

The movement of interest rates in 1986 prompted borrowers to "consolidate" their debt, i.e. to replace short-term credit by longer-term loans. In the light of the persistent fall in the rates charged for short and longer-term loans, many borrowers seemed to be convinced that a further easing of long-term lending rates was not very likely in future. The consolidation process is reflected in the fact that longer-term direct advances to enterprises and individuals grew by 6½% in 1986 while the amount of short-term credit outstanding was in effect reduced – for the first time since 1975. Banks which primarily rely on variable-rate deposit business for their funding found it difficult to avoid mismatching and hence a rise in their interest rate exposure in the face of the heavy demand for long-term fixed-rate loans and investors' reluctance to enter into long-term commitments.

Moderate monetary capital formation

This highlights another striking feature of monetary developments in 1986, namely the low propensity – relative to the strong increase in real income – to invest savings in longer-term assets. This had the consequence that, compared with the expansionary influences (i.e. the influx of funds from abroad and lending), the restraining effect of monetary capital formation on monetary growth was relatively small. The fact that the gap between the return on liquid assets and that on bonds has tended to widen over time has not changed this pattern, or at least had not changed it much up to the time this Report went to press. The main

Movement of selected bank interest rates



1) Under DM 1 million.- 2) Secured by residential real estate; effective rate.- 3) As from June 1982 only average interest rate for mortgage loans with variable interest rates; the figures are not fully comparable with previous data (June 1982 estimated).- 4) Yield on bonds outstanding.- 5) 1 month to 3 months inclusive and DM 100,000 and over but less than DM 1 million; up to and including May 1986 under DM 1 million and 3 months.

BBk

reason for investors' relatively low propensity to acquire longer-term assets was no doubt their lack of confidence in the durability of the interest rate level in the bond market and their fear of falling prices, particularly in the event of foreign buyers looking to other markets. An especially significant factor was that last year – for the first time since the currency reform – domestic non-banks did not on balance buy any bank bonds issued by residents, but ran down their portfolios of such paper by almost DM 5 billion. In part, this was because the amount of short-dated bank bonds outstanding dropped (by DM 21 billion) and non-bank enterprises acquired bank deposits, notably in the Euro-market, instead. Another indication of the fact that many investors were loath to engage in securities investments was their preference for forms of monetary capital formation not involving price risks, notably long-term time deposits, which went up most, viz. by DM 38 billion. The bulk of these funds came from institutional investors such as insurance companies, with "time deposits" also including borrowed funds in the form of borrowers' note loans of banks and registered bank bonds. Savings deposits at agreed notice were also built up strongly (by DM 15 billion). An important element in this was the increase in deposits under special saving schemes offering higher rates of interest than normal savings deposits. Thus the interest paid on savings contracts with one inpayment only and one year's notice, at some 4%, was roughly ½ percentage point higher in the second half of 1986 than the rate paid on savings deposits at twelve months' notice. Sales of bank savings bonds, by contrast, whose "interest edge" on savings deposits has shrunk further over the past year, tended to be moderate (at DM 10 billion).

(d) Business and profit situation of the individual categories of banks

Gains in big banks' market shares in domestic lending

In lending to domestic non-banks, the commercial banks (big banks, regional banks, private bankers) made further gains in 1986. This applies in particular to the big banks, which (at 10%) increased their lending to domestic non-banks much faster than all banks taken together (3.8%); moreover, they were the only major category of banks to register an increase over the year before. The growth of the domestic credit volume of regional banks and other commercial banks (3.9%) and private bankers (5.2%) was also above the average. The big banks expanded long-term lending in particular last year. Unlike the other banks, however, they also stepped up their short-term lending markedly. Much as in 1985, one reason for this was probably that enterprises sharply reduced their debt to foreign banks. Lending by private mortgage banks also went up disproportionately fast in 1986 (at 4.9%). They benefited in particular from the sustained strong demand for long-term fixed-rate loans. Public banks and – to an even greater extent – banks in the cooperative sector lost some ground in competing for domestic borrowers. Specifically, lending by savings banks to domestic non-banks increased by 3.5% and that by credit cooperatives by 1.4%. They were unable to step up long-term – primarily variable-rate – lending sufficiently to offset the weak demand for short-term lending to trade and industry and the government.

Profitability in the banking industry satisfactory again

The overall profitability of banks was satisfactory again in 1986. In interest business their margins probably narrowed further in many cases. In particular, savings deposit rates fell less than lending rates on an annual average. Moreover, the focus of lending shifted to less profitable long-term loans. On the other hand, the banks' commission income soared once more, even though securities business lost some of its momentum in the course of last year. Net of staff costs and other operating expenditure, which in part also grew fairly rapidly, the operating result of many banks seems to have almost matched that recorded in 1985. As a percentage of the volume of business, which continued to grow, this ratio may have fallen slightly further, however. In view of the favourable trend of earnings among many banks, their pre-tax annual profits are also likely to have been satisfactory. Many banks once again derived fairly high profits from trading for their own account in securities and foreign exchange business. Balance sheet adjustments are unlikely to have reduced their profits any more than in 1985. This is suggested firstly by the high level of provisioning already achieved. Secondly, with the progressive improvement in business activity in 1986 the insolvency risk inherent in domestic lending business decreased. In international lending business provision for risky loans increased further, if only as a result of exchange rate movements, while no major new lending enlarged existing country exposure. Nevertheless, in individual instances the risks posed by existing loan portfolios had to be rated higher than between 1983 and 1985, when rescheduling negotiations proceeded more smoothly than is now sometimes the case.

5. Capital market under the impact of external constraints

(a) Structural shifts in the overall financing cycle

Financial markets characterised by growing internationalisation

In 1986, as in the immediately preceding years, the securities markets became the focal point of the financing cycle as compared with the traditional channels of financing and accumulating financial assets via banks. The trend towards the "securitisation" of debt relationships, which also affected financial developments in Germany, reflects some very diverse stimuli. These proceeded not least from the international financial markets, where market participants tried, by means of securitisation, to take account of the greater risks posed by interest and exchange rate fluctuations, or at least to distribute these risks in a different way. A characteristic feature of recent years has been, moreover, the increasing interdependence of national and international capital markets. In 1986 this internationalisation of the financial markets had considerable implications for capital market trends in Germany. Last year almost three-quarters of the amount raised in the domestic securities markets came from foreign sources. By way of comparison, this share averaged roughly 10% during the seventies and barely 3% in the early eighties. At the same time domestic investors have bought heavily in foreign securities markets in recent years, for the first time since the currency reform. In 1986 their purchases in foreign stock markets made up over 90% of their longer-term investments in securities – although the overall propensity to save in the form of securities purchases was low. With respect to the global allocation of capital, the interpenetration of national capital markets can be rated in principle as an advance and a success of the world-wide efforts to liberalise the financial sector. In Germany, as in other countries, deregulative measures such as the abolition of coupon tax for non-residents, the opening of the Federal Bond Consortium to foreign banks, the authorisation of new forms of bonds, etc., were of some significance here. The markets in Germany, too, were not unaffected by the innovations emanating from the international financial markets. This stage of development is still too short-lived for it to be possible to tell whether it has been accompanied by an increase in efficiency in the economy as a whole. Above all, it remains an open question whether the observed inflation of financial turnover and the growing complexity of the instruments used are proving conducive to saving, investment and growth in the real economy, which is what ultimately counts in macroeconomic terms.

Shifts of emphasis in the financing cycle

The growing significance of the securities markets in the overall financing cycle emerged particularly clearly in Germany in 1986. Thus, last year the amount raised by the domestic non-financial sectors (households, the public sector and non-financial enterprises) through the issue of securities made up almost 50% of their overall financial volume, compared with a share of 9% in the seventies. At first sight this trend seems to show distinct parallels to the corresponding shifts of emphasis in the international financial markets, with their strong tendency towards the securitisation of lending. Nevertheless, it would at the least be premature to infer from recent developments that a permanent restructuring of financial patterns to the detriment of traditional credit relationships via banks had started in Germany. The increase in funding through bond issues was in large part due to the prevailing conditions. On the one hand (for reasons which still have to be explained), the supply of capital from abroad – especially in the bond market – was unusually large. On the other hand, public authorities in particular took advantage of the favourable capital market conditions to increase their borrowing in the bond market and improve their debt

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

Item	1970–1979 1	1980	1981	1982	1983	1984 p	1985 p	1986 p
	DM billion							
Acquisition of financial assets								
Longer-term 2	98.9	112.8	119.0	147.8	157.0	157.8	164.4	169.1
of which								
at banks	43.0	31.4	15.1	53.4	58.9	46.5	57.7	65.8
Bonds	13.7	20.2	36.1	22.9	23.4	45.2	35.3	22.2
Shares	3.8	7.2	6.0	5.6	10.0	2.8	2.6	1.4
Short-term	38.3	62.3	87.2	44.0	39.3	38.1	33.4	42.3
of which								
at banks 3	29.2	41.2	58.3	36.7	22.9	24.5	26.8	35.1
Bonds 4	0.9	5.5	11.0	– 2.2	7.6	– 7.4	– 6.5	– 19.7
abroad 5	0.9	5.0	3.8	1.9	0.7	7.5	7.9	26.4
Total	137.2	175.1	206.3	191.8	196.3	195.9	197.8	211.4
Incurrence of liabilities and issue of shares								
Longer-term	112.5	165.5	173.5	165.5	189.5	164.3	159.6	177.4
of which								
at banks	71.3	92.9	103.5	82.1	100.2	84.8	81.2	78.2
Bonds	9.0	3.0	– 3.7	28.0	33.9	36.3	43.5	58.0
Shares	3.3	5.3	3.6	4.5	5.9	4.6	6.8	12.5
Short-term	23.9	57.5	67.7	36.8	17.3	35.8	17.5	– 23.6
of which								
at banks	15.2	38.9	29.6	15.3	14.4	22.9	8.7	– 0.2
Total	136.5	223.0	241.2	202.3	206.8	200.1	177.2	153.8
	Percentage of total							
Acquisition of financial assets								
Longer-term 2	72.1	64.4	57.7	77.1	80.0	80.6	83.1	80.0
of which								
at banks	31.4	18.0	7.3	27.8	30.0	23.7	29.2	31.1
Bonds	10.0	11.5	17.5	12.0	11.9	23.0	17.8	10.5
Shares	2.8	4.1	2.9	2.9	5.1	1.4	1.3	0.7
Short-term	27.9	35.6	42.3	22.9	20.0	19.5	16.9	20.0
of which								
at banks 3	21.3	23.5	28.3	19.2	11.7	12.5	13.6	16.6
Bonds 4	0.7	3.1	5.3	– 1.1	3.9	– 3.8	– 3.3	– 9.3
abroad 5	0.6	2.9	1.8	1.0	0.4	3.8	4.0	12.5
Total	100	100	100	100	100	100	100	100
Incurrence of liabilities and issue of shares								
Longer-term	82.5	74.2	71.9	81.8	91.6	82.1	90.1	115.3
of which								
at banks	52.3	41.6	42.9	40.6	48.5	42.3	45.8	50.8
Bonds	6.6	1.3	– 1.5	13.8	16.4	18.1	24.6	37.7
Shares	2.4	2.4	1.5	2.2	2.8	2.3	3.8	8.1
Short-term	17.5	25.8	28.1	18.2	8.4	17.9	9.9	– 15.3
of which								
at banks	11.1	17.4	12.3	7.5	7.0	11.4	4.9	– 0.1
Total	100	100	100	100	100	100	100	100

* Households, enterprises (including housing sector), government (including social security funds). — **1** Average. — **2** Financial assets with maturities of more than one year, including all savings deposits. — **3** Including cash balances. — **4** Short-term bank bonds; estimated. — **5** Excluding trade credits. — **p** Provisional. Discrepancies in the totals are due to rounding. BBk

structure by substituting longer-term funds for shorter-term borrowing and replacing bank credit on its maturity by securities issues. Similar shifts of emphasis in public sector debt policy, especially on the part of the Federal Government, were evident on earlier occasions, too, when the bond market proved to be rather buoyant. Recourse to the bond market by the private sector, by contrast, remained low in 1986. Indirectly, however, the private sector benefited from the large scale of the security-based financing operations because long-term borrowing from banks was encouraged by the historically low interest rates. A major precondition for this borrowing was substantial issues of long-term bank bonds. In the event, all domestic non-financial sectors raised long-term funds on a relatively large scale in 1986, but at the same time they were able to reduce their short-term indebtedness, namely by DM 23.5 billion to roughly DM 620 billion.

Greater significance of financing through shares

The expansion of the securities markets also owed something to the share market, the significance of which for corporate financing increased conspicuously in 1986. Relative to enterprises' overall borrowing, the proportion of the capital raised by selling shares grew last year to 20% and thus more than doubled compared with the year before; compared with the seventies it even almost quadrupled. Here too, however, it still remains to be seen to what extent this change is of a lasting nature, as the upward trend in share prices – which at present has come to a standstill – has facilitated the increased use of the share as a financing instrument in recent years in a special way.

Strong liquidity preference of domestic investors

In striking contrast to the pronounced "trend towards securitisation" on the borrowing side, securities have decreased distinctly in significance as investment instruments of the domestic non-financial sectors of late. In 1986 the investments of these sectors in the securities markets accounted for less than 2% of their total acquisition of financial assets compared with shares of about 20% at the beginning of the eighties and an average of 13½% during the seventies. This reflects a number of quite divergent and in part probably temporary factors. On the one hand, it mirrors the circumstance that – as already outlined above (page 40ff.) – large amounts of short-term bank bonds were redeemed in 1986 and a considerable part of the funds thus made available was reinvested in short-term time accounts at domestic banks and in the Euro-market. On the other hand, investments in longer-term bonds clearly lost ground last year. Overall, they accounted for only about 10% of financial asset acquisition. Moreover, much the greater part of this sum consisted of investments in foreign paper; the domestic non-financial sectors' purchases of domestic bonds were thus very low. By contrast, more than 20% of the non-financial sectors' overall asset accumulation flowed to savings accounts, especially in the form of savings deposits at statutory notice, which in the context of this overall economic analysis are included among longer-term financial assets. Rather like the above-described stance of debtors, the relatively low level of longer-term financial asset acquisition is mainly attributable to the ruling interest rate pattern and the specific interest rate expectations entertained last year; the low interest rate level increased liquidity preference and led to restraint in securities buying because of the price risk.

Heavy purchasing by foreign investors in the German securities markets

In terms of "balance mechanics", the main counterpart of the conspicuous asymmetry between the described changes in the structure of financial asset acquisition and domestic borrowing in 1986 was to be found in external capital transactions. While, in view of the historically low level of interest rates in the German market, residents built up considerable holdings of liquid funds abroad and continued to purchase paper in foreign securities markets, foreign investors placed DM 74.5 billion in the German capital market – several times the amount of their annual capital investment in the German securities markets in the seventies and early eighties.

(b) Bond market in troubled waters

Bond rates under the impact of the international financial markets

Under these circumstances foreign buyers played an unusually predominant role in the domestic bond market last year. As the behaviour of this group of buyers is sometimes determined by extremely short-term yield considerations with respect to exchange rate and securities price changes, this was almost bound to have a somewhat unsettling effect on those domestic investors who had laid their plans at rather longer term. Interest rate movements in the German bond market in the course of 1986 were clearly in line with international trends and were guided thereby. As early as the first four months of last year record amounts flowed into the domestic bond market from abroad, thus pushing German bond prices to new peaks and lowering capital market rates in Germany by a full percentage point to 5½% from the beginning of the year to mid-April 1986. At that level they virtually returned for a while to their historical low of spring 1978.

Limited efficiency of interest rate policy at the long end of the capital market

Parallel to the fall in interest rates in the domestic capital market, the Bundesbank lowered its discount rate in March 1986 and kept the low central bank rates constant throughout the rest of the year, despite all external disturbances. The fact that interest rate fluctuations in the German bond market in 1986 were nonetheless not inconsiderable goes to show that at least in the short term other factors, especially events in the international financial markets, outweighed the influence of the central bank. Thus from spring 1986 onwards the situation in the German capital market alternated between short bullish periods and longer phases of uncertainty, with falling prices and corresponding rises in interest rates. The average bond yield increased from 5½%, with fluctuations, to 6¼% for a time, and had fallen back to 5½% by the middle of April 1987.

Investment motives of non-residents and banks primarily speculative

The predominance of foreign influences is demonstrated by the scale of the net bond purchases of non-residents; at roughly DM 58.5 billion they accounted in 1986 for more than two-thirds of the total sum raised by selling domestic bonds. The remainder (DM 28.5 billion) was bought on balance by domestic banks. As experience shows, both groups of buyers are guided to a large extent in their portfolio decisions by relatively short-term considerations. For example, a major factor in the banks' decisions to buy is not infrequently the prospect of quickly realisable profits on bond prices. Correspondingly, the bulk of the banks' purchases last year were effected in the early part of the various bullish periods. On the other hand, non-residents' purchases in 1986 were mainly motivated by speculation on appreciation gains, although "visions of falling interest rates" also seem to have stimulated non-residents' interest at times.

Continuation of domestic non-banks' "wait-and-see" attitude towards investment

Domestic non-banks' abstention from buying was due to a large extent to the fact that their investment objectives are more of a medium and long-term nature and that longer-term interest rate and inflation expectations therefore probably play an important role. They still seem to be guided quite significantly by past experience, which includes the fact that nominal yields of less than 6% have been observed only twice in the last 30 years, and only for a relatively short period each time. The successes achieved in containing inflation during recent years, to the point of reaching price stability, have apparently not proved to be durable enough in investors' eyes to convince them that there could be a prolonged period with nominal yields of around and less than 6%. At the beginning of 1987, too, this assessment still seems to predominate, even though the strong appreciation of the Deutsche Mark makes stabilisation policy concerns appear less justified than in the past and, moreover, domestic supply and demand conditions in the capital market – a rising level of saving accompanied by only a sluggish increase in domestic demand for credit – might rather warrant expectations of interest rate reductions. The lowering of central bank interest rates on January 22, 1987 and the further easing of conditions in the domestic money market led to a drop in interest rates at the short end of the bond market, but the longer-term field was scarcely reached to begin with. When this Report went to press it was still an open question whether the steeper course of the yield structure curve – i.e. the renewed wider gap between the yields on long remaining maturities and those on very short maturities – offered incentive enough to overcome domestic investors' wait-and-see attitude.

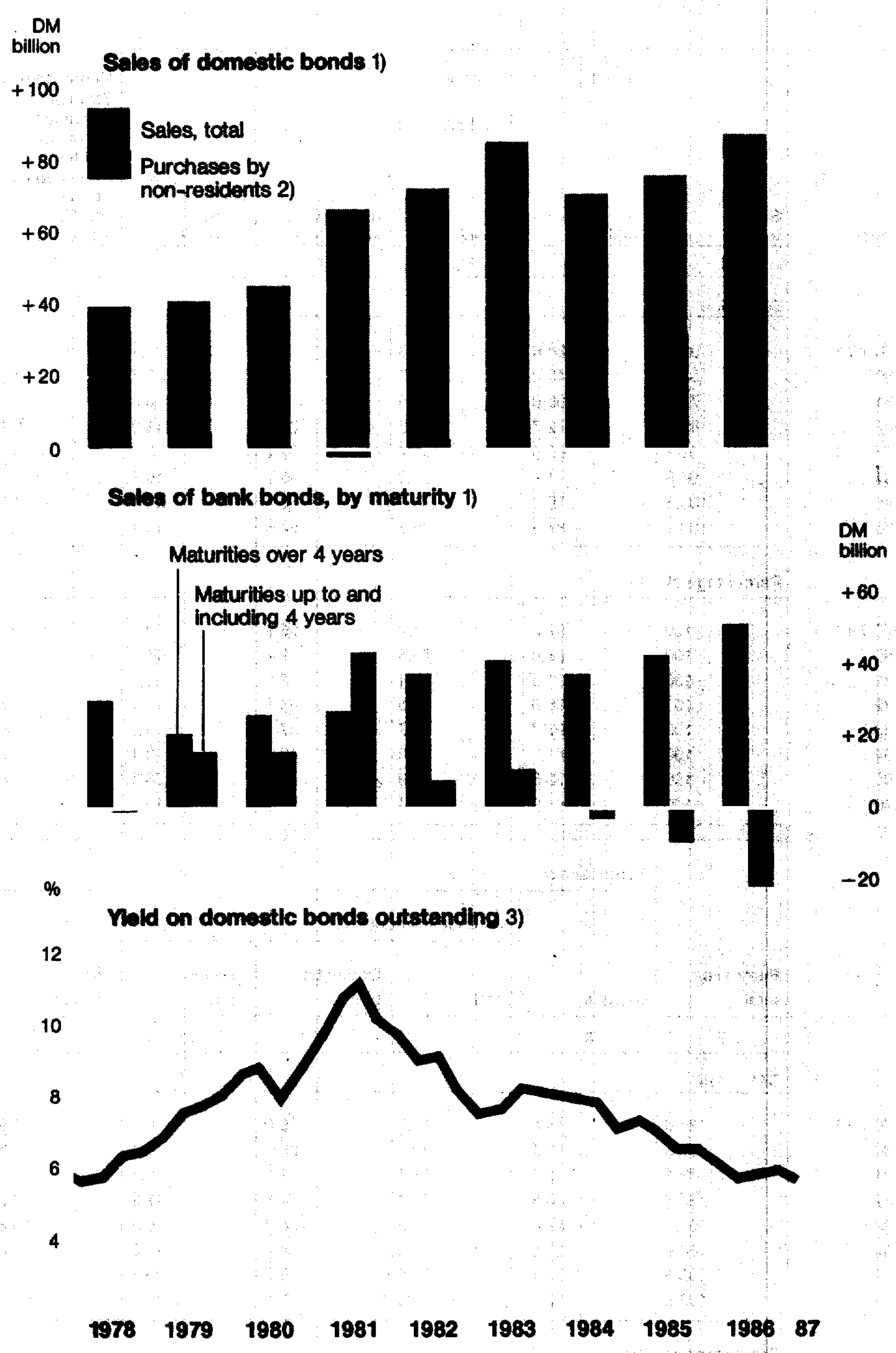
Sales and purchases of bonds in the Federal Republic of Germany

Period	Sales, total	Sales 1 of domestic bonds: Total 2	of which Issues: of banks	of which Issues: of public authorities	Sales of foreign bonds 3	Memo item Balance of transactions with non-residents 4 (− = capital exports) col. 12 less col. 5
	1	2	3	4	5	6
	DM billion					
1970-79 5	35.6	34.6	25.5	9.2	1.1	+ 0.9
1980	52.6	45.2	41.5	4.9	7.3	− 7.0
1981	73.1	66.9	70.5	− 2.6	6.2	− 7.7
1982	83.7	72.7	44.8	28.6	11.0	− 8.7
1983	91.3	85.5	51.7	34.4	5.7	+ 5.1
1984	86.8	71.1	34.6	36.7	15.7	− 1.9
1985	103.5	76.0	33.0	42.7	27.5	+ 4.0
1986	103.9	87.5	29.5	57.8	16.4	+42.3
	Percentage of total					
1970-79 5	100	97.0	71.7	25.9	3.0	×
1980	100	86.0	79.1	9.4	14.0	×
1981	100	91.5	96.4	− 3.6	8.5	×
1982	100	86.9	53.5	34.1	13.1	×
1983	100	93.7	56.7	37.7	6.3	×
1984	100	81.9	39.9	42.2	18.1	×
1985	100	73.5	31.9	41.3	26.5	×
1986	100	84.2	28.4	55.6	15.8	×

Period	Purchases, total	Purchases by: banks 6	domestic non-banks 7: Total	domestic non-banks 7: Domestic bonds	domestic non-banks 7: Foreign bonds	non-residents
	7	8	9	10	11	12
	DM billion					
1970-79 5	35.6	14.0	19.7	19.0	0.7	1.9
1980	52.6	19.1	33.2	29.1	4.1	0.3
1981	73.1	17.4	57.1	51.5	5.7	− 1.5
1982	83.7	44.8	36.7	24.5	12.2	2.3
1983	91.3	37.6	42.9	36.4	6.5	10.8
1984	86.8	23.0	50.0	34.2	15.8	13.8
1985	103.5	32.5	39.5	15.9	23.7	31.5
1986	103.9	32.4	12.8	0.1	12.7	58.7
	Percentage of total					
1970-79 5	100	39.3	55.2	53.3	1.9	5.4
1980	100	36.3	63.1	55.4	7.7	0.6
1981	100	23.8	78.2	70.5	7.7	− 2.0
1982	100	53.5	43.8	29.3	14.5	2.7
1983	100	41.2	47.0	39.9	7.1	11.8
1984	100	26.5	57.6	39.4	18.2	15.9
1985	100	31.4	38.2	15.3	22.9	30.4
1986	100	31.2	12.3	0.1	12.3	56.5

1 Net sales at market values plus/less changes in issuers' holdings of their own bonds. — 2 Including industrial bonds, which are not shown separately. — 3 Transaction values. — 4 Purchases of domestic bonds by non-residents less sales of foreign bonds to residents. — 5 Average. — 6 Including the Bundesbank. — 7 Residual.
Discrepancies in the totals are due to rounding. BBk

Trends on the bond market



1) Net sales at market values plus/less changes in issuers' holdings of their own bonds.- 2) Net purchases (+) or net sales (−).- 3) Quarterly averages.

BBk

Heavier sales of long-term bonds and high redemptions of short-dated paper ...

On the borrowers' and issuers' side the level of capital market rates reached in Germany definitely seems to be regarded as too low. This is suggested, firstly, by the heavy and strongly increased sales of long-term bonds and, secondly, by the observation that borrowers reduced their liabilities arising from shorter-term paper outstanding to an even greater extent in 1986 than in the previous year. Last year domestic issuers placed DM 112 billion (net) of bonds with maturities exceeding four years; in the shorter-term maturity categories, by contrast, they redeemed paper worth DM 24.5 billion (net). On balance, the amount raised by selling domestic bonds of all maturity categories in 1986 was DM 87.5 billion against DM 76 billion in the preceding year.

... especially pronounced in the case of banks' issues

The completely contrary trends in sales of bonds of different maturity categories are especially noticeable in the issuing behaviour of the banks. Overall, bank bonds with maturities exceeding four years were sold in 1986 to the amount of DM 51 billion (net), while the outstanding amount of shorter-term bank issues declined by DM 21.5 billion. Indirectly, this also reflects the shift in the structure of the issuing banks' lending business in favour of long-term loans with fixed interest rates. For especially private mortgage banks, public mortgage banks and the regional institutions of savings banks and credit cooperatives fund their mortgage loans, loans to the public sector and publicly guaranteed loans by offering mortgage bonds and communal bonds. In addition, these banks issue "uncovered" or "other" bank bonds for general funding purposes. However, with the inclusion of short-dated bank bonds in the minimum reserve requirements as from May 1986, one incentive to issue such paper with short-term maturities disappeared.

Diminishing significance of bank bonds

No doubt partly for this reason, sales of bank bonds further diminished in significance in the German bond market in 1986. Compared with the seventies and early eighties the importance of bank bonds decreased in 1986 from almost three-quarters to one-third of the total net sales of domestic bonds. The percentage remains higher if all short-dated paper is disregarded, but even then it was considerably lower in 1986, at about 46%, than in the preceding years. This reflects the fact that the traditional lines of lending business of the issuing institutions are growing less vigorously as a longer-term trend; in part, lending business – especially, for instance, the granting of loans to public authorities – has even been declining. Furthermore, given easy liquidity conditions for the banking system and a strong liquidity preference on the part of bank creditors, the bond market as a source of funding for banks' lending business cannot assume overriding importance, if only in terms of sales opportunities.

Bonds as a favoured instrument of public debt policy

Complementing this, the share of public bonds has increased to two-thirds in the last few years. Altogether, in 1986 the public authorities raised almost DM 58 billion (net, i.e. after deduction of redemptions) in the bond market, or DM 15 billion more than a year previously. This mirrors, on the one hand, the changed debt policy stance of the public authorities, which, besides new funding with the cheapest possible long-term resources – and these are raised via bond issues – were aiming at a consolidation of bank loans through bonds with the longest maturities possible; on the other hand, these developments also reflect non-residents' specific interest in public sector issues. The Federal Government in particular benefited from this. Besides the first-class standing of Federal bonds, large-scale institutional investors especially appreciate the high liquidity of this market segment, which is based among other things on the relatively large volume of this paper outstanding and the price regulation operations by the issuer. On the other hand, until a short while ago non-residents were less interested in Länder Government bonds, although these are equal to Federal bonds in terms of standing. Nevertheless, compared with previous years, sales of Länder Government bonds to non-residents increased strongly in 1986. Similarly, mortgage bonds and communal bonds were apparently not much in demand abroad for a long time, although their high standing is likewise indubitable in the light of the strict statutory security requirements. In both cases foreign investors who are interested in high "liquidity" were probably slightly put off by the fact that the secondary markets for this paper are not so well developed. Bank bonds – just like the practically insignificant "industrial bonds" – are, moreover, liable to securities transfer tax, whereas this does not apply to public bonds, which are issued as "value rights" and not in the form of physical certificates. From the investors' point of view, securities transfer tax also impedes, or increases the cost of, the rapid realisation of assets held in the form of paper subject to the tax. The Federal bonds for which foreign demand was strong in 1986 yielded, depending on their maturity, one-half up to – at the peak

— a full percentage point less than comparable communal bonds or Länder Government bonds. Naturally, the Federal Government took advantage of these market conditions by stepping up its issuing activity most in 1986 in the field of "traditional" bonds running as a rule for 10 years and sometimes even longer, while the inflow of funds from sales of its tap issues (five-year special Federal bonds and Federal savings bonds), which non-residents are prohibited from buying, lagged considerably behind the figures of the two preceding years. In all, the Federal Government took up DM 44.5 billion in the bond market last year. This was almost twice as much as would have been necessary to finance the budget deficit, and this permitted the above-mentioned restructuring of Federal debt.

Opening of the Federal Bond Consortium to foreign banks

In view of the greater importance of bond issues for financing the budget and in keeping with the strong interest abroad in Federal bonds, in 1986 the Federal Government strengthened the placing capacity of the Federal Bond Consortium, through which Federal bonds are issued under the direction of the Bundesbank. Last year, in consultation with the Bundesbank, the Consortium was extended to include a further 19 foreign banks which had not been represented in it before. At the same time the volume envisaged for a single issue was increased from previously DM 3 billion to normally DM 4 billion. Thanks to this extension of the sales channels, the Federal Government was able last year to place long-term issues tailored to the needs of large-scale investors on particularly favourable terms. It must not be overlooked in this connection that, especially among these investors, the long maturity of a bond permits no conclusion to be drawn as to any corresponding investment prospect. The strong internationalisation of the market for public bonds and the concomitant shortening of the time horizon for investment decisions exposes the debt policy of the Federal Government in greater measure to the quickly changing conditions in international markets, which of course may also have its drawbacks.

Liberalisation facilitates foreign investment in German bonds

The Bundesbank and the Federal Government saw the opening of the Federal Bond Consortium to foreign banks as a further step in the efforts to strengthen the international position of Germany as a financial centre. The abolition of "coupon tax" for non-residents in 1984 was the most important move here. In 1985 the Bundesbank made it possible for foreign banks domiciled in Germany to assume the lead-management when issuing foreign Deutsche Mark bonds. The simultaneous authorisation of new financing instruments until then not customary in the Deusche Mark area — such as floating-rate notes and zero-coupon bonds — and last but not least the approval of the Bundesbank for the issuing of Deutsche Mark certificates of deposit by banks domiciled in Germany also have to be mentioned in this context. Since the abolition of coupon tax, interest rate relationships between domestic and foreign Deutsche Mark bond issues have returned to normal. Unlike the situation in the preceding period, the yields of foreign Deutsche Mark bonds are now moving at the top of the interest rate range in the Deutsche Mark capital market, which has nevertheless not lost any of its attractiveness for foreign borrowers. With net sales totalling just under DM 24 billion, Deutsche Mark borrowing by foreign issuers in 1986 was equivalent to a good quarter of the simultaneous sales of bonds issued by residents in the German market, much as in the previous year. Taking the average of the seventies and in the early eighties, by contrast, this ratio was only about 15 % and 7 %, respectively. Now as before, the major part of the sales of foreign Deutsche Mark bonds is placed with foreign investors; in 1986 this share amounted to about 70 %.

For German industrial enterprises, too, the market for foreign Deutsche Mark bonds has increased in importance in the last two years. In 1986 alone German enterprises raised nearly DM 4 billion in the market for foreign Deutsche Mark bonds "indirectly" through the intermediation of financial subsidiaries abroad. In comparison with this, the total amount of domestic industrial bonds outstanding at the end of 1986 was only DM 2.5 billion. The rather paradoxical situation that major German enterprises of first-class standing take up bonds almost exclusively abroad via foreign subsidiaries, although the domestic market is itself very buoyant, owes something to the fact that the formal issue authorisation pursuant to sections 795 and 808a of the Civil Code, with the necessary provision of security, can be avoided in this way. Moreover, issuers in the foreign Deutsche Mark bond market are able to exploit the advantages of the broader placing potential and the keen competition among international investment banks.

Increased "indirect financing" of German enterprises in the foreign Deutsche Mark bond market

To a certain extent the loan instruments which were newly introduced in 1985 – especially floating-rate notes – have contributed to the growth noticeable in the last two years in the field of foreign Deutsche Mark bonds. At the end of 1986 the outstanding amount of these Deutsche Mark issues by non-residents was roughly DM 15.5 billion (DM 13 billion of which was floating-rate paper) or about one-tenth of the outstanding amount of foreign Deutsche Mark bonds. By contrast, these bonds have played a comparatively insignificant role in the domestic bond market up to the present. The outstanding amount of them at the end of 1986 was roughly DM 4 billion; this is less than ½% of the volume of domestic bonds outstanding. This might imply that the restraint previously exercised in authorising "innovative" loan instruments in the domestic market has resulted in no pent-up demand for such paper arising.

Mixed response to new loan instruments

(c) Share market put to the test

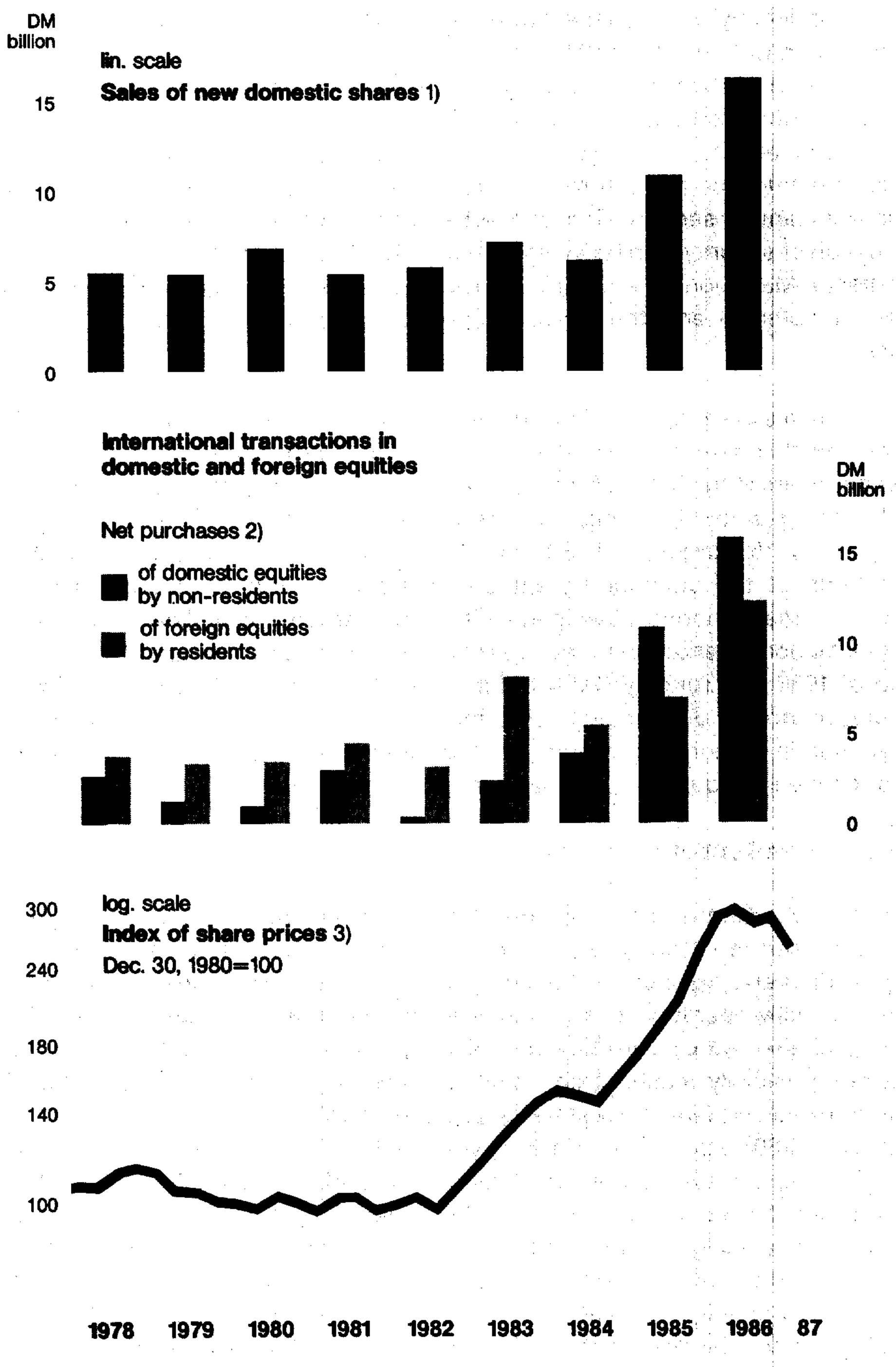
Trading in the German share market, similar to that in the bond market, has been characterised in recent years by the growing international links between the capital markets. Against the backdrop of investment strategies on the part of internationally-operating shareholders which were in many cases very short-term and affected by currency speculation, turnover on cross-border trade in equities positively mushroomed. With a transaction volume of some DM 260 billion (excluding direct investment), turnover in this sector in Germany in 1986 was almost 60% up on the previous year, eight times greater than in 1980 and fifteen times the average of the seventies. In 1986 risk capital totalling DM 16 billion (net) flowed into the German share market from foreign sources. As in 1985, this is virtually equivalent to the overall amount which German enterprises took up in the share market at the same time. However, non-residents were apparently primarily interested not so much in new issues as in outstanding leading stocks. On the other hand, residents spent DM 14.5 billion on foreign equities in 1986.

Rapid expansion in cross-border share trading

The increased integration of the share market in the international capital markets has made the trend in German share prices more dependent on price movements in the foreign share markets and on the exchange rate expectations of foreign investors. At the same time, the fundamentals of share rating – the earnings prospects of German enterprises – were not insignificant, although it is possible that they had a more decisive effect on the decisions of German stock market investors than on those of non-residents. On the whole, these market factors were fairly positive at the beginning of last year. The vast improvement in the profitability of domestic enterprises and their distinctly increased international competitiveness made the high price level in the German market appear soundly based. In the first quarter of 1986 alone foreigners acquired German shares to the value of DM 6.5 billion, essentially from domestic

Speculative investment motives become more important

Share market



1) At issuing prices.- 2) Including direct investment; transaction values.- 3) Quarterly averages; source: Federal Statistical Office.

BBk

portfolios. Moreover, the bullish tone which had been virtually continuous since the early eighties again made the share market more of a focal point for domestic private investors. These investors were particularly active in subscribing to the numerous new issues, often as a result of the prospects of fairly secure price gains which could be realised in the short term immediately after introduction to the stock exchange; at any rate, new issues were not infrequently heavily oversubscribed and some scaling-down and even a number of allocations by lot had to be effected. In the upshot, however, domestic non-banks would nevertheless appear to have reduced their holdings of domestic shares. The banks increased their share portfolios by a total of DM 6 billion in 1986.

Share prices at record level

In the wake of the strong foreign demand share prices, measured by the index of the Federal Statistical Office (December 30, 1980 = 100), reached an unprecedented high in mid-April 1986, at 334 points. The expansionary forces in the share market showed increasing signs of slackening in the ensuing period. The price level decreased, with fluctuations, and was only 5 % up on the previous year's level at the end of 1986. Investors' expectation that the Deutsche Mark would appreciate initially did much to fan the euphoria in the share market. However, it was the continuing appreciation itself which in the long run depressed the profitability in particular of those German enterprises which are exposed to foreign competition. This led in the first half of 1986 to a fundamental reassessment of the earnings prospects of domestic enterprises. It is likely that foreign investors have increasingly seen much less scope for further exchange rate gains and have been confronted with a decline in the competitiveness of German enterprises. Moreover, the accumulation of new issues and capital increases coupled with the issue of option loans also had a detrimental effect. At any rate, price movements in the German share market came under pressure on a broad front after the turn of 1986-87.

Longer-term orientation in the share market desirable

To stabilise market trading in the future and at the same time to guarantee the share market the role it should play in enterprises' equity formation, it would appear desirable to attach greater importance to investors in the share market who have long-term investment plans. However, the institutional framework of the German financial system would not seem to be particularly conducive to this at present. Because of the specific conditions attached to the tripartite German old-age provision scheme (statutory pension insurance funds without substantial capital accumulation, company old-age pension schemes linked with capital formation in the enterprise in question and private provision) the German share market, in comparison with the conditions in other industrial countries, lacks the investment potential of a major sector of insurance enterprises and pension funds. In other countries these large institutional investors are by far the most important group of purchasers in the share market. In Germany, however, the German insurance industry (including pension funds), with a share of about one-tenth in overall domestic share ownership, lags markedly behind private investors. While in 1986 the legislature improved the preconditions for these financial intermediaries to invest in shares by enabling them to step up their purchases of participations in domestic enterprises through a change in the investment guidelines which came into force at the beginning of 1987, it remains to be seen whether this will be impeded by accepted ideas on investment management at the insurance enterprises. Furthermore, a crucial factor in the further trend of the German share market is arguably the extent to which domestic private investors can be encouraged to step up their commitment in the share market. The attractiveness of investment in shares for these groups of investors is also determined by the distribution policy of public limited companies.

Gratifying increase in the importance of share financing in the enterprise sector

On the issuers' side, the readiness to utilise the share market as a source of finance has expanded reassuringly in recent years. The range on offer in the German share market was extended markedly in 1986 with first issues of nearly 30 public limited companies and a placing volume of over DM 4 billion. Together with the capital increases of already existing public limited companies, enterprises took up liable capital to the record amount of DM 16.5 billion. In addition, the market was affected last year by privatisations of publicly-owned enterprises amounting to roughly DM 1 billion. This would appear to have been due initially to the favourable market conditions obtaining in particular at the beginning of last year. However, enterprises continued to try to strengthen their capital base via the share market later in the year and reached a record level in the fourth quarter of 1986, with a volume of sales totalling more than DM 5.5 billion. The increased readiness last year to issue more common stock as against the non-voting preferred shares which had been given preference in the past, as well as the introduction to the stock exchange of numerous medium-sized enterprises which had previously been family-owned, show, incidentally, that fears of swamping and an aversion to publicity, which had often hindered their approach to the stock exchange in the past, have meanwhile declined in importance. Another contributory factor may have been the realisation that an inadequate capital base not only makes enterprises more crisis-prone, but also reduces their willingness to take risks and to innovate and ultimately has an adverse effect on competitiveness. The own funds ratio of enterprises organised as public limited companies rose to close on 28 % in 1985 and thus moved out of the trough of 1981 (barely 26 %). In 1986, for which no precise data are as yet available, this ratio would appear to have improved further, even though the figures of the beginning of the seventies (about 33 %) have not been attained again. Altogether, public limited companies, which in 1985 accounted for a good quarter of the balance sheet total of all domestic enterprises, had a markedly stronger capital base than other enterprises. With the Act on Risk Capital Investment Companies, which entered into force at the beginning of 1987, the legislature attempted to give medium-sized enterprises direct access to the procurement of capital through the stock exchange. Given the rigid balance sheet and organisational structure prescribed for risk capital investment companies under this Act, it remains to be seen, however, to what extent trade and industry will avail themselves of this new opportunity.

Further strengthening of the share market a task ahead

The preconditions for ensuring that the changed trend which has been evident in recent years in enterprises' financing policy will continue in future even if market conditions are more difficult have improved in other respects, too. For example, the "regulated market" will be introduced through the new Act Governing Admission to Listing on the Stock Exchange, which will enter into force on May 1, 1987; this is a further development of existing "regulated free trading" on the basis of stock exchange law and is meant to replace it gradually. This new market segment allows easier and lower-cost access to the stock exchange than official trading. The fact that interested enterprises have the choice of making an application for listing either together with a bank or with another suitable enterprise from the non-bank sector could, incidentally, give a new fillip to competition in stock exchange listing business, which has increased only in recent years. Of course, this presupposes that the responsible stock exchange bodies can make appropriate use of the scope afforded them by the legislature in the structuring of this extended listing arrangement in the new market segment. Further endeavours in the areas of organisation, legislation and, not least, taxation (as in the case of securities transfer tax and company tax) are undoubtedly necessary to develop the share market further. German trade and industry deserve a stock exchange in Germany of the standard which has long been enjoyed in other major industrial countries. Hence the reorganisation of the German stock exchange system which is currently under way must be pursued at a brisk pace, not primarily to foster business activity on the stock exchange, which is naturally imperative for its attractiveness, but to enable German companies increasingly to tap the market as a source of risk capital appropriate to growing enterprise units.

II. International monetary developments and policy

1. The situation in the world economy

World economy under the impact of considerable exchange rate changes and sharp falls in oil prices

The persistent drop in the US dollar and the unexpectedly sharp decline in crude oil prices confronted the world economy with unusual adjustment problems in 1986. The halving of oil prices within the space of one year once again led to an appreciable decrease in inflation rates almost everywhere. Lower dollar rates operated in the same direction in the industrial countries particularly affected by them. Although there was a distinct increase in real income and also in domestic demand in the industrial countries, the loss in purchasing power in the oil-exporting countries and the adverse impact of declining dollar rates on the exports of the industrial countries were not fully offset. The pace of economic growth in the industrial countries therefore slowed down from a good 3% in 1985 to barely 2½% in the following year.

Real external adjustment masked by terms of trade effects

External adjustment among the industrial countries was slow to get under way in 1986. The current account deficit of the United States, the country with by far the largest deficits, rose strongly once again. At the same time, the surpluses of other major countries, notably Japan and Germany as well as a number of threshold countries in Asia, also went up. In the industrial countries, however, this was entirely due to the decline in oil prices and the cheapening of imports caused by exchange rate changes. But adjustment in real terms made progress in 1986 and, as the example of Germany illustrates, should now work through to the nominal current account balances. The extent and pace of the further external adjustment depend not least on how economic activity develops in the individual countries and what scope the development of aggregate demand and supply leaves for the requisite corrections in the foreign balance. Developments in Germany in the past year were encouraging in this respect. In other major surplus and deficit countries less progress has been made to date in gearing the economy to the requirements of external adjustment. Although a lower rate of growth in domestic demand than in GNP is being forecast for the United States in 1987, implying a corresponding improvement in the US current account, considerable doubts are still entertained in this respect. If domestic and external adjustment in the United States were to remain inadequate, then this would jeopardise the latest efforts to stabilise exchange rates as well. In any event, a renewed overshooting of the exchange rate would be all the more likely, the longer the external imbalances persisted.

Improved international cooperation in economic and monetary policy

It became particularly clear last year how necessary closer economic and monetary policy cooperation is among the major industrial countries of the West if the individual countries are to move towards better balance of payments equilibrium without unduly impairing their economic growth or running the risk of a resurgence of inflationary forces. For this reason the Bundesbank supports the agreements on economic and monetary policy recently reached among the industrial countries – agreements which are designed to structure the economic policies of the countries concerned in such a way as to quickly correct existing disequilibria and prevent distortions of exchange rates as far as possible. In this context, coordinated interventions on the foreign exchange markets may be useful provided that the economic and financial policy stance in the individual countries generates confidence on the markets. If it fails to do so, exchange market interventions and even a monetary policy geared to stable exchange rates will not be able to produce the desired results on a durable basis.

Strengthening of the EMS through further progress towards convergence indispensable

The European Monetary System has made headway in recent years in terms both of convergence of economic performance and of agreement on the objectives of economic policy. Hence it has proved to be less susceptible to external shocks than was widely feared. However, the intramarginal interventions of individual member countries since the middle of 1986, the large-scale obligatory interventions of January 1987 and the subsequent realignment of central rates within the EMS make it clear that the inherent cohesion of the exchange rate arrangement is not yet strong enough for it to be able to withstand external constraints, such as those which proceed from the movement of the dollar, without inner tensions arising. This indicates that efforts to make economic, financial and monetary policy in the individual countries consistent with stability must not slacken if the system is to become firmly established as a zone of stable currencies in the judgement of the markets too. Given the progressive liberalisation of short and long-term capital transactions – an objective pursued by Germany for a long time past – and the associated greater integration of the financial markets, even greater importance attaches to these efforts. However, the satisfactory functioning of the EMS also makes it necessary for tensions of this nature which affect the system from outside to be countered by the employment of the available instruments in as flexible a manner as possible. This may include recourse to intramarginal interventions; but they must not go so far as to tie exchange rates together within the exchange bands and thus lessen the risk associated with speculative capital movements. Moreover, tensions in exchange rates can also be countered by changing the interest rate differentials between the currencies in question. However, the employment of monetary policy instruments to stabilise exchange rates comes up against its limits at the point where this would be incompatible with a monetary policy geared to stability.

Renewed exacerbation of the debt problems

The problems raised by the high level of foreign debt of a large number of developing countries became more acute again last year. Although the burden imposed on a good many debtor countries was eased to an appreciable extent by the fall in oil prices and interest rates, other countries – including Mexico, in particular – were hard hit by the decline in crude oil prices or contributed through their own policies to the renewed jeopardisation of their solvency. In the light of such setbacks the creditor banks are less and less inclined to further increase their lending to a number of countries that are already heavily indebted; the greater provisions they have meanwhile made for possible loan losses will probably operate in the same direction. The behaviour of some of the debtors and creditors involved therefore gives grounds for concern that the approach adopted up to the present – based as it has been on cooperation between debtor countries, international financial institutions and official and private creditors in dealing with the problems case by case – is running into serious difficulties and is being replaced by an atmosphere of confrontation. However, the refusal to effect some or all of the due debt service payments is not an appropriate way to help heavily-indebted countries to achieve satisfactory economic growth again. The financial scope gained by such methods bears no relationship to the damage that the debtor countries would suffer as a consequence in the longer run. Similarly, the adoption of a tougher stance by the creditor banks without taking account of the circumstances involved in each individual case would not be the right answer to the questions that arise at the present stage of grappling with the debt problems. Instead, in the light of past experience it appears necessary for the banks to show more flexibility in deploying the financial instruments at their disposal. At all events, the international organisations – meaning first and foremost the IMF, which has played a key role in overcoming the debt problems from the outset, and the World Bank, whose services were called upon to a greater extent only after the "Baker initiative" had been launched – should not be expected generally to soften the conditions on which they provide their financial assistance. There is no prospect of their expanding their lending operations to such a degree that both the debtor countries and the creditor banks would be freed of the necessity of playing an active role in overcoming the problems.

Despite exchange rate problems, renewed marked growth in world trade

According to provisional calculations by the IMF, the volume of world trade rose by just under 5 % in 1986 after having grown by only 3¼ % in the preceding year.[1] Imports by the industrial countries in particular provided the driving force behind the appreciable expansion of international trade: they increased by 9 % in real terms. Most of the non-oil developing countries also stepped up their imports slightly; the oil-exporting countries, by contrast, cut back their imports by just over one-fifth in response to price-induced shortfalls in their earnings. The growth in imports by the industrial countries was based both on an increase in their purchases of oil and on a steep rise in their imports of industrial and other goods. It was the developing countries that profited most from this; the non-oil exporters among them were able to expand their exports by 8 %. In contrast, the rise in the exports of the industrial countries was quite modest, at 3 %. These trends in international trade are fully in keeping with the requirements of global economic adjustment. However, the weak rate of growth of the industrial countries' exports gives cause for concern; the sluggish development of exports is having an adverse effect on the economic climate in those countries and hence also on their capacity to import more. A higher level of exports by major industrial countries has been prevented inter alia by recent exchange rate movements. The exports of the countries of Europe went up only by a small amount and Japan's exports actually declined. However, despite a considerable depreciation of the dollar against other major currencies, the exports of the United States did not entirely fill the gap.

With imports rising further, renewed increase in the US trade deficit

In 1986 US exports grew by 7 % in volume terms, based on the much-adjusted balance of payments figures. In value terms, however, US exports went up by only 3 %, mainly because of falling agricultural prices. There was a particularly marked rise in the value of US exports to Japan and those countries in Europe whose currencies appreciated strongly against the dollar. But there was a much steeper increase in the volume of US imports, at 15 %. This owes something to the fact that, despite the marked depreciation of the dollar, US import prices for industrial products have risen only a little up to now. After the reversal in the movement of the dollar, foreign suppliers obviously hardly raised their dollar prices at all to begin with, but largely absorbed exchange-rate-induced declines in their earnings in their profit margins. This appeared acceptable to them at first since their profit margins had widened considerably during the preceding appreciation of the dollar. However, there are other reasons as well for the buoyancy of US imports. They include the expectation of exchange-rate-induced price increases, the fear of protectionist restrictions and the fact that foreign products have gained a firm place on the US market owing to their high quality. Above all, however, the upsurge in US imports reflects the comparatively strong growth in domestic demand in the United States. Despite the simultaneous decline in oil prices, the value of US imports went up by 9 %; this was almost three times as much as the rise in the value of exports. As a result of these many and varied influences, the US trade deficit grew by $ 23 billion to $ 148 billion; including the transport and insurance costs associated with imports, it increased at a similarly rapid pace to $ 170 billion.

US current account deficit also higher

The US current account deficit rose to the same extent as its trade deficit to $ 141 billion. Although the interest burden on the United States caused by the increase in foreign debt associated with its persistent current account deficits also grew further, these additional outflows of dollars were offset by a decline in

1 Discrepancies exist in the statistical coverage of global imports and exports, and the aggregate rates of change of both variables also frequently differ. The volume of world trade is therefore measured as a rule in terms of the average change in imports and exports. Moreover, real global foreign trade flows can be ascertained only with a certain margin of uncertainty, especially if — as was the case last year — foreign trade earnings are strongly affected by price changes and shifts in exchange rates.

Balance of payments of the United States

US$ billion

Item	1981	1982	1983	1984	1985	1986 **pe**	Change in 1986 from 1985 [1] **pe**
A. Current account [2]							
Merchandise trade							
Exports	237.1	211.2	201.8	219.9	214.4	221.8	+ 7.3
Imports	265.1	247.6	268.9	332.4	338.9	369.5	– 30.6
Balance	– 28.0	– 36.4	– 67.1	– 112.5	– 124.4	– 147.7	– 23.3
Foods, feeds and beverages	+ 20.1	+ 14.5	+ 13.1	+ 10.3	+ 2.7	– 1.4	– 4.2
Capital goods	+ 44.9	+ 35.3	+ 25.8	+ 13.1	+ 11.6	+ 3.0	– 8.6
Automotive vehicles, parts and engines	– 11.1	– 16.7	– 24.8	– 34.1	– 40.6	– 55.3	– 14.8
Consumer goods (non-food)	– 22.3	– 24.9	– 32.9	– 47.5	– 52.2	– 63.4	– 11.2
Petroleum and products	– 73.7	– 54.8	– 50.1	– 52.6	– 45.5	– 30.1	+ 15.5
Other industrial supplies and materials	+ 8.5	+ 7.1	– 1.2	– 7.9	– 7.9	– 8.2	– 0.3
Other	+ 5.7	+ 3.0	+ 3.0	+ 6.2	+ 7.4	+ 7.8	+ 0.4
Investment income							
Receipts of income on US assets abroad	86.4	83.5	77.3	86.2	90.0	90.6	+ 0.6
Payments of income on foreign assets in the United States	52.3	54.9	52.4	67.5	64.8	67.7	– 2.9
Balance	+ 34.1	+ 28.7	+ 24.8	+ 18.8	+ 25.2	+ 22.9	– 2.3
Other services and military transactions	+ 7.7	+ 7.6	+ 5.1	– 0.5	– 3.4	– 0.6	+ 2.9
Unilateral transfers	– 7.4	– 8.9	– 9.5	– 12.2	– 15.0	– 15.1	– 0.2
Balance on current account	+ 6.3	– 9.1	– 46.6	– 106.5	– 117.7	– 140.6	– 22.9
B. Capital account							
(capital exports: –)							
US assets abroad							
Direct investment	– 9.6	+ 2.4	– 0.4	– 3.9	– 18.8	– 31.9	– 13.2
Portfolio investment	– 5.8	– 8.1	– 7.0	– 5.1	– 8.0	– 4.8	+ 3.2
Claims reported by enterprises	– 1.2	+ 6.6	– 6.5	+ 5.1	+ 1.7	[4] – 4.2	[4] – 5.8
Claims reported by banks	– 84.2	– 111.1	– 29.9	– 11.1	– 0.7	– 57.3	– 56.6
Claims reported by the US Government	– 5.1	– 6.1	– 5.0	– 5.5	– 2.8	– 2.0	+ 0.8
Total	– 105.9	– 116.3	– 48.8	– 20.5	– 28.6	– 100.1	– 71.5
Foreign assets in the United States							
Direct investment	+ 25.2	+ 13.8	+ 11.9	+ 25.4	+ 17.9	+ 25.6	+ 7.7
Portfolio investment	+ 10.1	+ 13.4	+ 17.4	+ 35.8	+ 71.4	+ 80.0	+ 8.6
Liabilities reported by enterprises	+ 0.9	– 2.4	– 0.1	+ 4.7	– 1.2	[4] – 3.1	[4] – 1.9
Liabilities reported by banks	+ 42.1	+ 65.6	+ 50.3	+ 33.8	+ 40.4	+ 77.4	+ 37.0
Liabilities reported by the US Government	– 0.3	+ 0.6	+ 0.7	+ 0.4	+ 0.5	+ 1.1	+ 0.6
Total	+ 78.0	+ 91.1	+ 80.3	+ 100.2	+ 128.9	+ 181.0	+ 52.1
Balance on capital account							
Direct investment	+ 15.6	+ 16.2	+ 11.6	+ 21.5	– 0.9	– 6.3	– 5.4
Portfolio investment	+ 4.3	+ 5.3	+ 10.4	+ 30.7	+ 63.4	+ 75.2	+ 11.8
Enterprise sector	– 0.3	+ 4.2	– 6.6	+ 9.8	+ 0.5	[4] – 7.3	[4] – 7.8
Banks	– 42.0	– 45.4	+ 20.4	+ 22.7	+ 39.7	+ 20.1	– 19.6
US Government	– 5.4	– 5.5	– 4.3	– 5.1	– 2.3	– 0.9	+ 1.4
Total	– 27.8	– 25.2	+ 31.4	+ 79.7	+ 100.3	+ 80.8	– 19.5
C. Statistical discrepancy	+ 20.3	+ 36.3	+ 11.1	+ 27.3	+ 23.0	+ 27.1	+ 4.1
D. Balance on official reserve transactions							
Official reserve assets [3]	+ 4.1	+ 5.0	+ 1.2	+ 3.1	+ 3.9	– 0.3	– 4.2
Liabilities to foreign official institutions (Increase: –)	– 5.3	– 3.0	– 5.2	– 2.6	+ 1.8	– 32.3	– 34.1
Balance on official reserve transactions (A plus B plus C)	– 1.2	+ 2.0	– 4.0	+ 0.5	+ 5.7	– 32.6	– 38.3

1 – = Decrease in receipts or increase in payments. — **2** Excluding unilateral military transfers to the rest of the world. — **3** Excluding SDR allocations. — **4** For the fourth quarter of 1986 these transactions are included in the item "Statistical discrepancy". — **pe** Partly estimated.

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

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the deficit deriving from miscellaneous transactions on services account. The reduction in the surplus on the US investment income account by $ 2 billion to $ 23 billion was relatively small because the investment income received by the United States in foreign currency also rose in purely mathematical terms as a consequence of the depreciation of the dollar. In the event of a stabilisation or recovery of the dollar on the foreign exchange markets, the US investment income account would be bound to deteriorate more strongly in future owing to the continuing rise in interest payments. The danger inherent in this situation of a self-reinforcing tendency towards larger current account deficits can be averted only through a rapid and lasting improvement in the US trade balance. However, the requisite process of adjustment cannot be brought about by exchange rates alone. There are limits here both for the United States itself and for its trading partners. This makes it all the more important for the United States to tackle its external problems resolutely by means of corresponding domestic economic policy measures.

Current account balances of the other industrial countries governed by oil-price and exchange-rate influences

Japan's current account surplus rose by $ 38 billion and Germany's surplus went up by $ 23 billion. The larger surpluses of both countries can be attributed to a considerable extent to the fall in their oil bills expressed in dollars and for the rest to exchange-rate-induced lower import prices. However, the adjustment process has meanwhile got under way unmistakably in both countries. If exports and imports had had to be paid for at 1985 prices, both Japan's and Germany's trade surpluses – instead of rising further – would have fallen appreciably in 1986 owing to the steep increases in imports (Japan's by $ 26 billion and Germany's by $ 10 billion). The current account balances of other industrial countries also improved markedly last year; those of Italy and France improved by a total of $ 13 billion. In contrast, the current account positions of the United Kingdom, Canada and Norway deteriorated substantially, i.e. by an aggregate amount of $ 20 billion. The deterioration in these countries, which also export oil, owed very much to the decline in crude oil prices. Despite the deteriorating trends in a number of countries, the aggregate current account deficit of all the industrial countries, including the United States, declined by no less than $ 46 billion to as little as $ 8 billion.

Deterioration in the current account position of the oil-exporting developing countries

The improvement in the current account balances of the industrial countries was accompanied by a deterioration of $ 38 billion in the aggregate current account position of the oil-exporting developing countries; the current accounts of this group of countries, which besides the OPEC countries includes Mexico and a number of smaller oil-exporting countries outside OPEC, switched from a small surplus to a deficit of $ 36 billion. Only the drastic cutback in their imports mentioned above prevented an even more unfavourable trend in the current account position of these countries. The exporters of other commodities suffered likewise in 1986 from falling export prices; these falls were offset, however, by the lower cost of their oil imports. Since, under the impact of their tight financial position, these countries endeavoured to prevent their imports from rising more strongly than their export earnings, they succeeded in stabilising their current account deficits at the level of 1985. The threshold countries of East Asia, by contrast, managed to strengthen their external position in various ways last year. They profited not only from the decline in the prices of oil and other commodities but also from the lower interest rates; but they benefited most from the steep rise in the demand for imports on the part of the industrial countries. The outcome was an improvement of $ 13 billion on aggregate in the current account position of those developing countries which export industrial products.

Current account balances of selected countries and groups of countries

US$ billion

Group of countries/Country	1981	1982	1983	1984	1985	1986 p	Change in 1986 from 1985 p
A. Industrial countries 1							
United States	+ 6.3	− 9.1	− 46.6	−106.5	−117.7	−140.6	− 22.9
Six other major countries	− 6.3	+ 2.6	+ 28.4	+ 42.2	+ 61.8	+123.0	+ 61.2
Japan	+ 4.8	+ 6.9	+ 20.8	+ 35.0	+ 48.2	+ 86.0	+ 37.8
Canada	− 5.5	+ 2.4	+ 2.4	+ 2.6	− 0.4	− 6.3	− 5.9
Federal Republic of Germany	− 5.1	+ 4.0	+ 4.3	+ 6.7	+ 13.8	+ 36.3	+ 22.5
France	− 4.8	− 12.1	− 4.7	− 0.8	− 0.2	+ 3.5	+ 3.7
United Kingdom	+ 12.5	+ 6.9	+ 4.8	+ 1.6	+ 4.6	− 1.6	− 6.2
Italy	− 8.2	− 5.5	+ 0.8	− 2.9	− 4.2	+ 5.1	+ 9.3
Other industrial countries	− 20.0	− 15.5	− 3.7	+ 2.5	+ 2.1	+ 10.1	+ 8.0
Total	− 20.0	− 22.1	− 22.0	− 61.8	− 53.9	− 7.5	+ 46.4
B. Developing countries							
1. By region							
Africa	− 22.6	− 21.7	− 12.5	− 7.4	− 0.3	− 6.8	− 6.5
Europe	− 14.2	− 8.6	− 5.7	− 3.6	− 3.2	− 1.9	+ 1.3
Latin America	− 42.7	− 42.4	− 10.9	− 2.6	− 4.8	− 15.1	− 10.3
Middle East **2**	+ 49.9	+ 2.9	− 19.3	− 16.4	− 2.6	− 24.9	− 22.3
Rest of Asia	− 19.2	− 17.5	− 15.4	− 4.2	− 12.9	+ 1.4	+ 14.3
2. By main export products **3**							
Oil exporters **4**	+ 34.8	− 18.2	− 18.7	− 5.4	+ 2.6	− 35.8	− 38.4
Other countries	− 83.5	− 69.1	− 45.1	− 28.9	− 26.5	− 11.5	+ 15.0
of which							
Exporters of industrial products **5**	− 15.1	− 4.0	+ 1.3	+ 6.2	− 2.8	+ 10.3	+ 13.1
3. By the significance of their debt service problems							
15 major debtor countries **6**	− 50.3	− 50.6	− 15.2	− 0.6	− 0.1	− 11.8	− 11.7
Other countries	+ 1.6	− 36.7	− 48.6	− 33.6	− 23.7	− 35.5	− 11.8
Total	− 48.7	− 87.3	− 63.8	− 34.2	− 23.8	− 47.3	− 23.5
C. Other countries 7	− 3.0	+ 2.8	+ 3.1	+ 4.4	+ 3.2	+ 0.7	− 2.5
D. Statistical discrepancy (A plus B plus C)	− 71.7	−106.6	− 82.7	− 91.6	− 74.5	− 54.2	+ 20.3
Memorandum items							
Statistical discrepancy by sector							
Merchandise trade	+ 17.2	− 2.7	+ 2.3	+ 9.8	+ 8.1	+ 9.4	+ 1.3
Services	− 76.6	− 88.8	− 74.0	− 90.7	− 71.4	− 48.9	+ 22.5
Transfers	− 12.4	− 15.0	− 11.0	− 10.7	− 11.2	− 14.7	− 3.5

1 OECD countries other than Greece, Portugal and Turkey. — **2** Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates, Yemen and Democratic Yemen. — **3** On the basis of exports in 1980, the countries are assigned to those product categories which account for at least one-half of their exports. — **4** OPEC countries, Bahrain, Congo, Mexico, Oman, Syria, Trinidad and Tobago, Tunisia. — **5** China, Hong Kong, Hungary, India, Israel, Poland, Romania, Singapore, South Korea, Taiwan, Yugoslavia. — **6** Countries to which the "Baker initiative" primarily relates (Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia). — **7** Eastern European non-members of the IMF. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Sources: IMF, OECD and national statistics. BBk

Progress in explaining discrepancies in the global pattern of current accounts

Earlier Annual Reports of the Bundesbank have already pointed out that in the global statistics on current account positions the deficits far exceed the corresponding surpluses. Discrepancies of this nature make it difficult to assess the current account balances of various groups of countries reliably, especially as these discrepancies vary widely from year to year. Thanks to intensive investigations by an IMF working party (in which the Bundesbank also took part) it has now proved possible to estimate some of the receipts not recorded in the national balance of payments statistics. According to these studies, the discrepancies in the global current account statistics are largely due to the incomplete coverage of sizeable amounts of investment income; although these sums appear as expenditure in the current accounts of the debtor countries, they are not reported as receipts in the creditor countries. The scale of the unrecorded investment income can be reconstructed fairly accurately, using the international claims and liabilities included in the banking statistics of the BIS and the IMF, and thus also classified approximately by major groups of countries. But a corresponding adjustment of the statistics on the global pattern of current accounts – which adjustment is not contained in the data regularly published by the IMF but is carried out by the Fund for illustrative purposes only – makes no substantial difference to the trend of the published current account data, neither for the industrial countries nor for the developing countries. These investigations have thus at the same time made it certain that the trends in the current account positions of major groups of countries have by and large been assessed correctly in the past. The IMF must, of course, now insist that this newly gained knowledge is duly taken into account in the balance of payments statistics of its members, so that better data on the global pattern of payments balances gradually become available.

3. Exchange rates and exchange rate policy

Further drop in the external value of the dollar

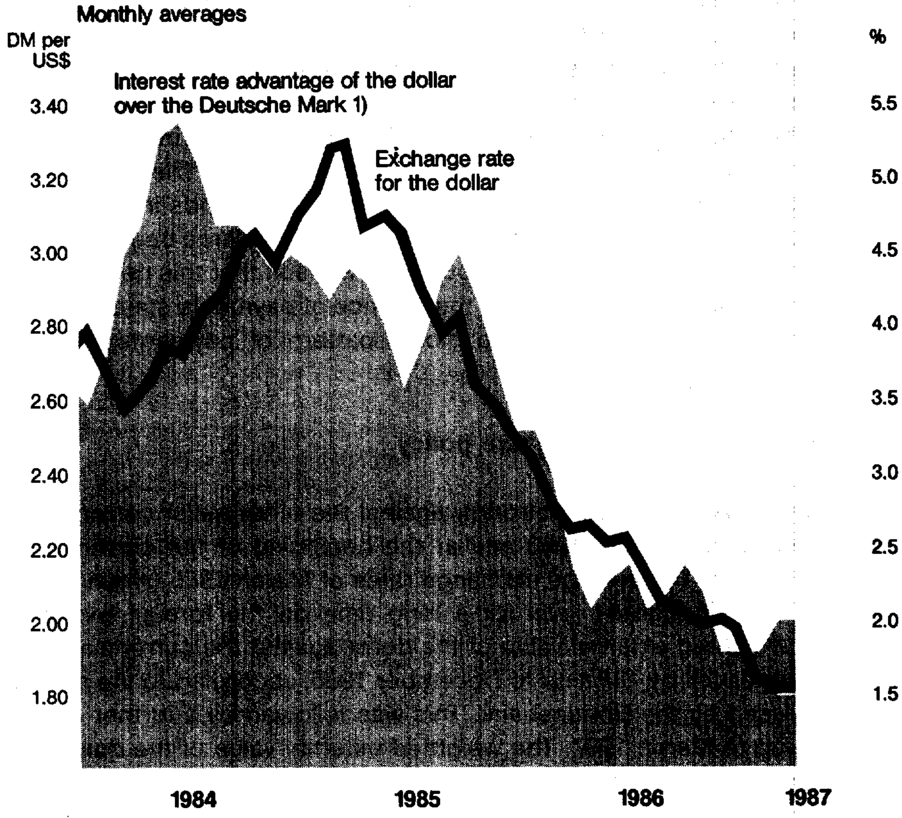
After the dollar had already fallen strongly against the other major currencies in 1985, this trend continued in 1986 and at the beginning of the current year. Measured in terms of the average exchange rates of March 1985 (when the US currency reached its highest level for a long time on the foreign exchange markets), the weighted external value of the dollar against the currencies of 14 industrial countries fell by 18 % up to December 1985, according to the method of calculation used by the Bundesbank. This was followed by a further drop in value of 19 % up to March 1987. The weighted external value of the dollar thus declined by 34 % within a period of just under two years. Hence the US currency lost the entire increase in its value during the preceding four years. Over this total period of six years prices and costs in the United States developed hardly any differently from their average trend in the other industrial countries. The real external value of the dollar therefore also went up sharply at first, before weakening just as markedly during the last two years. If the nominal and real depreciation of the dollar in the seventies is taken into account, the US economy has gained considerably over the other industrial countries in terms of competitiveness in the longer term, too, as far as the movement of exchange rates is concerned.

Large-scale purchases of dollars by foreign monetary authorities

There are many reasons behind the weakening of the dollar rate since the beginning of 1986. It reflects both the further rise in the US current account deficit and the growth in capital exports from the United States as well as greater reservations on the part of non-residents with respect to investments in dollar assets. A factor contributing to these reservations was that the pace of US economic activity slackened and, with an accommodating monetary policy, US interest rates declined appreciably. The interest rate differential between the United States and Germany with respect to long-term government bonds narrowed from 3.3 percentage points in December 1985 to 2 percentage points in March 1987. In mid-1984 the interest rate differential had been as wide as 5½ percentage points. As regards three-month money market assets, the interest rate differential dwindled to 1.7 percentage points at the same time, compared with 2.6 points in December 1985 and a peak of over 5 points in 1984. There has also been a distinct decline since the beginning of 1986 in the interest rate differential between long-term investments in dollar assets and those in yen assets. This has been compounded by the assessment on the part of many private investors abroad that the main cause of the constant outflows of dollars from the United States – the US deficit on current account – will hardly be overcome without a further depreciation of the US currency. It was not until the dollar rate fell perceptibly that there was a renewed upturn in US capital imports in the form of foreign investments in US securities and inflows of funds to US banks. Moreover, there was a rise in foreign exchange inflows in connection with

Deutsche Mark/US dollar exchange rate and international interest rate differential

Monthly averages



1) As measured by the yields on long-term public bonds outstanding.

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unclassifiable transactions (the balancing item of the balance of payments). The excess supply of dollars on the market that nevertheless remained was taken over in the circumstances by foreign monetary authorities. Several central banks were prepared to increase their monetary reserves, but this was done mainly with a view to counteracting even stronger pressure on the US currency and hence the appreciation of their own currencies. There was therefore a major change last year in the way the balance of payments deficit of the United States was financed. After the autonomous capital imports of the United States in 1985 had still been sufficiently high to offset the supply of dollars resulting from its current account deficit and exports of capital without the involvement of the monetary authorities (albeit at falling rates for the dollar), last year, with persistent marked declines in the dollar rate, almost one-quarter of the US deficit on current account, or over one-eighth of the total outflows of dollars from the United States, was financed by purchases of dollars by foreign monetary authorities.

Decline in the dollar mainly restricted to relationship with the currencies of Continental Europe and the yen

The dollar has weakened since March 1985 primarily vis-à-vis the currencies of Continental Europe and the yen. Its depreciation against sterling was substantially smaller, and its value vis-à-vis the Canadian dollar has hardly changed. In contrast, the dollar had strengthened distinctly in terms of all these currencies in the four-year period of its upswing. Thus, the reversal on the dollar market did not entirely offset the competitive disadvantages of the United States in price terms that had arisen over the period of many years when the dollar was strong. This becomes even more evident when the development of the dollar is not only viewed in relation to the currencies of the major industrial countries but account is also taken of the development of the dollar vis-à-vis a number of currencies in the Asian-Pacific region. Measured in terms of the currencies of seven of these countries,[1] which account for about one-seventh of US foreign trade and which in some cases are also major competitors of the United States on third markets, the dollar rose on average by 36 % from the beginning of 1981 to the beginning of 1985, using the method applied by the Federal Reserve Board in weighting the individual shifts in exchange rates.[2] The external value of the dollar against this group of currencies went up almost half as much in both nominal and real terms as it did against the currencies of the major industrial countries. Since these currencies, despite large current account surpluses on the part of most of the countries concerned, went down largely in line with the dollar's subsequent fall, no substantial change has occurred as yet in the preceding exchange-rate-induced deterioration of the competitive position of the United States in relation to the rising nations of the Asian-Pacific region. Manufacturers in countries with these currencies can therefore frequently step in when European and Japanese competitors are no longer competitive for exchange rate reasons. This is one of the reasons why the US trade balance did not show any substantial improvement with respect to imports and exports alike in 1986 either. The dollar has also appreciated in real terms since the beginning of the eighties in relation to the currencies of the major trading partners of the United States in Latin America. However, the countries of Latin America have succeeded less well in exploiting the associated improvement in market opportunities. At least, the US trade deficit vis-à-vis this group of countries has not risen any further of late.

Support operations for the dollar initially without major participation by the United States

From the spring of 1986 onwards there were increasing signs that the depreciation of the dollar in relation to individual currencies was threatening to overshoot a level that was appropriate over the longer term. For this reason the Bank of Japan intervened in the foreign exchange market in the six months encompassing the summer of 1986 through large-scale purchases of dollars. Moreover, at the end of October last year the Finance Ministers of the United States and Japan declared in a statement that the shift up to then in the exchange rate between the dollar and the yen took account of the situation in both countries and thus had gone far enough. The similarly sharp decline in the dollar in Europe was initially not of the same significance as in Japan owing to differences in the structure of foreign trade; however, the persistent pressure on the dollar created increasing exchange rate tensions within the EMS. Consequently, the Bundesbank intervened in September-October 1986 for the first time in a long while, likewise by purchasing dollars on the foreign exchange market, with other European central banks joining in in October. The Japanese central bank intervened in the market again at the beginning of 1987 with large-scale purchases of dollars. However, all this activity halted the fall in the dollar at best for a short time. These efforts were in vain, not least because statements by US officials repeatedly aroused the impression on the markets that the US authorities wanted the dollar to depreciate further. Moreover, until then the Americans hardly participated in the operations to support their currency. Nor did the Federal Reserve counteract the downward trend in the dollar through monetary policy measures, despite the risks to price stability which it clearly perceived.

Economic and monetary policy cooperation strengthened by the Paris accord of February 1987

Against the background of the uncertainty about the attitude of the United States towards the development of the dollar rate, the Finance Ministers and Central Bank Governors of the United States, Japan, Germany, France, the United Kingdom and Canada again discussed the international economic and monetary situation in Paris in February 1987. In the process, each of these

1 Australia, Hong Kong, Malaysia, Singapore, South Korea, Taiwan, Thailand.

2 The weights used were the shares of the corresponding countries in the total foreign trade of this group of countries (calculated on the basis of the years 1972 to 1976). In comparison with a weighting system using the bilateral shares of these countries in US foreign trade, this method has the advantage that in principle the weighting of the individual shifts in exchange rates also takes third-market effects into account, albeit in very general terms. The Federal Reserve Board uses a corresponding weighting system in order to measure the development of the external value of the US currency on the basis of the currencies of the other Group of Ten countries.

countries held out prospects of economic policy measures intended to help reduce the imbalances in the world economy. In the statement published after their discussion the Finance Ministers and Central Bank Governors pointed out that the shifts in exchange rates that had occurred since the New York agreement of September 1985 had brought about a pattern of exchange rates which "given the policy commitments summarised in this statement" corresponded to the fundamental economic conditions in the countries concerned. Moreover, they announced their intention of cooperating with the aim of stabilising the exchange rates of their currencies at about the level they had reached. When the dollar showed renewed signs of weakness, especially vis-à-vis the yen, as from the end of March 1987, Japan and the United States took counteraction in the shape of substantial coordinated exchange market interventions.

Strong rise in the external value of the Deutsche Mark

As explained in greater detail elsewhere in this Report, the marked appreciation of the Deutsche Mark since spring 1985 continued in 1986. In relation to the exchange rate level of December 1985, the German currency rose unusually fast up to March 1987 against the US dollar (+ 37 %), the Canadian dollar (+ 30 %) and sterling (+ 25 %). The value of the German currency also went up vis-à-vis the currencies participating in the exchange rate mechanism of the EMS. The external value of the Deutsche Mark rose by 11 % on a weighted average against the currencies of 14 industrial countries. Viewed over the longer term, this was about the extent indicated by the stronger increase in the level of prices abroad. Although prices abroad have continued to rise faster on average than in Germany since the beginning of the eighties, the weighted external value of the Deutsche Mark even declined initially. But the associated gain in competitiveness for German industry was offset by the renewed appreciation of the Deutsche Mark.

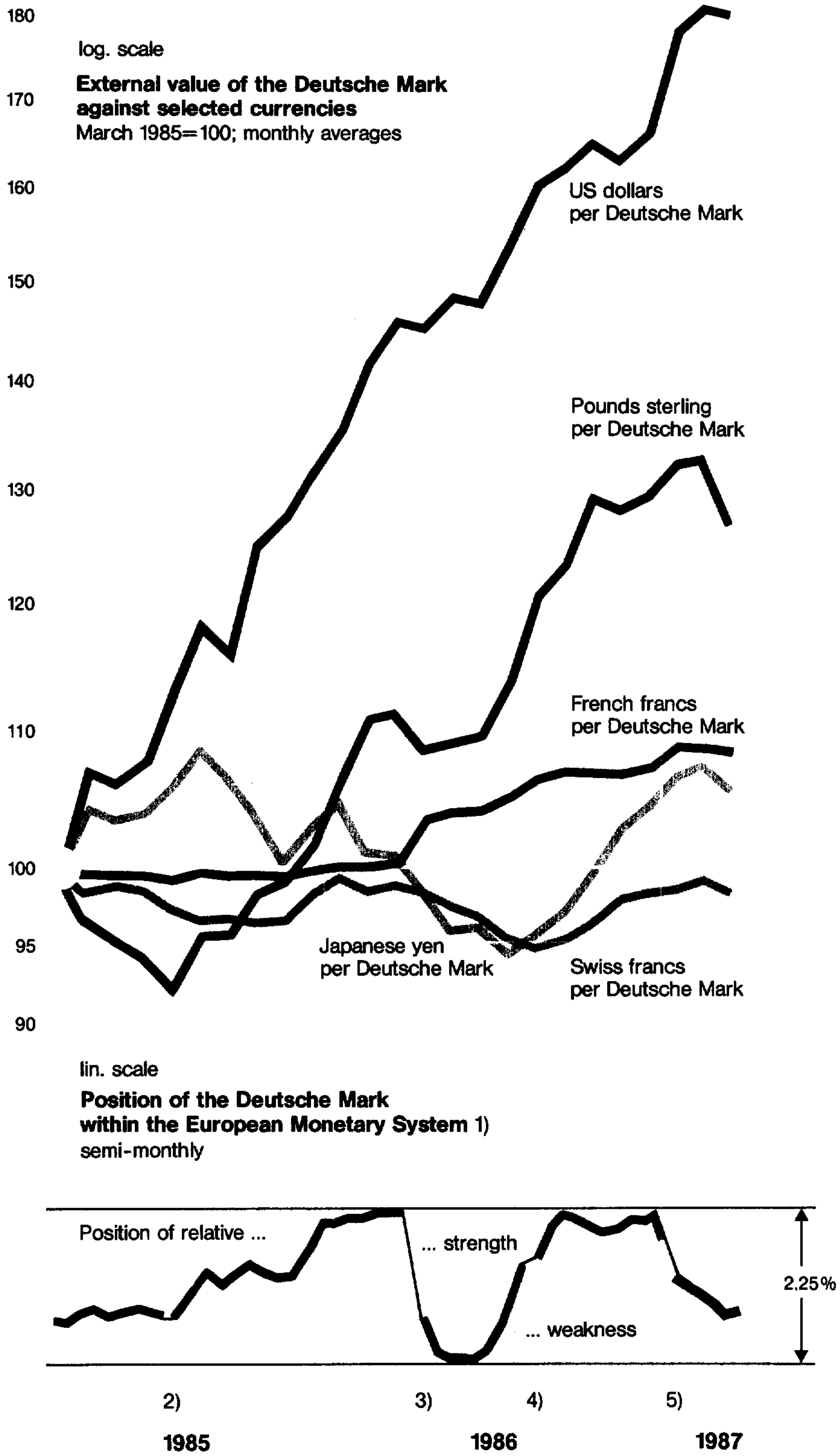
Strength of the Deutsche Mark partly determined by financial flows

Besides Germany's large current account surpluses, the strength of the Deutsche Mark on the foreign exchange markets also owed something to the fact that the German currency increased in importance as an international investment medium. This reflects the confidence of the international financial community in Germany's economic strength, the domestic stability of its currency and the soundness of Germany's financial system. In addition, the abolition of coupon tax in 1984 has made the Deutsche Mark more attractive to foreign investors. The inflow of foreign exchange from transactions on current and capital accounts also led to a rise in the Bundesbank's dollar reserves. This originated from purchases of dollars on the foreign exchange market amounting to $ 1.3 billion. Moreover, contrary to its usual practice, the Bundesbank refrained at times from channelling its current receipts of dollars from transactions outside the foreign exchange market into the market. The Bundesbank's dollar reserves rose last year by a total of $ 6 billion.

Yen rises most strongly on a weighted average

Since December 1985 the Japanese currency has risen against the dollar to about the same extent as the Deutsche Mark. In the preceding period since the reversal on the foreign exchange markets both currencies had developed similarly – albeit (then as now) with certain time-lags. However, the yen had not fallen anywhere near as far as the Deutsche Mark on the dollar market from the beginning of 1981 to the beginning of 1985. Thus the strengthening of the yen against the dollar since the spring of 1985 proceeded from a higher level than was the case with the Deutsche Mark. Taking the development from the beginning of 1981 to the beginning of 1987 together, the Japanese currency therefore appreciated substantially more than the Deutsche Mark vis-à-vis the dollar. Moreover, the weighted external value of the yen, which measures the importance of exchange rate changes on the basis of the affected Japanese foreign trade flows, has risen since early 1981 and also since the beginning of 1985 much more strongly than the external value of the Deutsche Mark and that

Deutsche Mark exchange rate movements since the turnaround on the dollar market



1) Calculated on the basis of official spot rates. Deviation from the arithmetical mean between the strongest and weakest currencies.- 2) Realignment of exchange rates in the EMS with effect from July 22, 1985.- 3) Realignment of exchange rates in the EMS with effect from April 7, 1986.- 4) Realignment of exchange rates in the EMS with effect from August 4, 1986.- 5) Realignment of exchange rates in the EMS with effect from January 12, 1987.

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of the other currencies of Europe. Even after allowing for Japan's advantage in terms of stability, there has been a substantial rise in the external value of the Japanese currency.

Appreciation of the yen despite large-scale exports of long-term capital

The main driving forces behind the strong appreciation of the yen were Japan's large current account surpluses and the expectation that, in the light of the pattern of Japan's foreign trade (concentration of exports on high-tech products and a large proportion of commodities in its imports), nothing much would change in this respect in the foreseeable future. The upward trend in the yen therefore continued although – in contrast to Germany – the current account surpluses were accompanied by considerable outflows of long-term capital. At $ 132 billion, Japan's net long-term capital exports in 1986 were more than twice as high as in the preceding year, exceeding the current account surplus at the same time by over one-half. This precipitous rise was due to a large extent to the liberalisation measures adopted by the Japanese government in the spring and summer of last year in the light of the strength of the yen. This made it possible for Japanese institutional investors to build up their investment abroad. However, exports of long-term capital were accompanied by considerably higher inflows of short-term funds to the banks, with borrowing by financial institutions to refinance the outflows of long-term capital playing a major role. To prevent the yen from rising even more strongly the Bank of Japan built up its dollar reserves by no less than $ 15 billion in 1986.

Swiss franc less affected than in the past by the weakness of the dollar

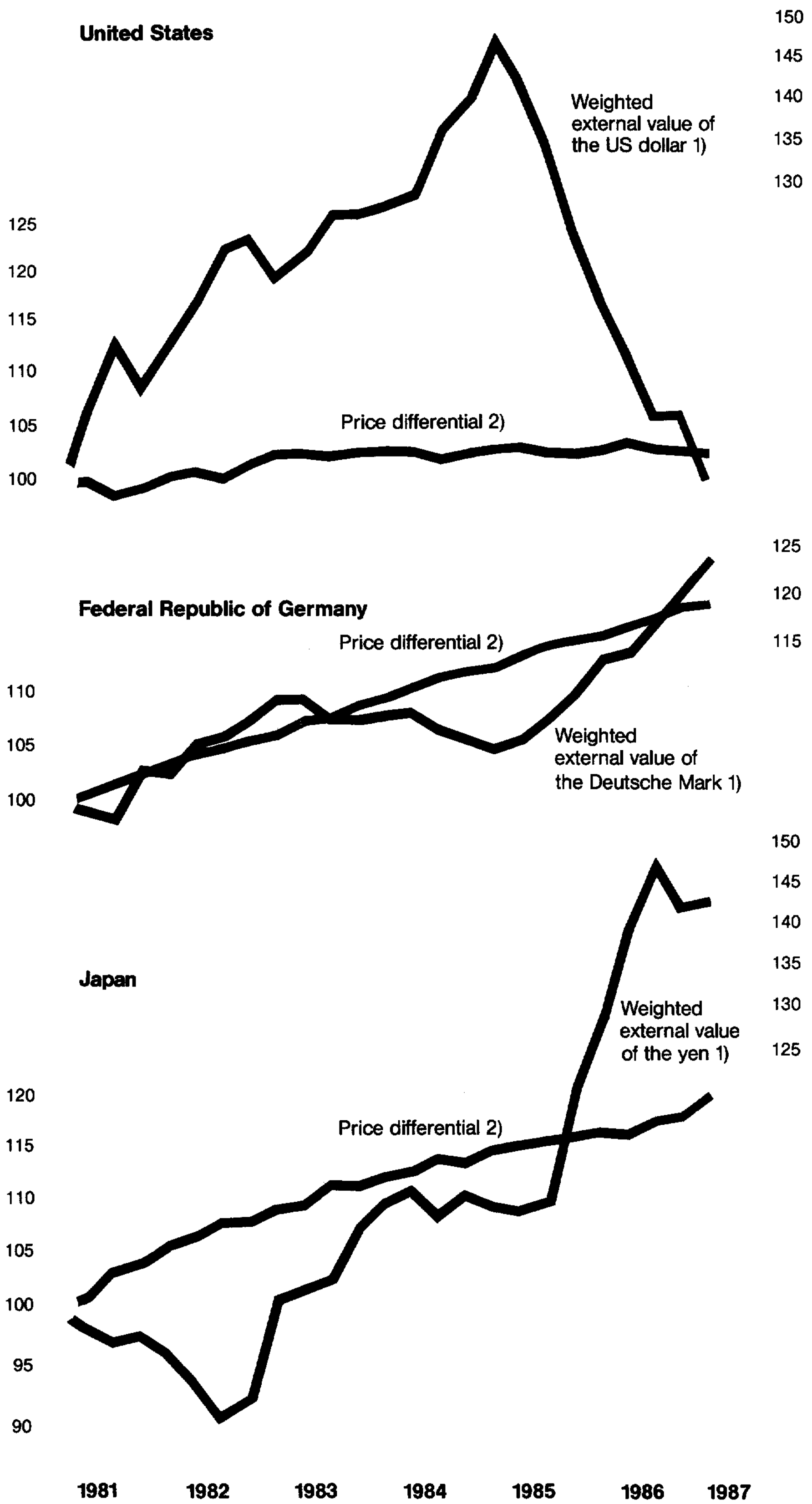
Since the end of 1985 the Swiss franc has strengthened against the US dollar and on a weighted average basis against all other major currencies to much the same extent as the Deutsche Mark. However, up to the summer of 1986 the Deutsche Mark-Swiss franc rate initially rose appreciably (to a peak of about DM 125 per Sfr 100), with the major role being played by rising money market rates in Switzerland. After the Swiss National Bank had brought interest rates down again in the third quarter of 1986 by pursuing a more generous liquidity policy, the external value of the Swiss franc fell equally quickly. The recent tendency for the Swiss franc and the Deutsche Mark to move parallel to each other contrasts sharply with developments in the years 1977-78, when the dollar was also under considerable downward pressure on the foreign exchange markets but the Swiss currency was much more strongly affected thereby than the Deutsche Mark. Inflows of funds into the Swiss franc are evidently being curbed at present by the fact that other financial centres have meanwhile gained in importance.

Sterling and Canadian dollar decline along with the US dollar

Sterling and the Canadian dollar largely followed in the wake of the US dollar last year. After sterling had made up for part of its exchange rate losses against the US dollar in 1985, the dollar-sterling relationship subsequently changed only a little. This was the outcome of two conflicting influences. Whereas sterling suffered a heavy burden through the decline in crude oil prices, it benefited from the fact that UK interest rates continued to considerably exceed the level prevailing in the United States. As a consequence, the weighted external value of sterling – like that of the dollar – weakened appreciably, viz. by 12 % between December 1985 and March 1987. A secular downward trend in sterling thus persisted. At all events, the rise in its value owing to the oil price hike of 1979-80 proved to be only temporary. It was lost again soon afterwards in the subsequent period when the dollar was strong. Despite the renewed depreciation of sterling, there has been no corresponding improvement in the competitiveness of British industry. Although the pace of price increases has been distinctly slower, wage costs in the United Kingdom have continued to rise considerably in the past two years and, in doing so, have gone up more strongly than in most comparable countries. Since the general turnaround on the foreign exchange markets the Canadian dollar has found itself playing a special role to an even greater extent than sterling. It has tended to be weak in the main against the US dollar and

Weighted external value of major currencies and international price differentials

First quarter of 1981=100; quarterly averages, log. scale



1) Geometrically weighted average against the currencies of 14 other industrial countries; the weighting pattern is based on the trade flows of industrial products from 1980 to 1982, after taking third-market effects into account.- 2) Geometrically weighted average of consumer price movements in 14 other industrial countries relative to those in the country in question.

BBk

could be prevented from suffering serious losses in value only through counteraction by the Canadian monetary authorities in their monetary and intervention policies. There were many different reasons for its weakness, the most important being unsolved budgetary problems, lagging behind in the fight against inflation, difficulties at a number of smaller banks and weaknesses in Canada's current account position, which grew even larger in 1986 owing to the oil price. Despite the economic problems of the United Kingdom and Canada mentioned above, both currencies have strengthened somewhat again in the recent past with the rise in crude oil prices. In order to counteract this movement, the Bank of England and the Bank of Canada have purchased large amounts of dollars on the foreign exchange market.

4. The European Monetary System

Shifts in exchange rates within the EMS owing to price and cost discrepancies ...

After a fairly long period of satisfactory exchange rate stability, marked tensions emerged again within the EMS in 1986. Starting in the first quarter of the year and then again from the middle of the year onwards, the Deutsche Mark moved into a relatively firm position vis-à-vis its partner currencies. The problems that arose at the beginning of 1986 were mainly due to the fact that, despite falling rates of inflation and narrower inflation differentials over the preceding years, discrepancies in prices and costs had nonetheless developed between Germany and a number of other EMS member countries. The markets therefore expected corresponding exchange rate changes, particularly as the competitiveness of the partner countries with less price stability was additionally burdened by the declining dollar. Central rates within the EMS therefore had to be realigned at the beginning of April 1986. As a result of this adjustment in exchange rates, the external value of the Deutsche Mark rose by about 3 % on a weighted average in terms of the central rates.

... but also because of the dollar rate

When the Deutsche Mark strengthened again distinctly in the EMS from the middle of 1986 onwards, this was ascribable above all to its strength on the dollar market. The Deutsche Mark had again become the preferred alternative to the dollar as an investment currency. Although the rise in its exchange rate vis-à-vis the dollar pulled up the external values of the other partner currencies more or less automatically as well, most currencies lagged a little behind the Deutsche Mark, with the result that the German currency rose in value against them. Consequently, the Irish pound initially came under increasing pressure, especially since sterling also depreciated vis-à-vis the currencies participating in the exchange rate mechanism; Ireland was particularly affected by this development owing to its close trade ties with the United Kingdom. The Irish pound was therefore devalued vis-à-vis all other currencies participating in the exchange rate mechanism in August 1986. Towards the end of the year tensions in the EMS mounted once again under the impact of the persistent weakness of the dollar. A role was played here both by expectations of a realignment within the EMS after the German general elections and by social conflicts in France. Whereas the Deutsche Mark and the Dutch guilder strengthened, the other EMS currencies tended to weaken. The central banks concerned initially countered this weakness by means of large-scale intramarginal interventions. After the French franc, the Danish krone and the Irish pound had fallen to their lower intervention points and had to be supported through obligatory interventions, another realignment took place within the EMS at the beginning of January 1987. In the process, the Deutsche Mark and the Dutch guilder were revalued against the other EMS currencies by 3 %, and the Belgian and Luxembourg francs were revalued by 2 %. These relatively slight shifts in central rates led to practically no change in market rates after the realignment.

Consumer price movements in the European Community

Change from previous year in %

Group of countries/Country	1981	1982	1983	1984	1985	1986 p
Federal Republic of Germany	6.3	5.3	3.3	2.4	2.2	– 0.2
EEC partner countries participating in the EMS exchange rate mechanism 1	13.6	12.3	10.1	7.8	6.3	3.3
France	13.4	11.8	9.6	7.4	5.8	2.7
Italy	17.9	16.5	14.7	10.8	9.2	5.9
Netherlands	6.7	5.9	2.8	3.3	2.3	0.2
Belgium	7.6	8.7	7.7	6.3	4.9	1.3
Denmark	11.7	10.1	6.9	6.3	4.7	3.6
Ireland	20.5	17.1	10.5	8.6	5.4	3.9
Luxembourg	8.1	9.4	8.7	4.6	4.1	0.3
Other EEC partner countries 1	13.6	11.3	8.2	8.3	8.0	6.2
United Kingdom	11.9	8.6	4.6	5.0	6.1	3.4
Spain **2**	14.6	14.4	12.2	11.3	8.8	8.8
Greece	24.5	21.0	20.2	18.5	19.3	23.0
Portugal **2**	20.0	22.4	25.5	29.3	19.3	11.7
All EEC partner countries of Germany 1	13.6	11.9	9.4	8.0	6.9	4.4
Memorandum items						
Relative rise in foreign prices compared with those in Germany in %						
EEC partner countries participating in the EMS exchange rate mechanism	6.9	6.6	6.6	5.3	4.0	3.5
Other EEC partner countries	6.9	5.7	4.7	5.8	5.7	6.4
All EEC partner countries	6.9	6.3	5.9	5.5	4.6	4.6

1 Weighted with private consumption expenditure between 1981 and 1983. – **2** Member since the beginning of 1986. – **p** Provisional.
Sources: National statistics and OECD. BBk

Under the impact of the weakness of the dollar, cohesion of the EMS more dependent than ever on progress towards convergence

The realignments that have taken place since the beginning of 1986 have not had a major influence on the international competitiveness of German industry. Neither have they led to notable setbacks in fighting inflation among the countries whose currencies were ultimately devalued, especially since the price-restraining effects of the lower oil prices and dollar rates have formed a counterpoise. In the light of the possible inflationary consequences of a devaluation, these countries were not nearly as willing as before to consider a correction in central rates as a solution to domestic problems. Precisely the latest realignment illustrated this clearly. Apart from this, since the inception of the EMS the shifts in exchange rates among the currencies participating in the exchange rate mechanism have been comparatively small; in essence, they offset the inflation differentials – which have meanwhile become appreciably smaller – between the member countries. However, the EMS can fulfil its function as a zone of relative exchange rate stability over the long term only if the economic policies and economic performance of all the members increasingly converge to form a community with internal stability. The convergence of economic performance and especially of the economic policies of the member countries did, indeed, make further headway last year. The discrepancies in price movements between Germany and the other EMS countries continued to decline. France also made notable progress in deregulating its economic and financial system; the most important measures included the dismantling of price controls, the abolition of capital controls and the reform of monetary policy instruments. Moreover, those member countries that still maintained foreign exchange controls for the granting of trade credits, for the admission of securities to the capital market and for trading in securities were required to abolish them by March 1987 under the terms of a further EEC Directive. However, this applies only to the extent that the countries concerned are not entitled temporarily to claim exceptions to the general liberalisation requirement by invoking protective clauses. In contrast, progress in reducing public sector deficits, which in some cases are still very large, was less satisfactory. Moreover, it is absolutely essential for all the Community countries to durably strengthen market forces in order to foster private initiative and achieve progress in structural change.

Large-scale support operations in Community currencies

Given the exchange rate tensions within the EMS, foreign exchange market interventions in Community currencies also increased considerably last year. Especially from the beginning of July 1986 to the eve of the realignment of January 1987 large amounts of Deutsche Mark were sold to support other currencies. For the most part this involved intramarginal interventions for which recourse to the short-term financing facilities of the EMS, which always also influences the liquidity position of banks in the country of the intervention currency, is precluded in principle. Instead, these support operations were mostly financed by drawing on Deutsche Mark reserves which Germany's partner countries had invested not with the Bundesbank but with the latter's consent in the market. However, at the end of December 1986, when the tensions within the EMS became more acute again, the focus shifted to obligatory sales of Deutsche Mark, in which the Bundesbank participated as well. Since then they have amounted to DM 16.5 billion and – together with intramarginal interventions totalling DM 0.5 billion which were financed by drawing on Deutsche Mark assets at the Bundesbank – have affected liquidity in Germany to the full amount. Although reflows of foreign exchange were modest immediately after the realignment, they gathered such force subsequently that the Bundesbank's partner central banks were able to restock their Deutsche Mark holdings on a considerable scale and meet part of their obligations arising from the preceding interventions by payments in Deutsche Mark.

Certain problems posed by intramarginal interventions

If intramarginal Deutsche Mark interventions do not result in changes in the foreign balances at the Bundesbank, they leave the liquidity position of banks in Germany unchanged and hence do not create any problems for money market policy. This is one of the major reasons for the willingness of the Bundesbank to agree to such interventions. The advantage of intramarginal interventions financed in this way would be jeopardised, however, if such operations were to be included in the very short-term financing facility, i. e. if they had to be financed by the partner central bank involved, as is being demanded by some countries. Recent experience, however, has confirmed that even large-scale intramarginal interventions cannot overcome the persistent weakness of a currency. They may help in many cases to bring temporary tensions under control. But keeping exchange rates within the margins in too rigid a manner may also strengthen the incentive to move out of the weak currency and into the strong currency at rates that still seem favourable and without incurring any great exchange rate risk. The foreign exchange movements triggered by such action may even foster the tendency of a currency towards weakness and require yet more sizeable obligatory interventions when exchange rates reach the outer ends of the band. Moreover, inflows of funds into countries with a strong currency may contribute to an expansion of the money supply there without requiring the central bank of the country in question to intervene. In periods of weakness of a currency exchange rates should therefore be left as much room as possible within the margins; in addition, speculative movements can be made more expensive by increasing interest rate differentials. The smaller realignments of exchange rates in the EMS owing to improved convergence should moreover help to limit speculative capital movements in future.

Fresh move to liberalise capital transactions

In February 1986 the members of the European Community agreed in the "Single European Act" to complete the common internal market by the end of 1992. With respect to this objective and also in order to strengthen the EMS, the member countries undertook a fresh move to permanently free their money and capital

Deutsche Mark interventions in the EMS*

DM billion
+ = Deutsche Mark sales or expansionary impact on liquidity in Germany
— = Deutsche Mark purchases or contractionary impact on liquidity in Germany

Period	Obligatory	Intramarginal	Total	Memo item Affecting liquidity in Germany **1**
A. By calendar years				
1979 **2** Purchases	—	– 2.7	– 2.7	– 2.4
Sales	+ 3.6	+ 8.1	+ 11.7	+ 11.7
Balance	+ 3.6	+ 5.4	+ 9.0	+ 9.2
1980 Purchases	– 5.9	– 5.9	– 11.8	– 11.1
Sales	—	+ 1.0	+ 1.0	+ 0.6
Balance	– 5.9	– 4.9	– 10.8	– 10.5
1981 Purchases	– 2.3	– 8.1	– 10.4	– 10.3
Sales	+ 17.3	+ 12.8	+ 30.1	+ 25.3
Balance	+ 15.0	+ 4.7	+ 19.7	+ 15.0
1982 Purchases	—	– 9.4	– 9.4	– 2.5
Sales	+ 3.0	+ 12.8	+ 15.8	+ 6.1
Balance	+ 3.0	+ 3.4	+ 6.4	+ 3.7
1983 Purchases	– 16.7	– 19.1	– 35.8	– 20.4
Sales	+ 8.3	+ 12.9	+ 21.2	+ 12.6
Balance	– 8.4	– 6.2	– 14.5	– 7.8
1984 Purchases	—	– 30.2	– 30.2	– 0.8
Sales	+ 4.7	+ 7.6	+ 12.3	+ 4.4
Balance	+ 4.7	– 22.7	– 17.9	+ 3.6
1985 Purchases	—	– 29.6	– 29.6	– 0.2
Sales	+ 0.4	+ 30.8	+ 31.1	—
Balance	+ 0.4	+ 1.2	+ 1.5	– 0.2
1986 Purchases	– 19.0	– 33.6	– 52.6	– 12.1
Sales	+ 4.1	+ 76.0	+ 80.1	+ 3.8
Balance	– 14.8	+ 42.4	+ 27.6	– 8.4
B. By selected periods, net				
March 21, 1983 to July 8, 1985				
From the first trading day after the realignment of March 21, 1983 to the end of major Deutsche Mark purchases by partner countries	– 11.8	– 49.8	– 61.6	– 16.9
July 11, 1985 to April 4, 1986				
From the end of major Deutsche Mark purchases by partner countries to the last trading day before the realignment of April 6, 1986	+ 0.7	+ 33.3	+ 34.0	+ 0.0
April 7, 1986 to July 7, 1986				
From the first trading day after the realignment of April 6, 1986 to the end of major Deutsche Mark purchases by partner countries	– 19.0	– 10.9	– 29.9	– 10.3
July 8, 1986 to January 9, 1987				
From the end of major Deutsche Mark purchases by partner countries to the last trading day before the realignment of January 12, 1987	+ 18.9	+ 44.1	+ 63.0	+ 17.4
January 12, 1987 to February 20, 1987				
From the first trading day after the realignment of January 12, 1987 to the last trading day before the Paris accord of February 22, 1987	—	– 7.3	– 7.3	– 0.9
February 23, 1987 to March 31, 1987				
From the first trading day after the Paris accord of February 22, 1987 to the end of the quarter	—	– 16.1	– 16.1	– 5.7

* Deutsche Mark interventions by other central banks participating in the EMS exchange rate mechanism and EMS interventions by the Bundesbank. — **1** Indicates the extent to which Deutsche Mark interventions in the EMS and the settlement of creditor and debtor positions in the EMCF affected the net external position of the Bundesbank and thus the banks' provision with central bank money; excluding transactions connected with the winding-up of the "snake", which was succeeded by the EMS. — **2** As from the beginning of the EMS on March 13, 1979. Discrepancies in the totals are due to rounding.

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transactions from the restrictions that still exist. On the basis of a two-stage liberalisation programme by the Commission, the Council of Ministers, in November 1986, adopted the above-mentioned Directive to liberalise those capital transactions that directly relate to the functioning of the Common Market and the integration of national capital markets. In a second stage the complete freedom of capital transactions within the Community is to be established. This relates in particular to the admission of financial credits, money market transactions and deposits on bank accounts as well as the abolition of two-tier foreign exchange markets and any discrimination in cross-border capital transactions.

Liberalisation of capital transactions accompanied by the necessity for even better convergence

The improved harmony in economic policies and economic performance within the Community has enhanced the prospects of permanently free capital transactions. However, considering the present state of economic and monetary policy integration, the complete liberalisation of capital transactions may have considerable repercussions on a country's monetary and financial policy since, with the dismantling of capital controls, cross-border money and capital transactions will intensify further. This requires a strengthening of convergence in economic and monetary policy and the associated outcome to a greater degree than in the past. Experience shows that, if they are to be successful, endeavours in this direction must be resolutely geared to the objective of stability in the domestic value of money. Any new commitments to coordinate national policies must therefore not call into question the primacy of domestic monetary stability. Freedom of capital transactions can thus additionally foster the convergence of economic and monetary policies in the direction of domestic stability. This will be the case above all if a satisfactory degree of domestic stability is assured in a sufficiently large number of countries within the Community. Positive effects emanate from such a nucleus of stability, which – given freedom of capital transactions – will have a bigger impact, the greater the economic weight of these countries is within the exchange rate arrangement.

Liberalisation of capital transactions also vis-à-vis third countries

The liberalisation of money and capital transactions must also be extended to include transactions with third countries. With freedom of capital movements within the Community, partial restrictions by individual nations vis-à-vis third countries could be maintained only if countries with free capital movements were prepared to deliberalise such transactions vis-à-vis third countries. The Federal Government and the Bundesbank are agreed that such a relapse into restrictions on money and capital transactions is out of the question.

5. Global monetary reserves

Further steep rise in global monetary reserves

According to IMF data, official gross global monetary reserves rose much more strongly in 1986 than in the preceding year. However, the increase of $ 61 billion to a total of $ 546 billion was due to a considerable extent once again to the exchange-rate-induced rise in the dollar value of reserve holdings denominated in other currencies, SDRs and ECUs. If these exchange rate effects are roughly eliminated by converting into dollars only transaction-related changes in reserve holdings not denominated in dollars and combining them with the changes in dollar reserves, then global monetary reserves went up by $ 29 billion.

Large increases in dollar balances

The transaction-related growth in global monetary reserves can be chiefly attributed to large increases in dollar balances. The official dollar balances shown in the statistics of the IMF alone rose by $ 21 billion. In addition, unidentified monetary reserves, the major part of which probably also consists of dollar assets, went up by $ 19 billion. Moreover, the dollars contributed to the European Monetary Cooperation Fund, which constitute one-fifth of the aggregate dollar reserves of the EMS member countries on specific dates, grew

Components of global monetary reserves*

US$ billion

Type of reserves	Level at end of year		Change					
			due to transactions 1		due to value adjustments 2		Total	
	1984	1986 p	1985	1986 p	1985	1986 p	1985	1986 p
Gold 3	40.0	40.1	+ 0.1	+ 0.1	–	–	+ 0.1	+ 0.1
Special drawing rights	16.1	23.8	+ 1.8	+ 1.5	+ 2.1	+ 2.4	+ 3.9	+ 3.8
Reserve positions in the IMF	40.7	43.2	– 3.0	– 3.9	+ 4.7	+ 4.6	+ 1.8	+ 0.7
Official ECU balances	37.7	48.7	+ 0.4	+ 4.3	+ 2.6	+ 3.8	+ 3.0	+ 8.0
– against gold	27.6	33.9	+ 0.0	+ 0.0	+ 2.6	+ 3.7	+ 2.6	+ 3.8
– against US dollars	10.1	14.3	+ 0.4	+ 3.8	–	–	+ 0.4	+ 3.8
– arising from very short-term financing	–	0.5	–	+ 0.5	–	+ 0.0	–	+ 0.5
Foreign exchange	303.3	389.6	+17.0	+26.7	+20.6	+22.0	+37.6	+48.7
US dollars	197.1	221.0	+ 3.5	+20.5	–	–	+ 3.5	+20.5
Deutsche Mark	37.6	55.8	+ 2.0	– 7.1	+10.8	+12.5	+12.8	+ 5.4
Yen	16.9	28.4	+ 3.3	– 2.3	+ 4.7	+ 5.9	+ 8.0	+ 3.6
Pounds sterling	9.0	10.2	– 0.7	– 0.4	+ 2.1	+ 0.2	+ 1.4	– 0.2
Swiss francs	6.2	7.4	– 0.1	– 2.1	+ 1.5	+ 1.8	+ 1.4	– 0.3
French francs	3.2	4.1	+ 0.2	– 0.8	+ 0.9	+ 0.6	+ 1.1	– 0.2
Dutch guilders	2.4	4.7	+ 0.3	+ 0.4	+ 0.7	+ 0.9	+ 1.0	+ 1.3
Unidentified assets	31.0	58.1	+ 8.5	+18.5	–	–	+ 8.5	+18.5
Total reserves	437.8	545.5	+16.3	+28.7	+30.0	+32.7	+46.4	+61.3

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

by $ 4 billion. In contrast, there was a decline in most other reserve components, with the Deutsche Mark assets reported to the IMF being the most strongly affected. The Deutsche Mark balances recorded by the IMF went down by DM 16 billion to DM 108 billion. The OPEC countries and the other developing countries reduced their identified Deutsche Mark reserves by a total of DM 10 billion. They evidently did so in order to meet part of their need for resources to finance current account deficits. The remaining sales of Deutsche Mark amounting to DM 6 billion were probably accounted for in the main by non-EMS countries. However, only part of the Deutsche Mark reserves of the EMS countries – which are subject to considerable fluctuations owing to the larger scale of intramarginal interventions – appears to be included in the IMF's statistics. While the Deutsche Mark holdings of the EMS countries that participate in the exchange rate mechanism reached a peak in mid-1985, by the eve of the latest realignment they had fallen very sharply to a small remaining amount owing to intramarginal Deutsche Mark sales before rising distinctly again of late as a result of intramarginal repurchases of Deutsche Mark. The data published by the IMF thus give a rather incomplete picture of the role played by the Deutsche Mark as a reserve currency. The share of the Deutsche Mark in published global foreign exchange reserves, as calculated on the basis of IMF data, is correspondingly to be regarded only as a lower limit. Despite the decline in the Deutsche Mark balances recorded by the IMF, their share in aggregate published foreign exchange reserves (including the dollar balances contributed to the EMCF) at the end of 1986, at 14 %, was unchanged in comparison with the preceding year since the dollar value of the Deutsche Mark reserve holdings went up at the same time. As a result, the Deutsche Mark remained the world's second most important reserve currency by a substantial margin, followed by the yen, whose share of 7 % was likewise just as large as in the preceding year.

Growth in reserves concentrated mainly on the industrial countries

Of the large nominal growth in global monetary reserves, $ 57 billion or more than nine-tenths was accounted for by the industrial countries. Owing to the lack of sufficient information on the composition of the reserves of all these countries, it cannot be stated reliably how much of this rise was due to valuation changes. Since, however, reserve assets not denominated in dollars are held primarily by the industrial countries (in the case of identified Deutsche Mark holdings, about three-quarters of them), by far the greater part of the valuation gains, estimated to total $ 33 billion, is also to be attributed to this group of countries. The increase over and above this amount owing to transactions was essentially the net result of the purchases of dollars associated with the weakness of the dollar and the simultaneous sales of Deutsche Mark by many countries.

Sharp fall in the monetary reserves of the developing countries, with a few exceptions

Among the developing countries, only a few registered an increase in their monetary reserves in 1986. Yet according to information from the central bank of that country, Taiwan's monetary reserves went up by no less than $ 24 billion, only $ 18 billion of which is as yet recorded in the IMF's provisional statistics;[1] the growth in reserves was about 50% higher than Taiwan's surplus on current account. At the end of 1986 Taiwan's published reserve holdings thus came to $ 47 billion. At present only Japan, Germany and, owing to its gold holdings, the United States hold higher monetary reserves; at the end of 1986 Japan's monetary reserves were still somewhat lower than those of Taiwan, but they have grown very sharply since then as a result of Japan's dollar purchases. The gross monetary reserves of a number of other threshold countries in East Asia also increased in 1986, albeit far less strongly than those of Taiwan. In contrast, the monetary reserves of all the other groups of countries in the Third World declined, with Latin America registering the largest fall, at $ 10 billion. At $ 6 billion, the monetary reserves of the countries of the Middle East also declined considerably; the reserve losses of these countries resulting from transactions were probably even higher than this since the oil-exporting countries among them have large reserve holdings not denominated in dollars and hence benefited from the exchange-rate-induced appreciation of these reserve components.

Low reserve holdings of many developing countries not a sufficient reason for new allocations of SDRs

The developing countries in particular once again saw the decline in their monetary reserves and their comparatively low holdings of reserves (in most cases) as a reason for demanding new allocations of special drawing rights from the IMF. Special drawing rights were created at the end of the sixties as a freely usable international means of payment to counteract a global lack of international liquidity. They were designed to avoid unacceptable adjustment constraints such as may arise from the general tendency towards greater fluctuations in payments balances in the event of insufficient growth in international liquidity. For this reason, special drawing rights are of a purely monetary nature. According to the Articles of the Fund, allocations of SDRs explicitly depend on there being a general lack of international liquidity which makes it difficult for deficit countries to mobilise the resources they need to balance their external payments even if they pursue appropriate economic policies. However, the constant growth of the international financial markets underlines the fact that international means of payment are available today on a more generous scale than ever before. Hence the extent to which a country can finance balance of payments deficits without difficulty no longer depends on the level of its monetary reserves but primarily on its international credit standing and thus ultimately on the credibility of the policies it pursues. The fact that many developing countries continue to have difficulty in importing capital shows, however, that deep-seated balance of payments problems still exist in this

1 Although this country is no longer a member of the IMF, its reserve data are still included in the Fund's statistics, but without being directly identifiable there.

Regional distribution of global monetary reserves*

US$ billion

Group of countries/Country 1	Level at end of year 1984	Level at end of year 1986 p	Change 1985	Change 1986 p
A. Industrial countries				
United States	34.9	48.6	+ 8.3	+ 5.4
Japan	27.5	43.3	+ 0.3	+ 15.5
Canada	3.3	4.1	+ 0.0	+ 0.7
Federal Republic of Germany	44.2	55.8	+ 4.2	+ 7.4
France	24.4	34.9	+ 5.6	+ 4.9
United Kingdom	10.2	19.2	+ 3.4	+ 5.6
Italy	23.6	22.8	− 5.3	+ 4.5
Other industrial countries	85.1	111.4	+ 13.0	+ 13.2
Total	253.3	340.0	+ 29.6	+ 57.1
B. Developing countries				
1. By region				
Africa	7.1	9.1	+ 2.5	− 0.4
Europe	9.8	12.8	+ 1.1	+ 1.9
Latin America	41.0	31.9	+ 0.6	− 9.8
Middle East	58.8	58.7	+ 5.7	− 5.9
Rest of Asia	67.8	93.0	+ 6.8	+ 18.4
2. By main export products				
Oil exporters	80.2	72.5	+ 5.2	− 12.9
Other countries	104.4	133.0	+ 11.5	+ 17.1
of which				
Exporters of industrial products	60.6	84.9	+ 6.5	+ 17.9
3. By the significance of their debt service problems				
15 major debtor countries	39.8	34.2	+ 1.0	− 6.6
Other countries	144.6	171.3	+ 15.7	+ 10.9
Total	184.5	205.5	+ 16.7	+ 4.3
C. All countries (A plus B)	437.8	545.5	+ 46.4	+ 61.3
Memorandum items				
Total reserves, excluding ECU balances created against the contribution of gold 2	413.8	515.2	+ 43.9	+ 57.6
of which				
All industrial countries	229.3	309.7	+ 27.1	+ 53.4
Federal Republic of Germany	37.5	47.4	+ 3.5	+ 6.4
France	18.7	27.7	+ 5.0	+ 4.0
United Kingdom	8.9	17.6	+ 3.3	+ 5.4
Italy	18.9	17.0	− 5.8	+ 3.8

* Gross monetary reserves of all IMF member countries plus Switzerland and Taiwan. — **1** For the definition of the groups of countries see the table on page 60. — **2** The gold underlying the ECU balances has been included in the other gold holdings again. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Sources: IMF and EMCF. BBk

context. They require these countries to conduct economic and monetary policies which promote their adjustment and, in particular, restore their credit standing on the financial markets. At all events, the shortage of reserves and balance of payments difficulties of the developing countries cannot be regarded as a sign of any general lack of international liquidity. Moreover, in the prevailing circumstances new allocations of SDRs might tend to lead to delays in adopting necessary adjustment measures and hence make it difficult for the deficit countries to redress their economies over the longer term.

6. The debt problems of the developing countries

Serious setbacks in overcoming the debt problems

The financing problems of a number of heavily-indebted developing countries became more severe again in 1986. In February 1987 Brazil even announced a unilateral cessation of the interest payments to international banks on its medium and long-term debt. In addition, Brazil is demanding that repayments of short-term liabilities should no longer be made to the foreign creditors but should be deposited with the Brazilian central bank. Brazil has thus intervened unilaterally in existing contracts. The Brazilian government evidently expects that it can induce the creditor banks by these measures to undertake further rescheduling operations and grant fresh credits on more favourable terms than before. The measures are also intended to pave the way for comprehensive "political solutions" to the debt problems. The new difficulties reflect signs of weariness on the part of debtor countries and creditors alike in grappling with the consequences of an excessive incurrence of foreign debt by many countries. Some countries, indeed, have contributed to the deterioration of their external situation themselves by departing from the adjustment programmes agreed with the IMF, especially since the flight of capital from most of these countries is still continuing, albeit on a smaller scale than in earlier years. Furthermore, the less favourable global economic environment has put the heavily-indebted countries in a more difficult position. Anyway, the trade and current account balances of the countries of Latin America – the region at the centre of the debt problem – deteriorated appreciably last year. The exports of this group of countries decreased by almost one-fifth in 1986 owing to falling sales and prices, whereas their imports roughly stagnated. The oil-exporting countries, whose export receipts declined by one-third in comparison with the preceding year, were particularly affected by these diverging trends. They therefore account for by far the greater part of the deterioration in the current accounts of all Latin American countries. Against this background, even the considerable easing of the burden of interest payments associated with the decline in the international level of interest rates did not provide a sufficient counterbalance. The resultant renewed rise in the financing needs of the countries of Latin America could be met in only a few cases by spontaneous lending by foreign commercial banks. Financing packages therefore had to be arranged once again for a number of countries. In this context, the "Baker initiative" (which was discussed in the Report of the Bundesbank for 1985 as well as in the Monthly Report of January 1987) is to be resorted to in full for the first time in the case of Mexico, where the fall in crude oil prices in particular has generated new balance of payments problems. This means that the IMF, the World Bank, the Paris Club and the commercial banks will provide comprehensive and combined assistance.

Banks in search of new financing techniques

As the financing problems of the countries of Latin America persisted, however, it emerged that a large number of banks that have written off or assigned their claims on these countries are less and less willing to participate in granting fresh credit. Hitherto, the participation of individual banks in the granting of fresh credit to heavily-indebted countries has been governed in general by the level of their credits outstanding on the outbreak of the debt crisis in August 1982. The greater reluctance of banks to participate in granting fresh credit on this basis has provided new incentives to search for alternative forms of financing. In the first place, such forms are designed to replace difficult negotiations among banks on the question of burden sharing by quasi-automatic rules, e.g. when converting interest payments into capital. Secondly, greater interest is being focused on converting fresh credit and outstanding claims into negotiable securities. This would give individual banks better possibilities of divesting themselves of their commitments. However, particularly those forms of financing which amount to the automatic granting of credit present considerable problems of a basic nature. In this respect, the question arises as to whether the technical advantages offered by such solutions outweigh the drawbacks they might have as regards the longer-term solution of the debt problems. In practical terms, the quasi-automatic granting of fresh credit would imply a further increase in the banks' exposure without the credit standing of the debtor country in question having been critically examined beforehand.

External debt of the developing countries *

US$ billion

Item/Group of countries **1**	1981	1982	1983	1984	1985	1986 **p**	Change in 1986 from 1985 **p**
A. **Long-term**	568	646	711	754	830	917	+87
Public creditors	221	248	274	298	340	400	+60
Banks	195	228	272	293	335	359	+24
Other creditors **2**	152	170	165	163	155	158	+ 3
B. **Short-term**	178	204	189	193	179	180	+ 1
C. **Total** (A plus B)	746	850	900	947	1 009	1 097	+88
1. By region							
Africa	107	122	131	133	140	157	+17
Europe	102	107	107	112	127	138	+11
Latin America	288	334	345	362	368	383	+15
Middle East	91	103	113	123	130	145	+14
Rest of Asia	158	184	204	217	244	275	+31
2. By main export products							
Oil exporters	217	250	260	267	277	296	+19
Other countries	529	600	640	680	732	801	+69
of which							
Exporters of industrial products	154	165	174	179	200	219	+20
3. By the significance of their debt service problems							
15 major debtor countries	331	383	396	411	417	437	+20
Other countries	415	467	504	536	592	660	+68
Memorandum items							
Debt service payments	127	138	127	142	141	147	+ 6
Interest	72	81	76	84	79	74	− 5
Repayment of long-term loans	55	57	51	59	62	73	+11
Debt service as a percentage of receipts from exports of goods and services							
Total	16.1	19.5	18.9	20.1	20.6	22.4	**3** + 1.8
15 major debtor countries	39.0	49.4	42.3	41.3	39.2	44.4	**3** + 5.2

* Excluding debt to the IMF. — **1** For the definition of the groups of countries see the table on page 60. — **2** Including those liabilities of public and private entities which are not guaranteed by the debtor country in question. — **3** In percentage points. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Source: IMF. BBk

Scale of current new debt heavily dependent on the capital imports of creditworthy countries

In 1986 the aggregate foreign debt of the developing countries rose by $ 88 billion, or 9%, to just under $ 1,100 billion. This amount was higher than in the preceding year in both absolute and percentage terms. However, as in the previous year, about two-thirds of the latest increase in foreign debt reflects the exchange-rate-induced appreciation of liabilities not denominated in dollars. In nominal terms, there was a further rise in 1986 in long-term liabilities, in particular, whereas short-term debt remained more or less at the same level as in the preceding year. Of the total increase in foreign debt, over one-third was accounted for by the countries of Asia outside the Middle East; most of these have managed to maintain their creditworthiness on the international markets. At $ 20 billion, there was also a considerable rise in the foreign debt of the large debtor countries to which the "Baker initiative" primarily relates; except for the Philippines, these are not Asian countries. In purely mathematical terms, this was a factor contributing to the further distinct deterioration in the imbalance between the economic potential of the major debtor countries and the level of their debt service commitments. After the ratio of debt service commitments to export earnings had reached a peak of 49½% among the main problem countries in 1982 and had fallen to 39% by 1985, it went up again last year to 44½%.

Further substantial rescheduling operations and prolongations of outstanding loans

Of the long-term liabilities of the debtor countries to banks, a total of $ 62 billion was rescheduled in 1986. This was almost five times as much as in 1985 ($ 13 billion) but considerably less than in 1984 ($ 102 billion). Of these rescheduling operations, Mexico accounted for $ 44 billion, followed by Brazil ($ 7 billion) and Nigeria ($ 4 billion). Agreements involving large sums were also concluded with Morocco, Uruguay and Poland. Moreover, short-term trade and interbank credits totalling $ 34 billion — i.e. slightly less than in 1985 — were prolonged last year in the context of rescheduling negotiations. In addition, the rescheduling operations agreed with official creditors within the Paris Club amounted to just over $ 12 billion in 1986 (against $ 18 billion in the preceding year). Three multi-year rescheduling arrangements, such as had been particularly recommended in 1984 by the heads of state and government of the major industrial countries, were concluded in 1986. The amounts involved are already included in the figures mentioned above.

No alternative to the strategy of cooperation

The renewed debt service difficulties besetting some countries emphasise how very much a lasting solution to the debt problems depends on all those involved performing the tasks incumbent upon them with tenacity. In this process, a policy geared to growth and open markets on the part of the industrial countries plays just as important a role as the adjustment policies pursued by the debtor countries. The "Baker initiative" and the additional financial assistance raised as a result of it have demonstrated that the creditor countries are prepared to give the developing countries further support in their efforts to foster the process of adjustment and speed up economic growth at the same time. In contrast, unilateral measures tantamount to seeking confrontation with the creditor countries entail the danger that adjustment and growth in the debtor countries will continue to be impeded, to the detriment of the world economy as a whole.

7. The international financial markets

Continuing strong growth in new lending

There was another very strong rise in the volume of funds raised on the international financial markets in 1986, with declining interest rates and the financing needs of the United States providing the main driving forces behind this process. In addition, borrowers from surplus countries had greater recourse to the international financial markets. Currency swaps in particular made it possible to issue non-dollar bonds to a greater extent than would otherwise have been feasible. According to BIS estimates, the aggregate volume of international bond issues and international loans granted by banks, at $ 240 billion net, was more than one-third greater than in the preceding year. This figure on the volume of new lending is adjusted both for redemptions of bond issues and loans and for interbank transactions within the reporting area. It also excludes large-scale double-counting between the credit and bond markets. Double-counting of this nature occurs on the one hand because the banks take over international bonds themselves; this is reflected not only in the statistics on bond issues but also in the asset positions of the banks concerned. In addition, double-counting of international financial operations can occur if the banks issue bonds themselves in order to fund their lending business. What is more, the BIS statistics also exclude exchange-rate-induced changes in banks' non-dollar asset positions.

International bond markets extremely buoyant despite growing significance of national markets

After deducting redemptions and repurchases, the volume of funds raised on the international bond markets in 1986 increased by $ 33 billion to $ 162 billion. In gross terms, the volume of issues rose by $ 59 billion to $ 226 billion. Another reason why the continuing buoyancy of the international bond markets is striking is that major national securities markets — particularly the market in Germany — have developed into serious competitors of the international markets in recent years owing to the abolition of withholding taxes and other obstacles to

New lending on the international financial markets

US$ billion

Item	1982	1983	1984	1985	1986 p
A. Net lending on the international financial markets according to BIS estimates					
1. Issues of Euro-bonds and traditional foreign bonds, less redemptions and repurchases **1, 2**	62.3	63.0	86.6	129.1	162.1
2. International lending by reporting banks, total **3, 4**	180.5	105.7	124.1	233.5	476.6
3. International lending by reporting banks, less double-counting caused by onward lending between these banks **5**	95.0	85.0	90.0	105.0	160.0
within the reporting area	45.5	50.5	76.5	77.0	141.8
outside the reporting area	39.5	28.0	13.5	23.8	9.1
Developed countries **6**	16.0	7.1	5.4	6.8	4.8
Eastern European countries	−4.6	−1.2	0.0	5.7	4.4
OPEC countries	8.3	9.8	−1.9	0.2	−0.2
Other Latin American countries	12.1	7.8	5.4	1.7	−1.6
Other developing countries	7.7	4.5	4.6	9.4	1.7
Not classifiable by region	10.0	6.5	—	4.2	9.1
4. Double-counting between bond and bank loan markets **7**	12.3	18.0	31.6	59.1	82.1
Net lending, total (1 plus 3 less 4)	145.0	130.0	145.0	175.0	240.0
B. Gross lending on the international capital markets according to OECD data 1					
1. Issues of Euro-bonds and traditional foreign bonds **2**	75.5	77.1	111.5	167.8	226.4
By type of issue					
Fixed-rate issues	57.0	49.4	58.4	92.5	147.2
Floating-rate issues	15.3	19.6	38.2	58.4	50.7
Convertible and option issues **8**	3.2	8.0	10.9	11.4	22.3
Other **9**	—	0.1	4.0	5.4	6.2
By currency or unit of account					
US dollar	48.2	43.9	71.6	102.5	124.2
Swiss franc	11.3	13.5	13.1	15.0	23.5
Yen	3.9	4.1	6.1	12.9	23.2
Deutsche Mark	5.4	6.6	6.7	11.2	16.9
Pound sterling	1.9	3.0	5.6	6.8	10.8
ECU	0.8	2.2	2.9	7.0	7.0
Other	4.0	3.8	5.5	12.3	20.8
2. Long-term syndicated loans **10**	98.2	67.2	62.0	60.1	58.4
Prolongation of existing facilities **11**	2.3	1.1	8.2	21.5	14.3
New lending associated with rescheduling operations	—	14.3	11.3	7.1	—
Other new lending	95.9	51.7	42.5	31.5	44.1
3. Back-up facilities **12**	5.4	9.5	28.8	49.8	32.1
Renegotiation of existing facilities	—	—	—	3.0	5.1
Other	5.4	9.5	28.8	46.8	27.0
Gross lending, total (1 plus 2 plus 3)	179.1	153.7	202.3	277.6	316.9
Memorandum items					
Non-underwritten facilities **13**	—	—	.	21.8	63.6
Issues of Euro-equities	—	—	0.3	1.9	7.6
Loan commitments associated with planned corporate mergers	—	4.0	26.5	7.1	0.7

1 Transactions not denominated in dollars have been converted into dollars on a monthly basis at market rates and then added together to yield annual figures. — **2** OECD data, which also include private placements and long-term floating-rate certificates of deposit. Euro-bonds are understood to mean issues launched by an international bank syndicate. — **3** Bank claims not denominated in dollars at successive ends of quarters have been converted into dollars at constant exchange rates (on the basis of the market rates at the latest end of quarter in each case). The resultant changes have then been combined to yield annual figures. — **4** As from 1984, 18 OECD countries and 6 offshore financial centres. — **5** Interbank lending to non-reporting offshore centres has also been deducted. — **6** OECD countries, Andorra, Cyprus, Gibraltar, Liechtenstein, Malta, Monaco, South Africa, Vatican City, Yugoslavia. — **7** International bonds acquired by reporting banks if recorded in the banking statistics, and bonds issued by reporting banks mainly for the purpose of funding their international lending. — **8** With share options. — **9** Zero-coupon bonds and dual-currency bonds. — **10** Publicised bank loans with maturities of more than one year granted mostly by international bank syndicates (Euro-loans) or in national currency by national bank syndicates (traditional foreign loans) which have not necessarily been drawn down yet. — **11** Renegotiation of credit terms with the original syndicate or new borrowing for the sake of repaying existing syndicated loans (refinancing). — **12** Facilities of banks to back up the revolving placement of short-dated paper, mostly for the sake of prematurely repaying syndicated loans. — **13** Euro-notes and Euro-commercial paper. — **p** Provisional. Discrepancies in the totals are due to rounding.

BBk

investment. However, the international bond markets have remained the domain of the industrial countries to a greater extent than ever. With a gross volume of issues of $ 4.5 billion, the already small share of the market accounted for by developing countries has declined even further; it fell to as little as 2 % (against 5 % in the preceding year).

Fall in issues of floating-rate notes

According to OECD data on developments in the international bond markets, there was a distinct fall in new issues of floating-rate notes last year. Their share in the aggregate volume of new issues, which was over one-third in 1985, went down to 22 %. Ultimately, this is also a result of the persistent pursuit of anti-inflationary policies by numerous countries. With the reduction of inflation and of inflationary expectations, confidence in the longer-term stability of interest rates has strengthened again, and this has made floating-rate notes appear less attractive to investors. On the secondary market for perpetual floating-rate notes, which were issued by UK banks in particular as surrogate capital, there was even a sharp fall in prices at the end of the year, which spread to the whole FRN sector. However, there was a decline in the importance of floating-rate notes for other reasons as well. On the one hand, they were exposed to increasing competition from Euro-notes and Euro-commercial paper as well as from similar paper issued on national markets. On the other hand, the distinction between fixed-rate and floating-rate issues decreased in importance because some fixed-rate bonds were virtually turned into floating-rate issues through interest rate swaps with floating-rate "non-securitised" loans.

Yen issues rise most

Calculated in Japanese currency, international yen issues rose by one-third in 1986 in comparison with the preceding year. Within the total volume, issues of Euro-yen bonds more than doubled, whereas the total amount of foreign bonds issued in Japan declined considerably. These divergent trends are not least attributable to the fierce competition among Japanese banks on the Euro-market. In contrast, international issues denominated in dollars, Swiss francs and Deutsche Mark grew at a distinctly slower pace (likewise when calculated in the relevant currencies), namely by 21 %, 17 % and 15 %, respectively. There was even a decline in the volume of issues denominated in ECUs, in part no doubt because ECU bonds yielded much less than Deutsche Mark bonds last year if the depreciation of the ECU against the Deutsche Mark is taken into consideration. For its part, the relatively modest rise in the volume of foreign bonds denominated in Deutsche Mark owed a great deal to the very strong growth of this market back in 1985; besides, foreign interest in domestic Deutsche Mark issues has greatly increased of late. In the light of the differing developments from currency to currency, the share of the yen in the aggregate volume of new international bond issues went up particularly sharply upon the appreciation of the Japanese currency (which increases the dollar value of yen issues); at just over 10 %, it reached the same figure as the Swiss franc. As a result of shifts in exchange rates, the share of the Deutsche Mark also rose slightly to 7½ %. Correspondingly, the share accounted for by the dollar as an international currency of issue declined further; it went down last year by 6 percentage points to 55 %.

International new lending by banks largely determined by securities purchases

Net international new lending by banks within the BIS reporting area, other than interbank lending, expanded last year by $ 55 billion to $ 160 billion. Besides short-term lending, this strong expansion was due in particular to the large-scale purchases of securities by banks mentioned above. Over and above the growth of the issuing markets, this also reflects the general trend towards the securitisation of international financing operations. The declining trend observable for some time in longer-term syndicated Euro-lending accordingly continued. Prime borrowers with access to the international bond markets increasingly lost interest in this financial instrument because it entails comparatively high costs and is frequently not sufficiently adaptable to the financing need in question. In regional terms, activity on the markets for international bank credits – rather like issuing business – was determined by the financing needs of the industrial countries. According to BIS data, bank claims on the developing countries rose no further in 1986; their claims on the countries of Latin America actually declined. A significant factor in this context was, however, that in the banks' accounts a low level of new lending to this group of countries was accompanied by a number of influences operating in the opposite direction. These included, in particular, write-downs and sales of claims to institutions other than the reporting banks. The effect was the same if government export credit insurance institutions took over claims from the banks or if claims were transformed into equity capital.

Shifts in emphasis among new placing facilities

Back-up facilities, which had gained appreciable significance in previous years, diminished in importance again in 1986. Financing commitments of this kind, which serve as a direct back-up facility for the revolving placement of short-term paper, were entered into last year to the extent of $ 27 billion. In 1985, by contrast, the volume of corresponding new back-up facilities reached a total of $ 47 billion, disregarding the mere adjustment of the terms applying to facilities already in existence. The latterly sluggish pace of developments in this field is mainly due to the fact that banks in the leading industrial countries have increasingly had to back their underwriting facilities with capital (in Germany too since mid-1986). Internationally operating banks have consequently made increasing use of underwriting facilities which are not directly backed up by a purchase commitment; the banks only undertake to use their "best efforts" to place the paper in question. In 1986 the total volume of such newly agreed facilities rose by $ 42 billion to $ 64 billion. Where placing facilities – whether backed up or not – led to the reporting banks buying corresponding short-dated paper, such as Euro-notes or Euro-commercial paper, this is already included in international bank lending as a special form of securitisation. The paper sold to non-reporting banks constitutes additional international lending on top of the aggregate volume of international extension of credit as ascertained by the BIS. However, the volume of such lending is not particularly large at present. According to OECD statistics, there was a rise of only $ 13 billion in 1986 in the outstanding amount of all kinds of securities associated with international placing facilities, compared with an overall volume of new placing facilities of no less than $ 91 billion. Moreover, an estimated one-third of this newly issued paper remained with the reporting banks or was purchased by them. Thus, all in all the significance of such paper as a borrowing instrument for non-banks (or for banks outside the reporting area) remained small. At the same time, the relationship between newly issued paper of this kind and the sum total of all new placing facilities demonstrates how little such facilities should be taken at their face value when estimating the actual scale of international lending.

Prudential problems posed by innovations only partly solved

The rapid structural changes on the international financial markets brought a number of advantages. The swift increase in securitised international financing instruments in the form of negotiable Euro-notes, Euro-commercial paper and similar paper provided large corporations with low-cost sources of finance tailored to their individual needs. By lending on the basis of securities the banks in turn enhanced the liquidity of their claims. Moreover, off-balance-sheet instruments opened up to banks and their clients the possibility of limiting certain interest rate and exchange rate risks or of passing them on to other market participants – though without the total risk being reduced in the process. But financial market innovations also pose problems. Securitised financing instruments reveal faster and more directly how a borrower's credit standing is developing. As a result, borrowers may ultimately run into financing difficulties sooner than they would in the context of established credit relations with banks. By the same token, banks may meet with difficulties relatively quickly if they do not take sufficient account of the solvency and market-related risks associated with securities purchases and off-balance-sheet transactions. Since the middle of 1986 German banks have been required to include liabilities arising from back-up facilities for placing money market paper in the item "other guarantees" when calculating the requisite capital in accordance with Solvency Principle I under the Banking Act. This applies to banking groups as well as to individual banks. Moreover, the supervisory authorities in Germany, as in other countries, assume that credit commitments, even if they are not directly associated with placing facilities, are duly taken into account in the management of bank liquidity. In addition, for some time now both international and national bodies have been discussing the question of how market-related risks, i.e. interest rate and exchange rate risks, can be quantified adequately and incorporated in official solvency ratios. What is more, the innovations on international financial markets have very adversely affected market transparency. In this respect, improvements will be possible only gradually and in cooperation with the international institutions.

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

(a) Financial assistance

Net repayments to the IMF

At SDR 3.9 billion, new lending by the IMF in 1986 was at about the same level as in the preceding year, with a slight rise in drawings within the credit tranches, access to which is subject to economic policy conditions. On the other hand, fewer new loans than in the preceding year were granted under the Extended Fund Facility (which is designed to help overcome longer-term balance of payments problems) and the Compensatory Financing Facility for shortfalls in export proceeds. However, the more or less unchanged level of new lending by the Fund was accompanied by a surge in repayments of credits, to a total of SDR 5.7 billion. Thus, for the first time since 1978-79, more resources flowed back to the Fund than were simultaneously lent. Total IMF loans outstanding correspondingly declined by SDR 1.8 billion to SDR 33.4 billion.

Fluctuations in recourse to the Fund an outcome of its strictly monetary role

The extent to which the Fund makes new credits available depends on a large number of factors that vary from year to year. For instance, the exceptionally high level of lending in 1983 (SDR 12.6 billion gross and SDR 10.6 billion net) was due to a bunching of drawings by larger countries. In contrast, the amount of credit granted in the last two years was substantially lower because it proved to be difficult for a number of major countries to carry out adjustment programmes as planned or to agree on new economic rehabilitation measures in time. A further dampening factor was that a number of problem countries had recourse to the possibility of "enhanced surveillance". In such cases, the Fund does not need to commit itself financially, but only gives its "seal of approval" to adjustment programmes elaborated by the countries concerned themselves. Moreover, the decline in crude oil prices greatly relieved the burden borne by the oil-importing developing countries, which are those that depend most heavily on IMF credits. Furthermore, many countries are affected by deep-rooted structural problems which can be solved only in part through the IMF's set of instruments; in such cases the Fund's assistance mainly acts as a catalyst by helping to mobilise other loan resources. For all these reasons, changes in the Fund's lending activities are in themselves not sufficiently indicative of how the IMF is assisting its members in the adjustment process. If the Fund "breathes", i. e. if periods with a high level of drawings are followed by times when lending is considerably lower and repayments rise, then this is, rather, quite consistent with the objectives of the Fund. In contrast to the regional development banks, whose task it is to provide capital, the main focus of the IMF is on monetary policy cooperation. This also follows from the fact that – with a few exceptions – its financial assistance is provided from the monetary reserves of its members. If only for this reason, the Fund has to ensure that its resources flow

Purchases and repurchases under IMF credit facilities

SDR billion

Item	1982	1983	1984	1985	1986
Credit tranches	2.5	4.9	3.1	2.6	3.0
Extended Fund Facility	2.1	4.6	3.3	0.4	0.3
Compensatory Financing Facility	2.6	2.8	0.8	0.9	0.6
Buffer Stock Facility	0.1	0.3	0.0	—	—
Total	7.4	12.6	7.3	4.0	3.8
Structural Adjustment Facility **1**	—	—	—	—	0.1
Total purchases	7.4	12.6	7.3	4.0	3.9
Total repurchases	1.6	2.0	2.3	3.6	5.7
Net purchases (net repurchases: —)	5.8	10.6	5.0	0.4	— 1.8

1 Financed out of a Special Disbursement Account of the Fund and available only to countries whose per capita income is particularly low.
Discrepancies in the totals are due to rounding.
Source: IMF. BBk

back relatively quickly and thus remain available in principle to all its members. This is why the IMF is in general subject to comparatively strict limits — and not only with respect to the period for which it grants credit. Above all, the Fund cannot but demand from its borrowers measures that are likely to bring about an improvement in their balance of payments difficulties within a reasonable space of time and hence also ensure the repayment of the IMF's assistance. Balance of payments assistance geared less to such demands would not be in the interests of the recipient countries either, because any delay in adjustment that is inescapable over the longer term would entail all the greater efforts later on. In this respect, it might well present problems if in future — as was recently the case with Mexico — the Fund were to make more use in its lending activities of clauses that automatically lead to higher lending or cutbacks in adjustment objectives in the event of a general deterioration in a country's economic situation.

Special borrowing agreement with Japan to safeguard the Fund's liquidity

In view of the persistent uncertainties besetting the world economy, the IMF decided at the end of 1986 to retain its "Policy of Enlarged Access to Fund Resources" in 1987. This scope for additional drawings, which was a response to the second oil price hike and was originally intended to end in 1983, was thus extended at short notice for the fourth time. In contrast to the earlier extensions, however, the ceilings for drawings were not lowered any further. If the revolving character of the loans granted on this basis is maintained, the IMF's liquidity position should enable it to continue its policy of Enlarged Access on the existing scale. Moreover, the Fund's borrowed resources, from which the extended scope for drawings is financed, have been further improved through a special borrowing agreement with Japan. This credit line, which was opened at the end of December 1986, allows the IMF to draw up to SDR 3 billion over a period of four years (which may be extended to six years), with each drawing having a final maturity of not more than five years.

Creation of a Structural Adjustment Facility for the poorest developing countries

In order to help solve protracted balance of payments problems of countries with particularly low per capita income, and at the same time to foster their economic growth, the Fund set up a Structural Adjustment Facility in March 1986. A Special Disbursement Account totalling SDR 2.7 billion is available for this purpose. Its resources will accrue up to 1991 from the return flows from the loans which the Trust Fund granted from 1976 to 1981 to the world's poorest developing countries out of the proceeds of sales of the Fund's gold holdings. The countries eligible to receive these new loans are the 60 nations that meet the requirements for access to the resources of the International Development Association. Initially, an amount equivalent to 47 % of the respective quota in the

IMF is available to each country. With the Structural Adjustment Facility, however, the IMF is in some respects embarking on new paths that are compatible with the specific tasks of the Fund to only a limited extent. Quite apart from the fact that the Structural Adjustment Facility serves to finance longer-term lending, the conditionality attached to its resources is framed in rather general terms, in contrast to traditional IMF lending. Moreover, the Fund grants loans from the Facility on concessionary terms. On the other hand, the effectiveness of IMF assistance of this nature is enhanced by the fact that, besides its conditionality, it is linked to a medium-term adjustment programme which has to be elaborated between the World Bank and the country concerned and may also involve loans from the World Bank. The special features of the Structural Adjustment Facility seem to be justified, inter alia because only resources which were intended from the start to constitute special assistance for developing countries are being employed for this purpose. All the more attention will have to be paid in future to ensuring that, within the context of the desirable cooperation between the IMF and the World Bank, tendencies directed towards using the Fund more generally for development finance purposes are not fostered.

Initial effects of the "Baker initiative" on lending by the development banks

The need for capital in the Third World was met to a greater extent by the international development banks last year. In comparison with the preceding year, the credit commitments of the World Bank group – comprising the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA) and the International Finance Corporation (IFC) – rose in the fiscal year 1985-86 by $ 2.2 billion to $ 17.5 billion. The IBRD in particular expanded its activities strongly, with special importance attaching to lending to those heavily-indebted countries which, in accordance with the "Baker initiative", require special assistance under certain conditions. While the IBRD's total loan commitments went up by 16 % to about $ 13 billion, its lending to the main problem countries rose by 38 % to some $ 6 billion. About one-third of the new loans granted to the "Baker countries" constituted sectoral and structural adjustment loans. These loans are intended to help overcome the balance of payments problems of these countries over the longer term via improved supply-side conditions. Their utilisation is therefore tied to the fulfilment of certain economic policy conditions, which are approved by the IMF as well. On the other hand, sectoral and structural adjustment loans – unlike traditional project loans – can be granted relatively quickly, with the result that assistance of this kind can also help to meet a country's short-term financing needs. There was also a rise in the last fiscal year (which in this case corresponds to the calendar year 1986) in the credit commitments of the major regional development banks for Latin America, Africa and Asia; they went up by a total of $ 0.6 billion to $ 6.7 billion, with lending by the African Development Bank growing fastest. As usual, the regional development banks had secured their current disbursements through borrowing beforehand to a large extent. With the continuing decline in interest rates on the international financial markets, however, they have greatly strengthened their liquidity position in recent times as well. Adding the total resources borrowed by all the regional development banks in their last fiscal year together, their gross volume of borrowing on the international financial markets, at $ 17.4 billion, was only slightly less than in the preceding year. With a share of 16 % in their aggregate longer-term borrowing, the German capital market was once again one of the most important sources of finance for these institutions.

Increase in IDA funds

In December 1986, upon the conclusion of the negotiations on the eighth replenishment of IDA's resources, additional steps were taken to provide the poorest developing countries in the world with even greater financial support than previously. A number of major donor countries, including Germany, provided IDA with a total amount of $ 12.4 billion for the fiscal years from 1988 to

1990 (IDA-8), after the replenishment for the three-year period now ending (IDA-7) had amounted to only $ 9 billion. In order to strengthen the planned cooperation between the Fund and the World Bank in the context of the IMF's Structural Adjustment Facility, it is intended that a relatively large share of the new IDA assistance — which is interest-free and now runs for 35 or 40 years — should likewise serve structural adjustment purposes and be employed as far as possible in conjunction with corresponding loans from the IMF. About half the new IDA loans will go to sub-Saharan countries.

(b) Multilateral surveillance of economic and monetary policy

New initiatives to improve the international coordination of economic policy

Separate reports on the functioning of the international monetary system and on possible improvements to it were presented by the industrial and developing countries some time ago under the auspices of the IMF.[1] Both studies agree that better functioning of the international monetary system and satisfactory development of the world economy can be expected only if the major countries pay greater attention than in the past to how their own policies affect other countries, and if they endeavour from the outset to harmonise their economic policies with one another more effectively. In order to achieve this aim it was recommended that the multilateral surveillance of the economic and monetary policies of the major countries that is embodied in a large number of international institutions should be strengthened. It was also agreed that the IMF should play a central role in multilateral surveillance since it has wide practical experience in this field. It was stressed in particular that the surveillance of the exchange rate policies of the members of the IMF, which is among the chief tasks performed by the Fund, constitutes a major element of multilateral surveillance, and that the Fund's periodic analyses of the world economy (which are published in the form of the "World Economic Outlook") and the discussions thereon represent further sound approaches to multilateral surveillance which could be deepened in future. Moreover, it was pointed out that the annual economic policy consultations which the Fund holds with its members provide a suitable opportunity for giving effect to the results of multilateral surveillance.

Uniform objective indicators being tested as an additional yardstick

In order to enhance multilateral surveillance under the auspices of the IMF in practice, the Fund decided in spring 1986 to develop a set of objective economic indicators and regularly to review on this basis the extent to which the expected economic trends in major countries imply problems for economic policy. These considerations were given extra emphasis by the fact that, at their conference in Tokyo in May 1986, the heads of state and government of the seven major industrial countries instructed their Ministers of Finance to check the mutual compatibility of the economic objectives and projections of their countries at least once a year in cooperation with the IMF and with the aid of certain indicators. However, the efforts undertaken in this direction have made it clear that providing reliable indicators for the envisaged international discussions presents considerable practical difficulties. This makes it all the more important for agreement to exist within the IMF and among the major industrial countries that the use of indicators is intended to make the international dialogue easier, but is not meant as a substitute for a careful overall assessment, much less as an automatic mechanism for triggering economic policy measures. Precisely this basic principle has constantly been emphasised by the Federal Government and the Bundesbank.

1 Deputies of the Group of Ten: "The Functioning of the International Monetary System", IMF Survey, Special Supplement, July 1985. Deputies of the Group of 24: "The Functioning and Improvement of the International Monetary System", IMF Survey, Special Supplement, September 1985.

Part B: Notes on the Deutsche Bundesbank's annual accounts for 1986

1. Legal basis, layout and valuation

Legal basis

The legal basis of the annual accounts of the Bank is provided by section 26 of the Deutsche Bundesbank Act (Gesetz über die Deutsche Bundesbank) of July 26, 1957 (Federal Law Gazette I, page 745); the provisions of that section regarding the accounting system and the annual accounts remained unchanged during the year under review. Section 26 (2) of the Deutsche Bundesbank Act as amended by the Act Concerning the EEC Annual Accounts Directive (Bilanzrichtliniengesetz) of December 19, 1985 is to be applied for the first time to the annual accounts for 1987.

Layout

The layout of the balance sheet remains unchanged against the previous year. In the profit and loss account, the expenditure item "Write-downs of monetary reserves and other foreign currency positions" has been added, while the item "Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions" has been deleted.

Valuation

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

2. Annual accounts

The annual accounts for 1986 are attached to this Report as an Appendix; as usual, the notes on them are presented in the same order as the items in the balance sheet and profit and loss account. At the same time a report is rendered on the Bank's activities during 1986.

Balance sheet

Comparison of balance sheet figures

The balance sheet total at December 31, 1986 was DM 220,851.2 million, as against DM 216,896.5 million at end-1985.

Assets

Gold

The gold holding at December 31, 1986, amounting to 95 million ounces of fine gold (excluding the gold reserves provisionally contributed to the European Monetary Cooperation Fund), is shown at the same figure as at end-1985, viz. DM 13,687.5 million.

Reserve position in the International Monetary Fund and special drawing rights

At December 31, 1986 the level of drawing rights within the reserve tranche in the IMF amounted to DM 6,462.0 million (= SDR 2,722.0 million), as against DM 7,418.2 million (= SDR 2,743.9 million) at end-1985. It corresponded to the difference between the German quota of SDR 5,403.7 million and the Deutsche Mark balances equivalent to SDR 2,681.7 million at the disposal of the IMF at the end of the year. Increases equivalent to SDR 357.5 million due to other members' Deutsche Mark drawings and other transactions of similar effect were accompanied by decreases equivalent to SDR 379.4 million due to other members' Deutsche Mark repayments and other transactions of similar effect.

Comparison of balance sheet figures

DM million

Assets	December 31 1985	December 31 1986
Gold	13,687.5	13,687.5
Reserve position in the International Monetary Fund and special drawing rights		
Drawing rights within the reserve tranche	7,418.2	6,462.0
Loans under special borrowing arrangements	1,955.1	1,006.7
Special drawing rights	3,806.6	3,919.8
Claims on the European Monetary Cooperation Fund in connection with the European Monetary System		
ECU balances **1**	17,185.5	15,364.2
Other claims	—	956.7
Balances with foreign banks and money market investments abroad	39,477.5	50,172.6
Foreign notes and coins	24.3	22.4
External loans and other external assets		
Loans to the World Bank	2,449.0	2,444.1
Lending to domestic banks		
Domestic bills of exchange	44,082.3	40,496.4
Securities bought in open market transactions under repurchase agreements	41,627.0	33,190.7
Foreign bills of exchange	17,301.3	20,363.2
Lombard loans	2,314.8	2,368.0
Cash advances	178.9	2,950.4
Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin	8,683.6	8,683.6
Securities	4,134.6	5,209.1
German coins	983.8	856.1
Balances on postal giro accounts	201.8	178.1
Land and buildings	1,837.8	2,144.6
Furniture and equipment	153.6	173.8
Items in course of settlement	6,421.4	7,556.6
Other assets	2,934.7	2,606.2
Prepaid expenses and deferred income	37.2	38.4
Balance sheet total	216,896.5	220,851.2
Contingent claims	0.1	0.1

Liabilities	December 31 1985	December 31 1986
Banknotes in circulation	105,416.0	113,983.0
Deposits of banks	55,824.1	55,869.5
Deposits of public authorities		
Federal Government	1,152.9	404.2
Equalisation of Burdens Fund and ERP Special Fund	6.1	4.9
Länder Governments	1,052.3	689.0
Other public depositors	38.1	45.7
Deposits of other domestic depositors		
Federal Railways	8.4	11.7
Federal Post Office	699.5	2,388.2
Other depositors	859.6	876.6
Liabilities arising from mobilisation and liquidity paper sold	8,767.8	4,808.2
Liabilities arising from external transactions	14,620.4	19,915.2
Counterpart of special drawing rights allocated	3,273.3	2,874.3
Provisions	5,792.2	4,743.2
Other liabilities	411.3	308.0
Deferred expenses and accrued income	439.1	282.9
Capital	290.0	290.0
Reserves	5,321.7	5,560.8
Unappropriated profit	12,923.7	7,795.8
Balance sheet total	216,896.5	220,851.2
Contingent liabilities	0.1	0.1

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

The loans under special borrowing arrangements amounted to DM 1,006.7 million at December 31, 1986 against DM 1,955.1 million at end-1985. The loans outstanding at the end of 1986 consisted entirely of claims on the IMF totalling SDR 424.1 million and arising from the financing of other members' drawings under the Supplementary Financing Facility.

The amount of special drawing rights (SDRs) held at December 31, 1986 was DM 3,919.8 million (= SDR 1,651.2 million) against DM 3,806.6 million (= SDR 1,408.0 million) at end-1985. It was composed of SDR 1,210.8 million of SDRs allocated, the counterpart of which is shown on the liabilities side, and SDR 440.4 million of SDRs purchased. In the year under review the Bank received SDR 160.4 million through designations, SDR 213.2 million through repayments and SDR 223.7 million through interest payments and remunerations. The Bank sold a total of SDR 354.1 million in freely agreed SDR transactions during the year under review.

Claims on the European Monetary Cooperation Fund

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

The ECU balances, amounting to DM 31,661.3 million, arise mainly from the provisional contribution of 20% of the Bank's gold and dollar reserves to the European Monetary Cooperation Fund (EMCF) in the form of three-month swaps. In addition, these balances include the reserve ECUs transferred to the Bank by other central banks participating in the European Monetary System (EMS). The gold and dollar reserves provisionally contributed to the European Monetary Cooperation Fund in connection with 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 16,297.1 million is deducted from the ECU balances.

At the end of 1986 other ECU claims arising from loans under the very short-term financing facility amounted to DM 956.7 million.

Balances with foreign banks and money market investments abroad

The balances with foreign banks and money market investments abroad, the vast bulk of which are denominated in US dollars and bear interest, amounted to DM 50,172.6 million at the end of 1986 against DM 39,477.5 million at December 31, 1985. The assets and liabilities expressed in US dollars have been valued at DM 1.7275, as before.

Foreign exchange dealing

Owing to smaller dollar sales on the foreign exchange market, the Bank's turnover in foreign exchange spot deals (foreign currency against Deutsche Mark) declined once again to DM 32,835.0 million against DM 37,054.4 million in 1985. The number of deals increased, however, from 5,297 in the previous year to 5,710. These deals consisted of

	1985		1986	
	Number	DM million	Number	DM million
Purchases	1,877	6,424.7	3,194	16,446.4
Sales	3,420	30,629.7	2,516	16,388.6
	5,297	37,054.4	5,710	32,835.0.

The volume of cross deals (foreign currency against foreign currency) declined from DM 4,479.9 million in the previous year to DM 3,343.5 million. At the same time the number of such deals fell from 343 in the previous year to 222. The volume of SDR-US dollar and SDR-Deutsche Mark deals (there were 43 such transactions) was equivalent to DM 1,196.8 million (1985: 45 transactions equivalent to DM 1,155.2 million). In addition, 189 US dollar inter-centre switch transactions totalling US$ 35.9 million were concluded (1985: 185 transactions amounting to US$ 26.9 million).

To fine-tune the money market, 162 US dollar swaps equivalent to DM 24,000.2 million were conducted with domestic banks in order to increase liquidity during the year under review (against 37 transactions amounting to DM 4,994.2 million in 1985).

External payments

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

External payments

Number of orders

Year	Outgoing external payment orders				
				of which	
	in foreign currencies	in Deutsche Mark	Total	Processed by automated standing order procedure	Processed automatically via S.W.I.F.T. 1
1985	410,623	2,196,172	2,606,795	2,349,463	177,912
1986	403,194	2,278,298	2,681,492	2,427,767	179,442
	Incoming external payment orders				
				of which Payments received via S.W.I.F.T.	
1985	15,370	218,464	233,834	205,425	
1986	16,300	225,877	242,177	212,971	

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

Sales of foreign cheques

During 1986 18,781 (1985: 16,553) foreign cheques payable to order totalling DM 381.9 million (1985: DM 516.6 million) were sold. In addition, the Bank sold 34,856 traveller's cheques amounting to DM 4.4 million against 28,334 traveller's cheques totalling DM 3.3 million in 1985.

Simplified collection procedure for foreign cheques

In 1986 the number of cheques presented under the simplified collection procedure for foreign cheques was again lower than in the preceding year. Details are given in Appendix 3 of the German original of this Report.

Foreign commission business

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

	1985 Number	1986 Number
Bills, cheques, etc.	39,868	33,996
Foreign notes and coins	5,652	7,081
	45,520	41,077.

Foreign notes and coins

The amount of foreign notes and coins held at end-1986, at DM 22.4 million, was DM 1.9 million lower than at end-1985. During the year under review, the Bank effected 19,200 purchases (1985: 22,727) and 44,210 sales (1985: 40,742) of foreign notes and coins.

External loans and other external assets

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

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

Lending to domestic banks

This item reflects domestic banks' recourse to the Bank's refinancing facilities.

Domestic bills of exchange

At the end of 1986 the Bank's portfolio of domestic bills amounted to DM 40,496.4 million against DM 44,082.3 million at the end of 1985. The Bank's average holding of domestic bills on all return days, at DM 42,109 million, was also lower than in the preceding year (DM 47,355 million). The domestic bill portfolio comprised:

	Dec. 31, 1985 DM million	Dec. 31, 1986 DM million
Domestic bills discounted	40,627.5	36,985.8
Prime bankers' acceptances acquired in the course of open market operations	3,454.8	3,510.6
	44,082.3	40,496.4.

The average value of the bills purchased in the year under review was DM 73,700 compared with DM 78,200 in the previous year.

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

Land Central Bank	1985 Thousands	1985 DM million	1986 Thousands	1986 DM million
Baden-Württemberg	641	31,391.1	594	29,153.2
Bavaria	390	28,473.3	377	26,714.4
Berlin	24	5,026.5	22	4,193.4
Bremen	39	3,253.4	37	2,967.8
Hamburg	122	13,960.2	113	12,501.7
Hesse	345	38,402.7	334	32,882.4
Lower Saxony	181	15,566.6	166	14,235.0
North Rhine-Westphalia	626	49,937.9	612	44,119.3
Rhineland-Palatinate	107	6,767.6	96	5,680.7
Saarland	27	2,384.8	23	2,062.6
Schleswig-Holstein	39	3,438.0	34	3,068.6
Total	2,541	198,602.1	2,408	177,579.1

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

	1985 Number	1985 DM million	1986 Number	1986 DM million
	15,036	185.2	13,191	186.4
as % of the total purchased	0.59	0.09	0.55	0.11.

Discount rate

During the year under review the Bank's discount rate for domestic and foreign bills was 4% until March 6, and 3½% as from March 7.

Prime bankers' acceptances

The amount of prime bankers' acceptances which the Bank is prepared to purchase in the course of its open market operations, at DM 4 billion, remained unchanged during the year under review. Throughout the year the Bank's buying rate for prime bankers' acceptances was 0.5 percentage point below the discount rate, and thus considerably lower than the money market rates; hence prime bankers' acceptances continued to be used heavily as a source of funding. During the year the Bank's purchases through Privatdiskont-Aktiengesellschaft came to DM 17,034.7 million (DM 16,599.3 million in the previous year). There were no resales to the market via the broker in 1986.

DM 16,978.9 million remained in the Bank's portfolio until payment on maturity (DM 16,816.5 million in the preceding year). At December 31, 1986 the Bank held prime bankers' acceptances stemming from open market operations totalling DM 3,510.6 million (end-1985: DM 3,454.8 million).

Securities repurchase agreements

During the year under review the Bank again offered the banks, by tender, open market transactions under repurchase agreements in securities on a considerable scale in order to provide liquidity for a limited period. In these transactions the Bank bought securities eligible as collateral for lombard loans subject to the condition that the sellers repurchased them forward. The repurchase periods varied between 27 and 63 days, and the interest rates between 4.30 and 4.65%. At the end of the year the claims deriving from these transactions amounted to DM 33,190.7 million (end-1985: DM 41,627.0 million).

Foreign bills of exchange

At the end of 1986 the portfolio of foreign bills accumulated through purchases in Germany amounted to DM 20,363.2 million (end-1985: DM 17,301.3 million). The share of Deutsche Mark bills in the total value of the foreign bills purchased averaged roughly 97% in 1986 (1985: about 96%).

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

Land Central Bank	1985 Number	1985 DM million	1986 Number	1986 DM million
Baden-Württemberg	52,285	8,468.4	53,222	10,205.0
Bavaria	31,360	8,559.4	31,818	10,275.5
Berlin	2,230	4,297.7	2,779	5,289.0
Bremen	2,697	939.3	2,438	1,195.8
Hamburg	14,595	8,761.1	16,167	10,946.2
Hesse	29,479	18,936.0	33,054	26,159.3
Lower Saxony	8,611	2,309.5	8,778	3,397.5
North Rhine-Westphalia	45,559	18,134.4	48,251	21,431.8
Rhineland-Palatinate	9,632	2,036.2	9,113	2,183.5
Saarland	3,763	1,083.1	3,758	1,282.9
Schleswig-Holstein	2,180	1,167.9	2,942	1,333.2
Total	202,391	74,693.0	212,320	93,699.7

Lombard loans

At the end of 1986 the outstanding amount of lombard loans granted to banks by the Bank was DM 2,368.0 million against DM 2,314.8 million at end-1985. The average level of such loans on all return days in the year under review was DM 932 million compared with DM 1,882 million in the previous year. The outstanding amount of such loans was subject to marked fluctuations, as in preceding years; it was largest on June 30, 1986, at DM 12,426 million.

Lombard rate

In the year under review the lombard rate was 5½ %.

Cash advances

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

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

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

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

Federal Government, Länder Governments

Cash advances outstanding

DM million

Borrower	December 31, 1985	December 31, 1986
Federal Government	–	2,014.9
Länder Governments		
Bavaria	7.5	–
Bremen	47.9	48.3
Lower Saxony	–	72.1
North Rhine-Westphalia	–	553.0
Rhineland-Palatinate	0.9	134.9
Saarland	39.8	40.0
Schleswig-Holstein	82.8	87.2
Total	178.9	2,950.4

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

Federal Railways, Federal Post Office

No cash advances to the Federal Railways or Federal Post Office were outstanding at December 31, 1986; such advances, together with claims arising from the purchase of Treasury bills and Treasury discount paper, are to be shown in the item "Lending to the Federal Railways and Federal Post Office" on the assets side of the Bank's balance sheet.

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

Treasury bills and Treasury discount paper

In the issuing of Treasury discount paper in 1986 the Bank again acted as selling agent for the Federal Government. This paper, which serves financing purposes, is distinct from the mobilisation and liquidity paper issued pursuant to sections 42 and 42a of the Bundesbank Act, which is reported on below. No Treasury bills serving financing purposes were issued during the year under review.

Federal Government

The issuing of Treasury discount paper to meet the Federal Government's borrowing requirements declined perceptibly in the year under review. Thus in 1986 Treasury discount paper type "BN", which is not returnable before maturity, was placed with domestic banks to the amount of only DM 1,793.8 million (1985: DM 4,638.2 million). DM 1,192.1 million (1985: DM 2,513.5 million) of Treasury "financing paper" was sold. A further DM 840 million of paper returnable prior to maturity (type "B") was purchased by an institutional investor.

After the redemption of DM 5,191.8 million (1985: DM 7,615.2 million) of matured Treasury discount paper (including Treasury "financing paper"), the total amount of Treasury discount paper types "B" and "BN" outstanding at December 31, 1986 was DM 9,025.9 million (end-1985: DM 10,391.8 million). Of this total, DM 1,090.0 million was repurchasable by the Bank (type "B"), as in the preceding year.

Federal Railways

At December 31, 1986 the outstanding amount of returnable Treasury discount paper of the Federal Railways was DM 131.0 million, just as at end-1985.

Federal Post Office

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

The total amount of money market paper issued for the account of the Federal Government and its Special Funds outstanding at December 31, 1986 was DM 9,156.9 million (end-1985: DM 10,522.8 million).

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

DM million

	1985	1986		
Type of paper	Outstanding at Dec. 31	Issued	Redeemed	Outstanding at Dec. 31
Treasury discount paper of the Federal Republic of Germany types "B" **1** and "BN" **2**	10,391.8	3,825.9	5,191.8	9,025.9
of which: Treasury "financing paper"	(3,945.8)	(1,192.1)	(2,191.8)	(2,946.1)
Treasury discount paper of the Federal Railways types "Ba" and "BaN" **2**	131.0	–	–	131.0
Treasury discount paper of the Federal Post Office type "PN" **2**	–	–	–	–
Total	10,522.8	3,825.9	5,191.8	9,156.9

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

Länder Governments

At end-1986, as in the preceding year, the Bank had no money market paper of the Länder Governments in its portfolio.

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

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

Lending to the Federal Railways and Federal Post Office

No loans to the Federal Railways or Federal Post Office were outstanding at December 31, 1986, as in the previous year. See also the notes on the items "Cash advances" and "Treasury bills and Treasury discount paper".

Securities

During the year under review the Bank's portfolio of securities — chiefly bonds of the Federal Republic of Germany, the Federal Railways and the Federal Post Office — increased by DM 1,074.5 million net to DM 5,209.1 million (end-1985: DM 4,134.6 million) owing to transactions in the open market and after taking account of redemptions on account of maturity.

Issue of bonds

In 1986 15 bond issues totalling DM 36,250 million (1985: 13 bond issues amounting to DM 24,250 million) were launched through the Federal Bond Consortium, which is under the direction of the Bank. Of these bonds, an amount of DM 7,800 million was reserved for the issuers' own institutions and for market regulation purposes.

At the end of 1986 the outstanding amount of bonds of the Federal Republic of Germany was DM 118,132.0 million (end-1985: DM 91,683.4 million), that of the Federal Railways was DM 19,855.3 million (end-1985: DM 16,616.6 million) and that of the Federal Post Office DM 20,644.2 million (end-1985: DM 16,665.1 million).

Bond issues of the Federal Republic of Germany, the Federal Railways and the Federal Post Office in 1986

Issuer	Amount issued (DM million)		Terms				Start of sales
	Total	of which Sold through Federal Bond Consortium	Nominal interest rate (%)	Maturity (years)	Issue price (%)	Yield (%)	
Federal Republic of Germany	3,000	2,250	6.375	10	100.25	6.34	Jan. 2
Federal Railways	850	700	6.375	10	100	6.38	Jan. 29
Federal Republic of Germany	3,000	2,250	6.375	10	100.25	6.34	Feb. 5
Federal Republic of Germany	3,000	2,250	6	12	100.50	5.94	Mar. 5
Federal Post Office	2,000	1,600	5.75	15	100.25	5.72	Apr. 7
Federal Republic of Germany	3,000	2,250	5.75	10	100	5.75	May 28
Federal Republic of Germany	1,000	750	6	30	99	6.07	May 28
Federal Post Office	2,000	1,600	6	10	100	6.00	Jun. 26
Federal Republic of Germany	4,000	3,200	5.75	10	99.75	5.78	July 14
Federal Railways	1,200	1,000	6	12	100.50	5.94	Aug. 8
Federal Republic of Germany	3,000	2,400	5.50	10	100	5.50	Sep. 2
Federal Republic of Germany	1,000	800	5.625	30	99.50	5.66	Sep. 2
Federal Republic of Germany	4,000	3,200	6	12	99.75	6.03	Oct. 6
Federal Railways	1,200	1,000	6.50	10	100	6.50	Nov. 5
Federal Republic of Germany	4,000	3,200	6.50	10	100	6.50	Nov. 17

Issue of Federal savings bonds

With the assistance of the Bank (selling operations through banks and sales of its own), Federal savings bonds to the value of DM 4,131.6 million (gross) were placed with private purchasers in 1986 (1985: DM 5,439.7 million).

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

During 1986 DM 77.7 million (1985: DM 92.9 million) of Federal savings bonds from earlier tranches were returned to the issuer before maturity, and a further DM 1,838.6 million were redeemed on maturity. The amount of Federal savings bonds outstanding accordingly rose from DM 25,920.6 million at end-1985 to DM 28,135.9 million at December 31, 1986.

Gross sales, interest rates and yields of Federal savings bonds in 1986

		Gross sales (DM million)			Interest rate (I) in, and yield (Y) after, the respective year after issue (% p.a.)							
Issue	Sales period 1986	Total	Federal savings bonds type A [1]	Federal savings bonds type B [2]		1st	2nd	3rd	4th	5th	6th	7th
1986/ 1+2	[3] Jan. 2– Feb. 27	[4] 1,630.6	776.7		I	4.00	5.50	6.00	7.00	7.50	8.00	
					Y	4.00	4.73	5.13	5.56	5.90	6.20	
				853.9	I	4.00	5.50	6.00	7.00	7.50	8.00	8.00
					Y	4.00	4.75	5.16	5.62	5.99	6.32	6.56
1986/ 3+4	Feb. 28– Apr. 3	611.9	321.4		I	3.50	5.00	5.50	6.00	7.00	8.00	
					Y	3.50	4.23	4.64	4.95	5.32	5.70	
				290.5	I	3.50	5.00	5.50	6.00	7.00	8.00	8.00
					Y	3.50	4.25	4.66	5.00	5.39	5.82	6.13
1986/ 5+6	Apr. 4– July 21	544.4	235.5		I	3.00	4.50	5.00	5.50	6.50	7.50	
					Y	3.00	3.74	4.14	4.46	4.82	5.21	
				308.9	I	3.00	4.50	5.00	5.50	6.50	7.50	8.00
					Y	3.00	3.75	4.16	4.50	4.89	5.32	5.70
1986/ 7+8	July 22– Oct. 24	730.7	309.7		I	3.50	4.50	5.00	6.00	7.00	8.00	
					Y	3.50	3.99	4.31	4.70	5.12	5.53	
				421.0	I	3.50	4.50	5.00	6.00	7.00	8.00	8.00
					Y	3.50	4.00	4.33	4.75	5.19	5.66	5.99
1986/ 9+10	Oct. 27– [5]	614.0	246.1		I	3.50	5.00	5.50	6.00	7.00	8.00	
					Y	3.50	4.23	4.64	4.95	5.32	5.70	
				367.9	I	3.50	5.00	5.50	6.00	7.00	8.00	8.00
					Y	3.50	4.25	4.66	5.00	5.39	5.82	6.13
Total	Jan. 2– Dec. 31 [5]	4,131.6	1,889.4	2,242.2								

1 With annual payment of interest. — 2 With accrual of interest. — 3 Start of sales on December 20, 1985. — 4 Sales from December 20, 1985 to December 31, 1985 FSB/A DM 27.5 million, FSB/B DM 46.0 million = total DM 73.5 million. — 5 Sales not completed on December 31, 1986.

Issue of five-year special Federal bonds

With the assistance of the Bank (selling operations through banks and sales of its own), newly-issued five-year special Federal bonds to the value of DM 16,575.9 million were sold (1985: DM 16,568.5 million). In addition, an amount of DM 3,316.3 million was reserved for market regulation purposes after the completion of the issue of each series.

During the year under review the terms of these special Federal bonds were brought into line with market conditions on 22 occasions.

Series 10 to 23 of the special Federal bonds to the amount of DM 12,170.0 million were redeemed on maturity in the year under review. The outstanding amount of five-year special Federal bonds at end-1986 was DM 81,216.5 million (end-1985: DM 73,639.1 million).

Sales and terms of issue of five-year special Federal bonds in 1986									
		Terms (%)			Amount issued (DM million)				
					Sales				
Designation of series	Start of sales	Nominal interest rate	Issue price	Yield	per issue price	Total	Price regulation share	Total	Date of admission to stock exchange dealing
S. 60 of 1986 (1991)	[1] Jan. 2	6.25	99.80	6.30	548.4				
	Jan. 3		100.30	6.18	941.2				
	Feb. 10		100.50	6.13	1,003.8				
	Feb. 17		100.80	6.06	93.0				
	Feb. 19		101.00	6.01	669.7	[2] 3,256.1	484.7	3,800	Mar. 13
S. 61 of 1986 (1991)	Feb. 25	6.00	100.10	5.98	626.3				
	Feb. 28		100.60	5.86	309.5				
	Mar. 5		101.00	5.76	1,325.3	2,261.1	538.9	2,800	Mar. 25
S. 62 of 1986 (1991)	Mar. 13	5.75	100.30	5.68	2,189.7				
	Apr. 2		101.00	5.52	110.9	2,300.6	499.4	2,800	Apr. 16
S. 63 of 1986 (1991)	Apr. 4	5.50	100.20	5.45	307.1				
	Apr. 10		100.80	5.31	1,387.5				
	Apr. 18		101.60	5.13	78.7				
	May 14		99.60	5,59	112.7				
	June 3		99.00	5.74	2,302.5	4,188.5	811.5	5,000	Aug. 5
S. 64 of 1986 (1991)	July 22	5.50	99.50	5.62	320.0				
	Aug. 4		100.00	5.50	447.5				
	Aug. 12		100.40	5.41	324.7	1,092.2	407.8	1,500	Sep. 12
S. 65 of 1986 (1991)	Sep. 2	5.25	99.60	5.34	48.5				
	Sep. 15		98.50	5.60	293.4	341.9	158.1	500	Nov. 6
S. 66 of 1986 (1991)	Oct. 27	5.75	100.00	5.75	2,474.2				
	Dec. 1		100.60	5.61	409.9	2,884.1	415.9	3,300	Dec. 16
S. 67 of 1986 (1991)	Dec. 4	5.50	100.00	5.50	251.4	251.4	[3] –	[3] –	16.02.87

1 Start of sales on December 20, 1985. — **2** Sales from December 20 to December 31, 1985 = DM 59.2 million. — **3** Sales of series not completed on December 31, 1986.

Through the agency of the Bank, DM 6,075.0 million of Treasury bonds (medium-term notes) of the Federal Republic of Germany and the Federal Railways were sold in seven issues by four tenders in 1986 (in the preceding year DM 3,211.3 billion by three tenders).

Issue of medium-term notes

At the end of 1986 the outstanding amount of medium-term notes of the Federal Republic of Germany was DM 23,220.0 million (end-1985: DM 15,473.1 million), that of the Federal Railways DM 2,141.8 million (end-1985: DM 1,924.0 million) and that of the Federal Post Office DM 946.5 million (end-1985: DM 1,687.5 million).

Treasury bonds (medium-term notes) of the Federal Republic of Germany and the Federal Railways sold by tender in 1986						
Issuer	Amount sold (DM million)	Nominal interest rate (%)	Maturity (years)	Selling price (%)	Yield on issue (%)	Value date
Federal Republic of Germany	1,297.7	5.50	4½	99.70	5.58	July 3
Federal Railways	577.8	5.50	4	99.90	5.53	July 21
Federal Republic of Germany	1,591.4	5.25	3	99.80	5.32	
	642.5	5.50	4	99.40	5.67	October 24
	513.0	5.75	5	99.70	5.82	
Federal Republic of Germany	682.3	5.50	4½	100.00	5.50	December 2
	770.3	5.75	5¾	99.80	5.79	

Admission to stock exchange dealing

In 1986 the Bank introduced the new bond issues of the Federal Republic of Germany, the Federal Railways, the Federal Post Office and the Reconstruction Loan Corporation, as well as the five-year special Federal bond series 59 to 66, to official dealing on all German stock exchanges; it also introduced a bond issue of Deutsche Ausgleichsbank to official dealing on the Frankfurt and Düsseldorf stock exchanges.

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

Furthermore, the Bank introduced the new issues of bearer bonds and medium-term notes of the Reconstruction Loan Corporation to official or semi-official dealing on particular German stock exchanges; it also introduced eight tranches of bearer bonds of Deutsche Ausgleichsbank to semi-official dealing on the Düsseldorf stock exchange.

Price regulation operations

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

The Bank as paying and collecting agent for bonds

As paying and collecting agent for, in particular, bonds (including external bonds) of the Federal Government and its Special Funds, the Bank paid 327,539 interest coupons and matured bonds in 1986 (1985: 366,701).

German coins

The amount of German coins held by the Bank at the end of 1986 was DM 856.1 million (end-1985: DM 983.8 million). In 1986 DM 341.9 million was credited to the Federal Government in respect of coins taken over from the Mints and DM 22.4 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1986 the Bank — acting for the account of the Federal Government — took over coins amounting to DM 12,323.2 million and redeemed DM 1,717.3 million of coins which were no longer fit for circulation or had been called in.

The total amount of coins in circulation at the end of 1986 (DM 9,749.8 million) divided by the number of inhabitants of the Federal Republic of Germany including Berlin (West) on September 30, 1986 (61.1 million) yields a coin circulation of DM 160 per head of population (end-1985: DM 153).

During the year under review the DM 5 commemorative coins "600jähriges Bestehen der Ruprecht-Karls-Universität Heidelberg" (600th anniversary of the foundation of Ruprecht Karl University, Heidelberg) and "Friedrich der Große" (Frederic the Great) were put into circulation.

Balances on postal giro accounts

At December 31, 1986 the postal giro account balances, including the branch offices' transfers in transit to the postal giro account of the Bank (Central Office) in Frankfurt am Main, amounted to DM 178.1 million (1985: DM 201.8 million). The Bank's credit balances on the latter account and on the postal giro account of the Land Central Bank in Berlin, other than those required for current payments, are offset daily, in rounded amounts, against the giro account balances of the Central Cash Office of the Federal Post Office and the Berlin (West) Postal Giro Office.

Postal giro transactions with third parties

Area	1985 Transfers received from third parties Number	DM million	1985 Transfers made to third parties Number	DM million	1986 Transfers received from third parties Number	DM million	1986 Transfers made to third parties Number	DM million
Land Central Bank								
Baden-Württemberg	43,026	20,319.2	5,101	3,112.6	44,896	21,378.6	5,339	3,496.9
Bavaria	38,639	14,206.6	9,531	8,750.8	40,214	14,499.6	9,596	9,597.6
Berlin	5,706	2,847.9	1,836	1,871.9	5,711	3,132.7	1,828	1,959.1
Bremen	4,760	361.7	125	0.0	5,404	346.6	107	0.0
Hamburg	46,938	19,430.2	1,801	517.4	26,818	20,214.9	1,809	403.5
Hesse	51,426	7,231.0	4,251	8,474.7	39,991	6,907.6	4,438	9,357.2
Lower Saxony	38,728	9,607.0	4,346	3,559.1	35,241	8,676.4	4,475	3,847.5
North Rhine-Westphalia	92,243	19,119.4	9,150	5,287.6	97,845	19,376.9	8,922	5,268.9
Rhineland-Palatinate	25,912	1,044.8	4,187	810.9	28,602	1,043.2	4,608	953.4
Saarland	4,072	2,042.1	156	0.1	2,666	2,060.1	169	0.1
Schleswig-Holstein	5,811	90.2	509	0.5	8,871	115.1	482	2.5
Total	357,261	96,300.1	40,993	32,385.6	336,259	97,751.7	41,773	34,886.7
Bundesbank — Central Office —	7,040	2,609.7	1,119	2.7	5,571	2,306.8	1,621	3.3
Grand total	364,301	98,909.8	42,112	32,388.3	341,830	100,058.5	43,394	34,890.0

Land and buildings

After additions of DM 432.7 million and depreciation totalling DM 125.9 million, land and buildings are shown at DM 2,144.6 million.

Furniture and equipment

The balance sheet value of furniture and equipment, after additions totalling DM 92.2 million and depreciation amounting to DM 72.0 million, is DM 173.8 million.

Items in course of settlement

The "Items in course of settlement" mainly comprise the intercity credit and debit transfers in transit within the Bank at the end of the year and the cheques and direct debits being cleared. At December 31, 1986 the balance of items in course of settlement stood at DM 7,556.6 million against DM 6,421.4 million at end-1985.

Other assets

At the end of 1986 other assets amounted to DM 2,606.2 million (end-1985: DM 2,934.7 million). They primarily comprise the interest due in 1987 but assignable to the profit and loss account for the year under review on funds invested abroad and securities (DM 2,091.2 million against DM 2,443.5 million at end-1985) and the balance resulting from intra-German settlements (commercial payments under the "Berlin Agreement"), which came to DM 194.1 million (1985: DM 191.5 million). The regulations governing intra-German payments are outlined in Part A IV of the German original of this Report.

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

Prepaid expenses and deferred income

The prepaid expenses and deferred income almost exclusively comprise salary and pension payments made in the year under review but relating to 1987.

Banknotes in circulation

The amount of banknotes in circulation at December 31, 1986, at DM 113,983.0 million, was DM 8,567.0 million larger than at end-1985.

Currency in circulation

DM million

End of	Bundesbank notes	Federal coins	Currency in circulation, total
1981	83,790.3	7,816.6	91,606.9
1982	88,574.7	8,120.2	96,694.9
1983	96,073.0	8,619.3	104,692.3
1984	100,636.0	8,956.1	109,592.1
1985	105,416.0	9,302.6	114,718.6
1986	113,983.0	9,749.8	123,732.8

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

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

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

	1981	1982	1983	1984	1985	1986
Number (millions)	662.3	834.5	582.9	569.0	575.4	595.7
Value (DM million)	28,793.9	39,604.0	24,938.5	25,098.5	26,046.7	27,035.3.

The number and value of the counterfeit Bundesbank notes detained in payments in the Federal Republic of Germany and Berlin (West) continued to go up along with the increase in the amount of banknotes in circulation. This was almost wholly due to counterfeit DM 100 notes. The number and value of counterfeit Federal coins, by contrast, declined.

Counterfeits detected in payments

	Bundesbank notes		Federal coins	
Year	Number	DM thousand	Number	DM thousand
1977	9,754	946.0	6,754	25.7
1978	6,341	586.4	9,835	35.5
1979	3,388	296.6	7,405	24.3
1980	2,421	183.4	9,428	25.1
1981	2,896	219.1	17,172	34.3
1982	3,317	250.7	19,975	43.3
1983	2,156	181.7	26,607	56.1
1984	7,318	710.3	21,365	49.3
1985	7,585	712.2	24,617	57.7
1986	8,257	807.4	17,111	46.6

Deposits of banks

The banks' deposits on giro accounts are mainly composed of the minimum reserves to be held at the Bank. The sub-item "Other" contains the deposits of domestic banks on US dollar accounts. At the end of the year, compared with end-1985, the deposits were made up as follows:

	Dec. 31, 1985 DM million	Dec. 31, 1986 DM million
Deposits on giro accounts	55,809.6	55,849.0
Other	14.5	20.5
	55,824.1	55,869.5.

Deposits of public authorities

The current balances of public authorities are shown as "Deposits of public authorities"; they break down as follows:

	Dec. 31, 1985 DM million	Dec. 31, 1986 DM million
Federal Government	1,152.9	404.2
Equalisation of Burdens Fund and ERP Special Fund	6.1	4.9
Länder Governments	1,052.3	689.0
Other public depositors	38.1	45.7
	2,249.4	1,144.8.

Deposits of other domestic depositors

The deposits of other domestic depositors are composed as follows:

	Dec. 31, 1985 DM million	Dec. 31, 1986 DM million
Federal Railways	8.4	11.7
Federal Post Office (including postal giro and postal savings bank offices)	699.5	2,388.2
Other depositors	859.6	876.6
	1,567.5	3,276.5.

Giro transactions, simplified cheque and direct debit collections

The entries on giro accounts increased by 6.3 % against 1985; the total turnover went up by 4.6 %. As in the preceding years, almost 100 % of the turnover was processed on a cashless basis.

Annual turnover on the giro accounts of the Bank

Type of turnover	1985 Number of transactions	1985 Total amount	1985 Average amount	1986 Number of transactions	1986 Total amount	1986 Average amount
	Thousands	DM million	DM thousand	Thousands	DM million	DM thousand
(a) Credits						
Cash payments	1,056	241,927	229.1	1,062	251,275	236.6
Clearings with account-holders	3,781	5,857,901	1,549.3	3,798	6,323,714	1,665.0
Local transfers	76,476	6,361,361	83.2	75,753	6,315,587	83.4
Intercity transfers	349,661	6,309,123	18.0	370,949	6,785,934	18.3
Cheque and direct debit collections (total presented)	1,316,209	2,487,983	1.9	1,405,382	2,571,907	1.8
Total	1,747,183	21,258,295	–	1,856,944	22,248,417	–
(b) Debits						
Cash payments	1,557	248,345	159.5	1,546	261,072	168.9
Clearings with account-holders	2,899	5,713,373	1,970.8	2,866	6,484,411	2,262.5
Local transfers	76,476	6,361,361	83.2	75,753	6,315,587	83.4
Intercity transfers	350,671	6,455,790	18.4	372,708	6,610,469	17.7
Cheque and direct debit collections (total paid)	1,309,405	2,482,139	1.9	1,398,472	2,571,105	1.8
Total	1,741,008	21,261,008	–	1,851,345	22,242,644	–
(c) Percentage of total turnover (credits and debits)						
Cash payments	0.08	1.15	–	0.07	1.15	–
Clearings with account-holders	0.19	27.22	–	0.18	28.79	–
Local transfers	4.38	29.92	–	4.09	28.39	–
Intercity transfers	20.08	30.02	–	20.05	30.11	–
Cheque and direct debit collections (total presented and paid)	75.27	11.69	–	75.61	11.56	–
Total	100.00	100.00	–	100.00	100.00	–

In the year under review virtually all the collection and credit transfer orders presented were processed on an automated basis at the Bank's computer centres. The volume of payments executed through the paperless exchange of data media (EDM) was about 21 % higher than in the preceding year. Such payments now account for more than 63 % of the payment items presented under the automated procedure. The strong increase in the collection orders recorded on magnetic tape is mainly due to the cheque truncation (CT) procedure for items up to DM 1,000. The conversion of cheques eligible for the CT procedure but still presented in paper form is in progress at all the computer centres of the Bank; altogether, 107 million cheques to the value of DM 29 billion were converted.

Automation of intercity transfers

Year	Collection orders presented							Intercity credit transfers presented						
		processed							processed					
		in paper-based operations				through the paperless exchange of data media			in paper-based operations				through the paperless exchange of data media	
	Total	conventional		automated				Total	conventional		automated			
	millions	millions	%	millions	%	millions	%	millions	millions	%	millions	%	millions	%
1977	587	47	8	359	61	181	31	169	36	21	87	51	46	28
1978	694	31	5	412	59	251	36	183	26	14	89	49	68	37
1979	775	15	2	441	57	319	41	192	13	7	95	49	84	44
1980	873	11	1	473	54	389	45	230	7	3	125	54	98	43
1981	1,023	8	1	490	48	525	51	271	7	2	162	60	102	38
1982	1,098	7	1	512	46	579	53	291	6	2	180	62	105	36
1983	1,159	6	1	524	45	629	54	319	5	2	202	63	112	35
1984	1,226	6	1	533	43	687	56	335	4	1	216	65	115	34
1985	1,316	6	1	511	39	799	60	350	4	1	224	64	122	35
1986	1,405	5	0	412	29	988	71	372	3	1	238	64	131	35

If, besides intercity transfers, local payments and clearing transactions — which, apart from local credit transfers in Hamburg, are not yet processed automatically — are taken into account, then about 83% of cashless payments at the Bank are automated. It should be borne in mind in this connection that, as part of the conventional clearing procedure, magnetic tapes containing payments are exchanged locally between banks on a considerable scale; however, only the total amounts of the magnetic tape data files are cleared in this way.

Liabilities arising from mobilisation and liquidity paper sold

For the sake of managing liquidity, mobilisation and liquidity paper pursuant to sections 42 and 42a of the Bundesbank Act in the form of short-term Treasury bills (running as a rule for three days) were again sold to domestic banks in the year under review. These transactions totalled DM 39,167.0 million (1985: DM 53,597.0 million). In addition, just as in the preceding years, Treasury bills were issued for the purpose of the revolving investment of funds by foreign institutions and the investment of funds by domestic public authorities. Altogether, sales amounting to DM 64,924.8 million (1985: DM 79,104.9 million) were accompanied by redemptions totalling DM 68,889.3 million (1985: DM 76,846.6 million), so that the amount outstanding decreased to DM 4,541.2 million (1985: DM 8,505.7 million).

Mobilisation and liquidity Treasury discount paper to the amount of DM 187.4 million was issued (1985: DM 186.7 million); after redemptions totalling DM 182.5 million (1985: DM 190.9 million), the amount of such paper outstanding at December 31, 1986 was DM 267.0 million (end-1985: DM 262.1 million).

At December 31, 1986 the total liabilities arising from mobilisation and liquidity paper outstanding came to DM 4,808.2 million (end-1985: DM 8,767.8 million).

Mobilisation and liquidity paper sold and redeemed

DM million

Type of paper	1985 Outstanding at December 31	1986 Sold	Redeemed	Outstanding at December 31
Treasury bills (running for up to 90 days)	8,505.7	64,924.8	68,889.3	4,541.2
Treasury discount paper (running for 6 to 24 months)	262.1	187.4	182.5	267.0
Total	8,767.8	65,112.2	69,071.8	4,808.2

Liabilities arising from external transactions

The liabilities arising from external transactions grew to DM 19,915.2 million at end-1986 (1985: DM 14,620.4 million). Liabilities to foreign monetary authorities increased most. Specifically, the liabilities arising from external transactions were made up as follows:

	Dec. 31, 1985 DM million	DM million	Dec. 31, 1986 DM million	DM million
Deposits of foreign depositors				
Banks	14,289.8		19,632.2	
Other depositors	304.8	14,594.6	266.2	19,898.4
Other				
Provision of cover for letters of credit, etc.	12.8		4.3	
Miscellaneous liabilities	13.0	25.8	12.5	16.8
		14,620.4		19,915.2.

Counterpart of special drawing rights allocated

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

Provisions for pensions

After the withdrawal of DM 138.2 million for the payment of pensions and an increase of DM 218.2 million, the provisions for pensions amount to DM 2,091.0 million (end-1985: DM 2,011.0 million); they correspond to the actuarially calculated requirements.

Provisions for other purposes

To offset losses arising from the valuation of the monetary reserves and other foreign currency positions, DM 1,129.0 million net was withdrawn from the provisions for other purposes, which serve primarily to cover general risks inherent in domestic and external transactions (see also the notes below on the expenditure item "Write-downs of monetary reserves and other foreign currency positions"). As a consequence, at December 31, 1986 the provisions for other purposes amounted to DM 2,652.2 million against DM 3,781.2 million at end-1985.

Other liabilities

The other liabilities declined by DM 103.3 million to DM 308.0 million. This was mainly due to the lower level of liabilities in respect of securities commission business at end-1985.

Deferred expenses and accrued income

Deferred expenses and accrued income amounted to DM 282.9 million at December 31, 1986 (end-1985: DM 439.1 million). As before, this item mainly comprised interest received in the year under review, but relating to the following year, on domestic and foreign bills of exchange and US Treasury Notes.

Capital

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

Reserves

In accordance with the decision taken by the Central Bank Council on April 10, 1986, the legal reserves were increased by DM 239.1 million out of the profit for 1985. After this increase, the legal reserves totalled DM 5,270.8 million; they thus reached the maximum level permissible by law of 5% of the amount of banknotes in circulation, which came to DM 105,416.0 million at the end of 1985. The other reserves reached the statutory ceiling of DM 290 million as long ago as end-1980.

Unappropriated profit

See the notes on page 108 of this Report.

Contingent liabilities and claims

The contingent liabilities and claims amounted to DM 92,000 against DM 75,000 at end-1985.

Profit and loss account

Comparison of expenditure and receipts

DM million

Expenditure	1985	1986	Receipts	1985	1986
			Interest received		
			Funds invested abroad	9,005.1	6,905.5
Interest paid on foreign exchange swap and repurchase transactions with domestic banks	5.8	6.9	Lending to domestic banks	4,631.1	3,663.6
			Equalisation claims	81.4	81.4
Interest paid on mobilisation and liquidity paper	258.4	203.3	Securities	341.5	387.8
Other interest paid	11.6	10.7	Cash advances	107.0	64.2
	275.8	220.9	Other interest received	3.0	2.8
Administrative expenditure				14,169.1	11,105.3
Staff costs	746.6	786.5	Fees received	18.8	24.2
Other	196.8	202.7			
Note printing	174.6	142.0			
Depreciation	154.9	197.9			
Increases in provisions			Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	279.5	–
for pensions	80.2	218.2	Other receipts	146.0	141.9
for other purposes	–	–			
Pension payments in respect of the Reichsbank	24.1	22.6			
Write-downs of monetary reserves and other foreign currency positions	–	1,636.3			
Other expenditure	36.7	48.5			
Profit for the year (= unappropriated profit)	12,923.7	7,795.8			
Total	14,613.4	11,271.4	Total	14,613.4	11,271.4

Receipts

Interest

	1985 DM million	1986 DM million
Interest received amounted to	14,169.1	11,105.3;
after deduction of interest paid, namely	275.8	220.9,
interest is shown in the profit and loss account at	13,893.3	10,884.4.

Total interest received declined against the previous year by DM 3,063.8 million to DM 11,105.3 billion, largely because of external transactions. Despite a rise in the volume of US dollar assets, the lower interest rate level in the United States and the decline in the US dollar were particularly significant factors. In addition, the interest received from lending to domestic banks declined (by DM 967.5 million to DM 3,663.6 million) and that received from cash advances also fell (by DM 42.8 million to DM 64.2 million) owing to interest rate reductions and smaller portfolios. The receipts from securities, by contrast, increased from DM 341.5 million to DM 387.8 million owing to the larger securities holdings. The interest received from equalisation claims again remained unchanged during the year under review, at DM 81.4 million.

The interest paid, at DM 220.9 million, was DM 54.9 million lower than in the previous year. Specifically, DM 203.3 million (1985: DM 258.4 million) was disbursed on Treasury bills and Treasury discount paper of the Federal Government (mobilisation and liquidity paper pursuant to sections 42 and 42a of the Bundesbank Act), and DM 6.9 million (1985: DM 5.8 million) was spent on foreign exchange repurchase agreements and swap transactions with domestic banks.

Fees

Fees totalling DM 24.2 million were received in the year under review (1985: DM 18.8 million).

Other receipts

The other receipts amounted to DM 141.9 million (1985: DM 146.0 million).

Expenditure

Staff costs

Staff costs went up against the previous year by DM 39.9 million to DM 786.5 million. This owed something to pay rises for the Bank's staff; moreover, in 1986 there was an increase in the number of employees, which had declined from 1982 to 1984. After having grown by 138 in 1985, the number of staff members rose by 182 in 1986 (+ 1.2%) to a total of 15,259. Roughly two-thirds of the increase was due to the recruitment of junior employees (about 116 trainees).

Staff of the Bank

Staff	Beginning of 1986					Beginning of 1987				
	Central Office	Land Central Banks	Total 1	of whom male	of whom female	Central Office	Land Central Banks	Total 1	of whom male	of whom female
Civil servants	925	5,520	6,445	5,877	568	946	5,565	6,511	5,884	627
Other salaried staff	1,599	5,952	7,551	3,509	4,042	1,639	6,026	7,665	3,529	4,136
Wage earners	238	843	1,081	198	883	236	847	1,083	203	880
Total	2,762	12,315	15,077	9,584	5,493	2,821	12,438	15,259	9,616	5,643

1 Including 107 (1986: 110) salaried staff working outside the Bank or released to work for international institutions, 797 (1986: 681) trainees, 595 (1986: 559) part-time salaried staff and 738 (1986: 750) part-time wage earners.

Payments to serving members of the Central Bank Council and the Directorate of the Bank amounted to DM 8,424,904.91 in the year under review. Former members of these bodies and of the Board of Directors and Board of Managers of the Bank deutscher Länder and the Managing Boards of the Land Central Banks, including their surviving dependents, received payments totalling DM 8,380,905.25.

Changes in staff regulations

In 1986 the Bank again entered into a number of pay agreements, thereby bringing the legal status of its wage and salary earners into line with the regulations applying to the wage and salary earners of the Federal Government, while paying due regard to the special conditions obtaining at the Bank.

Other

Other (non-staff) administrative expenditure increased by DM 5.9 million to DM 202.7 million during the financial year 1986.

Note printing

Expenditure on note printing amounted to DM 142.0 million against DM 174.6 million in the previous year.

Depreciation and increases in provisions

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

Pension payments in respect of the Reichsbank

Payments to members of the former Deutsche Reichsbank and other persons to whom the Act concerning Article 131 of the Basic Law applies, for whom the Bank is required to provide in accordance with section 41 of the Bundesbank Act, at DM 22.6 million, continued to decline in the year under review.

Write-downs of monetary reserves

This item contains the result of the valuation of the monetary reserves and other foreign currency positions. Valuation losses owing to the appreciation of the Deutsche Mark had no impact on the result inasmuch as provisions formed for this purpose in earlier years could be released. After offsetting against the receipts accruing in the year under review from purchases and sales of foreign currencies, valuation losses in excess of this amount entailed depreciation totalling DM 1,636.3 million; in the previous year, by contrast, receipts amounting to DM 279.5 million net had been recorded.

Other expenditure

Other expenditure is shown at DM 48.5 million (1985: DM 36.7 million).

Unappropriated profit	The profit and loss account for 1986 shows a profit for the year of which is recorded in the balance sheet as unappropriated profit (net profit).		DM 7,795,842,455.79,
Proposed distribution of profit	In accordance with section 27 of the Bundesbank Act, the Directorate proposes to the Central Bank Council that the following appropriations should be made:	DM	
	to the legal reserves	428,300,000.00	
	to the Fund for the Purchase of Equalisation Claims	30,000,000.00	458,300,000.00.
	The balance of		7,337,542,455.79
	will be transferred to the Federal Government.		

After this appropriation, the legal reserves will amount to DM 5,699,100,000.00; as in the previous year, they will then come up to the statutory ceiling of 5% of the total amount of banknotes in circulation, which came to DM 113,982,976,330.00 at the end of 1986. The other reserves reached the statutory ceiling of DM 290,000,000.00 at the end of 1980.

Frankfurt am Main, April 1987

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

Part D: Report of the Central Bank Council

The annual accounts of the Deutsche Bundesbank for 1986 and the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1986 have been audited by Treuarbeit Aktiengesellschaft Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft of Frankfurt am Main and Dr. Wollert — Dr. Elmendorff KG Wirtschaftsprüfungsgesellschaft of Düsseldorf, whom the Central Bank Council appointed to be auditors in accordance with section 26 of the Bundesbank Act.

In their certificates of audit the auditors have confirmed without any qualifications that the annual accounts for 1986 and the bookkeeping as shown by the books at December 31, 1986, comply with German law and that the Fund for the Purchase of Equalisation Claims has been properly administered.

The Central Bank Council approved the annual accounts for 1986 on April 16, 1987 and accepted the Directorate's proposal in respect of the profit distribution. At the same time it approved the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1986.

Since the publication of the Report for the Year 1985 the following changes have taken place in the Central Bank Council and the Directorate of the Deutsche Bundesbank:

Retired
as at the close of April 30, 1986
Herbert Zimmer
Vice-President of the Land Central Bank in Bavaria.

Appointed
with effect from May 1, 1986
Rudolf Ströhlein
to be Vice-President of the Land Central Bank in Bavaria,

with effect from December 1, 1986
Johann Wilhelm Gaddum,
hitherto President of the Land Central Bank in Rhineland-Palatinate,
to be a member of the Directorate of the Deutsche Bundesbank,

with effect from January 1, 1987
Dr. Heinrich Schreiner
to be President of the Land Central Bank in Rhineland-Palatinate.

The Central Bank Council, acting also on behalf of the Directorate and the Managing Boards of the Land Central Banks, expresses its thanks to the entire staff of the Deutsche Bundesbank — civil servants, other salaried employees and wage earners alike — for their loyal and understanding efforts during 1986. The Council likewise wishes to record its appreciation of the continued excellent collaboration with the staff representative bodies.

Frankfurt am Main, April 1987

Karl Otto Pöhl
President of the Deutsche Bundesbank

Appendix to Part B

Balance sheet of the Deutsche Bundesbank as at December 31, 1986

Assets

		DM	DM
1 Gold			13,687,518,821.70
2 Reserve position in the International Monetary Fund and special drawing rights			
2.1 Drawing rights within the reserve tranche		6,462,028,419.32	
2.2 Loans under special borrowing arrangements		1,006,742,911.18	
2.3 Special drawing rights		3,919,826,710.72	11,388,598,041.22
3 Claims on the European Monetary Cooperation Fund in connection with the European Monetary System			
3.1 ECU balances	31,661,322,615.39		
less Difference between the ECU value and the book value of the gold and dollar reserves contributed	16,297,167,279.93	15,364,155,335.46	
3.2 Other claims		956,723,406.05	16,320,878,741.51
4 Balances with foreign banks and money market investments abroad			50,172,612,180.38
5 Foreign notes and coins			22,359,633.77
6 External loans and other external assets			
6.1 Loans in connection with EEC medium-term monetary assistance		—	
6.2 Other loans to foreign monetary authorities		—	
6.3 Loans to the World Bank		2,444,123,750.—	2,444,123,750.—
7 Lending to domestic banks			
7.1 Domestic bills of exchange		40,496,404,537.39	
7.2 Securities bought in open market transactions under repurchase agreements		33,190,648,822.06	
7.3 Foreign bills of exchange		20,363,218,922.82	
7.4 Lombard loans		2,368,001,300.—	96,418,273,582.27
8 Cash advances			
8.1 Federal Government		2,014,900,000.—	
8.2 Equalisation of Burdens Fund		—	
8.3 Länder Governments		935,512,645.—	2,950,412,645.—
9 Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			8,683,585,988.93
10 Lending to the Federal Railways and Federal Post Office			
10.1 Cash advances		—	
10.2 Treasury bills and Treasury discount paper		—	—
11 Securities			5,209,124,461.26
12 German coins			856,126,244.96
13 Balances on postal giro accounts			178,077,354.56
14 Land and buildings			2,144,586,790.39
15 Furniture and equipment			173,793,397.—
16 Items in course of settlement			7,556,589,799.43
17 Other assets			2,606,212,800.01
18 Prepaid expenses and deferred income			38,368,022.05
Rights of recourse in respect of contingent liabilities		91,980.—	
			220,851,242,254.44

	DM	DM
1 Banknotes in circulation		113,982,976,330.–
2 Deposits of banks		
2.1 Deposits on giro accounts	55,848,958,934.53	
2.2 Other	20,512,249.74	55,869,471,184.27
3 Deposits of public authorities		
3.1 Federal Government	404,232,668.72	
3.2 Equalisation of Burdens Fund and ERP Special Fund	4,863,602.23	
3.3 Länder Governments	688,968,883.48	
3.4 Other public depositors	45,708,007.61	1,143,773,162.04
4 Deposits of other domestic depositors		
4.1 Federal Railways	11,693,964.55	
4.2 Federal Post Office (including postal giro and postal savings bank offices)	2,388,216,384.37	
4.3 Other depositors	876,594,048.78	3,276,504,397.70
5 Liabilities arising from mobilisation and liquidity paper sold		4,808,200,000.–
6 Liabilities arising from external transactions		
6.1 Deposits of foreign depositors	19,898,391,445.81	
6.2 Other	16,839,247.41	19,915,230,693.22
7 Counterpart of special drawing rights allocated		2,874,307,917.20
8 Provisions		
8.1 For pensions	2,091,000,000.–	
8.2 For other purposes	2,652,200,000.–	4,743,200,000.–
9 Other liabilities		308,032,993.90
10 Deferred expenses and accrued income		282,903,120.32
11 Capital		290,000,000.–
12 Reserves		
12.1 Legal reserves	5,270,800,000.–	
12.2 Other reserves	290,000,000.–	5,560,800,000.–
13 Unappropriated profit		7,795,842,455.79
Contingent liabilities	91,980.–	
		220,851,242,254.44

Profit and loss account of the Deutsche Bundesbank for the year 1986

Expenditure

	DM	DM
1 Administrative expenditure		
1.1 Staff costs	786,528,345.86	
1.2 Other	202,676,921.24	989,205,267.10
2 Note printing		141,982,679.26
3 Depreciation		
3.1 of land and buildings	125,917,879.91	
3.2 of furniture and equipment	71,950,006.15	197,867,886.06
4 Increase in provisions		
4.1 for pensions	218,180,737.52	
4.2 for other purposes	—	218,180,737.52
5 Pension payments in respect of the Reichsbank		22,602,824.42
6 Write-downs of monetary reserves and other foreign currency positions		1,636,330,125.66
7 Other expenditure		48,538,270.30
8 Profit for the year (= unappropriated profit)		7,795,842,455.79
		11,050,550,246.11

Receipts

	DM
1 Interest	10,884,439,666.54
2 Fees	24,182,025.83
3 Other receipts	141,928,553.74
	11,050,550,246.11

Frankfurt am Main, February 4, 1987

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

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

Frankfurt am Main, March 12, 1987

Treuarbeit Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

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Certified Auditor

Kern
Certified Auditor

Dr. Wollert — Dr. Elmendorff KG
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