Deutsche Bundesbank
Annual Report
1999

We mourn the death in 1999

of the President of the Land Central Bank
of North Rhine-Westphalia
and Member of the Central Bank Council

Prof. Dr Dr h.c. Reimut Jochimsen

† November 25, 1999,

and of the following members of our staff

Konrad Kögler	11. 1.1999
Berta Basckarone	4. 2.1999
Ingeborg Friedrich	8. 2.1999
Herbert Glaser	17. 2.1999
Hans Hofacker	7. 3.1999
Renate Czypek	10. 4.1999
Adolf Fehlner	15. 4.1999
Dr Bernd Goos	4. 6.1999
Renate Poremba	27. 6.1999
Günther Vollmer	5. 7.1999
Hans Schoppe	29. 7.1999
Dr Jürgen Weishaupt	11. 8.1999
Anna Janik	13. 8.1999
Ursel Just	16. 8.1999
Horst-Gerhard Becker	16. 8.1999
Katharina Schäfer	18. 8.1999
Manfred Samietz	27. 9.1999
Ulrich Schmaser	7.12.1999
Renate Lamparth	20.12.1999

We also keep in remembrance the retired staff members of the Bank and of the former Deutsche Reichsbank who died in 1999.

We will honour their memory.

DEUTSCHE BUNDESBANK

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on April 6, 2000

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Dr Jürgen Stark
Deputy Chairman of the Central Bank Council

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Dr Christian Milow
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(from August 2, 1999)
Vice-President
(until August 1, 1999)

Dietmar Girst
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(from November 10, 1999)

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Abbreviations and symbols

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	Figure unknown, not to be published or not meaningful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

Discrepancies in the totals are due to rounding.

Foreword
by the President
of the Deutsche Bundesbank

Foreword

The new century began with some quite auspicious economic omens. The uncertainty that had prevailed a year earlier, owing to the acute financial market crises and the sluggishness in parts of the world economy, has meanwhile given way to renewed confidence. Moreover, the difficulties besetting the international financial markets have been contained. The transition to the year 2000 was effected rather smoothly, without any of the feared computer problems – not least because of intensive preparations by central banks, credit institutions, public authorities and private enterprises.

With the ending of the impediments, the growth of the world economy has speeded up again. Forecasts by international organisations warrant expectations that the pace of growth will quicken further this year, and that the balance between the different regions will improve. In the euro area, too, which lagged behind economically for a long while, expansionary forces have now gained the upper hand. That owes something to the Eurosystem, which assumed responsibility for monetary policy in the euro area last year. After the launch of the euro on January 1, 1999 had been accomplished without major problems, the Eurosystem passed its first practical test as well. The monetary policy strategy and its operational framework have both proved their worth. The rise in consumer prices in the euro area was kept down to an average annual rate of about 1% – notwithstanding some steep increases in commodity prices. This means that, in 1999, the Eurosystem met its primary objective of maintaining price stability.

The favourable performance of the world economy is also affecting Germany, where economic activity is likewise picking up perceptibly. Even more important than stimuli from abroad is, however, the fact that the economic and fiscal policy makers are proceeding along the right track. The envisaged continuation of the retrenchment of public sector deficits is necessary to ensure that fiscal policy remains functional in the medium term, too. The planned – and, in part, already implemented – gradual tax relief will not only reduce the public sector's calls on economic resources. It will also bring the tax system as a whole more into line with the requirements of a closely interlinked, globalised economy.

But, to be able to face up to international competition and avoid wrong incentives, some additional reform measures will be required. In particular, it is essential to maintain and improve market functionality, especially by means of the further deregulation of the economy, and by the public sector relinquishing those tasks which can be performed just as well by the private sector. In the fields of social policy and structural policy, too, the signposts could be made to point even more emphatically in the direction of sustained growth. The aim must be to facilitate and socially cushion economic change, rather than to conserve outdated structures. These pressing tasks are certainly easier to discharge in a growing economy than under more unfavourable economic conditions. It is therefore desirable to take advantage of the propitious moment, and tackle the problems purposefully right away.

A glance at the labour market shows just how necessary further reforms are. Here, too, the signs of a change for the better are multiplying; after all, unemployment declined slightly in 1999, for the second year in succession. Yet with a jobless rate of approximately 10 %, unemployment remains unsatisfactorily high. Other countries have made faster headway than Germany in creating new jobs. In mastering the problems on the labour market, special responsibility rests upon management and labour. They must find solutions which take due account of the scarcities existing on the labour market, and which result in higher levels of employment. Moreover, they must not lose sight (especially under present conditions) of the impact of their wage settlements on prices. Viewed in terms of these macroeconomic requirements, the wage agreements concluded to date in the year 2000 have been rather encouraging.

The re-emergence of price risks casts some shadow over the generally bright economic picture. The adverse influences derive primarily from the steeply increased oil prices and the depreciation of the euro. Both effects caused import prices to soar in the course of last year, and have meanwhile reached the consumer level, too. The Governing Council of the ECB responded to the changed risk situation and raised central bank rates in the euro area in a number of steps. As part of its monetary policy strategy, it will continue to monitor price prospects (as well as the growth of the money stock) vigilantly, and to counteract resolutely any strengthening of inflation expectations.

The Bundesbank, too, will make its due contribution in this connection. Since the launch of monetary union, admittedly, it has no longer been directly responsible for monetary policy. That responsibility has passed to the Eurosystem, which comprises, besides the ECB, the central banks of the eleven countries that have already introduced the euro. But the Bank is an integral part of the

Eurosystem. It is involved in the Eurosystem's decision-making, and in the implementation of its policies. Specifically, this means, firstly, that the Bank is represented by its President in the ECB Governing Council (the supreme monetary policy decision-making body in the euro area). Secondly, it brings its experience and expertise to bear at the operational level in the various committees and working parties, and there engages in discussions with the representatives of the other central banks.

These changes in responsibilities also call for appropriate structures within the Bundesbank. Where possible, the Bank has already made adjustments. Moreover, in its Statement dated July 8, 1999 the Central Bank Council presented two models of the Bank's future organisational structure which have been widely debated ever since. Now it is up to Parliament to decide on the reorganisation. In view of the growing challenges which the Bank will have to face in monetary union, it will be essential, above all, to establish efficient decision-making processes, consistent with the duties to be performed, at the executive level. Not least for the sake of the Bank's staff members, certainty about its new organisational structure should be ensured as soon as possible.

The present Annual Report takes due account of the Bundesbank's changed responsibilities. The analyses of the monetary policy pursued by the Eurosystem last year are embedded in a description of the international and European setting. The Report likewise addresses economic developments in Germany and the changes in the underlying international monetary conditions. At the same time, the Bank presents its annual accounts for 1999, which have been audited (and certified) by two firms of auditors, and which were approved by the Central Bank Council on April 6, 2000.

Acting on behalf of the Central Bank Council, as well as speaking for myself, I should like to take this opportunity of expressing my gratitude to all members of the Bank's staff for the great commitment with which they carried out their duties in 1999; but for their efforts, the Bank's manifold functions – above all, the new activities entailed by monetary union – could not have been performed as envisaged. I also wish to thank the staff representative bodies for their cooperation, invariably in a spirit of mutual trust.

Frankfurt am Main, April 2000

Ernst Welteke
President, Deutsche Bundesbank

The currency and the economy

I. The international and European setting

1. The global economic background

The world economy picking up

After the economic policy debate at the beginning of 1999 had been characterised by fears of recession and deflation, in the further course of last year the world economy increasingly recovered from the grievous consequences of the financial and economic crises in eastern Asia, Latin America and Russia. Taking the average of 1999, the global growth of output came to nearly 3½% on account of the unexpectedly rapid pace of expansion in the second half of the year, and therefore was as high as the average rate in the eighties and nineties. In the first few months of the current year, the economic outlook brightened further, with the result that the growth of the world economy accelerated again. Price movements were once more favourable in 1999. Taking the average of the industrialised countries, at all events, the inflation rate stood at the historically low level of just under 1½%. However, price risks increased in the course of 1999 because of both the persistently heavy utilisation of capacity, especially in the United States, and the strong rise in the prices of energy and raw materials.

Robust growth in the United States

Last year, too, the United States was the driving force behind global economic expansion. With a 4.1% upturn in output, the US economy continued its upswing, which has now lasted for nine years, and thus become the longest on record. Throughout the business cycle, the average annual growth rate of the gross domestic product (GDP) has been over 3½%, without any marked inflationary tensions having arisen. The number of wage and salary earners in the United States increased by about two million in 1999, and the unemployment rate fell to 4% at the end of the year. The flexibility of the labour market and the high intensity of competition on the merchandise markets, along with the heavy investment in the field of information technology, constituted the key conditions for those trends. The favourable circumstances underlying those remarkable developments also included reforms of the US tax system that were initiated back in the eighties and have been systematically continued ever since, as well as the successes achieved in recent years in consolidating public sector budgets. This has created sufficient financial leeway for an expansion of private business activity, and has ensured corresponding performance incentives for enterprises and employees alike.

Macroeconomic benchmark figures of selected industrialised countries

Table 1

Country	Real GDP		Consumer prices 1		Current account balance		Unemployment rate 2	
	1998	1999 p	1998	1999 p	1998	1999 p	1998	1999 p
	Change from previous year in %				as % of GDP		in %	
Industrialised countries of which	2.3	2.8	1.4	1.3	–	–	7.1	6.8
EMU	2.8	2.2	1.1	1.1	0.7	0.4	10.9	10.0
United Kingdom	2.2	2.0	3.4	1.5	– 0.1	– 1.3	6.3	6.1
United States	4.3	4.1	1.6	2.2	– 2.5	– 3.7	4.5	4.2
Japan	– 2.5	0.2	0.6	– 0.3	3.2	2.5	4.1	4.7
Canada	3.1	4.2	0.9	1.7	– 1.8	– 0.5	8.3	7.6

Sources: IMF, OECD, EU Commission and national statistics. — **1** Consumer price index. — **2** Standardised unemployment rate, based on OECD and Eurostat calculations.

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Buoyant domestic demand

In 1999, the strongest stimuli to the growth of US output were again imparted by the rise in private consumer demand, which resulted from the mounting employment and the associated income prospects, and which was given an additional boost by the upturn in property income owing to the booming equity markets. Moreover, investment by trade and industry went up further in 1999, albeit not quite so strongly as in the previous year. With the improvement in the international setting, US exports likewise expanded steeply again in the second half of the year. At the same time, however, US imports increased even faster, on account of the marked buoyancy of domestic demand, so that the US trade and current account deficits rose further.

Price movements under control, but growing risks

In view of the mounting tensions on the labour market and a distinct upturn in import prices owing to the higher prices of raw materials and industrial primary products, fears of inflation multiplied in the course of 1999, especially as the US currency hardly appreciated at all on a trade-weighted average in that year, and the dampening effects exerted until then on the exchange-rate side therefore ceased to operate. In the bond market, the growing risks incurred on the price side after the world economy had started to recover from the consequences of the financial crises of 1997 and 1998 gave rise to distinct increases in interest rates, by about 1½ percentage points. The US central bank counteracted the burgeoning fears of inflation by raising the rates it controlled in the money market in several small steps from the summer of 1999 onwards. Taking the average of 1999, the US inflation rate, at 2.2 %, was just over ½ percentage point higher than in 1998, when it had hit an all-time low. During the second half of the year, however, consumer prices in the United States went up faster, and passed the 3 % mark in February 2000.

Unstable economic conditions in Japan

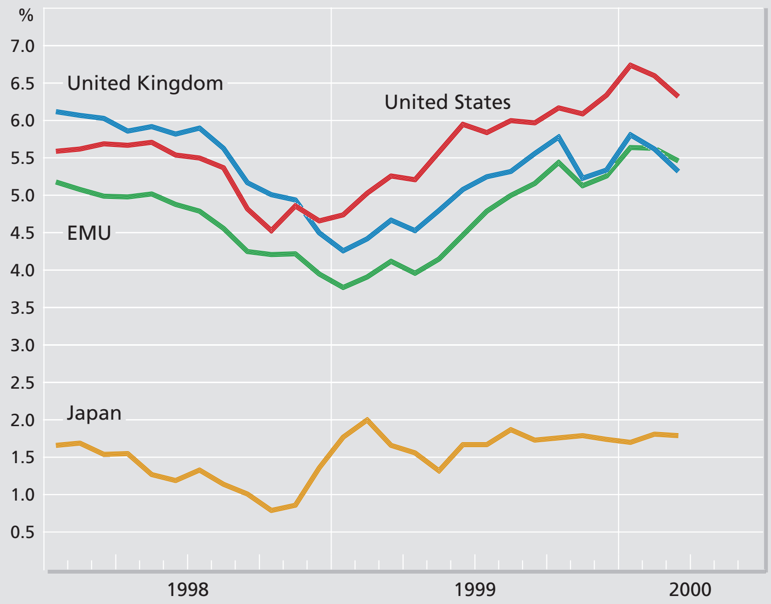
Last year, the Japanese economy grew marginally (by less than ½ %), after it had contracted by 2½ % in 1998. The decidedly strong expansion in the first half of the year was due to extensive government pump-priming programmes that increased public sector investment and fostered private residential construction. However, these stimuli slackened perceptibly in the later part of the year. After mid-year, the Japanese economy benefited primarily from the recovery in the Asian crisis regions and the associated upturn in demand in neighbouring countries, so that Japanese exports initially went up significantly in real terms. That growth gave a boost notably to the yen, which had lost ground continuously until the second half of 1998 under the impact of the persistent structural weaknesses in the Japanese economy. Ultimately, however, Japan's structural problems were only masked by the fiscal pump-priming measures and the growing demand for exports. After the partial solution of Japanese banks' asset and earnings problems, it is primarily the uncertainties and burdens faced by Japanese households and enterprises that are standing in the way of a lasting and self-sustained upswing in private consumer and investment demand. At all events, private domestic demand tended to be sluggish towards the end of the year, and the appreciation of the yen was still a stumbling block for Japanese exporters, with the result that aggregate output contracted during the second half of last year against the first. New risks might arise from the fact that the overall debt ratio is already equivalent to over 100 % of GDP, and from the unsolved problems posed by provision for old age in a dwindling population, given the worsening situation of public finances; the expansionary fiscal policy stance adopted in recent years might then turn out to be a grave handicap.

Favourable trends in the other industrialised countries of western Europe

In Germany's European neighbours outside EMU, economic growth accelerated on the whole in 1999. The British economy, which had faltered at times in the winter half of 1998-9 in the upswing that has persisted since mid-1992, gathered pace again in the course of last year, and reached an average growth rate of 2 % during 1999. The strong rise in output in the services sector was

Capital market rates of selected industrialised countries *

Chart 1



* Government bonds with residual maturities of about ten years.

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accompanied by a marked decrease in the (standardised) unemployment rate, which was standing at about 6 % at the end of 1999.

Recession in south-east Asia overcome

Just over two years after the outbreak of the crises, the situation in the east Asian emerging economies stabilised last year, and most of the countries in the region moved back to a growth path. The successes achieved in the field of stabilisation differed considerably from country to country. With the improvement in the major fundamentals of most countries in eastern Asia (such as the rising current account surpluses, the distinct reduction in short-term debt and the increase in monetary reserves), however, the economic prospects for the next few years have brightened again. And yet, in view of the unresolved financial and structural problems evident in the banking and enterprise sectors of many countries, risks still remain.

Central and eastern European countries in transition have recovered again

The central and eastern European countries in transition managed to expand their aggregate output by over 2 % in 1999, after having stagnated in the crisis year 1998. This was primarily because of developments in Russia, which had adversely affected the entire region in the preceding year and which now, by contrast, strengthened the expansionary forces again. Following the steep depreci-

International repercussions of the oil-price hike

After some sharp price falls on international crude oil markets, which began early in 1997 and culminated in an oil price of less than US$ 10 per barrel (measured in terms of the benchmark oil type North Sea Brent) at the end of 1998, oil prices on international commodity markets went up steeply again in 1999. The highest level since the Gulf War in 1991 was reached in March 2000, at US$ 32 per barrel. The main reason for the upturn in the cost of oil was cuts in production by the OPEC countries, which, contrary to some previous experience, were mostly observed. In addition, the distinct revival of global economic growth in the course of 1999 resulted in an increase in the demand for oil.

The significance of the rise in oil prices for the world economy is not easy to quantify since an upturn in oil prices has very diverse repercussions on individual regions of the world, and feedback effects are difficult to identify. Initially, higher oil prices lead to a transfer of incomes from oil consumers to oil producers. Given an average oil price that was US$ 5 per barrel higher in 1999 than in 1998, on the assumption of constant export quantities in 1998 (averaging 36 million barrels a day), the export proceeds of the oil-exporting countries went up by about US$ 65 billion on price grounds alone. The bulk of global oil exports (about 56 %) is accounted for by the OPEC countries, whose export proceeds, according to this rough calculation, rose by about US$ 37 billion, or just under 6 % of their aggregate gross domestic product. Moreover, especially Russia and Norway, the largest oil exporters outside OPEC, benefited from the steep increase in oil prices. On the above assumption, their export proceeds went up in 1999 by an estimated US$ 4½ billion and US$ 5 billion, respectively.

On account of their larger income from oil business, the current account positions of the oil-exporting countries improved distinctly in 1999. The aggregate current account balance of the OPEC countries swung from a deficit of US$ 15 billion in 1998 to a surplus estimated at US$ 15 billion in 1999. As a result of its larger receipts from exports of oil and natural gas, accompanied by declining imports, Russia was able to expand its current account surplus from US$ 2½ billion in 1998 to US$ 19½ billion in 1999.

On the other hand, the industrialised countries and the more advanced emerging economies bore over 90 % of the higher cost of oil imports because, on balance, they accounted for the greater part of those imports. As the mirror image of the improvements in the value of the current accounts of the oil-exporting countries due to the oil price rises, the current accounts of the industrialised countries and emerging economies therefore deteriorated in 1999. Relative to their gross domestic product, however, the deterioration in the current account situation of the industrialised countries was not so significant as the improvement among the oil exporters. The ratio of the energy imports of the industrialised countries to their total imports has declined markedly in the past twenty years. In Germany it has decreased from almost 25 % in the early eighties to an average of 6 % in 1998 and 1999; in the United States it has fallen over the same period from just under 30 % to about 6 %. Altogether, the dampening effect of the higher cost of energy imports on the gross domestic product of the industrialised countries might turn out to be lower than the stimulating effect on the oil-producing countries. That seems all the more likely if it is borne in mind that the higher proceeds of Russia and a number of countries in Latin America from oil exports might have prevented a steeper slide into critical downturns in growth.

The risks posed by the dramatic oil-price hike since the beginning of last year mainly lie on the price side, especially if the shifts in relative prices in industrialised countries were no longer accepted as such, but rather triggered off further price and cost rises. With progressive global economic growth and improving capacity utilisation, the consequent inflationary dangers generally increase in significance. Central banks are therefore monitoring developments with particular vigilance.

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ation of the rouble in 1998, there was now a fairly strong increase in domestic demand, mainly as a result of the greater substitution of imports and of growing receipts from exports, owing to price rises on the international energy and commodity markets. A gratifying factor in this connection was that the relatively strict fiscal policy stance enabled the budget deficit to be reduced, and that the high inflation rate slackened distinctly during the second half of the year. But the difficult political situation and the structural shortcomings in major sectors of the Russian economy, such as the high level of debt and the management problems encountered in Russian enterprises and banks, continue to stand in the way of an all-round revival of growth. Although economic activity in Poland and Hungary increased less sharply in 1999 than in the preceding year, in the course of last year growth gathered pace in those countries, too, driven by the upswing in the industrialised countries, which absorb over four-fifths of Polish and Hungarian exports.

Conditions in Latin America stabilised

Economic conditions in Latin America, which had continued to cloud over at the start of 1999, likewise showed signs of improving again around the turn of 1999-2000. Argentina had been hit particularly hard by the financial market upheavals emanating originally from Brazil at the beginning of 1999. Economic output there declined by over 3 % against the preceding year. The sharp depreciation of the currency of Brazil, Argentina's principal trading partner, and the pegging of its own currency to the US dollar, led to a marked deterioration in the price competitiveness of the Argentine economy, and to corresponding export losses. The other South American economies were also adversely affected by the crisis in Brazil; in part, they were still having to contend with the negative consequences when economic conditions in Brazil started to pick up again. The relatively swift economic recovery in Brazil during 1999 was mainly due to the depreciation of the real early in 1999 and to a speedy implementation of the necessary adjustment measures in the context of a credit agreement concluded with the IMF towards the end of 1998. That provided a basis for new confidence in the markets, with the result that growth, at ½ %, turned out to be much stronger than had generally been supposed at the beginning of last year. At the same time, price rises at the consumer level were kept within the single-digit range despite the 30 % depreciation of the real, thanks to the consistency of monetary policy and the support of fiscal policy.

Changes in the international pattern of current accounts

The easing of tensions in the crisis regions, the gradual reduction of the growth differentials between the industrialised countries and the shifts in the terms of trade between the commodity-producing and commodity-importing countries tended to result in a better-balanced international pattern of current accounts. At any rate, the current account surpluses of both Japan and EMU decreased significantly in 1999. Relative to GDP, the Japanese surplus fell from 3.2 % to 2.5 %, and that of the EMU states from 0.7 % to 0.4 %. On the other hand, the current account situation improved in Canada and South America, whose current account deficits contracted. In the central and eastern European countries in transition, the aggregate current account balance swung from a deficit to a surplus. In the case of Russia, this owed much to the steep rise in oil prices. By contrast, the US current account deficit increased markedly (as described above) from 2.5 % to 3.7 % of GDP owing to the sustained import pull and the deterioration in the terms of trade, which caused the value of imports to go up sharply. Unlike the position during the eighties, however, this was not because of high public sector deficits, but rather because of private consumption and investment decisions, against the background of a flourishing economy. On account of the sound budget policy, the sustained buoyancy of business activity and the remarkable flexibility and adaptability shown by the US economy in recent years, the huge external deficits have therefore evidently failed to lessen the attractiveness of dollar assets in the eyes of international investors.

2. Economic developments in the euro area

(a) Macroeconomic trends

Short-lived slowdown in business activity overcome

Economic growth in the euro area accelerated appreciably in the course of last year. Seasonally adjusted real GDP, expressed as an annual rate, rose by 3 ½ % in the second half of the year, compared with barely 2 % in the first. Hence the economic slowdown that had emerged after mid-1998 owing to the marked decline in exports to the then crisis regions was overcome. Taking the average of the year, however, economic growth in the euro area, at 2.2 %, fell distinctly short of the 1998 figure (+2.8 %). Aggregate output by and large kept pace with the expansion of production potential, so that the underutilisation of production capacities that had been manifest for some time remained virtually unchanged in 1999 as a whole. Judging by OECD estimates of potential GDP, capacity utilisation is likely to improve again in the current year, and, on an average, normal utilisation will probably be regained in the euro area. The economic outlook for the euro area is generally rated quite favourable. Economic trends after the turn of 1999-2000 are consistent with this; they are characterised by a high

Economic performance in the euro area

Table 2

Country	Real gross domestic product		Consumer prices 1		Unemployment rate 2		Public sector financial balance 3	
	1998	1999 p	1998	1999 p	1998	1999 p	1998	1999 p
	Changes from previous year in %				in %		as % of GDP	
Euro area	2.8	2.2	1.1	1.1	10.9	10.0	– 2.0	– 1.2
Germany	2.2	1.5	0.6	0.7	9.4	8.7	– 1.7	– 1.1
France	3.4	2.7	0.7	0.5	11.8	11.3	– 2.7	– 1.8
Italy	1.3	1.4	2.0	1.7	11.8	11.3	– 2.8	– 1.9
Spain	4.0	3.7	1.8	2.2	18.8	15.9	– 2.6	– 1.1
Netherlands	3.7	3.5	1.8	2.0	4.0	3.3	– 0.8	0.5
Belgium	2.7	2.3	0.9	1.2	9.5	9.0	– 1.0	– 0.9
Austria	3.3	...	0.8	0.5	4.5	3.7	– 2.5	– 2.0
Finland	5.0	3.5	1.4	1.3	11.4	10.2	1.3	2.3
Portugal	3.5	...	2.3	2.1	5.2	4.5	– 2.1	– 2.0
Ireland	8.9	...	2.2	2.5	7.6	5.8	2.1	2.0

1 Harmonised consumer price index (HCPI). — **2** Standardised unemployment rate according to calculations by Eurostat (ILO definition). — **3** As defined in the Maastricht Treaty.

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degree of capacity utilisation in industry, a substantial backlog of foreign orders and a relatively high level of confidence among enterprises and consumers.

Revival of foreign demand ...

The quickening of the pace of growth in the euro area in the course of last year is primarily attributable to the revival of foreign demand. This owed something, firstly, to the surprisingly strong economic recovery of the emerging economies in eastern Asia. Secondly, deliveries to North America, where business activity remains in full swing and production capacities continue to be fully utilised, were distinctly stepped up again. The improvement in the price competitiveness of exports from the euro area played some part in that; it was fostered additionally by the depreciation of the euro against the US dollar.

... accompanied by consistently buoyant domestic business activity

In addition, domestic demand in the euro area, which increased by almost 3 % over 1999 as a whole, imparted a major boost to economic activity. It grew particularly strongly during the period of sluggish exports in the winter half of 1998-9, with the result that a more pronounced cyclical downturn was avoided. Private consumer spending, which was stimulated by a marked expansion of real incomes and a moderate increase in employment, rose strongly again in 1999. Gross fixed capital formation also went up distinctly.

Fewer cyclical divergences in the euro area ...

In the course of last year the differences in growth rates between the individual EMU member states tended to diminish. The main reason was that the erstwhile economic "laggards", Germany and Italy, whose exports had been hit particularly hard by the international crises, were able to catch up with the EMU average again after mid-1999. As a result, the cyclical divergences of these two countries vis-à-vis France dwindled, too; on the French side, it was the pronounced optimism of consumers, the strong rise in disposable income and – relative to Germany – the great buoyancy of construction activity and distinctly faster growth of government consumption which were mainly responsible for that.

... but considerable differences between growth trends persist

Once again, the economies of Finland, Ireland, Portugal and Spain grew at a far above-average pace. That owed something to the fact that those countries had benefited especially strongly from the preceding interest-rate-convergence process; in part, it mirrored a steeper rise in the trend of potential GDP, which is probably of a longer-term nature. Such differences often reflect the economic catching-up process of economies whose level of prosperity is still in part substantially below that of the "rich" core countries.

Decline in unemployment

In the course of the economic recovery, conditions on the labour markets of the euro area have continued to brighten. The decline in unemployment that started in 1997 continued during 1999. As an annual average, the standardised unemployment rate stood at 10.0 %; that was 0.9 percentage point lower than in 1998. In July last year, after seasonal adjustment, the 10 % mark was undershot, for the first time since December 1992. In February this year, 9.5 % of the labour force were out of work.

The reduction in unemployment proceeded in very different ways in the various countries. Conspicuous successes were scored in Spain, where the unemployment rate fell from 17.6 % to 15.2 % in the course of 1999. Of the three large countries, France managed to reduce its underemployment most, not least with the aid of extensive public job-creation programmes. In the smaller member states, most of which already exhibited comparatively good labour-market conditions at the end of 1998, unemployment decreased again, in part perceptibly. In four countries (Austria, Luxembourg, the Netherlands and Portugal) fewer than 5 % of the labour force were out of work at the end of 1999. In those countries a further strong rise in employment will presumably only be possible by means of a greater mobilisation of hidden reserves or a heavier influx of foreign workers, either as commuters or as immigrants.

Inflation accelerates in the course of the year

The rate of price rises at the consumer level accelerated distinctly again from the low point of 0.8 % reached at the turn of 1998-9. By December 1999 the year-on-year rate of price increases had widened to 1.7 %; in February 2000 it actually came to 2.0 %. This was mainly because of the strong upturn in energy prices, which was chiefly ascribable to the steep rises in the dollar quotations for crude oil since March 1999, as well as to the weakness of the euro in the foreign exchange markets. Not counting the prices of energy and of food, beverages and tobacco, which are often subject to special factors, price pressure in December 1999, at just over 1 %, was, however, ½ percentage point lower than a year before. That may have owed something to the keener competition in the euro area caused by the greater transparency of prices since the launch of Stage Three of European monetary union. Taking the average of last year, consumer prices rose by 1.1 %, both including and excluding food and energy. Hence the inflation rate (as in the previous year) lay within the range which, according to the ECB Governing Council, is consistent with price stability. In view of the ongoing economic recovery, the steep rises in energy prices and the present weakness of the euro, however, risks to further price movements cannot simply be dismissed.

In a number of member states (particularly ones in which the economic recovery has already progressed further and major successes have already been achieved on the labour market) price rises were sometimes distinctly above the EU average. In Ireland, the Netherlands, Portugal and Spain, for instance, inflation ran at around 2 % or more in 1999, whereas in Austria, France and Germany it was below 1 %. These inflation differentials probably owed something not only to cyclical influences but also to forces which, in the lower-income countries, work towards a harmonisation of prices at the EMU level, as well as to special factors. It must also be borne in mind in this connection that Spain and Portugal, as well as Italy, have quite recently lowered indirect taxes in order to mitigate price rises, which has tended to narrow the gap vis-à-vis the countries with more stable prices. In a number of EMU countries, price rises have been moderated by deregulatory measures in the areas of telecommunications and electricity supply.

(b) External economic developments

Faster growth of exports during the year ...

With the brightening of the global economic setting, European exporters managed to recover comparatively quickly during 1999 from the slumps in turnover suffered in the preceding year in the wake of the crises in Asia, Russia and Latin America. Hence foreign demand once again became the main driving force behind economic expansion in the euro area. Although, on an average, the value of the goods delivered by euro-area countries to customers outside EMU exceeded the previous year's figure by only 2 ½ % in 1999, that rise masks a distinct acceleration of export growth in the course of last year. Whereas the exports of the euro area were just over 5 % below the previous year's figure in the first quarter of 1999, in the final quarter of last year they were almost 12 % higher than a year before.

... and strong rise in the value of imports

At the same time, imports increased steeply in the euro area. The value of merchandise imports actually rose against the previous year much more sharply than that of exports. In the last quarter of 1999 import turnover was 16 ½ % up on the preceding year; over the whole year, the increase came to almost 6 %. Firstly, this rise in imports reflected the more rapid pace of exports, which caused the demand for raw materials and primary products from third countries to increase correspondingly. Moreover, this development is quite in keeping with the picture of stronger domestic demand acting as a second mainstay of the economic recovery process. Secondly, the upturn in the value of imports last year was greatly inflated by the increase in the cost of energy and raw materials that occurred in the course of 1999. For instance, towards the end of last year the world-market prices of petroleum, on a dollar basis, were two and a half times as high as a year before. In addition, the world-market prices of commodities (other than energy) and semi-finished products went up markedly during last year. Added to these were the rises in import prices expressed in national currency caused by the depreciation of the euro. The quantitative dimensions of these factors cannot be determined precisely for lack of appropriate statistical data, but estimates suggest that almost one-half of the nominal increase in imports can be put down to price rises.

Smaller current account surplus

The marked deterioration in the terms of trade (the relationship between the prices of exports and imports) in the foreign trade of the euro area resulted on balance in the trade surplus declining, despite the reinvigoration of exports, from ECU 119 billion in 1998 to € 100 billion last year. Developments in merchandise trade were ultimately also responsible for changes in the current account of the euro area, for the deficit of the euro area on "invisible" current account transactions with third countries, at € 75 ½ billion in the year under review, remained at the level of 1998. Overall, the current account surplus dropped to € 24 ½ billion in 1999, compared with ECU 43 ½ billion a year earlier. That surplus is equivalent to 0.4 % of the GDP of the euro area.

Euro weaker against the US dollar ...

Since its launch at the beginning of last year, the euro has weakened perceptibly against the major world currencies. For instance, the exchange rate of the euro against the US dollar tended to depreciate in 1999, especially in the first half of the year, and reached a new low on July 12, at US$ 1.01 (per euro), representing a depreciation of 14.1 % against the beginning of the year. This development was mainly due to the growth differential between the two monetary areas, which had shifted in favour of the US economy in the early months of 1999. It was only in the summer, when signs of a revival of growth in the euro-area countries multiplied, that the exchange-rate trend reversed again. But, before long, unexpectedly favourable business data in the United States led to another revision of the markets' expectations, with the result that the euro briefly weakened again against the US dollar, and then showed no unequivocal direction for some time, while conditions remained highly volatile. The fluctuating assessments of inflation and growth prospects in the United States, growing uncertainties about possible adjustments in the US equity markets and increasing signs of an all-round recovery in the euro area determined the frequently changing market trends. It was only towards the end of the year that market expectations again shifted unambiguously in favour of the US dollar, accompanied by a widening of the interest-rate advantage of the United States, so that the euro ended the last trading day of the year almost at a rate of 1:1 against the US dollar, and thus 14.8 % weaker than it had been at the start of the year. But after a temporary strengthening of the euro immediately after the turn of 1999-2000, its downward trend resumed. A certain line of resistance was not reached by the euro until it had fallen below the level of US$ 1.

... Japanese yen ...

In contrast to that, the euro initially moved against the Japanese yen without any recognisable trend under highly volatile conditions. The structural weaknesses and rather gloomy growth prospects for Japan at the time were detrimental to the Japanese currency. Conditions improved for it only towards the end of the first half of 1999, when the signs of a stronger-than-expected recovery of the Japanese economy multiplied, and new optimism about growth relegated the structural problems somewhat into the background. Much the same effect was exerted by temporary, heavy capital inflows, some of which were due to repatriations of Japanese foreign assets. Under the impact of these developments, market conditions swung against the euro. Altogether, it depreciated by 23.2 % against the Japanese currency during the year. This occurred even though the Japanese central bank attempted on several occasions to curb the steep appreciation of the yen, and thereby counteract the associated adverse effects on economic growth, by intervening in the foreign exchange market. A certain stabilisation was brought about in the early months of the present year by reports of a renewed slackening of economic growth in Japan. Overall, the movement of the euro against the yen was characterised by considerable uncertainty on the part of market players, which was reflected in high implicit volatilities.

... and pound sterling

The euro likewise depreciated distinctly against the pound sterling in 1999. Over long stretches of last year, the pound sterling moved in relatively close step with the US dollar. Rather as in the case of the latter currency, the markets responded in that way to the better-than-generally-expected performance of the UK economy last year. Altogether, the euro depreciated against the pound by 12.6 % in the course of 1999. After the turn of 1999-2000, the euro weakened distinctly once again. Expressed in terms of Deutsche Mark, the British currency, at DM 3.25 per pound, reached its highest value since the late eighties.

Altogether, the euro depreciates distinctly

If the overall movement of the euro against the currencies of major trading partners is considered, in 1999 the euro suffered a loss in value of 13.6 %, which, in view of the very small inflation differentials between the home market and abroad, is tantamount to an almost identical real depreciation. After the successful launch of the euro and in view of its high degree of domestic stability (also maintained in the ensuing period), and the much improved growth prospects of the euro-area economy in the meantime, this has commonly been felt to be surprising and unexpected. Moreover, it is also widely agreed that the euro has substantial appreciation potential. On the other hand, the favourable factors have apparently been overshadowed by other influences (such as unresolved structural problems in the large participating countries and the challenges posed by the future enlargement of the EU, which are difficult to assess).

(c) Fiscal policy

Decline in the deficit ratio due mainly to lower interest payments

After the launch of monetary union, the situation of the public budgets in member states improved further. Whereas the public sector deficit in 1998 had amounted to 2.0 % of GDP, last year it came to only 1.2 %. There are considerable differences between the individual member states. Particular progress was made towards consolidation by the countries whose deficit ratios were still very close to the reference value of 3 % in 1998. The decline in the deficit ratio in the euro area is mainly attributable to lower interest payments. By contrast, the ratio of other expenditure to GDP actually went up. That rise was accompanied by an even more pronounced, and unexpectedly strong, increase in the government revenue ratio. The government debt ratio was reduced only slightly last year, and, at 72.1 % (with marked differences between one country and another), still lay far above the reference value of 60 %.

Additional consolidation efforts still required

All in all, the Stability and Growth Pact has so far proved an effective mechanism for ensuring a stability-oriented fiscal policy. However, the call it includes for a budget that is "close to balance or in surplus" in the medium term will entail further efforts at consolidation in most countries, especially in the form of a containment of government spending. To this extent, no "all clear" can be sounded yet in the field of fiscal policy, even if the stability and convergence programmes for the next few years presented by the individual euro-area states certainly constitute a major step in the right direction. (For details, see page 102 f. of this Report.)

II. Monetary policy and financial markets

1. The monetary policy of the Eurosystem

(a) Monetary policy course eased in spring, tightened in autumn

Transfer of monetary policy to the Eurosystem

With the launching of stage three of economic and monetary union on January 1, 1999 responsibility for deciding and implementing the single monetary policy in the euro area was transferred to the Eurosystem[1]. The ECB Governing Council, which since that date has been responsible for making monetary policy decisions, defined the first interest rates for the Eurosystem on December 22, 1998. It decided to put the first main refinancing operation out to tender at a fixed interest rate of 3 %. In doing so it formally confirmed the level of convergence of the national central bank interest rates which had been reached at the end of 1998 as the starting level for the corresponding interest rate of the Eurosystem. At the same time it emphasised its intention to maintain this central rate for the money market for the time being. With a view to stabilising market expectations, the terms of the following fixed-interest rate tenders were pre-announced following each meeting of the ECB Governing Council – reflecting the practice which the Bundesbank had adopted in the past.

1 The term Eurosystem denotes the ECB plus the 11 central banks of the countries which introduced the euro as their common currency on January 1, 1999.

Creation of a single money market

For the first three weeks of monetary union the ECB Governing Council defined a very narrow corridor for fluctuations in the overnight money market rate, based on the interest rates which it had set for the two standing facilities; it set the interest rate for the marginal lending facility at 3.25 % and that for the deposit facility at 2.75 %, i.e. equidistant from the main tender rate of 3.0 %. This made it easier for market participants to adjust to the new money market environment in EMU and prevented major interest rate fluctuations in the overnight money market. In view of the rapid advances made in the integration of the national money markets and in the settlement of cross-border payments and given the decline in the initially large simultaneous utilisation of both standing facilities to an unavoidable frictional level, this transitional arrangement was discontinued as scheduled on January 22, 1999 and the interest rate corridor was widened to between 2.0 % and 4.5 %.

Interest rate cut in April 1999

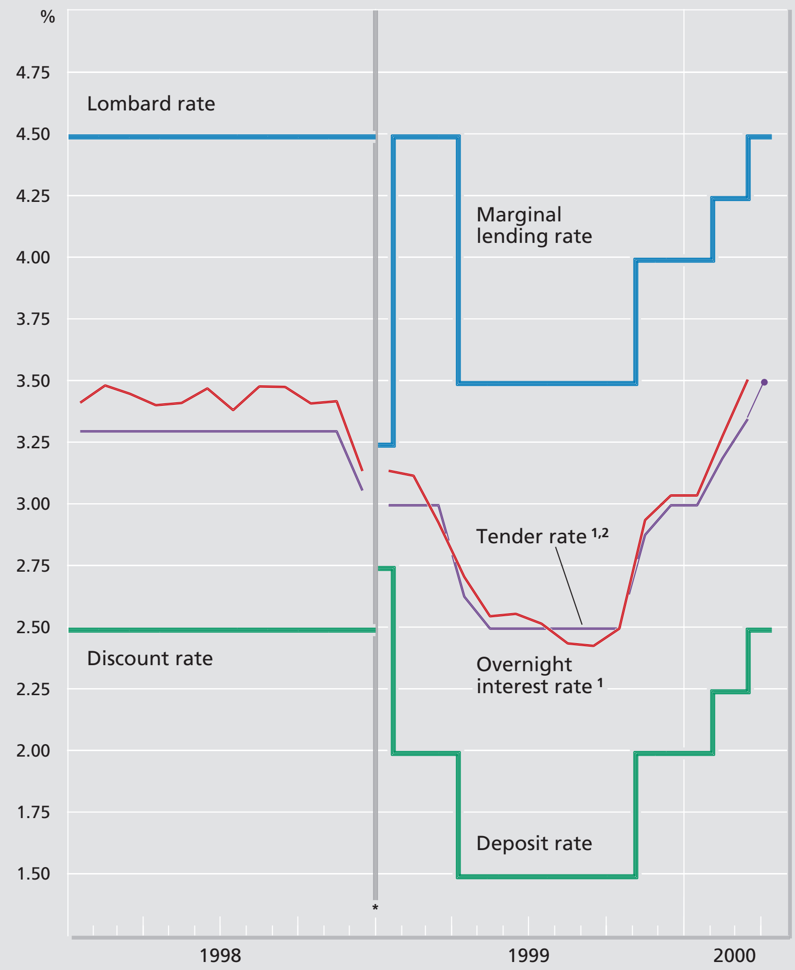
At the beginning of April the ECB Governing Council lowered central bank interest rates. With effect from April 9 it reduced the interest rates applying to the marginal lending facility and the deposit facility to 3.5 % and 1.5 %, respectively, and cut the interest rate on the main refinancing operations (which continued to be offered as fixed-rate tenders) to 2.5 % as of April 14. Neither monetary growth, which was strongly influenced by the transition to stage three, nor other indicators at the time were signalling any inflationary risks on the horizon. The move was simply intended to pre-empt potential deflationary tendencies in the context of global economic uncertainty and the weakening economic momentum in the euro area. With these measures the Eurosystem sought to create an economic setting in which the considerable growth potential of the euro-area countries could be fully exploited.

Interest rate rises in November 1999 ...

The inflationary risks increased from early summer onwards. The outlook for the world economy brightened as a result of the sustained dynamism of the US economy and clear signs of recovery in the crisis-ridden countries. The growth prospects for Europe improved distinctly. Monetary and credit growth remained vigorous, indicating a fairly generous provision of liquidity in the euro area. Against this background pronounced expansionary monetary stimuli were no longer appropriate. From the summer onwards, therefore, the ECB Governing Council prepared the markets and the general public for an increase in central bank interest rates. On November 5 it then raised the interest rate applying to the marginal lending facility from 3.5 % to 4.0% and the rate applying to the deposit facility from 1.5 % to 2.0 % and lifted the interest rate on the main refinancing operations (which continued to take the form of fixed-rate tenders)

Official interest rates and overnight interest rate

Chart 2



1 Monthly averages. — 2 Up to the end of 1998 interest rate for securities repurchase agreements; from 1999, interest rate for main refinancing operations.— o Up to the end of 1998, quotations in Deutsche Mark; from 1999, quotations in euro. — ● = Latest position: April 5, 2000.

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from 2.5 % to 3.0 % with effect from November 10. This interest rate rise cancelled out the reduction made in April. The intention behind it was to nip the incipient risks of upward pressures on prices in the bud and in this way promote sustained non-inflationary economic growth. Even after the interest rate rise, however, the monetary policy stance remained relaxed.

... and in February and March 2000

After steering a steady course in the money market into the new year, the ECB Governing Council increased central bank rates again at the beginning of February and in mid-March – both times by a uniform margin of ¼ percentage point. Since March 17 the interest rate applying to the marginal lending facility has

Record of domestic and external monetary policy measures

January 1, 1999
Upon the introduction of the euro as the common currency in eleven EU member states participating in European monetary union, the responsibility for monetary policy is transferred from the national central banks to the Eurosystem. Some major amendments of the Bundesbank Act come into effect; they include, in particular, the restructuring of the Bank's duties and the redefinition of the functions of the Central Bank Council and of the Bank's powers in the field of external monetary policy.

The European Monetary System ceases to be in effect. It is superseded by the new European exchange rate mechanism ERM II, under which the four EU member states that are not introducing the euro for the time being are given the option of linking their currencies to the euro. Denmark and Greece join ERM II; the fluctuation margins of their currencies around the central rate against the euro are ± 2 ¼ % for the Danish krone and ± 15 % for the Greek drachma.

January 4, 1999
The ESCB puts into operation the payment system TARGET, which links up 15 national real-time gross settlement systems with the payment system of the ECB, and paves the way for the emergence of a single money market in the euro area.

January 21, 1999
Against the background of the rapid integration of the national money markets, the Governing Council of the ECB revokes, as planned, the transitional arrangement for the standing facilities adopted on December 22, 1998, under which the interest rates for the marginal lending facility and the deposit facility were set at 3.25 % and 2.75 %, respectively, and sets those rates at 4.5 % and 2.0 %, respectively, with effect from January 22, 1999.

January 22, 1999
The resolved increase in the IMF quotas from SDR 145.6 billion (US$ 204 billion) to SDR 212 billion (US$ 297 billion) comes into effect, after having been endorsed by the requisite number of countries, together holding more than 85 % of the former quotas. The quota increase results in an enlargement of the German quota share from 5.66 % to 6.14 %. In agreement with the Federal Cabinet, the Bank transfers Germany's share, amounting to SDR 4.8 billion or US$ 6.6 billion, to the IMF on February 12, 1999.

March 4, 1999
The Governing Council of the ECB decides that the allotment of longer-term refinancing operations, which are offered in the form of variable-rate tenders, will no longer be effected by a Dutch-style auction (single-rate allotment procedure) but until

further notice by a US-style auction (multiple-rate allotment procedure).

March 31, 1999
The ECB announces that the TARGET system will be closed on December 31, 1999 to enhance the security of the year 2000 transition .

April 8, 1999
The Governing Council of the ECB lowers the interest rate applied to the main refinancing operations to be conducted from April 14 onwards by 0.5 percentage point to 2.5 %, and decides to reduce the interest rate on the marginal lending facility by 1 percentage point to 3.5 %, and that on the deposit facility by 0.5 percentage point to 1.5 %, both with effect from April 9, 1999.

April 14, 1999
Under the chairmanship of the Bank's President, Hans Tietmeyer, the Financial Stability Forum holds its first meeting at the International Monetary Fund (IMF) in Washington.

April 15, 1999
The Central Bank Council approves the Bank's annual accounts for the financial year 1998. DM 16.22 billion of the net profit is paid over to the Federal Government.

April 22, 1999
The Governing Council of the ECB decides that, in the longer-term refinancing operations to be conducted during the next six months, it remains its intention to allot an amount of € 15 billion per operation.

April 23, 1999
The IMF decides to enlarge its Supplemental Reserve Facility (SRF) by Contingent Credit Lines (CCL). The CCL are meant to be extended, as a confidence-building measure, to countries with sound economic policies faced by risks of contagion. The CCL, like the SRF, enable distinctly higher loans and quicker disbursements to be made, in case of need, than do the Fund's standard facilities.

June 18–20, 1999
The so-called "Cologne Debt Initiative", i.e. an extension of the debt-relief initiative in favour of heavily-indebted poor countries (HIPC), is adopted at the Global Economic Summit.
It is designed to ensure that debt relief is granted earlier and more widely and is accessible to a larger number of countries. In the ensuing months, the executive bodies of the IMF, World Bank and other international organisations take decisions implementing the Cologne Debt Initiative.

September 23, 1999
The Governing Council of the ECB announces that no main refinancing operations will be conducted, or mature, in the first week of the year 2000. This step is being taken in order to minimise any difficulties faced by counterparties of the Eurosystem and the financial markets as a result of the conduct and settlement of a main tender immediately after the millennium change.

September 26, 1999
The ECB, the national central banks of the eleven participating states, the Bank of England, the Swiss National Bank and the Sveriges Riksbank announce, in a "joint statement on gold", that gold will remain an important element of global monetary reserves and that the gold sales already decided will be achieved through a concerted programme of sales over the next five years; annual sales will not exceed approximately 400 tons and total sales over that period will not surpass 2,000 tons. Gold leasings and the use of gold futures and options will not be stepped up over the next five years.

October 20, 1999
On the conclusion of the annual economic policy consultation with Germany, the IMF publishes, for the first time, the staff's consultation report (which in previous years had been strictly confidential). This publication forms part of a pilot project, with German participation, whose object is to make the consultation procedure more transparent. The report is made available in German, too, on the Bank's website (www.bundesbank.de).

Record of domestic and external monetary policy measures

(continued)

October 21, 1999
The Governing Council of the ECB decides to raise the amounts to be allotted in the longer-term refinancing operations conducted between October and December 1999 by € 10 billion to € 25 billion each. The ECB intends to contribute by that means to a smooth transition to the year 2000.

November 4, 1999
The Governing Council of the ECB raises the interest rate on the main refinancing operations conducted from November 10, 1999 onwards by 0.5 percentage point to 3.0 % and, with effect from November 5, 1999, the interest rates on the marginal lending facility and the deposit facility by likewise 0.5 percentage point to 4.0 % and 2.0 %, respectively.

November 11–12, 1999
A "seminar on the accession process" is held in Helsinki, attended by the Eurosystem and by the governors of the central banks of the twelve candidates for accession to the EU. The object of the seminar is to gain a complete overview of the central banking topics associated with the accession process, to ascertain the principal problem areas and to foster cooperation between the Eurosystem and the central banks of the accession countries.

December 2, 1999
The Governing Council of the ECB reviews and reaffirms the quantitative reference value for monetary growth which it set in December 1998, viz. an annual growth rate of 4 ½ % for the monetary aggregate M3.

The Governing Council of the ECB decides to increase from 10 % to 30 % the flat-rate deduction from the reserve base to be applied to debt securities with maturities of up to two years and to money-market paper. The new provision will take effect for the first time in the determination of the reserve requirement for the maintenance period starting on January 24, 2000.

January 5, 2000
For the first time, the Eurosystem conducts a fine-tuning operation, in the shape of the collection of fixed-term deposits by means of a one-week quick tender.

January 17, 2000
The central rate of the Greek drachma in ERM II is raised by 3 ½ %.

January 20, 2000
The Governing Council of the ECB announces that the Eurosystem intends to allot an amount of € 20 billion in each of the longer-term refinancing operations to be conducted in the first half of the year 2000.

February 3, 2000
The Governing Council of the ECB raises the interest rate on

the main refinancing operations conducted from February 9, 2000 onwards by 0.25 percentage point to 3.25 %, and the interest rates on the marginal lending facility and the deposit facility by likewise 0.25 percentage point to 4.25 % and 2.25 %, respectively, both with effect from February 4, 2000.

February 11, 2000
In agreement with the Federal Government, the Bank provides an interest-free long-term loan of € 300 million to finance debt relief granted by the International Monetary Fund (IMF) to heavily-indebted poor countries (HIPC). Besides Germany, other IMF creditor countries and many developing countries also make bilateral contributions.

March 9, 2000
The Greek Government applies for membership of European monetary union with effect from January 1, 2001.

March 16, 2000
The Governing Council of the ECB raises the interest rates on the marginal lending facility and the deposit facility by 0.25 percentage point each to 4.50 % and 2.50 %, respectively, with effect from March 17, 2000, and the interest rate on the main refinancing operations conducted from March 22, 2000 onwards by likewise 0.25 percentage point to 3.50 %.

April 6, 2000
The Central Bank Council approves the Bank's annual accounts for the financial year 1999. The profit for the year, amounting to € 3.90 billion, is paid over to the Federal Government.

been 4.5 % and that applying to the deposit facility has been 2.5 %. The interest rate for main refinancing operations was raised to 3.5 %. The rate rises were appropriate because the risks to price stability had increased to a greater extent than had been anticipated in the autumn. This was attributable to the accelerated cyclical recovery in the euro area, the higher oil prices and the sharp increase in import prices as well as to the ample supply of liquidity. The interest rate increases were intended to prevent external price pressures from influencing price and cost developments in the euro area and to safeguard price stability in the medium term.

Money market management within a European framework

The operational framework for the implementation of monetary policy, especially for the ongoing money market management of the Eurosystem, functioned satisfactorily during the first year of the euro. It enabled the Eurosystem to control its operational target – the overnight interest rate – effectively and to signal its monetary policy intentions with a sufficient degree of precision and differentiation. The monetary policy instruments were deployed with the primary aim of keeping the financial sector extremely short of liquidity, thus forcing the credit institutions to refinance themselves via the Eurosystem. Furthermore, the minimum reserve requirements, which have to be observed not daily but on an average over the reserve maintenance period, stabilised the demand for central bank money and had a steadying effect on interest rate movements in the overnight money market.

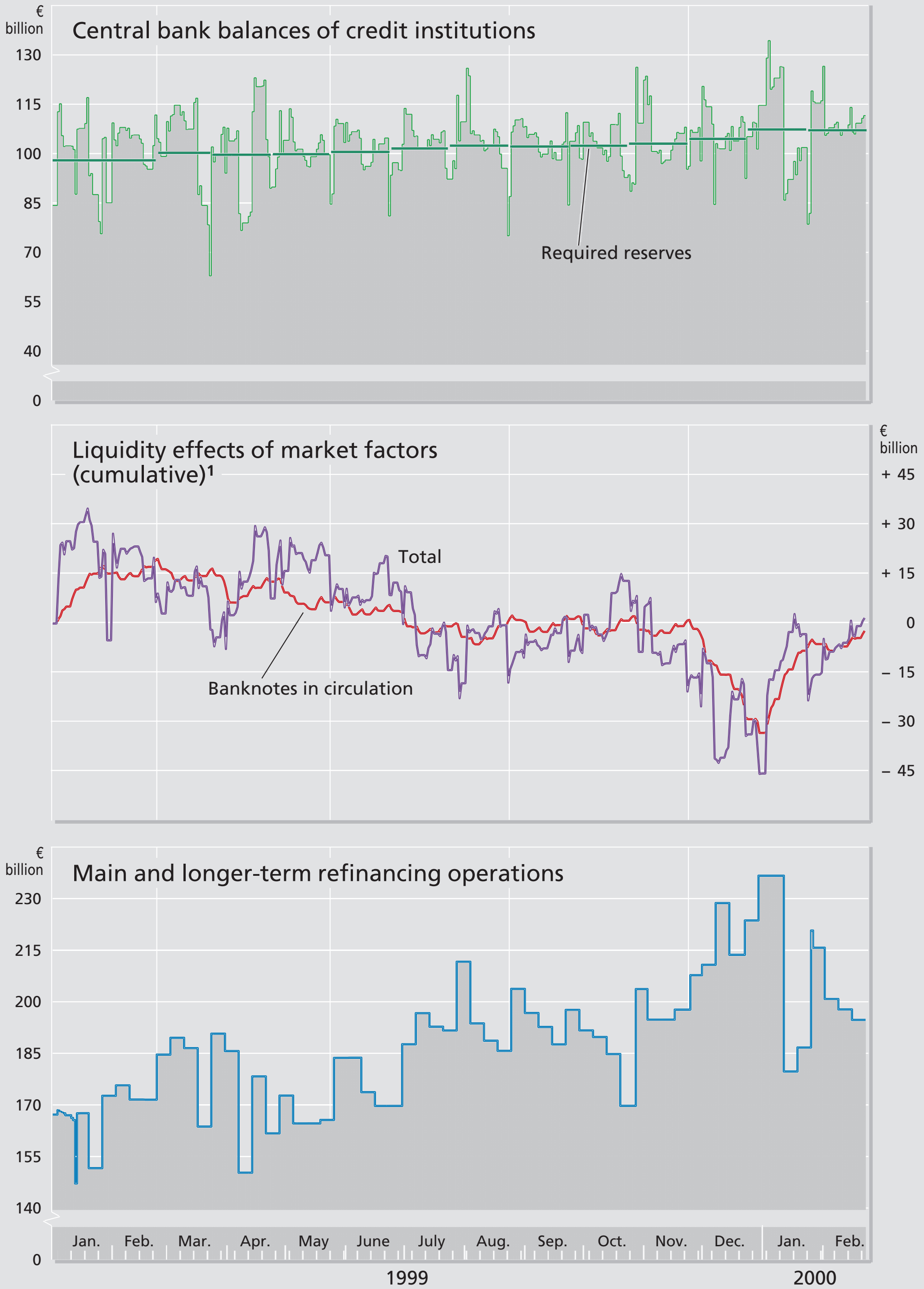
Main refinancing operations to the fore

These conditions allowed the Eurosystem to base its liquidity management in 1999 exclusively on the regular main and longer-term refinancing instruments designed to provide liquidity and on the two standing facilities. This concentration on a handful of standardised instruments also enhanced the transparency of money market management and facilitated their utilisation by a large number of market participants. The primary emphasis was laid on weekly main refinancing operations with a maturity of usually two weeks. At an annual average of around € 140 billion, they accounted for roughly three-quarters of the total refinancing volume. The main tender operations were offered solely in the form of fixed-rate tenders in which the around 2,500 credit institutions that are eligible to take part in open market operations were able to submit bids at an interest rate preset by the Eurosystem. The average number of participants was just under 800. From the outset the aggregate volume of bids submitted by banks far exceeded the amounts allotted in line with appropriate liquidity requirements, as a result of which bidding rivalry began among the banks in the expectation that the allotment amounts would be scaled down substantially; this

Liquidity management in the Eurosystem

Chart 3

Daily values



1 Banknotes in circulation, net position of general government vis-à-vis the Eurosystem, net foreign reserves of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances.

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bidding rivalry forced the allotment rates down to between 4 % and 7 % in the second half of 1999. The Eurosystem sought to counter this bidding rivalry by means of a more ample provision of liquidity and to keep the overnight money market rate (EONIA) very close to the tender rate. The aim of this was to avoid giving a systematic price advantage to direct refinancing from the central bank compared with borrowing in the interbank market. No fundamental change in bidding behaviour was achieved, however.

High volatility of the market factors determining liquidity

In order to keep the money market more or less steady, it was necessary to equalise the relatively large daily changes in the market factors determining liquidity as early as possible. The Eurosystem had to take account not only of fluctuations in the demand for banknotes and changes in the items in course of settlement but also of the high volatility of the central bank deposits of general government. As a result of the Italian tax payment deadlines, in particular, large amounts of liquidity were regularly and suddenly withdrawn from the credit institutions, and this liquidity returned to the market only gradually.

Longer-term refinancing operations

The monthly longer-term refinancing operations with a maturity of three months generally have no specific monetary policy aims but instead are intended to serve banks solely as an instrument of longer-term liquidity planning. Consequently, these operations have all been offered in the form of variable-rate tenders – at first, as "Dutch auctions" and, since March 1999, as "US-style auctions" – with a preannounced volume, with the result that the Eurosystem has always acted as a rate taker. With the exception of the basic tenders which were in operation at the turn of the year, the uniform or marginal allotment rate has always been just under the market rate for uncollateralised three-month funds in interbank trading.

At an average of around € 47 billion, basic tenders accounted last year for approximately one-quarter of the total liquidity provided by the Eurosystem. The volume of the individual operations was initially set at € 15 billion; this was raised to € 25 billion in the autumn in anticipation of the millennium date change and reduced to € 20 billion from January 2000. As collateral for the open market operations and utilisation of the marginal lending facility, credit institutions primarily used tier-1 debt instruments, which exclusively comprise marketable paper. The banks used tier-2 collateral – non-marketable loans to trade and industry (loans and advances, bills of exchange) – to varying degrees but, on the whole, were still rather reluctant to do so. Loans and advances, in particular, might eventually become more widely used as collateral for central bank funding in some countries. The cross-border use of collateral increased perceptibly in the course of the year.

Equalisation operations by banks

Recourse by credit institutions to the Eurosystem's marginal lending facility and deposit facility was limited to € 1.0 billion and € 0.8 billion, respectively, on an annual average. Except for the first few days after the start of monetary union, banks used the standing facilities mostly on the final days of the reserve requirement period. Owing to the fairly ample provisions of funds through the regular open market operations, banks resorted more often to the deposit facility. In addition, more extensive use was made of the marginal lending facility at the turn of the year. The standing facilities were used principally by credit institutions in Germany.

Year 2000 changeover unproblematical

By and large, the euro money market coped with the millennium date change without any problems. To make the changeover to the year 2000 easier, the ECB Governing Council decided not to operate the TARGET system on December 31, and not to carry out any main refinancing operations, while making sure than none matured, in the first business week of January; it also decided to increase the longer-term refinancing operations extending into the new year by € 10 billion to € 25 billion each. The initially large premia for uncollateralised liquidity extending beyond the end of 1999 had already begun to decrease in the last few of the year. Money market rates returned to normal immediately after that.

First fine-tuning operation in January

At the beginning of January 2000 the substantial reflux of banknotes, strongly expansionary government cash flows and the greater recourse to the marginal lending facility at the turn of the year, together with the sizeable increase in the last main tender in December, led to considerable excess liquidity. Against this backdrop, and on account of the decision taken in September not to conduct a main tender in the first week of January, the Eurosystem offered for the first time on January 5 to absorb the banks' liquidity through the collection of fixed-term deposits via a "US-style" variable-rate quick tender to mature one week later. The amount absorbed by the quick tender was less than that intended and preannounced by the Eurosystem, however, with the result that the supply of liquidity to the banking system could be normalised only by sharply reducing the subsequent first main tender of this year.

The refinancing needs of the credit institutions in the euro area have grown since the beginning of monetary union (see table 3 on page 38). This growth is

Factors determining bank liquidity *

Table 3

€ billion; changes during the period

Item	1999–2000 Feb. 24 to May 23	May 24 to Aug. 23	Aug. 24 to Nov. 23	Nov. 24 to Feb. 23	Total
I. Provision (+) or absorption (–) of central bank balances by					
1. Change in banknotes in circulation (increase: –)	– 4.6	– 10.9	+ 1.7	– 4.5	– 18.3
2. Change in general government deposits with the Eurosystem	+ 4.7	– 11.0	– 4.2	+ 2.3	– 8.2
3. Change in net foreign reserves 1	+ 14.3	+ 0.7	+ 8.6	+ 16.0	+ 39.6
4. Other factors 2	– 9.1	– 4.1	– 5.2	– 16.9	– 35.3
Total	+ 5.3	– 25.3	+ 0.9	– 3.1	– 22.2
II. Money policy operations of the Eurosystem					
1. Open-market operations					
(a) Main refinancing operations	+ 17.0	+ 28.5	– 9.6	– 9.6	+ 26.3
(b) Longer-term refinancing operations	+ 10.8	+ 0.0	+ 8.7	+ 16.8	+ 36.3
(c) Other operations 3	– 30.0	–	–	± 0.0	– 30.0
2. Standing facilities					
(a) Marginal lending facility	– 3.0	– 0.3	– 0.2	– 0.2	– 3.7
(b) Deposit facility (increase: –)	+ 0.9	– 0.6	+ 0.6	+ 0.2	+ 1.1
Total	– 4.3	+ 27.6	– 0.5	+ 7.2	+ 30.0
III. Change in credit institutions' current accounts (I + II)	+ 0.9	+ 2.4	+ 0.6	+ 3.9	+ 7.8
IV. Change in the minimum reserve requirement (increase: –)	– 1.9	– 2.6	– 0.6	– 4.1	– 9.2
Memo items: 4					
Main refinancing operations	121.6	150.1	140.5	130.9	130.9
Longer-term refinancing operations	45.0	45.0	53.7	70.5	70.5
Other operations	–	–	–	–	–
Marginal lending facility	0.8	0.5	0.3	0.1	0.1
Deposit facility	0.4	1.0	0.4	0.2	0.2

* Calculated on the basis of daily averages in the last reserve maintenance period of the period under review. — 1 Including liquidity-neutral valuation adjustments at the end of the quarter. — 2 Including outright transactions and the issuance of debt certificates (overhanging from stage two). — 3 Including monetary policy operations concluded in stage two and maturing at the start of stage three; excluding outright transactions and the issuance of debt certificates. — 4 Amounts outstanding on an average of the last reserve maintenance period of the period under review.

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Growing refinancing needs

due first and foremost to the increase in banknotes in circulation and in the required minimum reserves; the volume of Deutsche Mark notes in circulation has likewise expanded further after contracting for the first time in the course of 1998. In addition, both government cash transactions and the changes in net foreign reserves – adjusted for the liquidity-neutral valuation adjustments and interest received on foreign currency investments – tended to absorb funds during the period under review. The market-related withdrawals of liquidity and the expiry of the monetary policy operations left over from stage two of EMU (amounting to an average of € 30 billion) were squared by stepping up the main and longer-term refinancing operations to a total of € 201.4 billion.

(b) Initial experience of the two-pillar strategy

Eurosystem's stability-oriented monetary policy strategy

The transfer of responsibility for monetary policy to the Eurosystem on January 1, 1999 brought a reorientation of the monetary policy strategy. The basis for monetary policy decisions in the euro area is now provided by the stability-oriented monetary policy strategy of the Eurosystem which was laid down by the ECB Governing Council at the end of 1998.

Quantitative definition of price stability ...

The starting point of the new single monetary policy is the specification of a concrete figure for the primary objective of price stability. It is defined by the ECB Governing Council as a "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 %". This objective relates to the medium term. By quantifying the objective of monetary stability, the ECB Governing Council has expressed its firm commitment to price stability. The target figure also clearly implies that neither inflationary nor deflationary developments are compatible with the concept of price stability. Furthermore, by choosing a quantitative definition of price stability, the ECB Governing Council has given the general public a yardstick to gauge the success of the single monetary policy. As a result, the monetary policy makers not only render their intentions transparent but also make their performance measurable.

... and "two pillars"

The Eurosystem's strategy for achieving price stability rests on two "pillars". Firstly, the ECB Governing Council attaches prominent strategic importance to the broadly defined monetary aggregate M3. This acknowledges the finding that in the long term inflation is a monetary phenomenon. In the short term, however, price developments are also influenced by a range of non-monetary factors. Secondly, therefore, the Eurosystem undertakes a broadly based analysis of the price outlook and of the risks to price stability in the euro area. This estimation is based on a broad spectrum of real economic and financial indicators which – like monetary growth – tend to run ahead of price movements and so permit an assessment of future price developments.

Monetary reference value for 1999

The ECB Governing Council set a reference value of 4 ½ % for the growth of the monetary aggregate M3[1] in 1999. For its derivation the Governing Council as-

1 The aggregate M3 comprises currency in circulation and the short-term deposits with monetary financial institutions (MFIs) in the euro area (overnight deposits, deposits with an agreed maturity of up to two years, deposits redeemable at notice of up to three months held in each case by euro-area residents), plus marketable instruments such as the repurchase agreements of MFIs, the debt securities issued by them with an original maturity of up to two years as well as money market fund units and money market paper. It is thus more broadly defined than the M3 concept used by the Bundesbank in its monetary policy until the end of 1998.

sumed an annual trend-growth of real GDP of 2 % to 2 ½ %, a rise in the HICP in line with the quantitative definition of price stability of less than 2 % and an add-on for the expected decline in the velocity of circulation of M3 in the medium term of ½ to 1 percentage point per year. The reference value does not represent a monetary target; deviations of monetary growth from the reference value do not automatically trigger a monetary policy reaction. Nevertheless, under normal circumstances they do signal risks to price stability. The ECB Governing Council has invariably justified its interest rate policy decisions by reference to the monetary situation and the outlook for price developments (see page 27 ff.).

Monetary growth in the euro area above the reference value

The money holdings in the euro area grew vigorously last year. They were already surging ahead in January, i.e. immediately after entry into stage three of monetary union. Subsequently the moving three-month average of the 12-month growth rates of M3 moved further and further away from its reference value. On an average of the months October to December M3 was 6 % higher than 12 months previously, in other words 1½ percentage points above the reference value of 4 ½ %. That indicates an ample supply of liquidity. It should be noted, however, that the year-on-year comparison does not precisely reflect the underlying monetary momentum in the course of 1999 owing to baseline effects, specifically the rather robust growth of the monetary aggregate in the first half of 1998 and the comparatively subdued monetary growth in the second half of that year (especially in December). If seasonally adjusted growth rates over shorter periods are used in order to eliminate such baseline effects, the resulting impression is one of weakening growth throughout the euro area in the course of 1999. For example, whereas the monetary aggregate M3 had expanded in the first half of last year at a seasonally adjusted annual rate of 7 %, it grew in the second half at a rate of only 5 ½ %. In February of this year, however, monetary growth accelerated perceptibly.

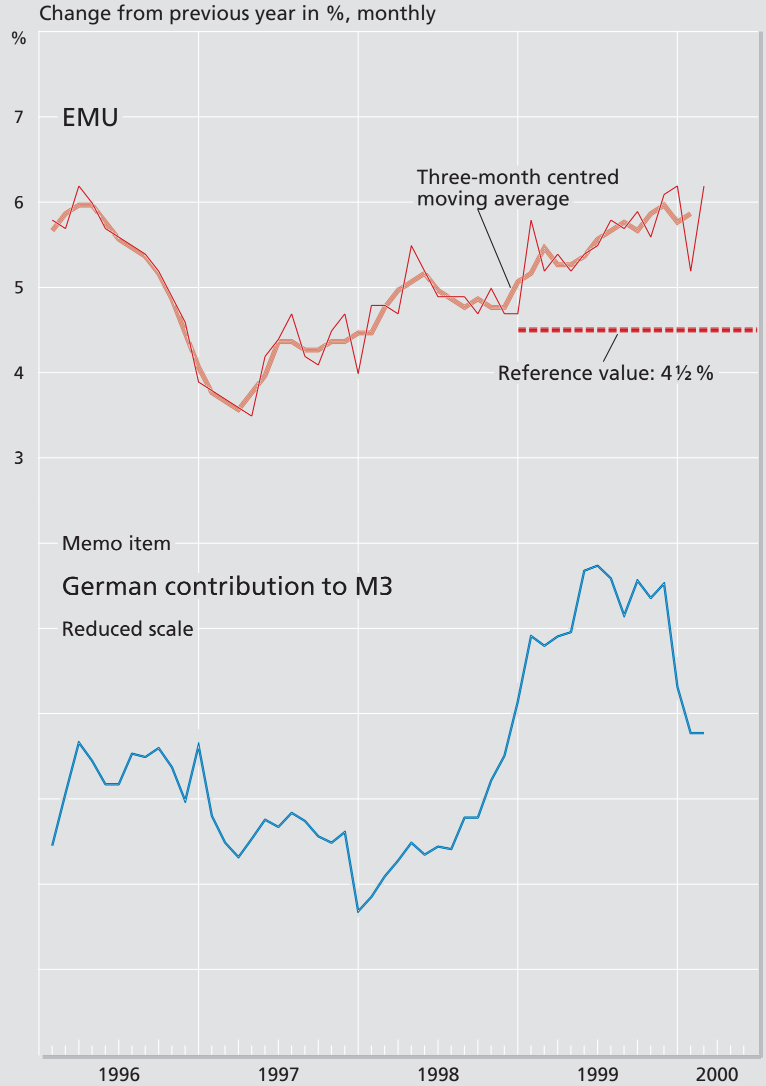
Cautious interpretation appropriate

On balance, monetary expansion is quite consistent with interest rate movements and cyclical developments in the euro area. It was fostered both by the low opportunity cost of holding money and by the burgeoning economic upturn. Even so, the change of monetary regime at the start of 1999 and the heterogeneous developments in the individual euro-area countries suggest that a certain degree of caution is called for when interpreting the rate of monetary growth. Thus liquidity holdings in all countries increased at a noticeably fast pace at the beginning of monetary union. Simultaneously, however, a greater propensity for medium-term investment was evident in the wake of the sharp

Growth of the money stock M3 in the euro area

Chart 4

Change from previous year in %, monthly



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decline in inflation rates in some countries. New minimum reserve requirements (particularly the remuneration of minimum reserve balances) and changes in tax legislation likewise had an impact on the holding of money. Finally, there is still some statistical uncertainty regarding, for example, purchases of marketable instruments by non-euro-area residents. All in all, however, there is no cause to call into question the prominent role of the money stock within the framework of the Eurosystem's stability-oriented monetary policy strategy.

Of the components of M3, overnight deposits grew particularly strongly in 1999. They increased by € 147½ billion, or 10 %. This rise was concentrated on

Particularly strong growth of overnight deposits and marketable instruments

the month of January and primarily reflects uncertainty in connection with the launch of monetary union. It weakened later in the year, but demand for overnight deposits continued to be fostered by their low opportunity cost. Currency in circulation showed a more marked rise only towards the end of the year, no doubt in connection with the year 2000 changeover. In contrast to overnight deposits, the other short-term bank deposits developed weakly. Deposits with an agreed maturity of up to two years decreased by € 23 billion in the course of 1999. Similarly, there was far less demand than in 1998 for deposits redeemable at notice of up to three months. A counterweight to the muted trend in short-term bank deposits was provided by the dynamic expansion of marketable instruments, above all money market fund units and money market paper. While repurchase agreements declined by € 27½ billion, bank debt securities with an original maturity of up to two years and, in particular, money market paper and money market fund units expanded strongly in 1999 by a total of € 104½ billion, or 27 %. As a result, marketable instruments accounted for 28 % of monetary growth in 1999, although their share of M3 in the euro area averaged only 13½ % last year. The marketable components of the monetary aggregate grew particularly strongly, especially in the later part of the year, as interest rates rose and interest rate uncertainty increased. As far as anyone can tell, another contributory factor seems to have been fairly large purchases by non-euro-area residents, which cannot be distinguished in the statistics from purchases by euro-area residents.

Reference value left at 4½ % following review

In a review at the beginning of December 1999 the ECB Governing Council decided to leave the reference value for monetary growth unchanged at 4½ %. The decision was prompted not only by its medium-term character. A review of the assumptions on which the derivation of the reference value for 1999 had been based did not indicate a need for adjustment either. For the year 2000 the ECB Governing Council has assumed an unchanged trend-growth of real GDP of 2 % to 2½ % and a long-term decline in the velocity of circulation of M3 of ½ to 1 percentage point. The Governing Council also retained the definition of price stability as a rise of less than 2 % in the euro-area HICP. In future the ECB Governing Council will review the reference value at regular annual intervals. The next review of the reference value will take place in December 2000.

German contribution

For much of 1999 the German contribution to euro-area M3 grew far more strongly than the overall European aggregate. In December it was 8.7 % above its December 1998 level. As at the European level, money holdings expanded substantially at the start of the year, owing *inter alia* to sizeable repatriations of short-term funds which had previously been invested in the Euro-market (see page 54 f.). In mid-1999, however, monetary expansion in Germany began to slacken off noticeably; in the second half of the year the German contribution to M3 grew largely in line with the euro-area aggregate. The increase in the German contribution was concentrated to a larger extent than in the euro area as a whole on money market paper – issued by German MFIs. The German balance of payments statistics indicate, however, that a large part of this paper was sold to investors outside the euro area. To that extent, the figures overstate the expansion of the German contribution.

(c) Determinants of monetary growth

Strong growth of lending to the private sector

Monetary growth in the euro area in 1999 was fuelled above all by the steep increase in lending to the private sector. Credits granted by MFIs to resident enterprises and households rose by € 580½ billion, or 10½%. The buoyant demand for credit was encouraged both by the low interest rates for borrowers and by the progressive economic recovery in the euro area. Another factor was the expiry at the end 1998 of the special depreciation allowances for investment in eastern Germany, resulting in a surge in lending and in the money stock in Germany at the turn of 1998-9, an event which also had an impact on the euro-area aggregate. Finally, the flurry of corporate mergers and acquisitions, the continuing rise in real estate prices in some countries and the strong outflows of funds stemming from the payment transactions of enterprises and individuals with non-residents likewise tended to boost the demand for credit in the euro area. Loans to the private sector expanded by 9½% last year. The rising interest rate trend for longer-term loans since the early summer has so far failed to dampen their growth; instead, the rise in interest rates appears to have prompted borrowers to bring forward their loan requests. Only in December 1999 did banks' credit business moderate appreciably. MFIs also substantially stepped up their securitised lending to enterprises in the euro area again in 1999. It went up by € 98 billion, or 19½%. Despite this dynamic growth, its average share of all lending to the private sector in the euro area in 1999 amounted to not quite 10%.

Solely securitised lending extended to government on balance

Lending to general government grew only slightly during the year under review (by € 36½ billion, or just under 2%) on account of that sector's diminished financing requirements. On balance this exclusively took the form of additional securitised lending; at € 1½ billion, direct government borrowing from MFIs in the euro area declined marginally.

Monetary developments in the euro area in 1999

Table 4

Changes in the course of the year

Item	Euro area	Memo item German contribution
	in %	
I. Growth of the monetary aggregates		
M1 [1]	9.8	8.5
M2 [2]	5.1	5.1
M3 [3]	6.2	8.7
	€ billion	
II. Money stock and its counterparts		
Money Stock M3 (=1+2–3–4–5)	276.4	113.0
of which		
Currency in circulation and overnight deposits	174.5	43.4
Other short-term bank deposits	24.7	21.1
Marketable instruments	77.2	48.5
Balance sheet counterparts		
1. Credit to non-MFIs in the euro area	616.9	206.9
of which		
Credit to general government	36.5	38.1
Credit to other non-MFIs in the euro area	580.4	168.8
2. Net claims on non-euro-area residents	– 172.6	– 57.3
3. Deposits of central government	6.0	1.9
4. Longer-term financial liabilities to other non-MFIs in the euro area	257.7	116.4
5. Other counterparts of M3	– 95.8	– 81.7

1 Currency in circulation and overnight deposits held by euro-area residents with MFIs in the euro area. — **2** M1 plus other short-term bank deposits held by euro-area residents with MFIs in the euro area (deposits with an agreed maturity of up to two years and deposits redeemable at notice of up to three months). — **3** M2 plus marketable instruments (repurchase agreements concluded by MFIs with non-MFIs in the euro area, debt securities with an original maturity of up to two years and money market fund units and money market paper of MFIs in the euro area).

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Robust monetary capital formation

Longer-term financial asset formation with MFIs in the euro area increased distinctly in 1999 by € 257½ billion, or almost 8%. In this respect monetary growth was therefore slowed appreciably. In the first few months of the year the propensity to invest over the longer term was rather muted. The low longer-term interest rates and the fairly considerable uncertainty which prevailed for a time in the financial markets favoured a wait-and-see attitude on the part of investors. However, their sentiment changed with the rise in longer-term interest rates from mid-1999, and they then stepped up their acquisition of longer-term financial assets. There was brisk demand last year for bank debt securities with a maturity of more than two years, in particular. They were sold to non-MFIs to the tune of € 110 billion. Some of the purchasers were probably non-euro-area residents. MFIs' capital and reserves expanded by € 100 billion, a major part of which was due to the very large increase in December. Domestic non-MFIs accumulated deposits with an agreed maturity of more than two years in the amount of € 59 billion. By contrast, they ran down their deposits redeemable at notice of over three months by € 11 ½ billion.

Large outflows in payment transactions with non-residents

The payment transactions of resident non-MFIs with non-residents in 1999 again resulted in sizeable net outflows. The net external position of MFIs in the euro area, which reflects such transactions statistically, fell by € 172 ½ billion. These outflows of funds from the euro area are principally attributable to direct investment by euro-area residents, though portfolio purchases also played a role.

2. The financial markets in the euro area

(a) Capital market rates caught between deflation fears and more buoyant growth

Further decline in capital market yields at the start of 1999

Developments in euro-area capital market rates were influenced in 1999 by the assessment of the prospects for European and global growth becoming more optimistic again. At the start of the year, however, the unresolved economic problems in Japan and the escalating currency crisis in Brazil initially caused the economic outlook to become even gloomier and the already-low capital market rates to go down even further. Besides the emerging fears of deflation, another factor that encouraged the decline in interest rates in the industrial countries was that those countries continued to function as "safe havens" for funds from the regions in crisis. Finally, there was additionally the fact that the problem-free start to monetary union triggered portfolio shifts into the euro area. The yield on euro-area countries' ten-year government bonds, which had already dropped below the 4 % mark towards the end of 1998, fell to a record low of 3 ¾ % at the beginning of 1999; by the end of April, yields were in the region of 4 %.

Interest-rate rise initially as a return to normal ...

During the spring, the picture on the euro-area capital market began to change radically. From May onwards, yields began to go up moderately at first. This rise then accelerated in the summer months and persisted until the end of October. In that period, yields on ten-year bonds went up on a euro-area average by 1½ percentage points to 5 ½ %. The driving force behind the rise in interest rates was initially the fact that the prospect of the economic situation returning to a certain normality was increasingly displacing fears of a crisis, which, up to then, had been exerting a dampening impact on interest rates. At the same time, with the ebbing of the regional crises and the calming in the international financial markets, the bond markets of the industrial countries became less important as "safe havens". Given the still-subdued prospects for growth for the larger EMU member countries, interest rates in Europe rose much less sharply than in the United States up to the end of June. The yield spread of the US market for ten-year bonds therefore increased to 1½ percentage points by the middle of the year.

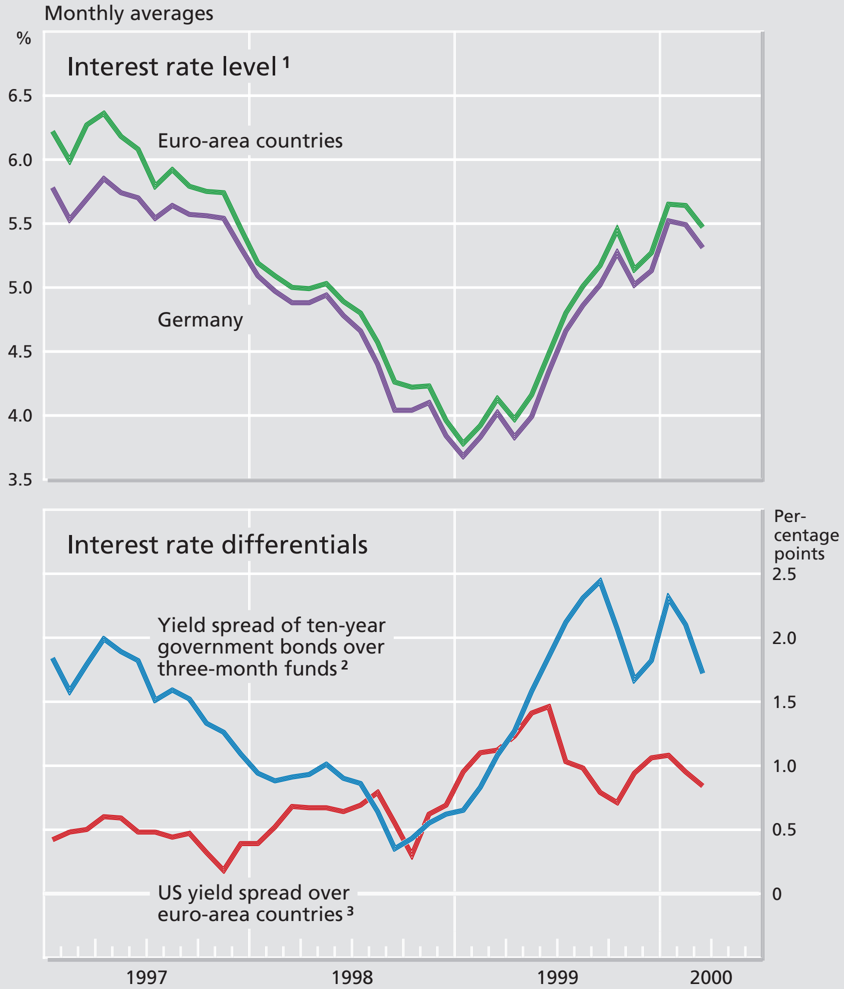
... and then as a "catching-up" process

From mid-year onwards, there were gradually growing signs of a strong economic recovery in continental Europe, which eventually initiated a process of "catching-up" with capital market rates in the United States. Within a few weeks, the US interest rate advantage shrank to below 1 percentage point. The marked firming of the euro exchange rate against the US dollar was one sign that the increase in yields during that period was pointing to economic recovery. Another was that various indicators pointed to a sharp increase in the real capital market rate in that period. Finally, the euro-area yield curve fanned out noticeably in the summer. This is usually indicative of the expectation that short-term interest rates will rise in future and that the economy will pick up. Along with the improved outlook for a sustained economic recovery, however, the risks to price stability were also gradually becoming more conspicuous. Against that background, both the inflation expectations contained in the capital market rates and the inflation risk premiums went up. They were dampened again perceptibly by the Eurosystem's raising of interest rates in early November, at which time the capital market rates fell temporarily by ½ percentage point to 5 %.

Uneven development since the end of the year

Between December 1999 and mid-February 2000, yields again edged up, reaching 5¾ %. At the turn of the year, fairly powerful stimuli to rising interest rates were generated by the US bond market, in particular, where emerging fears of inflation engendered higher yields. In the euro area, yields firmed due to the increasingly evident acceleration in growth and in view of increasing uncertainty about price developments. In connection with the second and third interest-rate increases by the Eurosystem in early February and mid-March, respectively, as well as the announced buy-back of bonds by the US government, the capital market rates retreated slightly. In early April 2000, the yield on ten-year government bonds amounted to roughly 5⅓ % on a euro-area average. Overall, the

Interest rate movements in the euro-area bond market — Chart 5



1 Government bonds with a residual maturity of around ten years; euro-area countries: GDP-weighted average. — **2** Interest rate for three-month funds: up to the end of 1998 GDP-weighted average of the euro-area countries; thereafter three-month EURIBOR. — **3** For ten-year government bonds.

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development in the capital market rates since early 1999 is testimony to the fact that long-term inflation expectations have been kept at a low level.

(b) Stock markets buck interest-rate rise

European share prices in hunt for a record

The European stock exchanges recorded sharp price increases throughout 1999. The market-wide Dow Jones Euro Stoxx price index was up by almost 40 % on its level at the end of 1998. During the year, however, there were contrasting movements in prices. After rising briefly at the start of the year, stock prices gained comparatively little ground up to and well into the summer. In that period, the rise remained far below that in the United States, where share prices had already picked up sharply in the first half of the year. At the end of October, a strong rally set in, during which the prices on many European stock markets attained new all-time highs. This trend also continued at the start of 2000, with further record levels being reached. It was only in March that this led into a period of marked price fluctuations, during which European prices were at times, in fact, slightly down again on their level at the end of 1999.

Driving forces behind the rally

The main driving forces behind this rally in prices were the much-improved outlook for the economy and growth for the euro area as a whole as well as the favourable international setting, for which the record highs on the US stock market were mainly responsible. Moreover, vigorous merger and acquisition activity, which had been given a further boost by the introduction of the euro, helped push prices upwards. One of the reasons for the price rises, say, in telecoms and industry, is that investors expect the international concentration of forces to provide enterprises in the euro area with further gains in efficiency and an improved competitive position. Nevertheless, not all industries were equally involved in this surge in prices, which primarily benefited hi-tech shares in addition to those sectors particularly affected by mergers. The market is evidently entertaining extremely optimistic long-term profit expectations for hi-tech enterprises, although such firms often operate at a loss for a long time at the start of their life cycle owing to the high level of investment needed.

Robust development in prices despite rise in interest rates

How favourably the prospects on the stock market up to and into March were assessed is also reflected by the relative developments in prices. For example, the price-earnings ratio and the dividend yield on the US and the European stock markets are currently higher and lower, respectively, than at any time in decades. Despite the high valuation level, the upturn in prices has proved to be extremely robust so far. Prices have gone up even in spite of the marked rise in long-term interest rates, which in itself should have contributed to a curbing of share prices. This may be an indication that share prices are currently being determined not only by the traditional "cyclical" factors such as interest rates and profit expectations but also by structural shifts in the demand relationships owing to a more marked propensity on the part of investors to run risks. Admittedly, it cannot be ruled out that the boom is being fostered by the mere expectation of further price rises in future.

3. The financial markets in Germany

(a) Successful start to the age of the euro

Federal bonds as euro-area benchmark

In the first year of the euro, the German capital market was able to maintain and strengthen its key role in Europe. In terms of price formation in the European bond market, Federal bonds function as a benchmark for the issues of other debtors from the euro area. Federal bonds' role as a benchmark rests on the high liquidity of the issues and the mature infrastructure on the primary, secondary and futures markets. Another factor is the Bundesbank's advisory function in its capacity as a fiscal agent. These advantages, along with what are fairly slight differences in financial standing, mean that the yields on Federal bonds are below those on other European government bonds. In 1999, the yield on ten-year Federal bonds were for the most part consistently some 20 basis points lower than the average of the other euro-area countries. Even within the German bond market, there was little change in the yield differentials in 1999. The yields on bank bonds in the first and second half of 1999 averaged around 30 and 40 basis points higher, respectively, than those on Federal bonds.

Interest rates provide favourable setting

Despite the changing interest-rate setting during the year, the financing terms formed a stable basis for the revival of economic growth in Germany. The capital market rates did rise perceptibly in nominal and real terms in 1999; the yield on ten-year Federal bonds at the end of 1999 was 5⅓ %, and thus 1½ percentage points up on the year. The "expected" long-term real rate of interest, which is calculated using long-term inflation expectations determined on the basis of surveys (Consensus Forecast), went up on a similar scale during the same period, being somewhat more than 3½ % at the end of 1999. The interest-rate level is therefore no longer as extremely low as it had been at the beginning of the year, a period that was marked by fears of a crisis. Nevertheless, there has now been a great improvement in the outlook for the economy and for profits. Also, the nominal and real capital market rates are both still below their long-term averages. The terms for long-term bank loans, which generally closely follow the capital market rates, likewise remain favourable. The interest rate on long-term fixed-rate loans to enterprises, for example, was around 6¾ % at the start of 2000, which is roughly 1¼ percentage points more than 12 months previously.

Issue volume on the bond market at a record level

There was a further sharp rise in issuing activity in the German bond market last year. At a market value of € 571 billion, the gross sales of domestic bonds were not quite 10 % higher than in 1998 and thus reached a new record. In 1999,

Sales and purchases of securities

Table 5

€ billion

Period	Sales					
	Bonds		Equities		Investment fund certificates	
	Total 1	of which Foreign bonds 2	Total 3	of which Foreign equities 2	Total	of which Investment funds open to the general public
1995	116.1	12.3	23.7	11.7	28.2	8.6
1996	130.1	10.7	37.1	19.6	42.6	8.4
1997	170.1	41.9	60.7	49.4	74.5	16.1
1998	213.4	56.0	122.6	97.6	95.7	19.9
1999	290.9	92.8	149.0	113.0	111.1	37.7
1999 1st qtr	99.0	36.5	22.0	18.9	32.2	13.9
2nd qtr	78.9	28.9	33.6	15.4	26.1	9.6
3rd qtr	76.2	17.9	30.6	22.4	19.8	9.5
4th qtr	36.7	9.5	62.8	56.2	33.0	4.7
	Purchases					
	Non-residents 2		Domestic non-banks 4		Domestic credit institutions (including Bundesbank) 5	
	Domestic bonds	Domestic equities	Bonds	Equities	Bonds	Equities
1995	43.9	– 1.5	48.3	19.1	24.0	6.1
1996	54.3	8.5	16.2	22.2	59.6	6.5
1997	65.6	11.6	30.8	44.8	73.7	4.4
1998	83.5	51.8	26.1	60.4	104.0	10.4
1999	128.9	52.1	87.2	78.3	74.7	18.6
1999 1st qtr	34.2	– 17.4	48.1	17.6	16.6	21.9
2nd qtr	26.9	22.0	14.5	25.3	37.4	– 13.7
3rd qtr	38.2	10.6	17.5	20.6	20.5	– 0.7
4th qtr	29.5	36.8	7.1	14.8	0.2	11.1

1 Net sales of domestic bonds at market values plus/less changes in issuers' holdings of their own bonds. — **2** Transaction values. — **3** Sales of domestic equities at issue prices. — **4** Residual. — **5** Book values, statistically adjusted.

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after deducting redemptions and including changes in issuers' holdings of their own bonds, net sales came to € 198 billion, which was one-quarter higher than the figure for the previous year. German issuers accounted for around 40 % of net sales of euro-area bonds; this, too, underlines the key role of the German capital market in monetary union mentioned previously. On the issuers' side, the banks remained the driving force, selling, on balance, € 156½ billion worth of their own bonds. Other bank bonds, in particular, recorded sharp rates of growth. In 1999, their net sales, at € 51½ billion, almost doubled compared with 1998. Short-dated paper, which met with buoyant demand particularly from foreign investors, accounted for more than one-half of this increase. The issuance of communal bonds *(Öffentliche Pfandbriefe)* declined somewhat at a high level. At € 71½ billion, this paper still made up just under one-half of total net sales of bank bonds, however. At € 39½ billion, the public sector raised an amount that was roughly 50 % higher than in 1998. The Federal Government increased its new borrowing in the bond market by € 56½ billion, primarily by issuing ten-year bonds. This was accompanied by redemptions of public debtors which – like the Treuhand agency or the former Federal Post Office – are no longer active as issuers. The outstanding amount of bonds of such special funds declined by € 17½ billion. Although there was a year-on-year rise of more than one-third in the net sales of industrial bonds in 1999, they remain of minor importance, at just over € 2 billion.

Equity market strongly influenced by national economic policy

The German equity market behaved more or less as though it had a life of its own in 1999. For a long time, it derived little benefit from the worldwide price rise and also lagged behind the development in the other large European countries. It was only towards the end of the year that a rally set in, the momentum of which exceeded the rise in prices on most other stock markets. Overall, the CDAX price index went up 30 % in 1999, and was thus only slightly behind the growth in the European market as a whole. Domestic economic policy played a key role in price movements on the equity market. Persistent uncertainty about the direction of economic policy had been placing a strain on the equity market well into the spring. However, the reform projects that were announced towards the end of the year – from which business expects improved incentive structures and significant increases in earnings – generated a surge in prices. The individual sectors benefited to varying degrees from the favourable underlying conditions. Restructuring in the corporate sector was a sector-specific driving force. This was associated with mergers and acquisitions, with mere speculation often being enough to trigger sharp price movements. Within the space of one year, industrial and telecoms share prices more than doubled and made the top gains in prices. Above-average rates of growth were achieved by the technology, media and software sectors, in which advances in information technology are particularly manifest. The general upward movement in prices accelerated in the first quarter of 2000. It was only in early March that this trend was curbed by the start of a period of sharp price fluctuations, although this predominantly affected hi-tech shares.

Equity financing still on the advance

Shares continued their advance as a financing instrument last year. In 1999, domestic enterprises issued equities with a market value of € 36 billion, of which € 31 billion consisted of listed shares. Once again, this is significantly higher than the previous record figure in 1998 (€ 25 billion). Approximately one-third of sales were by domestic enterprises going public on the stock market in 1999. At 168 new listings, the figure for 1999 was two-and-a-half times higher than the previous year's peak. Against the backdrop of large price advances, the market capitalisation of all listed domestic *Aktiengesellschaften* (public limited companies) went up by around € 500 billion to more than € 1,400 billion. Conditions in the German equity market were also characterised by ever-greater internationalisation. Net sales of foreign securities held as investments were once again exceptionally high in the reporting year, at € 113 billion (1988: € 97 ½ billion).

Measures to promote shares

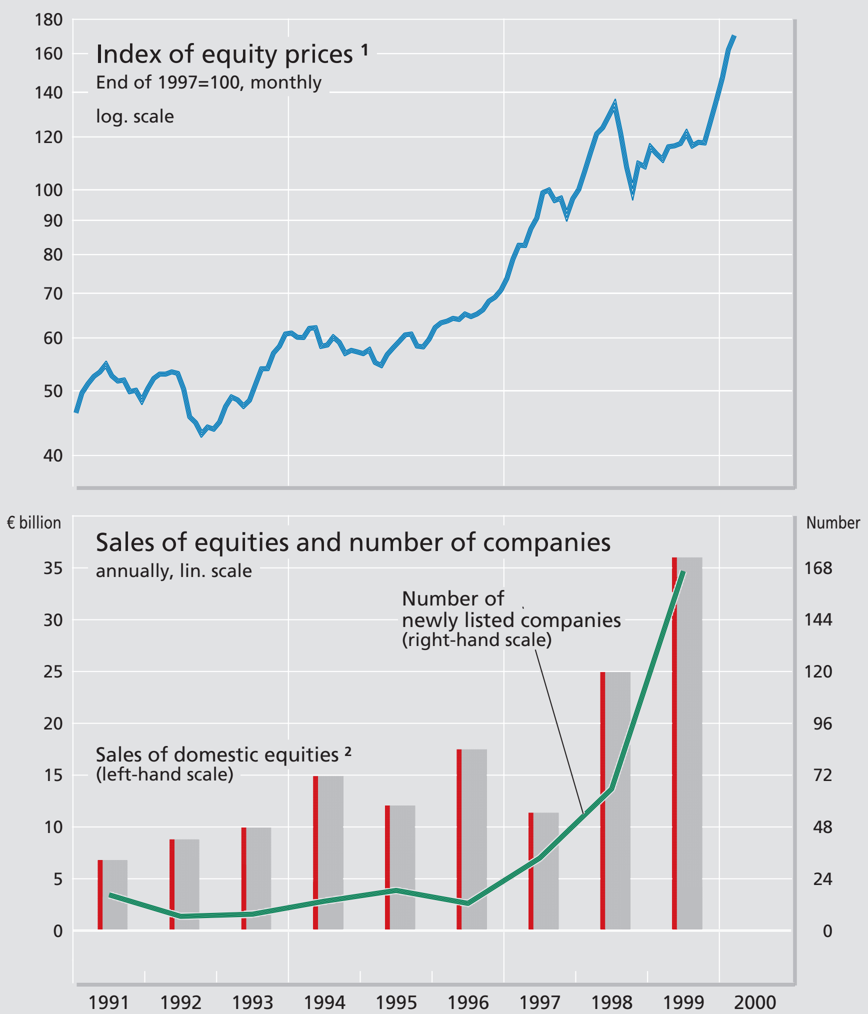
The growing popularity of shares is due, not least, to further measures aimed at enhancing the efficiency of the German equity market. These include the establishment of new market segments tailored to the requirements of certain groups of issuers and investors. Last year, for example, there was a further acceleration in the dynamic growth of the *Neuer Markt* – the German hi-tech stock market for young, innovative small and medium-sized enterprises. The transparency and liquidity requirements in this market segment are especially strict. This is designed to keep the higher-than-average risks for investors resulting from such an issuer structure reasonably predictable. More than 200 enterprises with a capitalisation of around € 110 billion were listed on the *Neuer Markt* at the end of the year. This corresponds to just over 8 % of the market capitalisation of all German stock exchanges. In addition, the SMAX segment, with similarly high quality standards, was created in spring 1999. The SMAX segment is geared to established enterprises from industries characterised by medium-sized businesses. It started with 91 "small-caps"; at the end of the year, 127 enterprises were already listed in this segment.

Sharp rates of growth in investment funds

At € 111 billion, domestic and foreign investment funds raised a substantially greater volume of financial resources in the German market than in 1998 (€ 95 ½ billion). Domestic funds open to the general public displayed particularly sharp rates of growth; at € 37 ½ billion, they received inflows that were almost twice as high as in 1998. Within the funds open to the general public, interest was focused on investment in equities and real estate; on balance, share-based funds and real-estate funds sold € 17 billion and € 7 ½ billion worth of share certificates, respectively. In 1999, share-based funds were evidently used mainly as a vehicle for cross-border investment. Share-based funds' assets invested in foreign shares accordingly rose by almost € 40 billion. The inflows of funds to the specialised funds, which received € 59 ½ billion, stabilised at a high level. As

Conditions in the equity market

Chart 6



1 CDAX share price index of the Deutsche Börse AG; monthly averages. — **2** Sales at market prices.

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usual in the case of the domestic specialised funds, the mixed funds, which allow institutional investors to pursue a very flexible investment policy, predominated.

Acquisition of securities marked by advancing international integration

In 1999, the buyers' side of the domestic securities markets was marked once again by growing international integration. The removal of national barriers to the acquisition of securities – fostered by technological advances and the institutionalisation of saving – had already set in before the introduction of the euro, but it was this factor which has generated a further surge in integration. Last year, non-residents acquired domestic bonds to the value of € 129 billion net, which corresponds to a growth of more than one-half compared with 1998. At € 103 billion, they invested principally in bank bonds, whereas public sector bonds, at € 26 billion, played a much less important role. At € 52 billion, purchases of shares by non-residents stabilised at a high level. Conversely, domestic buyers of securities invested heavily abroad. Domestic non-banks, for example, bought € 103½ billion worth of foreign equities, just under one-half of which was direct investment. In the case of non-banks' purchases of bonds, which amounted to a net total of € 86 billion, the vast majority, at € 46 billion, likewise consisted of paper issued by foreign debtors. At € 28 billion, the credit institutions invested much less extensively in domestic bonds than a year before (€ 60½ billion). On balance, they were exclusively bank bonds (€ 42½ billion); by contrast, their portfolio holdings of public sector bonds and corporate bonds declined by € 14½ billion.

Changes in the stock market environment

The international integration of the securities markets is also making progress in terms of their infrastructure. The first tangible outcome of a strategic cooperation among the major European stock markets has been a harmonisation of trading hours. Further efforts are being made to establish a joint market model for the most important bonds. Electronic trading continued to make advances during the reporting year. Since spring 1999, bonds have also been traded electronically. A trend is emerging in this area, with standardised products such as government bonds being traded electronically and less liquid bonds being traded over the phone. There has been a further concentration of derivatives business with Eurex, which permits cross-border electronic trading. The established stock markets may face competition from the increasing number of OTC electronic trading systems, although the latter are still of minor significance at present, at least in equity trading.

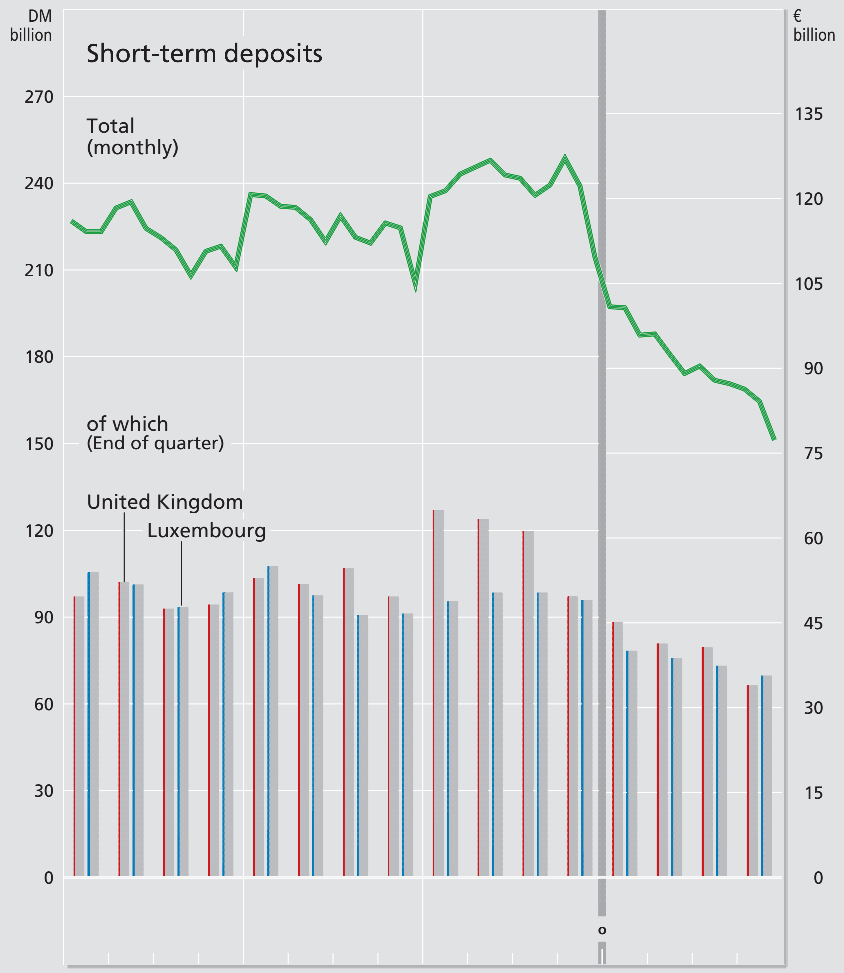
(b) Dynamic development in the deposit and lending business of German MFIs with domestic customers

Further sharp rise in overnight deposits

In 1999, overnight deposits again showed the sharpest growth in German MFIs' deposit business with domestic investors. They went up by € 34½ billion, or 9 %, compared with € 50 billion, or 15 %, in 1998. However, their rate of growth declined markedly as the year progressed. A sharp rise in overnight deposits, especially at the turn of 1998-9 and in the first half of 1999, was followed from the summer months onwards first by a slowdown and then, towards the end of the year, by a sharp reduction. The exceptional expansion of liquidity holdings at the start of the year was due, firstly, to the financial mar-

Short-term deposits of domestic non-banks at the subsidiaries and branches of German MFIs abroad

Chart 7



o From 1999 in euro.

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kets' increased uncertainty owing to the introduction of the euro, and, secondly, to the phasing-out of special depreciation facilities in eastern Germany at the end of 1998. In addition to this, the remuneration of reserve holdings with the start of monetary union led to massive return flows into the domestic banking system of short-term funds previously invested in the Euro-market. In 1999 as a whole, domestic non-banks reduced their short-term deposits with subsidiaries and branches of German credit institutions abroad by a total of € 32.9 billion, or 30 %. In 1998, by contrast, these deposits had been increased by as much as € 5.1 billion, or just under 5 %. At € 16.1 billion, somewhat more short-term funds were withdrawn from London than from Luxembourg (€ 13.6 billion).

During the year, the repatriations of short-term Euro-deposits and the matching build-up of sight deposits decreased, although the latter were still tending to be encouraged by improving economic conditions.

Quite sharp growth in shorter-term fixed deposits ...

In addition to overnight deposits, deposits with an agreed maturity of up to two years also rose quite sharply in 1999, although their rate of increase, at slightly more than 5½%, was slower than in 1998 (just over 8%). In contrast to overnight deposits, the growth in short-term time deposits was quite dynamic in the last quarter of 1999. This was probably connected with shifts away from overnight deposits owing to the rising remuneration of fixed-term deposits since October. Growth in deposits redeemable at up to three months' notice was only very moderate in the year under review, rising by € 7½ billion, or 1½%. In 1999, in contrast to previous years, there was hardly any demand for the higher-yielding special savings facilities.

... moderate growth in savings deposits

Scarcely any demand for longer-term bank deposits on the part of the general public

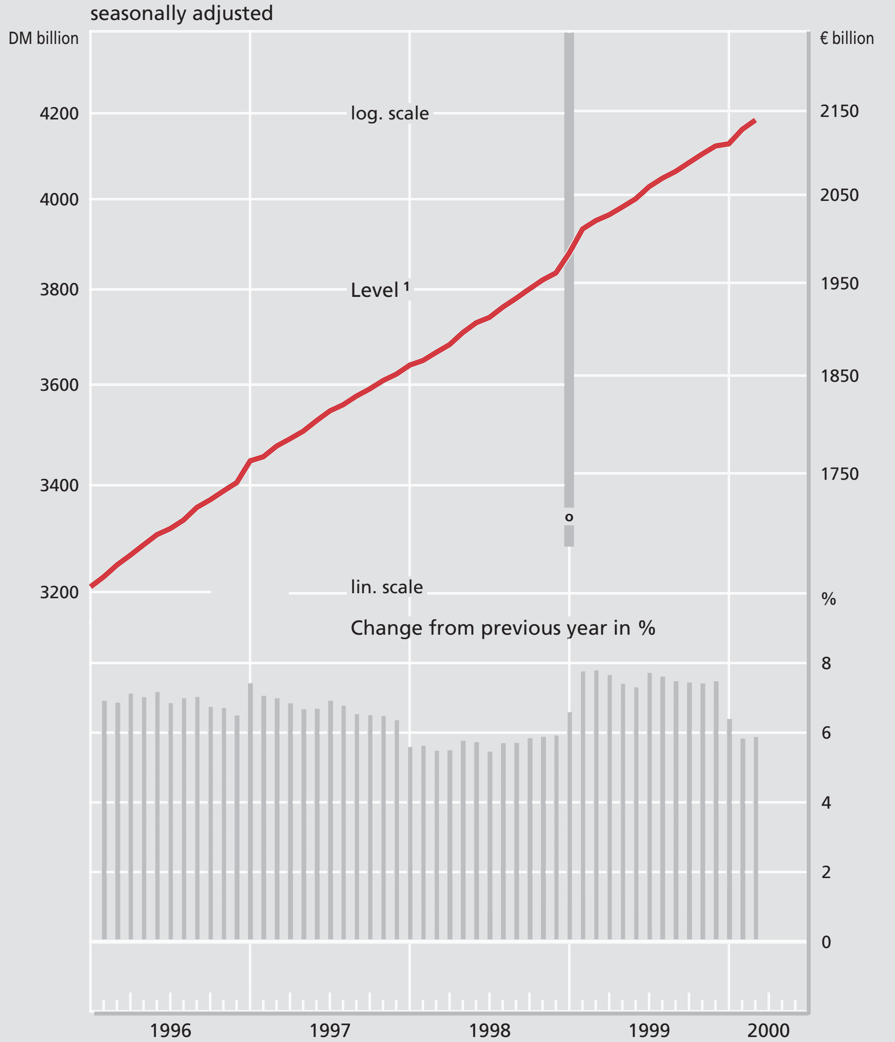
Deposits with an agreed maturity of over two years evidently benefited from the rise in longer-term interest rates over the course of the year. Whereas domestic non-banks increased their holdings of longer-term time deposits only slightly in the first half of 1999, they increased them much more sharply from the middle of the year onwards. With a growth of € 23½ billion, these deposits went up more sharply in 1999 as a whole than in the preceding year (€ 6 billion); on balance, however, it is solely insurance corporations that have chosen this form of investment. Deposits redeemable at notice over three months declined once again last year. At € 12½ billion, or 9½%, the reduction was, in fact, even greater than in the year before (€ 4½ billion, or just over 2%).

Quite sharp expansion of private sector borrowing in 1999, too

There was a further quite sharp expansion of lending to the domestic private sector in 1999. It rose by € 156½ billion, or just over 7%; compared with € 172½ billion, or 8½%, in 1998. Especially at the turn of 1998-9, lending to domestic enterprises and individuals was very buoyant owing to the expiry of special depreciation facilities for investment in eastern Germany. As the year progressed, however, things increasingly returned to normal. Loans increased by 6½% in 1999, and thus as sharply as in the year before. Demand was mainly for medium and long-term loans, which rose by € 122 billion, whereas loans with a maturity of up to one year were increased by only € 3½ billion. Long-term lending to the private sector was marked by customers' continuing preference for acquiring their own home as well as by a growing demand for loans on the part of industry, which benefited from the fact that interest rates continued to be quite low. In 1999, domestic credit institutions purchased German corpor-

Loans to enterprises and individuals in Germany

Chart 8



1 End of month; statistical changes eliminated. — **o** From 1999 in euro.

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ate securities to the amount of € 30½ billion, which was significantly less than in 1998 (€ 47 billion).

Only moderate rise in lending to the domestic public sector

In the reporting year, there was only a slight rise in domestic public sector borrowing from domestic MFIs. A slight increase of € 8½ billion in loans was accompanied by a reduction of € 6½ billion in securitised lending. Since the mid-nineties, the expansion of the domestic public sector's indebtedness to German MFIs has become progressively smaller. The share of securitised lending has remained largely unchanged.

(c) Developments in the banking sector

Lending operations by groups of banks with domestic non-banks

In lending operations with domestic non-banks, it was mainly banks with special functions, the regional institutions of credit cooperatives, and the mortgage banks which expanded their market share in 1999. At 15½%, 11½%, and 8%, respectively, they stepped up their loans much more sharply than banks as a whole (just over 5½%). The big banks' expansion of their domestic lending business was somewhat higher than average, at not quite 6½%; the savings banks were slightly below that figure, at 5%. As had already been the case in 1997 and 1998, the Land banks and the credit cooperatives (3½% each) as well as the regional and other credit banks (2%) recorded a comparatively subdued expansion of their lending business with non-banks in Germany.

Prospective earnings trend

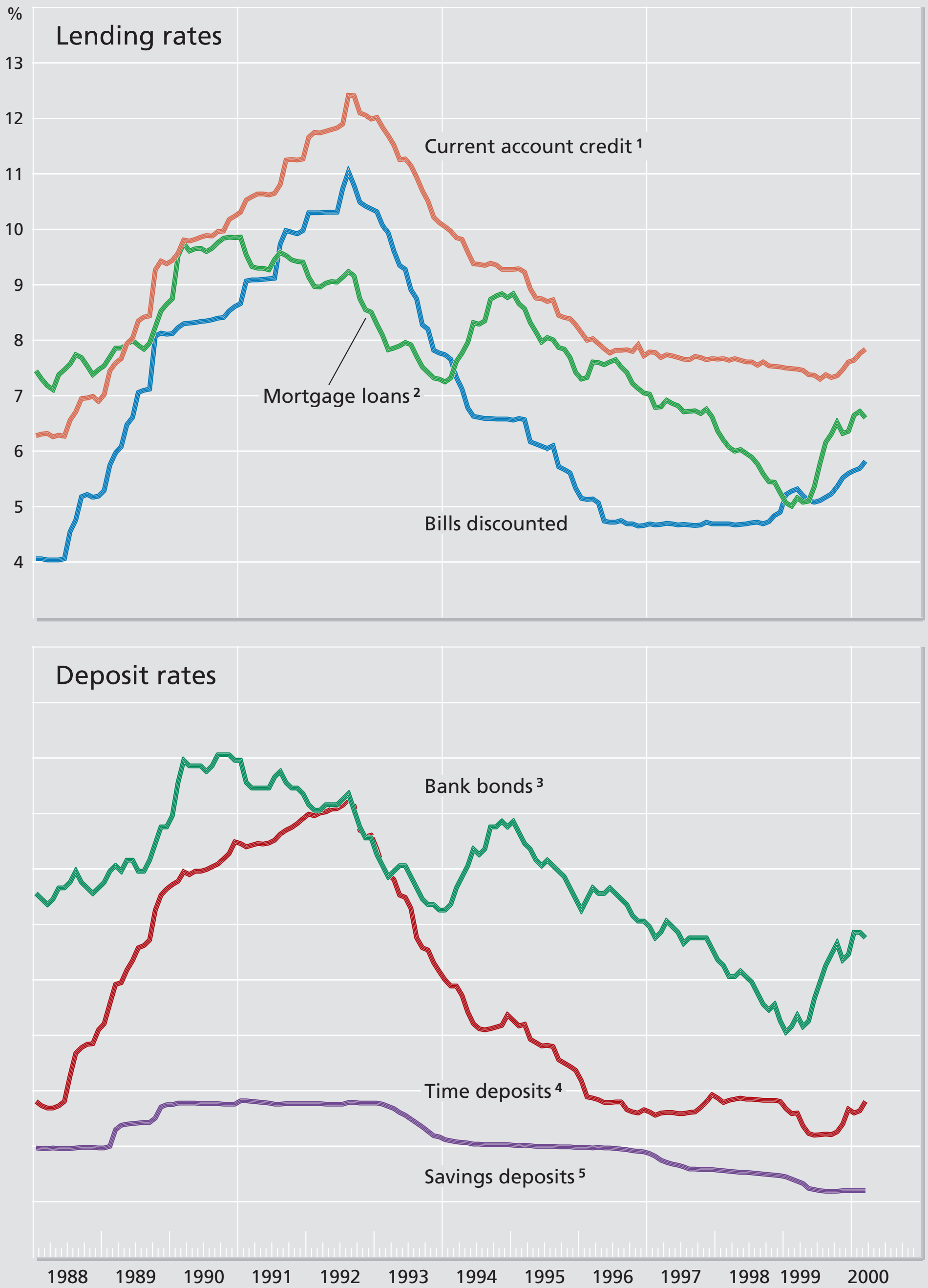
According to the information available at present, the earnings position of the banking industry in Germany is likely to have been satisfactory in 1999. The operating result after valuation may have been comparatively stable. The profit for the year, which had been bloated in 1998 (partly for accounting reasons) by special earnings from financial fixed assets, is likely to have picked up from where it had left off in the preceding years. In business on a commission basis, the banks mainly benefited from customers' increasing demand for investment in securities in the form of shares and investment fund certificates. The larger volume of credit means that net interest income is likely to have risen once again; given the continuing fierce competition in deposit business, however, the interest rate margin has probably continued its slide. In terms of the valuation of assets, the favourable developments in the German economy and in the situation of borrowers in South-East Asia mean that lower depreciation requirements can be expected for credits and assets; on the other hand, on account of falling prices in the case of fixed-interest bonds, significant write-downs of the market prices are to be anticipated. As in previous years, administrative costs are likely to have been characterised by comparatively high expenditure on investment in information technology. Additional factors included Y2K preparations and the further expansion of electronic banking services and marketing channels.

Share of domestic credits in the business volume

The institutions' lending to non-banks grew last year somewhat more slowly than the volume of business. The share of credits in the business volume went down from 59½% at the end of 1998 to 57½% at the end of 1999. At that juncture, credits to domestic non-banks still accounted for just 50% of the business volume, compared with not quite 60% at the end of 1994. Among the various groups of banks, the savings banks and the credit cooperatives were an

Movements in selected bank interest rates *

Chart 9



* Since January 1991 including the rates applying in the new Länder. — **1** Of DM 1 million and more but less than DM 5 million; movement in November-December 1996 influenced by the changeover to new interest rate statistics. — **2** Average effective rate for fixed-rate mortgage loans secured by residential real estate with interest locked in for ten years. — **3** Yield on bank bonds outstanding with a residual maturity of over nine but not more than ten years. — **4** Up to and including October 1996 with an agreed maturity of one month to three months inclusive, from November 1996 with a maturity of one month for amounts of DM 100,000 and more but less than DM 1 million. — **5** Until the end of June 1993 savings deposits at statutory notice, thereafter at three months' notice; earning minimum/basic interest.

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exception insofar as domestic credits largely continued to make up roughly two-thirds of their business volume. The slowdown in domestic banks' credit business is being accompanied by sharp growth in lending through foreign branches – in particular, to foreign non-banks. Between 1994 and 1999, they expanded their volume of lending by 230 %, whereas the domestic institutions recorded growth of no more than just under 50 % during the same period.

Ongoing structural change

In the 1999 financial year, the number of banks submitting reports for the balance sheet statistics went down by just under 250 to around 3,000 institutions; this decline almost exclusively affected the credit cooperatives. With the advancing integration of the European banking market, alliances are currently much to the fore. By contrast, cross-border mergers have so far tended to be the exception. Within the two major associations, there were further efforts to make better use of potential cost synergies by entering into domestic alliances and by combining back-office functions. At the same time, there has been a further expansion of electronic banking services, which are becoming increasingly important as a marketing channel. There were more than 6½ million on-line bank accounts in 1998, with a further rise taking place in 1999. Competition from direct banks has accelerated the setting-up of additional electronic payment facilities at the groups of institutions that operate primarily through branch networks.

III. Economic trend and economic policy in Germany

1. Return to growth

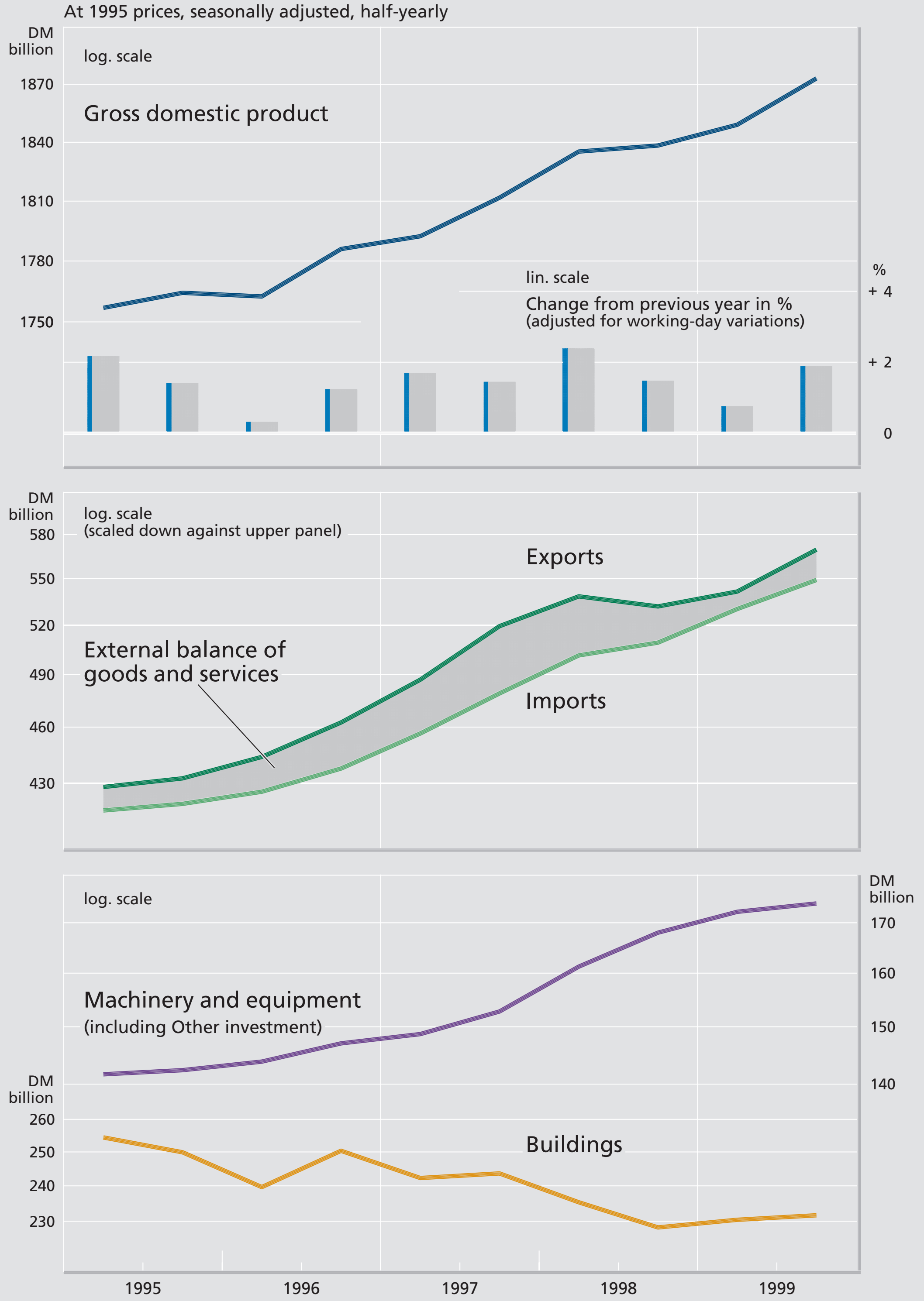
Light and shade

The year 1999 was a difficult one for German business on the whole. Little progress was made in reducing either the persistently high level of unemployment or the economic differences between eastern and western Germany. These structural burdens from the past were first compounded by cyclical problems which had already emerged during the second half of 1998 as a result of the downturn in the global economic trend at that time and which had an increasingly strong impact on the business climate in manufacturing. With the distinct change for the better in the general world economic climate, however, German business recovered from this setback fairly quickly, a fact which shows yet again how strongly the cyclical picture and the underlying macroeconomic trend are

Gross domestic product and
selected real expenditure components

Chart 10

At 1995 prices, seasonally adjusted, half-yearly



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influenced by foreign trade. In the spring of 1999 the signs of economic recovery became stronger, and the situation stabilised; after the middle of the year macroeconomic developments were visibly accelerating. The present economic cycle has since entered a new phase; the outlook has brightened discernibly.

Even so, the "dip" in growth is fairly significant when seen as an annual average. Germany was one of the economic stragglers within the euro area. If the different number of working days is taken into consideration, aggregate output rose by 1.4 % (in terms of calendar months + 1.5 %) in 1999 compared with 1.9 % (2.2 %) a year earlier. In that case the degree of capacity utilisation probably declined by ¼ to ½ percentage point in what was, incidentally, a period of weak potential growth. Although, in terms of the increase in the output gap, the cyclical downturn was therefore quite significant, it was still not excessive. An important reason for this was that domestic demand continued to rise even though on an annual average the upswing slackened here, too. Problems of the country's own making were partly to blame. For quite some time economic policy makers had failed to take a clear and convincing stance; it was not until later in the year that measures to foster growth were again given greater emphasis.

Generally speaking, wage agreements in 1999 exceeded growth in labour productivity in real terms and therefore – in contrast to what had happened in the previous two years – did not help to improve the employment situation. By contrast, the monetary policy makers in the euro area tried to preserve the high degree of stability that they had inherited and to maintain favourable monetary conditions. Despite strong inflationary stimuli from abroad, the underlying domestic price climate remained largely unaffected.

Shock-absorbing forces

The weakness in growth did not become entrenched, despite the vulnerability of the German economy to external influences, and, with hindsight, could be stemmed relatively quickly. This was certainly due primarily to the fact that the number of orders on hand was initially still high and that an increase in stockbuilding cushioned part of the export shock. Many enterprises also reacted fairly sensibly regarding their staffing policy. These enterprises benefited from the fact that in many case they no longer had fairly large staff surpluses and that labour cost pressures had eased significantly during the previous few years.

Fresh stimuli from abroad

The main reason, however, was that the retarding influences emanating from the global economy subsided faster than many had expected and made way for a rapid economic recovery, especially in the emerging markets of South-East

Key economic variables in Germany

Table 6

Change from previous year in %

Item	1996	1997	1998	1999
Growth (real) [1]				
Private consumption	+ 0.8	+ 0.7	+ 2.3	+ 2.1
Government consumption	+ 2.1	– 1.1	+ 0.5	+ 0.2
Expenditure on machinery and equipment	+ 1.2	+ 3.4	+ 9.2	+ 5.1
Buildings	– 2.9	– 1.4	– 3.9	+ 0.0
Other investment	+ 8.9	+ 5.9	+ 15.1	+ 9.4
Stockbuilding				
Change (in DM billion)	– 13.1	+ 13.8	+ 25.9	+ 16.5
Domestic demand	+ 0.3	+ 0.7	+ 2.5	+ 2.2
External balance of goods and services [2]				
Change (in DM billion)	+ 17.7	+ 27.1	– 9.2	– 26.8
Exports	+ 5.1	+ 10.9	+ 7.0	+ 4.2
Imports	+ 3.2	+ 8.3	+ 8.5	+ 7.1
Gross domestic product	+ 0.8	+ 1.5	+ 2.2	+ 1.5
Contribution to GDP growth in percentage points				
Domestic demand (excluding stocks)	+ 0.6	+ 0.3	+ 1.7	+ 1.7
Stockbuilding	– 0.4	+ 0.4	+ 0.7	+ 0.4
External balance of goods and services	+ 0.5	+ 0.8	– 0.3	– 0.7
Employment				
Employed [3]	– 0.7	– 0.8	+ 0.4	+ 0.3
Average working time per employed person	– 0.8	+ 0.0	+ 0.5	+ 0.2
Total number of hours worked	– 1.5	– 0.7	+ 0.9	+ 0.5
Unemployed (in thousands)	3,965	4,384	4,279	4,099
Western Germany	2,796	3,021	2,904	2,756
Eastern Germany	1,169	1,364	1,375	1,344
do. as % of the total economically active population	10.4	11.4	11.1	10.5
Western Germany	9.1	9.8	9.4	8.8
Eastern Germany	15.7	18.1	18.2	17.6
Prices				
Consumer price index	+ 1.4	+ 1.9	+ 1.0	+ 0.6
Producer prices of industrial products [4]	– 1.2	+ 1.1	– 0.4	– 1.0
Overall construction price level	– 0.2	– 0.8	– 0.2	– 0.3
Import prices	+ 0.4	+ 3.6	– 3.2	– 0.5
Export prices	+ 0.0	+ 1.5	– 0.1	– 0.5
Terms of trade	– 0.4	– 2.0	+ 3.2	+ 0.0
GDP deflator	+ 1.0	+ 0.8	+ 1.0	+ 1.0
Productivity and labour costs				
GDP per hour worked by employed persons [1]	+ 2.3	+ 2.2	+ 1.3	+ 1.0
Compensation per hour worked by employees [3]	+ 3.2	+ 1.6	+ 0.9	+ 1.6
Labour costs per unit of value added in real terms in the economy as a whole [5]	+ 0.9	– 0.6	– 0.4	+ 0.6

Sources: Federal Statistical Office; Federal Labour Office. — **1** At 1995 prices. — **2** Balance of transactions in goods and services with the rest of the world. — **3** Work-place concept. — **4** Domestic sales. — **5** Gross compensation generated in Germany per hour worked by employees divided by real GDP per hour worked by employed persons. – The data from the national accounts and the figures on employed persons are provisional.

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Asia. In addition, the United States retained its role as the global "economic engine". After a lengthy downswing initial signs of a return to stabilisation began to emerge in Japan. Recessionary pressures did not last long in Latin America; the recovery of the international commodity markets provided a major counterweight here. The depreciation of the euro also boosted foreign demand. The high degree of price stability achieved, further rationalisation efforts and substantial investment probably also increased the attractiveness and price competitiveness of German products significantly. These trends were further encouraged by the strengthening of the international economy and the improvement in the economic situation in major partner countries. Orders from abroad, which preceded the actual export of goods and services by the usual time lag in the course of the year, had been showing a marked upward trend since the spring of 1999. However, this is inadequately reflected by the plus of just over 4 % in the annual result, which was due to the comparatively low starting level at the beginning of 1999.

Domestic economy: strengths and weaknesses

Domestic economic forces initially withstood the global economic turbulence but were unable to escape fully the resultant second-round and third-market effects. Consequently, domestic demand lost some momentum; it rose by approximately 2 % on an annual average in 1999 compared with 2 ½ % in the previous year.

Even so, the propensity to invest proved to be relatively robust although after a buoyant start at the beginning of 1999 investment in machinery and equipment[1] lost momentum. At constant prices, this investment exceeded the 1998 level by 5 ½ % on an annual average. The investment climate was adversely affected not only by the temporary uncertainty created by economic policy makers but probably also by impaired profitability. The profits of the (non-financial) corporations as defined by the new ESA 95 fell by almost 6 % in 1999 compared with 1998, which, admittedly, was a year in which profitability was high. For the first time in two years unit labour costs rose, and real interest rates also increased somewhat, albeit from a decidedly low level. It is also likely that the tightening of provisions governing the determination of profit placed a greater tax burden on corporate profits. A wait-and-see attitude with respect to undertaking new investment projects also seemed reasonable in view of the existing production capacity. According to the surveys conducted by the ifo institute, capacity utilisation in the manufacturing sector, which did not revive appreciably

1 Here, as in the following item, including "Other investment", which mainly encompasses expenditure on computer software.

until the second half of the year, was, on average, about 1 percentage point lower in 1999 than in 1998; admittedly, it had reached a peak at that time.

Decline in construction investment stopped

In 1999 the macroeconomic development in Germany benefited from the fact that the retarding effects of the construction sector were much less pronounced than in the previous few years. After four consecutive years of decline, amounting to almost one-tenth of output, the pressure to adjust in the construction industry eased last year. However, the situation remained precarious, especially as a result of the renewed weakness in housebuilding in the second half of 1999.

Excess capacity in industrial construction was probably less pronounced. The extension of the telecommunications network and the private sector transportation infrastructure projects also stimulated demand, especially for civil engineering work. All in all, investment in industrial construction, which had been declining sharply for quite some time, maintained its 1998 level.

It is possible that public sector construction also stabilised. Following years of budget cutbacks, a level had been reached in many cases where further retrenchment would have entailed erosion of the infrastructure. Furthermore, the improved financial situation of numerous west German local authorities evidently restored greater scope for investment, which offset corresponding cutbacks in the case of east German local authorities. Consequently, public sector customers invested about 1% more in real terms in new buildings than a year earlier.

The weight of the detrimental factors affecting investment on residential buildings was still very considerable. Besides, appreciable differences remained between eastern and western Germany. For example, the number of newly built dwellings in eastern Germany fell by almost one-quarter in 1999 and by almost one-half in the case of blocks of flats alone. The reason was the large stock of unoccupied dwellings and a correction for an expected return on investment which was often too optimistic – sometimes also as a result of tax policy. In western Germany, by contrast, the number of new completions was somewhat higher than in 1998 because in the west of the country private housebuilding for owner-occupation provided a counterweight. As a result of the expected reduction in tax incentives for owner-occupied dwellings from the year 2000, mortgage interest rates that were still comparatively low, stable building prices and the emerging prospect of higher incomes, about 185,000 housing units were completed in the west in 1999, which was approximately 11% more than in the previous year. This compensated for the significant downturn in the building of multi-storey blocks in both parts of the country that resulted partly from the reduced incentives for social welfare housing.

Stable trend in private consumption ...

As in the previous year, expenditure on private consumption in 1999 provided an important stimulus to economic growth. There was still considerable demand for private cars, but classical retail outlets (other than car showrooms and petrol stations) also benefited from the increased demand for consumer goods even if the (real) growth in turnover, according to the retail statistics, was only about 1%. Sales were depressed by the lower demand for household furniture and appliances, in particular. By contrast, budgets for trips abroad increased substantially. If price increases are eliminated, overall private consumer expenditure rose by 2 %.

... despite reduced income growth

The fairly stable level of consumption is also remarkable given the comparatively modest rise in incomes. For example, in 1999 net wages and salaries increased by no more than just under 2 % despite the reduced contribution rates to the social security scheme. This was the same increase as in 1998 although in that year growth in productivity was lower. However, individuals received considerably larger payments from public cash offices and private social security systems than a year earlier (+ 3 ½ %). The increase in child benefit at the beginning of 1999 had the greatest impact. Mass income, which comprises net wages and salaries and all social security transfers, rose by 2 ½ % overall. As other income, which includes self-employed persons' income and property income, increased by a lesser net amount, at 2 %, total net disposable income[1] grew nominally by just over 2 %. Although the general rate of inflation played only a minor role in 1999, improvements in income were insufficient to finance additional consumption with the result that last year, too, households restricted their asset acquisition. The saving ratio averaged 9 ½ % of disposable income in 1999, which means that it was ½ percentage point lower than in the year before. Thus, the downturn in private saving propensity continued; the difference between the high level at the beginning of the nineties and the level last year amounted to just over 3 ½ percentage points.

1999 wage round

In the 1999 wage round, management and labour departed from the basic principle of moderate wage increases pursued during the previous three years and agreed appreciably more generous pay settlements. The settlement in the metal-working and electrical engineering industry, which represented a rise in agreed pay rates of 3.2 % from March 1, 1999, set a precedent for all other

1 Here and later in the paragraph, including the increase in company pension rights.

wage agreements. Including the lump sum for the first two months of 1999 and the one-off payment amounting to 1% of the basic annual negotiated remuneration, the extent of this settlement, given the agreed validity of 14 months, amounted to 4.3%, or 3.6% on a 12-month basis. Following the metal industry agreement, almost all of the major wage-bargaining sectors such as the public sector, retailing and the chemical industry obtained increases of approximately 3% in their negotiated monthly wage rates in the course of last year. The crisis-ridden construction sector was the only one which deviated from this "norm". While here, too, negotiated monthly rates were improved by almost 3% in western Germany, the volume of last year's agreement in the west German construction sector amounted to only 1.6% owing to the substantial reduction in the Christmas bonus. A one-year "wage pause" was actually agreed in the east German construction sector.

Wage drift

In 1999 the aggregate monthly negotiated wage and salary level rose by just over 2½% on an annual average. Consequently, the pay agreements were distinctly in excess of the wage increases that would have had a neutral effect on employment. The intended reduction in statutory non-wage labour costs was undermined. Another factor was that no further progress was made with respect to structural improvements, greater flexibility in the economic sectors and an increased number of possibilities to pay wages below negotiated levels at the lower end of the pay scale. In view of the persistently high competitive pressures, enterprises increased their efforts to keep costs down. After all, at just under 2%, the increase in actual earnings, that is to say, the increase in the wage or salary actually paid per employee, remained about ¾ percentage point below the rise in negotiated earnings. It is true that more than just a few employees probably gave up their "second job" as a result of the changes in the statutory regulations governing the conditions of part-time workers below a certain earnings level and that this, in purely mathematical terms, had a negative effect on average earnings. Nevertheless, most of the negative wage drift was probably due to the increased efforts of enterprises to cut back on payments above agreed pay scales, on the one hand, and, on the other, to make greater use of the more flexible arrangements established in earlier wage agreements, especially with regard to annual working time accounts. Another important factor may have been that more and more enterprises have stopped recognising industry-wide wage bargaining.

One of the trade unions' main arguments when deciding on their demands for last year's wage round was that more generous pay settlements would increase

Increase in mass purchasing power?

mass purchasing power and thereby boost the domestic economic from the consumer side. A glance at income trends in 1999 shows, however, that this strategy was unsuccessful. Although in 1999 the increase in agreed earnings throughout the economy was ¾ percentage point higher than in 1998, the distinctly negative wage drift and the greater net intervention of the government in the form of larger levies meant that the relative rise in net wages and salaries per employee last year was no greater than in 1998. Furthermore, the number of those employed declined until the autumn of 1999, partly as a result of the large wage agreements. As no more than just over two-fifths of the disposable income of households is now earned through dependent employment, the purchasing power argument has become less convincing anyway. Instead, improving the chances of the unemployed on the primary labour market and generally strengthening expansionary forces are more promising. At the same time that could make room for the reduction in the burden of levies on the income from employment, which is too large not only by international standards.

Little progress in the labour market

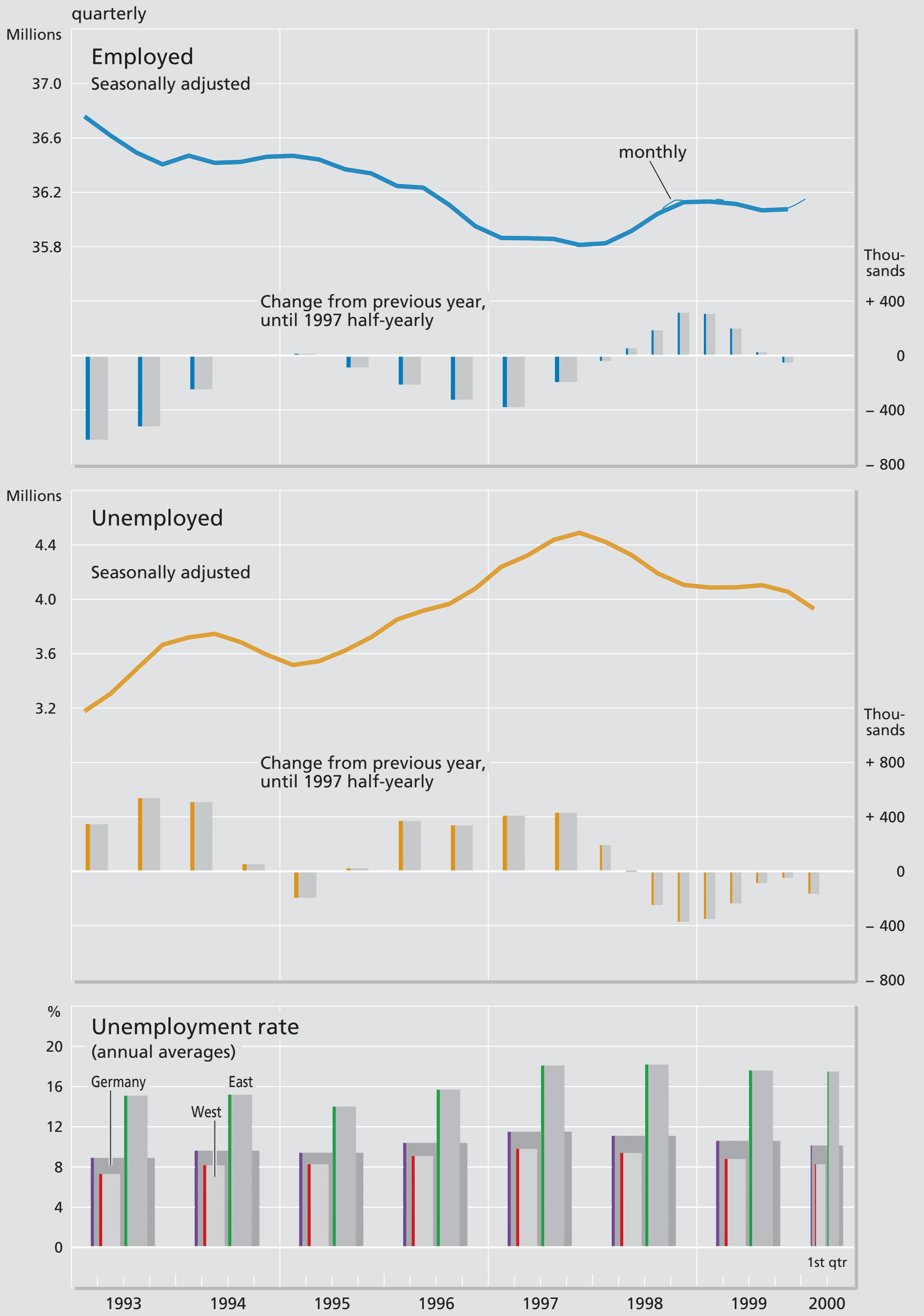
The recovery in the labour market, which had set in during 1998, faltered for a time in 1999 as a result of the dip in overall economic growth. It was not until the autumn that a slight increase in the numbers employed could be recorded in seasonally adjusted terms. At the end of the year there were 36.1 million persons in work with the result that the level of December 1998 had been more or less regained. However, the fact that there was an increase of almost 120,000 in the number of persons employed on an annual average in 1999 was due solely to the favourable developments in 1998. The rise in employment was reflected in a fall in the number of unemployed. The decline was comparatively large because the labour supply had fallen at the same time. According to data provided by the Federal Labour Office, there were 150,000 fewer persons out of work at the end of 1999 than at the end of 1998. In December the seasonally adjusted unemployment rate was ½ percentage point lower, at 10.2 %, than a year earlier; it has to be remembered, however, that a more complete recording of the persons in low-paid part-time employment had been lowering the unemployment rate by just under ⅕ percentage point since May 1999. Despite the high unemployment rate, however, enterprises are increasingly complaining about a shortage of suitable workers in some segments of the labour market.

Demographical factors

According to the labour force figure as shown in the national accounts, the (actual) labour supply declined by 30,000 in 1999. This trend will continue in the current year. It is essentially due to the retirement of persons born in years in which there was a relatively high birth rate. Furthermore, the influx of job-

Labour market

Chart 11



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Demographic trends and the labour market in Germany — Table 7

Item	1995	1996	1997	1998	1999 2
	in thousands				
Resident population					
Total	81,661	81,896	82,053	82,030	82,110
Between 15 and 64 years of age	55,763	55,895	55,998	55,980	55,953
Labour force	39,574	39,597	39,711	39,640	39,610
Employed persons	36,376	36,099	35,804	35,930	36,047
Unemployed persons 1	3,198	3,498	3,907	3,710	3,563
	Change from the previous year in thousands				
Resident population					
Total	239	235	157	– 23	80
Between 15 and 64 years of age	87	132	103	– 18	– 27
Labour force	– 182	23	114	– 71	– 30
Employed persons	– 65	– 277	– 295	126	117
Unemployed persons 1	– 117	300	409	– 197	– 147

Source: Federal Statistical Office. — **1** As defined by the national accounts. — **2** Partly estimated by the Bundesbank.

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seekers from abroad has almost dried up. This means that the unemployment rate may fall, given the number of available jobs in the short term. There is also another reason for a likely fall in the unemployment rate, namely that the percentage of 55 to 59-year-old persons in the working population is showing a temporary decline. Given the current conditions on the German labour market and the incentive structure of the German social security system, this group of persons is disproportionately unemployment-prone.

Growing gap between western and eastern Germany

The gap between the west German and east German labour markets increased further last year. At the end of 1999 2.6 million persons were unemployed, in seasonally adjusted terms, in western Germany; that was 200,000 fewer than 12 months earlier. The unemployment rate in December fell below 8.5 % for the first time since the autumn of 1995. In eastern Germany, by contrast, the number of unemployed at the end of the year exceeded the corresponding figure for 1998 by 45,000. At 17 ½ %, the unemployment rate in eastern Germany was more than twice as high as in western Germany. Another point is that active labour market policies played a much more important role in eastern Germany than in western Germany. The available indicators suggest that the employment trend is tending to fall further in eastern Germany. Although the numbers employed in east German industry rose again last year, these were partly offset by larger redundancies in construction and in public administration.

Pattern of unemployment

Little changed in the pattern of unemployment during 1999. As was the case 12 months earlier, in December somewhat less than one-half of the unemployed were women; approximately 10 % of those concerned were under 25 years of age while those aged 55 and above accounted for more than 20 % of the total. One-third of all concerned had been without regular work for more than 12 months. The estimated average length of time during which workers are unemployed declined only very slightly and continued to amount to just under seven months last year.

New emphasis in the case of active labour market policies

With the changeover from the Work Promotion Act to Social Security Code III at the beginning of 1998 the aim of the active labour market policies was altered to promote regular employment. Responsibility was decentralised further at the same time. Accordingly, the classical tools used by the active labour market policy makers, such as job creation measures and structural adjustment measures, have now lost some significance. The same is true of further education. The structural adjustment measures reserved for enterprises in eastern Germany received reduced funds last year. In the course of 1999 there was a decline of 190,000 in the total number of persons participating in these programmes. By contrast, 92,000 persons were receiving reintegration grants, for example, at the end of 1999 – which was 30 % more than a year earlier – while 61,000 took part in various measures which are now at the discretion of individual labour exchanges. In 1999 there were almost 90,000 participants in the special programme introduced by the Federal Government to reduce youth unemployment.

Marginal price rise

The overall price trend was favourable in 1999. At 0.6 % on an annual average, the increase in consumer prices, which is usually seen as a gauge of current inflation, was clearly within the range of an annual inflation rate of under 2 % set by the ECB Governing Council as its definition of price stability. In the course of the year, however, prices clearly came under the influence of external disturbances, which in the first few months of 1999 ended the period of an almost stable price level. At that time the year-on-year price increase had fallen to approximately ¼ %. This was due to sharply lower prices as a result of the deregulation of the telecommunications markets. The previous oil price reductions were still having an effect as well. Moreover, the Federal Government again reduced the prescription charges for medicines. Health-care services likewise became cheaper.

Sharp rise in energy prices in course of year

At the start of the spring, however, the first stage of the ecological tax reform introducing, or increasing, energy taxes on electricity, natural gas and mineral oil products came into force. At approximately the same time there was an about-turn in the price trend on the international oil markets, and the roughly two-year period of price reductions came to an end. As a result of production limits and greater cartel discipline within the OPEC countries as well as a cyclical upturn in demand, oil prices soon made up all of their previous decline; at approximately US $ 32 per barrel, the spot market price for North Sea Brent crude reached a new peak in March 2000, which was three times higher than the lowest price at the end of 1998 and the beginning of 1999. Another factor affecting German importers was that the US dollar had become markedly stronger against the euro; at the end of 1999 the resultant price rise amounted to approximately 15 %. This steep price rise had an almost immediate effect on import prices for energy; in December it amounted to over 100 % compared with the same time a year earlier. Prices for mineral oil products also rose sharply at the consumer level; following the further increases in energy tax at the beginning of the year 2000, the prices of heating oil and petrol exceeded the levels 12 months earlier by approximately 30 %. If mineral oil products are excluded, the price rise amounted to only 0.3 %. One factor that helped to check the rising price trend was the deregulation of the power markets.

Slight move in prices of manufactured goods

It was important in this connection that the rise in consumer prices for manufactured goods remained within bounds. This can be seen not least in the fact that in the case of these goods the year-on-year rate had fallen from ¾ % in January to – ¼ % by the end of 1999. There were some significant price reductions, especially for computers, radios and televisions; household appliances also became cheaper. Consequently, consumer prices followed the trends set for these goods at the industrial producer level and in imports. Furniture and fixtures, motor vehicles as well as clothing and shoes were subject to marginal price increases, most of which were not more than 1% and in some cases were actually much less than that. As in earlier years, only books, newspapers and magazines became disproportionately more expensive.

Food

Food became decidedly cheaper in 1999. Prices at the consumer level fell by just over 1% on an annual average. Firstly, fierce competition broke out among major supermarket chains. Secondly, an ample supply in the case of some products resulted in price reductions at the producer level. In the case of imported agricultural products, too, substantial price reductions were recorded over much of the year.

Domestic prices

Chart 12

Change from previous year in %, quarterly

1 Calculated by the Bundesbank.

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Effects of deregulation in the services sector

The services sector was marked by distinct price reductions in telecommunications last year. As a result of deregulation, which brought an end to the post monopoly and the market entrance of additional suppliers, the rates for individual telephone calls were reduced dramatically. According to calculations by the Federal Statistical Office, the cost of telephone services as a whole fell by just over one-tenth. This in conjunction with health-care services, which likewise became cheaper, largely compensated for the increase in the prices of some other services such as education and insurance. Thus, on an annual average, services as a whole cost only approximately ¼ % more in 1999 than a year earlier.

Rise in rents curbed

The increase in rents (of slightly more than 1% on average) weakened only marginally in 1999. Nevertheless, historically, such minor rent adjustments are decidedly rare. This suggests that on the whole the supply of and demand for residential accommodation is closer to equilibrium than in previous years. Presumably the substantial amount of construction at the beginning of the nineties had something to do with it. Construction work is currently being stimulated not only by the low interest rates but also by the fact that construction prices have been more or less unchanged for some time.

2. German exports given renewed impetus

Exports brisk

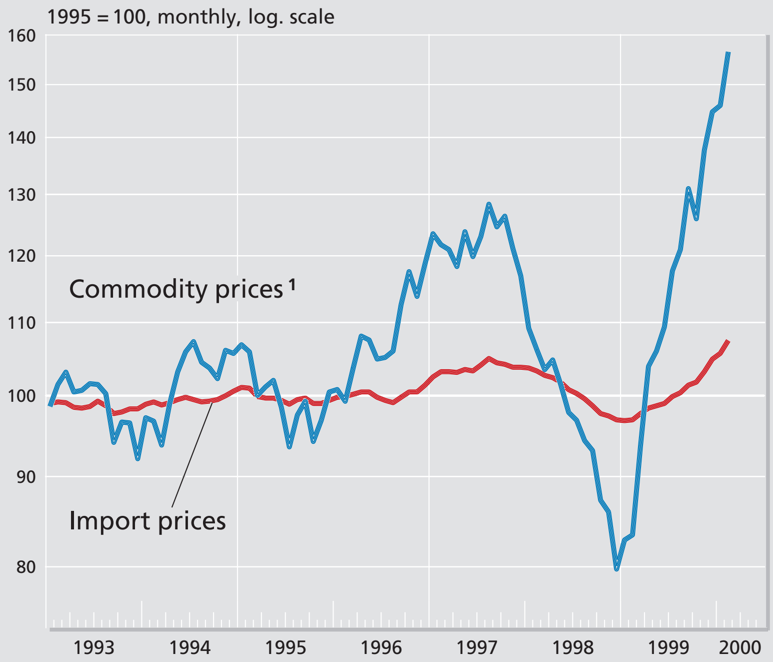
Following the slump in export business in the second half of 1998, German exports enjoyed a distinct revival in the course of 1999. Although the annual value of exported goods exceeded the previous year's level by no more than just under 4 %, the underlying growth dynamic can be seen more clearly if the final quarter of 1999 is compared with the corresponding period in 1998; calculated on these terms, German exports rose by 10 % in the course of last year. The (real) export volume likewise increased sharply in the course of the year (+ 8 ½ %).

Changed pattern of export growth

The initial stimuli that revived exports came primarily from non-euro-area countries – notably those in the former crisis regions following the stabilisation of the local circumstances. German exporters also recorded a distinctly sharp rise in sales in the United States. The substantial absorption capacity of the US market and the favourable price competitiveness from the German point of view following the depreciation of the euro against the US dollar played major roles in this. Later in the year, however, the pattern of German export growth shifted in favour of the country's European sales markets. Consequently, the recovery in European partner countries, which set in earlier and was more advanced than

International commodity and import prices

Chart 13



1 HWWA index of commodity prices, Deutsche Mark basis.

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the recovery in Germany, also had an impact on German business. After all, demand from the other euro-area partner countries accounts for more than 40 % of German exports.

Importance of exchange rate influences

Exchange-rate-related competitive advantages arising from the depreciation of the euro certainly contributed to the export success of German industry. Even so, the renewed strength of the growth rate in the various export markets played a more important role. It is consistent with this picture that German exports to Japan, whose economic growth was checked by the weakness in domestic demand, eased during the year despite the sharp depreciation of the euro against the yen whereas German exports to the growth regions increased steeply. Owing to the interrelationships described, there is equally no need to fear any immediate deterioration in Germany's export business when, as is widely expected, the euro firms in future. The decisive factor now and in the longer term is that German business retains its competitiveness through cost discipline at home and is imaginative in following the shifts in demand on the world markets.

Weaker growth in imports

German imports grew more slowly than exports. Their volume rose by only 3 ½ % compared with the previous year. Firstly, large stocks which had been built up in 1998 as a result of the sharp reductions in the prices of petroleum and other raw materials tended to reduce the real need for imports. Secondly, the somewhat hesitant revival in domestic demand probably also curbed the trend. By contrast, nominal imports (on an f.o.b. basis) had been rising much faster owing to the sharp price increases of imported raw materials and energy since the spring of 1999 and the exchange-rate-related price increases during the year. The 5½ % annual growth rate, however, does not fully reflect the underlying momentum. A more accurate picture is obtained from a comparison of the final quarter of 1999 with the corresponding quarter of 1998. According to that, imports rose by 12 % in the course of 1999. Most of the increase was due to the simultaneous rise in prices. German oil imports alone became 165 % more expensive in the course of last year.

Export surplus slightly down

Despite the more buoyant export business, the rise in import prices was the main reason why Germany's foreign trade surplus did not rise further in 1999. In terms of value, the total trade surplus last year amounted to € 67 billion (on an f.o.b./f.o.b. basis, i.e. excluding the cost of freight and insurance, which is shown under services); the surplus was therefore € 4½ billion less than in 1998.

Larger deficit on current account

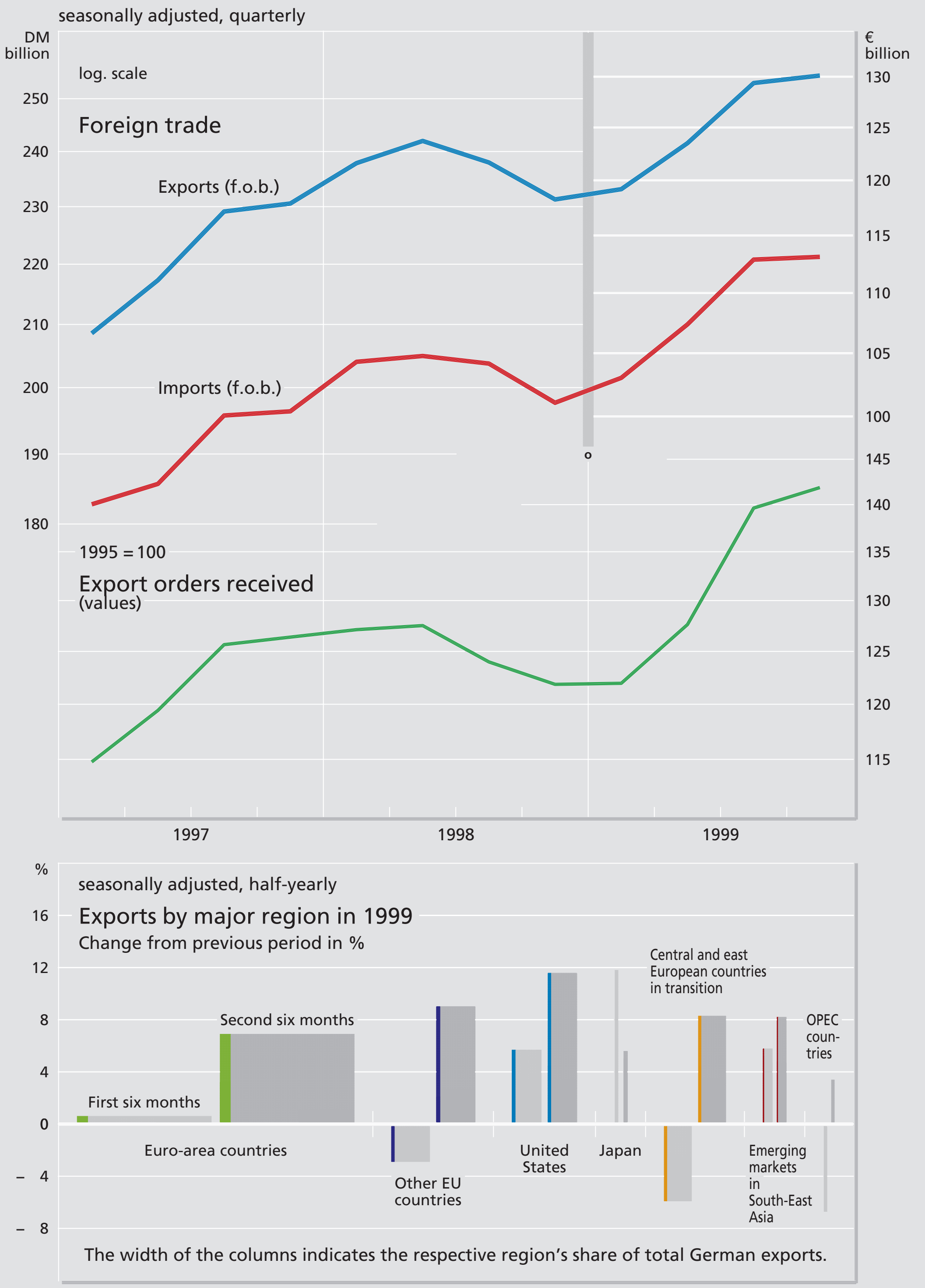
In 1999 the aggregate current account actually ran a distinctly larger deficit than in the previous year, partly because of larger deficits on the invisible current transactions with non-residents. The deficits on invisibles rose to € 86½ billion last year compared with the equivalent of just under € 76 billion in 1998 with the result that the total current account deficit increased to € 19½ billion. Germany had greater net expenditure than in the previous year, especially in the case of services and investment income. For example, the deficit on the services account (including the cost of freight and insurance for imports) rose by € 6½ billion to € 49 billion while the net investment income paid to non-residents rose by € 6 billion to € 11 billion. By contrast, the deficit on current transfers declined by € 1½ billion to € 25½ billion, essentially as a result of small contributions by Germany to the EU budget.

Trends in financial transactions following entry into monetary union

German financial transactions with non-residents in 1999 were influenced above all by portfolio shifts and reorientation moves on the part of resident and non-resident investors alike following the introduction of the euro. German institutional investors took advantage of the greater opportunities within the single currency area brought about by the introduction of the euro, especially at the beginning of the year. Later, these developments were increasingly overtaken by adjustments to take account of changed interest rate and exchange

Trend in foreign trade

Chart 14



o From 1999 data in euro.

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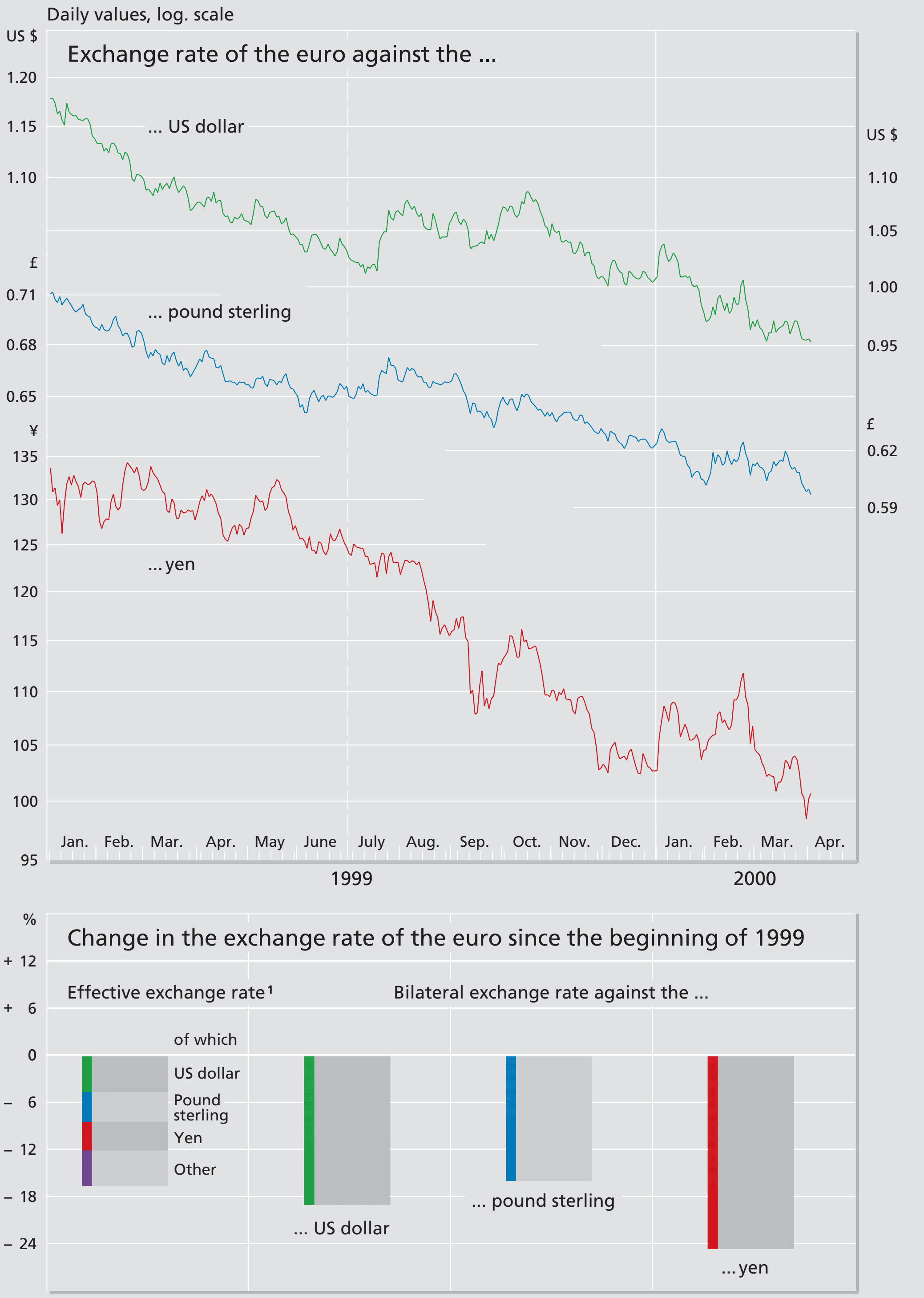
Exchange rate of the euro

Chart 15



1 According to calculations by the ECB based on the weighted averages of the euro exchange rates against the currencies of 13 countries.

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rate assessments and by a global increase in liquidity preference. As a result of the interplay of these factors, turnover in cross-border portfolio transactions reached new peaks. At the same time, several large corporate mergers also inflated the direct investment flows substantially.

Lively interest in foreign bonds and notes and in equities

Once exchange rate risks had disappeared within the euro area, German investors, in particular, geared their security portfolios to a greater extent to the enlarged currency area. This resulted in large outflows of funds from the German securities markets, especially at the beginning of 1999, although, subsequently, these outflows were partly offset by non-residents' increased buying of securities on the German market. The upshot was a net export of only € 12 billion through security transactions in 1999. German investors, on the other hand, added foreign securities worth € 176½ billion to their portfolios; this was 39 % more than the previous record of 1998. Foreign bonds and notes (€ 93 billion) accounted for more than one-half of this. German investors particularly favoured bonds issued in other euro-area countries and now uniformly denominated in euro. This paper offered better yields than comparable (German) Federal securities and, as a result, evidently attracted greater attention when portfolios were being reviewed in connection with the introduction of monetary union. German residents' investment in foreign equities (€ 66½ billion) and investment fund certificates (€ 14 billion) likewise increased sharply. One possible reason for this was that the economic outlook for other countries was assessed more favourably than for Germany during much of the year.

Heavy demand for German money market paper

Foreign investors built up their holdings of German securities by € 164½ billion. Given the relatively heavy foreign investment in the German capital market in previous years, this result is far less striking than the extensive purchases of foreign securities by German investors. Compared with 1998, however, the rise in the influx of foreign funds amounted to just over one-quarter. Another point worthy of note was the shift in the pattern of investment towards the shorter end of the market, and this was reflected right up until the end of the year in a particularly lively interest in German money market paper (€ 46½ billion). Concern about possible liquidity shortages in connection with the year 2000 problem and increasing interest rate risks arguably helped to direct a greater amount of funds into the short end of the investment spectrum in 1999.

Foreign investment in German bond market declines

Although non-residents' purchases of German bonds and notes significantly exceeded this sum (€ 84½ billion), they declined in relative terms. This is particularly true of Federal bonds, whose share of foreign security portfolios had al-

Balance of payments

Table 8

€ billion

Item	1996	1997	1998	1999
I. Current account	– 6.1	– 2.5	– 4.1	– 19.6
1. Foreign trade	+ 54.4	+ 64.0	+ 71.7	+ 67.2
Exports (f.o.b.) [1]	402.2	452.9	487.6	506.5
Imports (f.o.b.) [1]	347.8	389.0	416.0	439.3
2. Services	– 35.0	– 38.2	– 42.6	– 49.1
of which				
Foreign travel	– 27.1	– 27.7	– 28.9	– 29,8
3. Factor income	+ 0.7	– 1.3	– 5.9	– 11.9
of which				
Investment income	+ 1.6	– 0.4	– 5.1	– 11.1
4. Current transfers	– 26.2	– 27.0	– 27.3	– 25.7
of which				
Net contributions to the EU budget [2]	– 13.9	– 14.3	– 15.1	– 13.3
Other official current transfers to non-residents (net)	– 4.1	– 4.5	– 3.9	– 3.8
II. Capital transfers	– 1.7	+ 0.0	+ 0.7	– 0.1
III. Financial account (net capital exports: –)	+ 12.1	– 0.6	+ 8.8	– 20.6
1. Direct investment	– 34.0	– 26.3	– 62.9	– 43.6
German investment abroad	– 39.1	– 36.1	– 82.0	– 92.9
Foreign investment in Germany	+ 5.1	+ 9.8	+ 19.1	+ 49.2
2. Portfolio investment	+ 48.6	+ 0.8	+ 3.4	– 11.9
German investment abroad	– 23.7	– 79.8	– 126.9	– 176.3
of which: Shares	– 11.2	– 34.0	– 58.1	– 66.7
Bonds and notes	– 10.7	– 41.9	– 56.0	– 92.8
Foreign investment in Germany	+ 72.3	+ 80.6	+ 130.3	+ 164.4
of which: Shares	+ 11.3	+ 13.9	+ 51.6	+ 27.5
Bonds and notes	+ 52.2	+ 62.6	+ 74.0	+ 84.6
3. Financial derivatives	– 4.5	– 7.9	– 6.0	+ 1.9
4. Credit transactions	+ 4.0	+ 35.3	+ 78.6	+ 34.3
Credit institutions	– 2.6	+ 33.0	+ 73.6	+ 50.3
of which: short-term	– 14.4	+ 34.7	+ 73.7	+ 58.7
Enterprises and individuals	+ 4.8	+ 11.1	+ 5.4	+ 37.1
of which: short-term	+ 5.4	+ 12.0	– 0.9	+ 37.5
General government	+ 2.5	– 8.7	– 2.1	– 3.5
of which: short-term	+ 2.1	– 3.4	+ 3.1	+ 5.2
Bundesbank	– 0.6	– 0.1	+ 1.8	– 49.5
5. Other investment	– 2.0	– 2.6	– 4.2	– 1.2
IV. Change in the monetary reserves at transaction values (increase: –) [3]	+ 1.0	+ 3.4	– 3.6	+ 12.5
V. Balance of unclassifiable transactions	– 5.2	– 0.3	– 1.7	+ 27.8

1 Special trade, according to the official foreign trade statistics, including supplementary trade items; imports excluding freight and sea transport insurance costs, which are included under services. — **2** Excluding collection expenses, EAGGF (Guidance Fund) and Regional Fund. — **3** Excluding SDR allocation and changes due to valuation adjustments.

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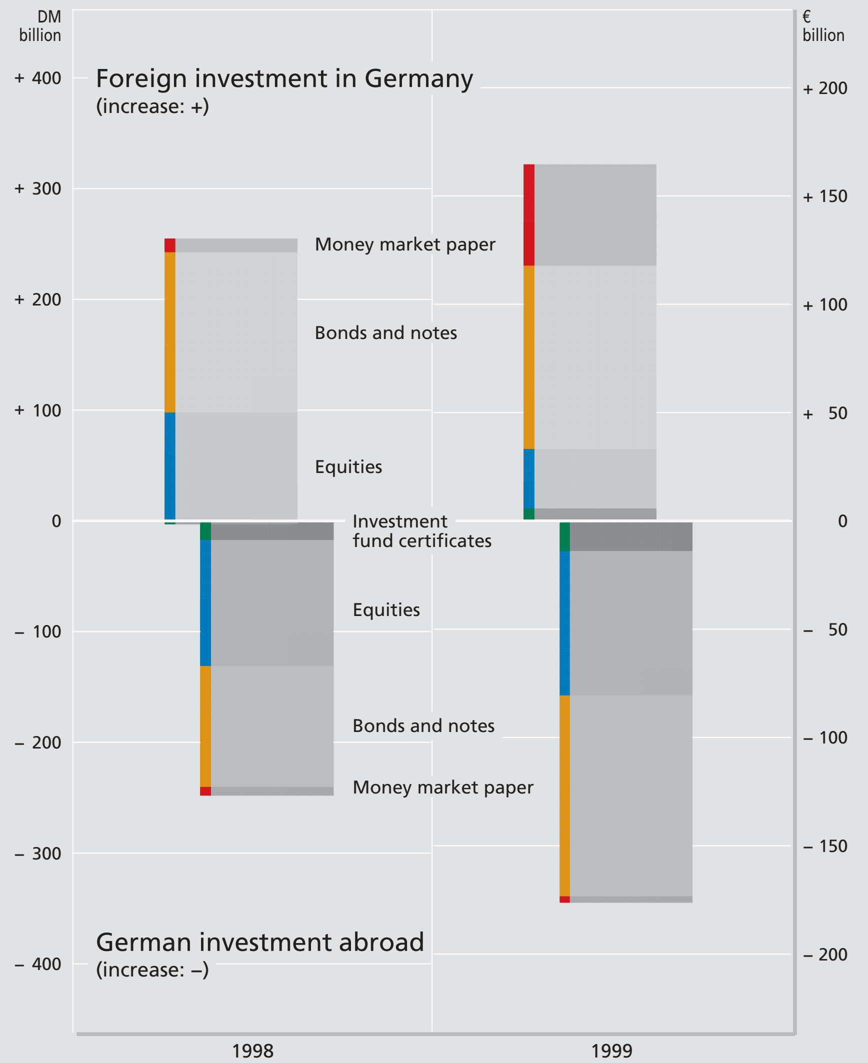
Security transactions with non-residents

Chart 16



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ready declined in 1998 in favour of higher-yielding bank issues and again in 1999, probably in favour of bonds issued by other government borrowers in the euro area. Foreign investment in the German equity market also weakened during the period under review despite the improved economic prospects for German enterprises (€ 27 ½ billion compared with € 51½ billion). However, the difference is almost solely due to one major transaction in connection with a corporate merger in 1998. If this single item is excluded, non-residents' acquisition of German equities in 1999 was more or less of the same order as in 1998.

Large direct investment

The speed of globalisation seems to have increased further in the corporated sector. At all events, this is suggested by the large number of mergers and acquisitions, in which more and more German firms have also been participating. These events are reflected in a further rise in the direct investment flows recorded in the German balance of payments. Against the background of a flourishing export industry, German firms invested € 93 billion last year in international operating bases and thereby actually exceeded the previous year's already very substantial sum. The lion's share of the investible funds flowed into EU partner countries, especially the United Kingdom, which was the host country of several major investment projects in the telecommunications sector. In terms of the amounts involved, the statistically recorded direct investment of foreign investors in Germany also increased sharply in the last calendar year (€ 49 billion). The main reason for this was that for the first time a "mega-merger" resulted in a substantial influx of direct investment funds. Furthermore, foreign proprietors granted loans amounting to € 28½ billion to their subsidiaries in Germany last year, and these loans likewise count as direct investment. All in all, net capital exports through direct investment amounted to € 43½ billion (1998: € 63 billion).

Large influx of funds through non-banks' credit transactions

The net capital outflows through security transactions and direct investment were partly offset by net inflows through unsecuritised credit transactions (€ 34½ billion). Notably German enterprises and individuals reduced their external assets by € 37 billion. These were essentially short-term balances held with foreign banks. The previous competitive disadvantage of bank deposits in Germany was removed as a result of the remuneration of minimum reserve balances in the euro area.

Little change in the external position of the banking system

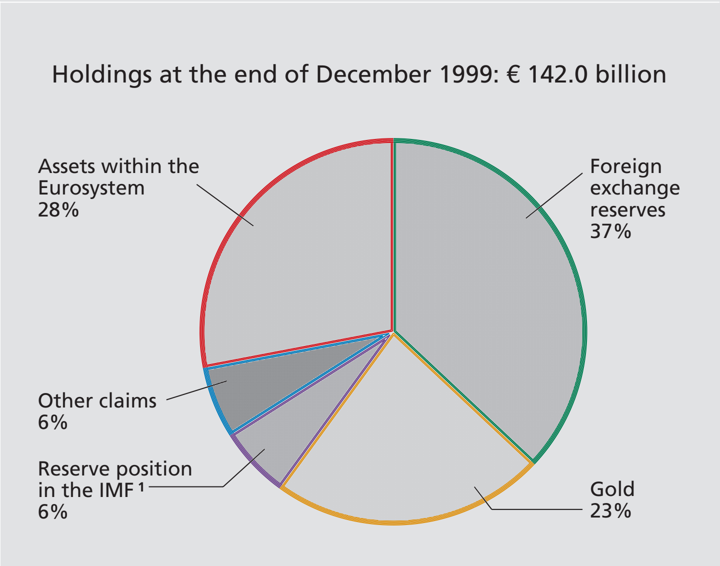
By contrast, the external transactions of the banking system (excluding the foreign reserves of the Bank) virtually cancelled out. However, this conceals diverging liquidity trends in the case of the credit institutions and the Bank. Whereas in the case of German credit institutions there were net inflows of foreign funds amounting to € 50½ billion, the net external assets of the Bank (excluding foreign reserves) rose by more or less the same amount – mainly as a result of the balances within the EU payment system TARGET. The Bank's foreign reserves declined by € 12½ billion at the same time, mainly as a result of the transfer of a partial amount to the ECB.

Breakdown of the external position

In addition to these transaction-related changes, there were also revaluation-related adjustments to the Bank's external position in 1999 owing to changes in market prices and exchange rates. The higher valuation of gold and the appreci-

Structure of the external assets of the Bundesbank

Chart 17



1 Including special drawing rights.

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ation of the US dollar played a particularly important role here. All in all, the external assets at the end of 1999 amounted to € 142 billion and the external liabilities to € 6 billion.

The foreign reserves accounted for € 93 billion of the external assets compared with € 94 billion at the beginning of the year. As a result of last year's changes in the price of gold and exchange rates, the foreign reserve holdings shown in the balance sheet remained virtually unchanged despite the transfer of reserves to the European Central Bank at the beginning of the year.[1] At € 52 ½ billion, most were denominated in US dollars. The Bank's monetary gold was shown in the balance sheet as amounting to € 32 ½ billion at end-1999 rates. The reserve position at the IMF (including special drawing rights) amounted to € 8 ½ billion.

1 This was done using a gold price on the balance sheet date in 1999 (value in brackets: valuation in the opening balance sheet of 1999) of € 289.518 per ounce of fine gold (€ 246.368 per ounce of fine gold) and a dollar rate of $ 1.0046 per euro ($ 1.16675 per euro). Special drawing rights (SDRs) were shown in the balance sheet with a value of SDR 0.732614 per euro (SDR 0.830248 per euro).

3. Shifts of focus in fiscal policy

(a) Trends in 1999

Slowdown in deficit reduction

In 1999 the general government deficit – as defined in the Maastricht Treaty – decreased further, albeit at a slower rate than in the previous year. This was partly due to a stronger growth of general government expenditure, which reflected, among other things, shifts in the economic and fiscal policy focus following the change of government as a result of the *Bundestag* elections in September 1998. Demand-side and distribution-oriented policies predominated at first, resulting *inter alia* in the cancellation of cuts in social benefits that had been planned by the former Federal Government. In addition, non-tax receipts showed a poor out-turn. These developments, however, were accompanied by a rise in tax revenue which was surprisingly steep considering the modest level of economic growth. As a consequence, public sector budgets recorded significantly better results than had been anticipated at the beginning of the year.

Marked acceleration in expenditure growth

As defined in the budgetary accounts, the expenditure of the central, regional and local authorities grew by almost 3 % vis-à-vis 1998. This was mainly due to the continued subsidising of the statutory pension insurance scheme through additional Federal grants funded by the receipts from the increase in energy taxation as from April 1, 1999 and to substantial first-time Federal transfers to the Post Office benefit funds. Personnel expenditure in the public sector also rose more strongly following the higher pay settlement. Thanks to continued staff reductions, the rise in personnel expenses was contained to just under 1 ½ %. Other operating expenditure increased by a larger margin (+ 3 ½ %). Fixed capital expenditure, which in 1998 had risen slightly for the first time since 1992, increased by 2 % last year owing to an improvement in local authorities' financial situation. By contrast, transfers to households decreased somewhat, in part due to declining unemployment. The growth in the expenditure of the social security funds accelerated markedly (+ 3 %). This owed something to the cancellation of austerity measures in the fields of statutory pension and health insurance that had been introduced by the previous Federal Government. Moreover, active labour market policy measures, which had been substantially expanded in the course of 1998, were maintained at a high level. Total general government expenditure increased by approximately 2 % (compared with 1 % in 1998).

Sharp growth in tax receipts

Tax revenue in 1999 was almost 6 ½ % up on the preceding year. Despite the slower pace of economic growth, it expanded faster than in 1998, exceeding

Public sector finance *

Table 9

Item	1997	1998 pe	1999 pe	1999 pe	1997	1998 pe	1999 pe
	DM billion			€ billion	Change from previous year in %		
Central, regional and local authorities							
Expenditure							
Expenditure on personnel	325.0	326	330.5	169	– 0.4	+ 0.5	+ 1.5
Other operating expenditure	135.7	136.5	141.5	72.5	– 0.9	+ 0.5	+ 3.5
Transfers 1	356.3	371.5	395.5	202	– 1.6	+ 4	+ 6.5
Interest paid	132.1	133.5	137	70	+ 1.0	+ 1	+ 2.5
Fixed capital expenditure	80.1	80	81.5	42	– 4.5	+ 0	+ 2
Financial aid 2	79.2	78.5	73.5	37.5	– 1.2	– 1	– 6.5
Total expenditure 3	1,108.6	1,128.5	1,161.5	594	– 1.3	+ 2	+ 3
of which							
Federal Government 4	480,3	496	521.5	266.5	– 2.1	+ 3	+ 5
West German Länder Governments 5	376.5	381	385.5	197	– 0.8	+ 1	+ 1.5
East German Länder Governments	105.2	103.5	103.5	53	– 0.3	– 1.5	+ 0
West German local authorities	226.9	226.5	232	118.5	– 2.6	– 0	+ 2.5
East German local authorities	54.2	52.5	52	26.5	– 6.2	– 2.5	– 2
EU 6	41.6	42.5	39.5	20.5	+ 5.5	+ 1.5	– 6.5
Receipts							
Tax revenue	796.8	832.5	886	453	– 0.4	+ 4.5	+ 6.5
Other receipts	220.8	246.5	226	115.5	+ 7.3	+ 11.5	– 8.5
Total receipts 3	1,014.1	1,074	1,106	565.5	+ 1.3	+ 6	+ 3
of which							
Federal Government 4, 7	416.8	439.5	470	240.5	+ 1.2	+ 5.5	+ 7
West German Länder Governments 5	349.2	360.5	371.5	190	+ 1.3	+ 3	+ 3
East German Länder Governments	94.3	96	97.5	50	+ 0.6	+ 2	+ 1
West German local authorities	222.9	232.5	237.5	121.5	– 2.1	+ 4.5	+ 2
East German local authorities	52.6	52	51	26	– 4.4	– 1.5	– 1
EU	41.6	42.5	39.5	20.5	+ 5.5	+ 1.5	– 6.5
Deficit (–)	– 94.5	– 54.5	– 55.5	– 28.5	.	.	.
of which							
Federal Government	– 63.5	– 56.5	– 51.5	– 26	.	.	.
West German Länder Governments 5	– 27.3	– 20.5	– 14	– 7	.	.	.
East German Länder Governments	– 10.9	– 7.5	– 6.5	– 3.5	.	.	.
West German local authorities	– 4.0	+ 6	+ 6	+ 3	.	.	.
East German local authorities	– 1.6	– 1	– 0.5	– 0.5	.	.	.
"German Unity" Fund	+ 3.3	+ 0.5	+ 0.5	+ 0.5	.	.	.
Redemption Fund for Inherited Liabilities	+ 8.0	+ 24	+ 9.5	+ 5	.	.	.
ERP Special Fund	+ 1.2	– 0	+ 1	+ 0.5	.	.	.
Federal Railways Fund	+ 0.5	– 0	– 0	– 0	.	.	.
Social security funds							
Expenditure	794.4	807.5	830	424.5	+ 1.3	+ 1.5	+ 3
Receipts	797.0	811.5	839	429	+ 3.6	+ 2	+ 3.5
Surplus (+)	+ 2.7	+ 4	+ 9	+ 4.5	.	.	.
Public sector, total							
Expenditure	1,796.5	1,817.5	1,856	949	– 0.3	+ 1	+ 2
Receipts	1,704.6	1,767	1,809.5	925	+ 2.3	+ 3.5	+ 2.5
Deficit (–)	– 91.9	– 50.5	– 46.5	– 24	.	.	.

* As defined in the financial statistics; excluding hospitals keeping commercial accounts, but including special accounts. — **1** Mainly social expenditure and current grants to the corporate sector. — **2** Expenditure on investment grants and loans to third parties, plus the acquisition of participating interests. — **3** Including differences in clearing operations. — **4** The supplementary Federal grants and the share of mineral oil tax are included here on a gross basis. — **5** Including Berlin. — **6** EU expenditure financed out of EU revenue in Germany. — **7** The figure includes the Bundesbank's profit transfer in the amount of DM 7 billion as provided for in the budget. The amount of the actual Bundesbank profit transfer in excess of this is booked as revenue of the Redemption Fund for Inherited Liabilities.

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the expectations of autumn 1998 by € 6½ billion. The overall tax ratio increased by 0.9 percentage point to 22.9 % (as recorded in the financial statistics). This was due not only to the rise in energy taxation as of April 1, 1999, but also to the surprisingly strong growth in turnover tax receipts and the fact that assessed income tax revenue virtually doubled (to just under € 11 billion). This reflected the continuing reversal of the earlier erosion of the tax base brought about not least by the ending of special depreciation allowances on investment in eastern Germany. Corporation tax receipts likewise grew considerably. Even so, their volume lagged far behind expectations, mainly owing to surprisingly large profit distributions. As a result, revenue from non-assessed taxes on earnings distinctly exceeded the initial forecasts. By contrast, wage tax receipts – which rose by slightly more than 1 % – barely met the expectations of autumn 1998, despite higher negotiated pay rates. This was primarily attributable to the lower increase in actual earnings resulting from the strongly negative wage drift. Wage tax receipts were also dampened by the measures which came into effect at the beginning of 1999 and which comprised the raising of child benefit, an increase in the basic tax allowance and a lowering of the entry tax rate.

Weak trend in non-tax revenue

Unlike tax revenue, receipts from social security contributions increased by no more than 1½ %. This was due to the fact that the lowering of the contribution rate to the statutory pension insurance scheme by 0.8 percentage point as of April 1, 1999 – which was financed by the increase in energy taxation – far outweighed the effect of additional contribution receipts stemming from the introduction of an insurance obligation for part-time workers below a certain earnings level. Other receipts decreased considerably, mainly as a result of the smaller Bundesbank profit and reduced asset sales.

Overall result for 1999

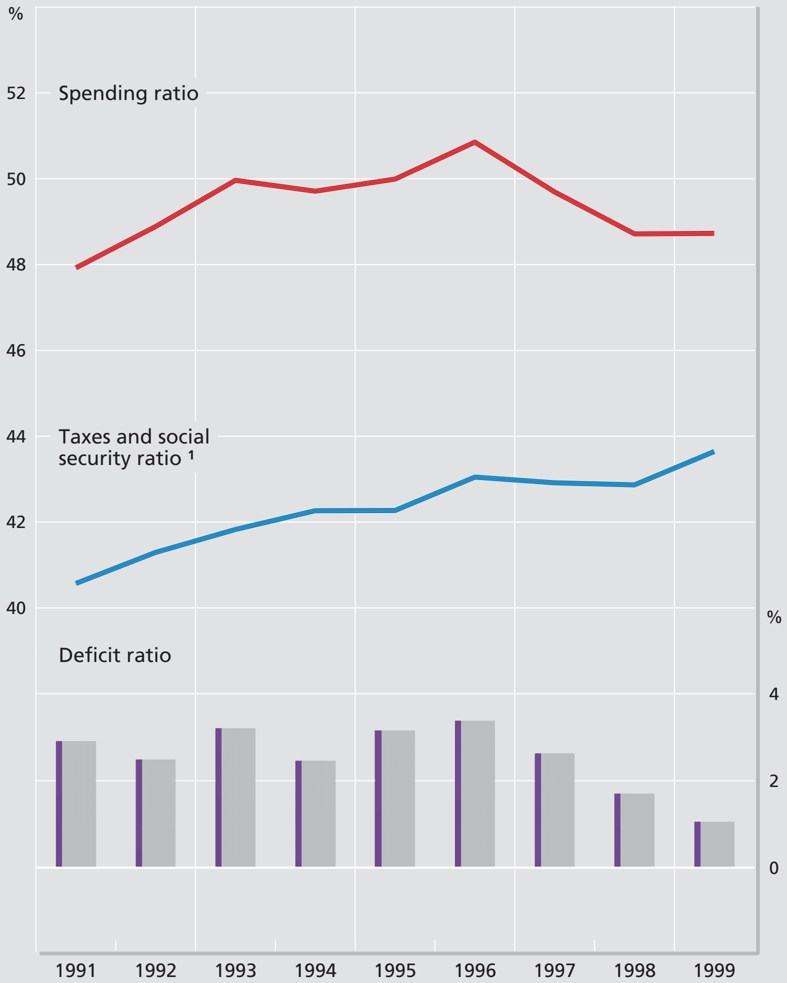
The upshot of all this was that the aggregate deficit of the central, regional and local authorities increased slightly compared with 1998 (to € 28½ billion), although less than envisaged in the budgets. By contrast, the surplus generated by the social security funds rose to € 4½ billion, mainly as a result of the replenishment of the fluctuation reserves of the statutory pension insurance scheme. The total general government deficit decreased by € 2 billion.

However, in the definition used in the national accounts, where the decline in proceeds from public-sector financial assets and a large part of the fall in the Bundesbank profit have no effect on the deficit, the general government deficit ratio decreased by just over ½ percentage point to 1.1 %. Given the sluggish economic growth, this suggests at first sight that consolidation efforts were rela-

Ratios of public sector budgets *

Chart 18

as % of gross domestic product



* As defined in the national accounts (ESA 1995). — 1 Taxes and social security contributions; the other revenue of the public sector budgets (1999: 4% of GDP) is not included here.

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tively successful. However, the improvement was partly brought about by extraordinary factors, above all the large surplus generated by the statutory pension insurance scheme and the high amount of retrospective payments of assessed taxes. Moreover, the pattern of overall economic growth tended to have a positive impact on tax revenue. The taxes and social security ratio increased by 0.8 percentage point to 43.7 %, and – unlike in the two preceding years – the general government expenditure ratio (48.8 %) did not decline any further. The debt ratio rose almost ½ percentage point to 61 %, thus exceeding the limit specified in the Maastricht Treaty to a larger extent than in 1998.

Indebtedness of the central, regional and local authorities

Table 10

Item	DM billion 1998	DM billion 1999 pe	€ billion 1999 pe	DM billion 1998	DM billion 1999 pe	€ billion 1999 pe
	Level at year-end			Change from previous year		
Borrowers' note loans	921.0	897.5	459	+ 11.5	– 23.5	– 12
Securities	1,269.0	1,357	693.5	+ 53.6	+ 88	+ 45
Other debt	90.1	89.5	46	– 0.9	– 0.5	– 0.5
Total indebtedness	1 2,280.2	1 2,344	1 1,198.5	2 + 64.3	2 + 63.5	2 + 32.5
Federal Government 3	958.0	1,396.5	714	+ 52.3	+ 438.5	+ 224.5
West German Länder Governments	525.4	536.5	274.5	+ 20.1	+ 11	+ 5.5
East German Länder Governments	98.2	104	53	+ 8.0	+ 6	+ 3
West German local authorities 4	159.0	156.5	80	– 1.2	– 2.5	– 1
East German local authorities 4	39.9	40	20.5	+ 1.2	+ 0.5	+ 0
"German Unity" Fund	79.3	78.5	40	– 0.4	– 1	– 0.5
ERP Special Fund	34.2	31.5	16	+ 0.5	– 3	– 1.5
Federal Railways Fund	77.2	–	–	– 0.0	– 77	– 39.5
Redemption Fund for Inherited Liabilities	305.0	–	–	– 17.1	– 305	– 156
Equalisation Fund for Safeguarding the Use of Coal	4.0	–	–	+ 0.7	– 4	– 2
Indemnification Fund	0.1	0.5	0	+ 0.1	+ 0	+ 0

1 In the definition relevant for compliance with the EMU convergence criterion, the indebtedness comes to DM 2,298 billion in 1998 and DM 2,364 billion in 1999. — **2** The change in the debt level deviates from net borrowing, since it includes the assumption of old debt and transfers of items previously included in public sector accounts. — **3** As of July 1, 1999, the Federal Government assumed joint responsibility for the debt of the Redemption Fund for Inherited Liabilities, the Federal Railways Fund and the Equalisation Fund for Safeguarding the Use of Coal. Since that time, the figures regarding these special funds have been included in the Federal Government figures. — **4** Including municipal special-purpose associations.

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(b) Further outlook and fiscal policy requirements

Shift of focus with a consolidation package

With its "Programme 2000 for the Future" presented in summer 1999, the Federal Government shifted its fiscal policy focus more strongly towards a consolidation of public finances. In connection with its draft budget for the year 2000, the Federal Government approved a consolidation package which envisaged savings at the Federal level of over € 15 billion, increasing to around € 25 billion by 2003. The bulk of the saving measures have already passed the various legislative stages. They include a two-year limitation of the increase in pensions and other social benefits (such as unemployment benefits and unemployment assistance) to the rate of inflation.

Moderate spending expected in 2000 ...

In the Federal draft budget for 2000, these retrenchment measures are reflected in a decline by just under 1 % in expenditure compared with the actual figures for 1999. Expenditure of the Länder Governments and the local authorities is likely to increase only moderately. On the whole, the consolidation course, in conjunction with strengthened economic growth, will give rise to favourable prospects for a marked reduction in the general government expenditure ratio in 2000.

... but dampened prospects for revenue

On the receipts side, only a moderate rise in tax revenue is currently forecast, notwithstanding a more favourable economic momentum. Thus, according to the official tax estimate of November (which has been amended to take account of recent changes in tax legislation), tax revenue is expected to rise by no more than 2½% in 2000 against the backdrop of nominal economic growth of slightly over 3½%. Although energy taxation was raised once more at the beginning of this year (part of the resulting additional revenue is being used to cut the contribution rate to the statutory pension insurance scheme), this factor will be outweighed by tax shortfalls resulting from other measures which became effective at the beginning of this year, such as the second stage of the 1999/2000/2002 Tax Relief Act and the extension of family assistance measures. Furthermore, retrospective assessed tax payments for earlier years are expected to decrease. In addition, non-tax receipts are likely to diminish further. In particular, the decline in the Bundesbank profit to € 3.9 billion will depress this receipts item.

No further consolidation progress in 2000

On balance, therefore, the aggregate budget deficit of the central, regional and local authorities is likely to be of the same order as in 1999. The social security surplus will diminish following the replenishment of the pension insurance reserves to the statutory minimum level of one month's expenditure. Measured by the definition used in the national accounts, too, the figures indicate no significant progress towards a decline in the general government deficit in 2000.

Medium-term consolidation requirements

The European Stability and Growth Pact requires deficits to be reduced further during the next few years if the medium-term objective of a budgetary position close to balance or in surplus is to be achieved. With its updated stability programme, the Federal Government signalled its determination to cut the general government deficit ratio to ½% by 2003. Furthermore, the Federal Government intends to balance its budget by 2006 at the latest. The general government expenditure ratio is to be cut by 3½ percentage points by 2003 in order not only to reduce the deficits but also to create leeway for a substantial lowering of the burden of taxes and levies. This objective requires expenditure to be strictly contained at all levels of government. From a macroeconomic perspective, however, it needs to be remembered that certain public capital expenditure items are complementary to corporate investment.

Tax reform bill

In February 2000 the Federal Government approved a bill for a tax reform consisting of two components. Firstly, it provides for a reform of business taxation planned for 2001; secondly, the third stage of the 1999/2000/2002 Tax Relief

Record of general economic and fiscal policy measures

January 1, 1999
A number of fiscal policy measures come into effect: they include, in particular, the raising of child benefit, the lowering of the entry rate of income tax and raising of the basic income-tax allowance and adjustments in the areas of pension-, health-insurance and labour-market policy.

January 4, 1999
The Federal Cabinet approves a stabilisation programme designed to take due account of the commitments arising from the Stability and Growth Pact. To meet the medium-term objective of a fiscal position that is "close to balance or in surplus", the deficit ratio is to be reduced to 1% in the year 2002 by limiting the growth rate of general government expenditure to 2% p.a. The programme also provides for the debt ratio being reduced to 59½% by the year 2002.

January 19, 1999
The Federal Constitutional Court announces a number of rulings relating to family taxation and requiring Parliament to define the subsistence level for children (which is to be exempt from taxation) much more broadly in future than it has been hitherto.

January 20, 1999
The Federal Cabinet approves the new draft budget for 1999, showing a deficit of DM 56.3 billion, which is thus just as large as that budgeted for by the previous government. At DM 488 billion, the planned volume of expenditure is much larger than in the original draft, and is 6.8% above the out-turn for 1998. That is due mainly to the inclusion of new expenditure, and primarily to additional tax-financed subsidies to the pension-insurance scheme.

January 28, 1999
In its Annual Economic Report for 1999, the Federal Cabinet predicts a growth of around 2% in the real gross domestic product. To achieve this, a reorientation of economic and fiscal policy towards higher employment levels at stable prices is to be initiated. That entails – in the Federal Cabinet's view – not only macroeconomic coordination but also an alliance fostering jobs, training and competitiveness.

February 27, 1999
For public sector employees, a pay settlement is agreed that runs for 15 months and provides for an increase of 3.1% in wages and salaries from April 1, 1999, and for a lump-sum payment of DM 300 for the period from January to March 1999.

March 3 and 4, 1999
The Bundestag passes the "Act Introducing an Ecological Tax Reform", the "1999-2000-2002 Tax Relief Act" and the "Act Amending the Provisions Governing Low-Paid Jobs". During the final stage in 2002, the

income tax reform will bring net relief amounting to an estimated DM 20 billion. For low-paid jobs, a salary ceiling of DM 630 a month is stipulated, the previous flat-rate taxation is abolished and an obligation to contribute to the statutory pension- and health-insurance schemes is introduced.

April 1, 1999
The increase in energy taxation, the lowering of the contribution rate to the statutory pension-insurance scheme by 0.8 percentage point to 19.5 % and the new provisions governing low-paid jobs come into effect.

April 30, 1999
The commission set up by the Federal Cabinet to prepare a reform of business taxation submits its "Brühl recommendations". For corporations, they provide for corporation tax being lowered to a uniform rate of 25 %, and for the imputation system being replaced by the 50 % inclusion of dividends in shareholders' income-tax-assessment basis. For sole proprietors and partnerships, three different relief models are put up for discussion.

May 6, 1999
The Bundestag adopts the 1999 Federal Budget Act. Compared with the draft, the deficit has been reduced by DM 2.7 billion to DM 53.6 billion (principally because of a lower level of expenditure).

June 16, 1999
In the Financial Planning Council, the Federal Government, Länder Governments and local authorities reaffirm their intention of lastingly complying with the Maastricht criteria and consistently reducing the fiscal deficit, in line with the objectives of the European Stability and Growth Pact, according to which a balanced budget is to be aimed at. They agree to limit the growth of public spending to not more than 2 % p. a. over the medium term.

June 23, 1999
The Federal Cabinet approves the draft Federal budget for the year 2000, involving expenditure totalling DM 478.2 billion (1.5 % below the amount budgeted for in 1999) and a deficit amounting to DM 49.6 billion. According to the medium-term financial plan, which is submitted at the same time, the growth rate of spending is to be limited to an average of 1.8 % p. a. between the years 2001 and 2003 and the deficit is to be cut to DM 31.1 billion in 2003. Progress towards consolidation is to be achieved by means of a retrenchment package that is to result in relief totalling DM 30 billion for the Federal Government in the year 2000, increasing to DM 50 billion p. a. by 2003. In addition, the "Programme 2000 for the Future" approved by the Federal Cabinet defines the benchmarks of a number of tax-policy projects, including the restructuring of family taxation, the further stages of the "Ecological Tax Reform" and a reform of business taxation.
Moreover, the Federal Cabinet approves a "Bill to Reform the Statutory Health-Insurance Scheme" (2000 Statutory Health-Insurance-Scheme Reform), designed to improve both the cost-effectiveness and the quality of health care. In order to stabilise contribution rates, it is planned, inter alia, to introduce a budget encompassing all sectors.

August 25, 1999
The Federal Cabinet approves a number of bills intended to implement key parts of the "Programme 2000 for the Future". They include the Budget-Restructuring Act, the "Act Continuing the Ecological Tax Reform", the "Act on Family Assistance Measures" and the 1999 Tax Adjustment Act. The Budget-Restructuring Act implements the retrenchment package, e.g. the limitation of pension increases in the years 2000 and 2001 to offsetting inflation. The continuation of the "Ecological Tax Reform" in the years from 2000 to 2003 envisages a further raising of the mineral-oil tax on fuels by 6 pfennigs per litre p. a. and an increase in electricity tax by 0.5 pfennig per kilowatt-hour p.a. In a first stage, starting in 2000, the family assistance measures will be enhanced by introducing a child-care allowance of around DM 3,000 per child and by further increasing child benefit

Record of general economic and fiscal policy measures

(continued)

by DM 20 to DM 270 a month for the first and second child. The 1999 Tax Adjustment Act is intended, inter alia, to correct some of the counterfinancing measures of the 1999-2000-2002 Tax Relief Act that affect the enterprise sector.

November 11, 1999
The Federal Constitutional Court delivers a ruling on revenue apportionment between the public authorities in Germany, according to which a benchmark act defining and supplementing the hitherto vague concepts in the revenue-apportionment and equalisation system is to be submitted by the end of the year 2002. On this basis, the revenue-apportionment act then has to be revised by the end of 2004.

The "Act Continuing the Ecological Tax Reform" is passed by the Bundestag.

November 12, 1999
The Bundestag passes the Budget Consolidation Act.

November 16, 1999
The German Council of Economic Experts, in its Annual Report for 1999–2000, discerns an improvement in the economic situation and outlook in Germany. It considers it possible for aggregate output to increase by 2.7 % in the year 2000, after a growth of 1.4 % in the previous year. It stresses the need for fundamental structural reforms to reduce the high and entrenched unemployment, and also in the areas of tax policy and social security.

December 1, 1999
The Federal Cabinet approves an updated stability programme whose objective is to reduce the deficit ratio to ½ % and the debt ratio to 58 % by the year 2003. To that end, the general government spending ratio is to be cut by 3 ½ percentage points to 45 ½ % by 2003, which should likewise enable the overall tax ratio to be lowered. In addition, the Federal Cabinet is aiming at a completely balanced Federal budget not later than 2006.

December 15, 1999
The Mediation Committee of the Bundestag and Bundesrat endorses the Act on Family Assistance Measures and makes some amendments to the 1999 Tax Adjustment Act and to that part of the retrenchment package which is subject to Bundesrat approval. These changes reduce the volume of savings of the Federal Government to around DM 28 billion in the year 2000.

December 17, 1999
The 2000 Statutory Health-Insurance-Scheme Reform – adjusted for major clauses requiring Bundesrat approval – and the "Act Amending Provisions of the Statutory Health-Insurance Scheme" are passed by the Bundesrat.

December 21, 1999
The Federal Cabinet submits a "2000 Tax-Reform" plan comprising, firstly, the business-tax reform planned for the year 2001 and, secondly, further reductions in the income-tax scale. The business-tax reform is broadly in line with the "Brühl recommendations" as far as corporations are concerned; in addition, the government plan provides for corporations' profits from sales of domestic participating interests being tax-free. Partnerships are granted the option of being taxed like corporations. Enterprises which do not avail themselves of this option are to be allowed to set off twice the basic amount of trade tax against their income-tax liability. With respect to income tax, the third stage of the (already adopted) 1999-2000-2002 Tax Relief Act is to be brought forward by one year to 2001; moreover, the top rate and the entry rate of income tax are to be lowered to 45 % and 15 %, respectively, by 2005. The new measures are expected to bring tax relief totalling DM 42 ½ billion.

January 1, 2000
Some major new fiscal policy provisions enter into effect. They include, in particular, the second stage of the 1999-2000-2002 Tax Relief Act, the amplified family assistance measures, the second stage of the "ecological tax reform" and the lowering of the contribution rate to the statutory pension-insurance scheme by 0.2 percentage point to 19.3 %.

January 14, 2000
According to preliminary budget results, the deficit recorded in the Federal budget for 1999 amounts to DM 51.3 billion, and is thus DM 2.3 billion below the budget estimate. On the expenditure side, the originally planned volume is undershot by DM 2.9 billion. On the revenue side, tax receipts are DM 4.7 billion higher than was budgeted for. The favourable budget performance made it possible to postpone planned sales of financial assets on a substantial scale, thus gaining additional room for manoeuvre for future budgets.

January 26, 2000
In its Annual Economic Report for the year 2000, the Federal Cabinet expects the real gross domestic product to grow by 2 ½ % in the current year. Stronger foreign demand is expected to be accompanied by increasing domestic stimuli generated by private consumption and fixed capital formation. The labour market will benefit markedly from the acceleration of growth; price stability will be maintained.

February 1, 2000
In a stability programme supplemented by the full effects of the planned tax reform, the Federal Cabinet expects – in the event of faster economic growth and an unchanged target figure for 2003 – a temporary rise in the deficit ratio of ½ percentage point to 1 ½ % in the year 2001.

February 9, 2000
The Federal Cabinet approves a Tax Reduction Bill, in which the tax reform projects presented in December have been given concrete shape.

Act is to enter into effect one year earlier than originally envisaged, and income tax rates are to be lowered further in 2003 and 2005. Additional tax relief measures totalling € 22 ½ billion are planned to be introduced in 2005. The key components of the business taxation reform are the lowering of corporation tax rates to a uniform 25 % and the replacement of the present imputation system, which allows shareholders to credit the corporation tax already paid on their dividends against their personal income tax liability, by an income tax relief on dividends. Non-corporations – i.e. partnerships – will be given the option of being taxed like corporations. Alternatively, they may have their trade tax payments partly offset against their income tax liability. In addition, non-corporations will benefit from the progressive lowering of income tax rates to an entry rate of 15 % and a top rate of 45 %. At the same time, the existing rules for claiming depreciation allowances will be tightened considerably.

Reform concept in need of further amendments

All in all, the planned tax reform constitutes a move which will substantially improve the fiscal conditions for investors, especially corporations, and offer enterprises a palpable relief in net terms, too. The envisaged tax exemption for corporations' capital gains from the disposal of participating interests will facilitate corporate restructuring. However, since the tax relief measures will predominantly benefit corporations, they will result in new distortions in the taxation system. This therefore suggests a need for more extensive reform measures aimed at ensuring equal tax treatment for the different types of income and saving. Such measures should include a correction of the marked preferential treatment of retained profits over distributed profits which is envisaged in the reform plans – not least owing to the distortions to which this would give rise in the capital markets. From a macroeconomic point of view, it seems inappropriate to give preferential tax treatment to saving within enterprises over non-enterprise saving since, ultimately, all types of saving serve to finance investment. Bearing in mind all these aspects, above all a more radical lowering of income tax rates would be appropriate. Such a move would also obviate the need for complex makeshift constructs for the taxation of non-corporations. The larger the cuts in tax rates – relieving all types of income by an equal margin – the sooner tax payers' incentive to circumvent the tax regime would be durably eliminated, which, in turn, would have a positive impact on tax revenue. In order not to jeopardise the consolidation course, however, the central, regional and local authorities would have to create sufficient financial leeway by cutting spending further and abolishing special tax privileges outside the corporate sector, too.

Need for more far-reaching reform

The demographic trends give rise to a specific need for consolidation in the field of old-age provision, in particular. Besides a complementary funded pension component and a further extension of the retirement age, this notably raises the question of to what extent the present system of adjusting pensions in line with net wages needs to be durably corrected in order to keep the future financial burden at a sustainable level. The unfavourable long-term outlook also suggests that it would be advisable to run down the general government debt ratio, which remains high, as swiftly as possible. The remaining privatisation potential, existing not least at the regional and local levels, should also be used for this purpose. At the same time, this would have the advantage of improving the national allocation of resources.

4. Continuation of economic reforms

More favourable economic outlook

The German economy began the year 2000 from a favourable starting position. Overall capacity utilisation has increased in the last few months, while the situation on the labour market is looking brighter. The domestic price climate has remained generally stable, despite some recognisable strains; cost pressures have been limited, on the whole. The available indicators suggest that the upswing will continue briskly – an assessment which is shared by many enterprises and associations. External business is benefiting not only from the general upturn in world trade; the regional focus of German exports and the particular type of products in which German exporters specialise, together with favourable international price competitiveness, suggest that products "made in Germany" will sell exceptionally well in international markets. Although higher capital market interest rates and higher import prices are exerting a dampening effect *per se,* their impact so far has been negligible. The supply of liquidity continues to be ample, the rise in interest rates also reflects enhanced economic prospects and the likelihood of higher returns, and the inflationary pressures stemming from external factors are likely to subside in the course of the year. The crucial question is how quickly and dynamically the impetus from exports galvanises domestic demand and the latter generates its own momentum.

Lasting improvement of the labour market situation through reforms

Even if the cyclical recovery appears to be more broadly based this time – in contrast to 1995, for example – the German economy and national economic policy continue to face serious problems. The last decade witnessed the weakest growth in post-war German history, accompanied by the highest level of structural unemployment. Although the number of unemployed has recently begun to decline, underemployment remains unacceptably high. Many continental European countries are confronted with this problem, which means that solutions have also been sought at the European Union level (see the employment guidelines described on page 98 of this Report). Nevertheless, responsibility for the labour market remains largely in the hands of national economic and structural policymakers. Their principal objective must be to increase labour market efficiency and, in particular, to improve the wage formation process in a way that promotes employment.

No fundamental successes to be expected from short-term orientation

Much will depend on whether this year's round of pay negotiations creates the right setting for the medium term. Last year's attempt to boost the economy by means of an expansionary wage policy did not achieve the desired purpose. Active labour market policy instruments can likewise improve the situation only to a limited extent, as experiences in eastern Germany confirm. The secondary labour market is a stop-gap measure which can only be assigned a supporting role. Early retirement or a mandatory reduction of overtime working represent questionable interventions in the labour market which have merely selective effects, when viewed from a somewhat longer perspective. Of far greater importance for stimulating employment are appropriate wage policy agreements in line with the Joint Declaration of January 9, 2000 issued by the parties involved in the Alliance for Jobs, Training and Competitiveness *(Bündnis für Arbeit, Ausbildung und Wettbewerbsfähigkeit),* i.e. the Federal Government, the employers' federations and the trade unions. From a macroeconomic point of view, a wage policy designed to promote employment should satisfy the following requirements, in particular:

Basic criteria for a wage policy that will promote employment

1. Wage adjustments should be oriented towards the longer term and "forward-looking" so as to provide a reliable basis for corporate decisions.

2. Nominal wage increases must be consistent with price stability.

3. In a situation of full employment, a general orientation of the envisaged level of real wages to productivity is entirely appropriate. However, in a situation of high unemployment – as has been the case for many years now – the scope for real wage increases is limited.

4. The wage structure should be geared to productivity patterns.

Unemployment cannot be reduced significantly without an active contribution from wage bargainers. The outcome of pay negotiations for the year 2000 have certainly been encouraging thus far. It is equally true, however, that wage policymakers cannot solve the problem on their own. Lasting success can only be achieved by the right combination of reform measures and the interrelated actions of all the social partners involved in keeping with the proven principles of the market economy. Globalisation and the integration of the European Union make it all the more necessary that economic policymakers should concentrate their efforts on promoting efficient market structures.

Greater financial freedom for government ...

The changes in the fiscal policy course that were made last year are conducive to significantly improving the conditions for higher growth and employment in Germany. The Federal Government has therefore rightly emphasised the restoration of the scope for fiscal policy action as a cornerstone of its strategy. If a course of both quantitative and qualitative fiscal consolidation is pursued, the consumption of national economic resources by the government will be more effectively curtailed. In addition, realistic options will be opened up for dismantling the tax wedge between the wage costs of enterprises and the net wages of employees and between the gross and net return on productive capital – both of which are inhibiting growth and welfare – and for reducing the taxation-induced distortions between present and future consumption. When implementing the policy changes care must be taken, however, not to violate the principle of equitability of the taxation system and not to interfere with the capital market's function of selecting and sanctioning enterprises. A radical lowering of the tax rates coupled with a reduction in tax deductions (i.e. a widening of the tax basis) would also be the best means of achieving a simple and transparent taxation and transfer system.

... as well as for households and enterprises as key components of a forward-looking fiscal policy

Social security system needs to be structured more efficiently

If this objective is to be attained, policymakers must also recognise the urgent need for action and correction with regard to the social security system. The systematic harmonisation of the individual social security schemes would open up the prospect of making the social security systems more efficient and of distributing the burdens more fairly. In so doing, it should also be possible to overcome or at least mitigate the effects of the current system which distort incentives on the labour market. As a consequence, reform measures adopted within the social security system could have positive effects that extend to all segments of the labour market; given the particularly high unemployment among poorly skilled workers, such measures are also required to help them find a way out of the "poverty trap". Another reform measure of great urgency and societal relevance will be to slow down the dynamic development of pension costs in a manner that is consistent with long-term needs, close existing financing gaps through supplementary funded schemes and so put the system of old-age provision on a sound and viable long-term footing.

On the way to the "New Economy"

Economic policymakers committed to reform can provide an important impetus for sustained and appropriate economic growth. However, enterprises must likewise contribute to this process. In this respect many changes have evidently been set in motion in the past few years – independently of official policy. The corporate landscape is undergoing a process of radical transformation; old market structures are dissolving. The wave of mergers and acquisitions and the launching of new enterprises in the service sector attest to the dynamic nature of this process. The energy sector and the telecommunications industry are two examples of the kind of potential that could be released by deregulation and privatisation on the goods markets. It is important that this momentum be sustained and encouraged. An efficient financial system is an important prerequisite for achieving this objective; the role of the financial sector in this context is to mediate and support the modernisation and growth of the real sector. These processes of renewal, already underway, are reflected in the growing importance of share issues as a means of corporate financing and in the more flexible provision of venture capital, including outside the stock market. Given a strong commitment to reform, there is no reason why the German economy should be any less successful in realising its development potential and exploiting its technological opportunities on the way to a "New Economy" than those countries that are further advanced in their reform efforts.

IV. International monetary policy cooperation

1. European integration

(a) Further development of the economic policy coordination process

"Broad economic policy guidelines" at the core of the coordination process

Under the EC Treaty, although economic policy remains a national responsibility, it is regarded by the member states as a matter of common interest. Under the terms of the Treaty, the central coordinating body is the Council of Economic and Financial Ministers (ECOFIN Council). The need for coordination has increased since the launch of monetary union, since, in a single monetary area, economic policy decisions taken in individual euro-area countries are of particular significance to the other partners. The "Broad economic policy guidelines" are the most important instrument for coordinating economic policy, covering all member states of the Community. Published annually, they describe the economic situation and economic policy requirements. The "1999 Broad economic policy guidelines" were more concrete and more country-specific than those of the preceding years. In particular, the important role that structural reforms will play in employment and growth is described more explicitly. As regards public finances, further consolidation efforts are recommended, although investment should be impaired as little as possible. The Bank is involved in the preparatory work on the "Broad economic policy guidelines" through its participation in the Economic Policy Committee and the Economic and Financial Committee.

Special arrangements for budgetary policy

In the area of public finances, the articles of the EC Treaty governing the avoidance of excessive deficits, supplemented by the provisions of the Stability and Growth Pact, make up the key framework for coordination and surveillance. Parts of the Pact entered into force on July 1, 1998, with the rest following on January 1, 1999, when monetary union was launched. Experience so far has been decidedly positive. In 1999 the EU member states came closer to achieving the objective of a budget "close to balance or in surplus". Bearing in mind the favourable business climate and the diminishing burden of effective interest rates in the euro area, however, a more rapid pace of consolidation would have been desirable, and possible, in some countries. According to the EU Commission's current assessment, the deficit ratio for the Community as a whole will decline from 0.6 % of GDP in 1999 to 0.4 % in 2000. The deficit ratio for the euro-area countries is expected to go down from 1.2 % to 0.9 % during the same period. 1999 showed that the question as to whether the fiscal policy goals listed in the stability and convergence programmes will actually be achieved is being afforded great attention not only by the financial markets but also by the general public.

Macroeconomic dialogue as a new element

In June 1999 the Cologne European Council adopted the European Employment Pact elaborated under the German presidency; this pact unites all of the Union's employment policy measures in a coherent overall strategy. It encompasses the coordinated employment strategy agreed in 1997 (the "Luxembourg Process") and the coordinated structural reform approach adopted in 1998 (the "Cardiff Process"). A macroeconomic dialogue was added as a third component (the "Cologne Process"). The most important parties responsible for economic policy

Elements and mode of operation of the Stability and Growth Pact

The Stability and Growth Pact comprises the following elements:

- Resolution of the European Council on the Stability and Growth Pact of June 17, 1997; [1]
- Council Regulation (EC) No 1466/97 of July 7, 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies; [2]
- Council Regulation (EC) No 1467/97 of July 7, 1997 on speeding up and clarifying the implementation of the excessive deficit procedure. [2]

The European Council, in its Resolution of June 1997, underlines the crucial importance of sound government finances in order to safeguard monetary policy's mandate of maintaining price stability and in order to enhance the conditions for strong, sustainable, and employment-promoting growth. In addition, the Resolution contains corresponding declarations of commitment by the member states, the European Commission and the ECOFIN Council. The most important provision is the agreement by the member states to aim at the medium-term objective of government budgetary positions that are close to balance or in surplus. That would enable the EU member states to cope with ordinary cyclical fluctuations in future without exceeding the Treaty's budget deficit ceiling of 3 % of GDP. In the event of signs of the emergence of an excessive deficit, the member states, the Commission and the ECOFIN Council are required to take the necessary corrective action without delay.

The Council Regulation on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies contains rules governing the content, the presentation and the assessment of the stability and convergence programmes of the euro-area countries and the remaining EU countries. Those programmes are designed to enable the risk of an excessive deficit to be recognised at a very early stage. The stability programmes presented by the member states participating in monetary union essentially constitute their medium-term budgetary policy. In content, the convergence programmes of the other EU countries largely match the stability programmes. The ECOFIN Council then examines (after an evaluation by the Commission and following a preliminary examination by the EU Economic and Financial Committee), in particular, whether the stability and convergence programmes contain adequate precautions to ensure that the fiscal balance is kept below the ceiling specified in the Treaty even under adverse conditions. If necessary, the ECOFIN Council may require the member state concerned to take corrective action. Even as early as the onset of considerable deviations of the budgetary situation from the medium-term budgetary objective or from the corresponding adjustment path towards such an objective, the ECOFIN Council is empowered to make fiscal policy recommendations to the member state concerned in good time prior to the emergence of an excessive deficit. If the deficit ceiling as defined in the Treaty is exceeded nonetheless, the ECOFIN Council is normally required to diagnose an excessive deficit (for which a qualified majority is necessary).

Under the Council Regulation on speeding up and clarifying the implementation of the excessive deficit procedure, sanctions may be imposed, by qualified majority vote, on euro-area countries by the ECOFIN Council within ten months following reporting of the excessive deficit (generally beginning with a non-interest-bearing deposit at the Commission).

These elements of the Stability and Growth Pact have been supplemented by a stability declaration issued by the ECOFIN Council on May 1, 1998 [3] (and reaffirmed by the European Council at its June 1998 meeting in Cardiff). It contains additional important self-commitments by the member states to continue to pursue sound fiscal policies. In particular, in cases where economic performance is more favourable than expected, the EU countries should devote this "growth dividend" to enhanced budgetary consolidation. Moreover, on October 12, 1998 [4] the ECOFIN Council decided that member states should achieve the objective of government budgetary positions that are "close to balance or in surplus" no later than by the end of 2002.

1 Official Journal of the European Communities, No C 236, of August 2, 1997. — **2** Official Journal of the European Communities, No. L 209, of August 2, 1997. — **3** Bulletin issued by the Press and Information Office of the Federal Government, No. 30, of May 11, 1998. — **4** Press release issued by the General Secretariat of the Council of the European Union, No. 11825/98.

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in the Community – i.e. representatives of the governments, the Commission, the ECB and the social partners – participate in this dialogue. This is designed to facilitate tension-free cooperation among the various areas of policy making, with express recognition of the ECB's independence. The first macroeconomic dialogue took place in November 1999.

Report by the ECOFIN Council on the functioning of coordination

The ECOFIN Council presented to the European Council, for its December 1999 summit in Helsinki, a report on the functioning of economic policy coordination in Stage Three of EMU. According to that report, past experience has shown that the existing institutional and political framework is largely appropriate and suited to the intended purpose. However, the European Council demanded that increased attention be paid to the actual implementation of the guidelines embodied in the "Broad economic policy guidelines" and to effectively implementing and streamlining the existing rules and procedures. Despite all the advantages offered by dialogue and coordination among the most important economic policy agents at the EU level, the limits to this approach must also be borne in mind. The economic policy problems that member states face differ considerably at times. Accordingly, different measures are necessary. In addition, coordination must not be allowed to obscure individual responsibilities.

Tasks of the Euro-11 Group

Since mid-1998 the finance ministers of the 11 euro-area countries have been meeting in the so-called Euro-11 Group to discuss issues of common interest. The European Commission and the ECB are also represented at these meetings. Owing to the limited number of participants, the Euro-11 Group is a suitable forum for intensive and confidential discussions. On the other hand, this informal group cannot take any legally binding decisions. In 1999, the public sector budgets of selected partner countries, among other things, were studied in depth at those meetings, and common policy positions on the euro's external value were agreed. Whichever country holds the EU presidency also chairs the Euro-11 Group, as a general rule; however, no arrangements have been made for the event of the EU presidency rotating to a non-euro-area country. Since the second half of 1999, the Euro-11 Group chairman has represented the euro area alongside the President of the ECB at meetings of the finance ministers and central bank governors of the G-7 countries. The ECB President and the chairman of the Euro-11 Group participate in discussions on the state of the global economy and on exchange-rate issues (instead of the central bank governors of Germany, France and Italy), whereas the other issues are addressed by this group in its usual composition.

(b) Ongoing monitoring of commitments under the Stability and Growth Pact

According to the stability and convergence programmes, further headway in consolidation planned

According to the Stability and Growth Pact, the countries participating in monetary union and the remaining EU countries are required to present stability or convergence programmes, and to update them annually. In the period between January and March 2000, the ECOFIN Council examined most of the updated versions of the programmes, presented for the first time. It was found that, according to the results available so far, the deficit goals for 1999 set forth in the original programmes had been achieved, and in many cases even better results had been attained. However, in some cases this was the result of unexpectedly strong growth, or of a marked shift among growth components towards domestic consumption, which benefited tax revenue. In countries with heavy government debt, the relatively low capital market rates likewise had a dampening effect that was stronger than had originally been assumed. Despite its comparatively sluggish economic growth, Italy, too, apparently achieved its deficit goal for 1999 of 2 % of GDP, thanks to unplanned high levels of tax revenue and to reductions in interest payments; it therefore did not need to have recourse to the higher deficit ceiling of up to 2.4 % granted by the Council in June 1999. The ECOFIN Council, in its examination of the original programmes, did not identify any member state as having failed to meet the medium-term budgetary objectives of the Stability and Growth Pact, although it often drew attention to risks which did not seem to have been adequately covered, and the decision on the existence of an excessive deficit continued to stand in the case of Greece. The updated programmes, by contrast, permit a somewhat more favourable assessment of consolidation progress. However, in many countries a more rapid consolidation of public sector budgets would be possible if the "growth dividend" were devoted in full to deficit reduction. Some countries at an advanced stage of the business cycle could, by accelerating budgetary consolidation, also help to fight inflationary tensions which are either looming or already exist.

Decision on the existence of an excessive deficit in Greece revoked

In Greece, too, public finance developed more favourably in 1999 than had been expected. In November, the ECOFIN Council revoked its decision on the existence of an excessive deficit in Greece. Thus, one of the preconditions for Greece's planned accession to the euro area on January 1, 2001 has been met.

Planned fiscal developments according to the EU countries' updated stability or convergence programmes Table 11

Programme/country	Year the programme expires	Fiscal balance as % of GDP 1999 [1]	Fiscal balance as % of GDP Final year of the programme	Gross debt as % of GDP 1999 [1]	Gross debt as % of GDP Final year of the programme
Stability programmes (Euro-area countries)					
Austria	2003	– 2.0	– 1.3	64.9	61.2
Belgium	2003	– 1.1	0.2	114.9	101.2
Finland	2003	3.1	4.7	46.6	35.2
France	2003	– 2.1	[2] – 0.3/– 0.5	60.3	[2] 57.2/57.7
Germany	2003	– 1.2	– 0.5	61.0	58.5
Ireland	2002	3.2	2.9	52.0	36.0
Italy	2002	– 2.0	– 0.1	114.7	100.0
Luxembourg	2003	2.3	3.1	4.3	< 4.3
Netherlands	2002	– 0.6	– 1.1	64.3	61.0
Portugal	2004	– 2.0	0.0	56.6	48.4
Spain	2003	– 1.3	0.2	63.5	55.8
Convergence programmes (Other EU countries)					
Denmark	2005	2.9	2.8	52.8	35.9
Greece	2002	– 1.5	0.2	104.2	98.0
Sweden	2002	1.7	2.0	66.1	52.0
United Kingdom	[3] 2004/5	0.3	– 0.5	44.9	38.0

1 Estimates given in the programmes. — **2** This band depends on expected real economic growth, estimated to be 2.5 % to 3 % annually. — **3** Fiscal years, each beginning on April 1.

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(c) Prospects for the enlargement of the EU and monetary union

Accession negotiations intensified and expanded

The negotiations on EU enlargement which began in March 1998 with a first group of accession candidates[1] made further headway during the period under review. The negotiations on about one-third of the total of 31 issues had been completed for the present by the end of 1999. In addition, in December 1999 the European Council adopted the Commission's proposals for further intensifying and expanding the accession negotiations. At the same time, the European Council agreed to grant Turkey the status of a candidate state. On February 15, 2000, the EU correspondingly opened negotiations with a second group of countries.[2] In the context of accession partnerships with the countries applying for membership, in December 1999 the EU Council published principles, priorities, interim objectives and conditions for accession to the EU. The preconditions for accession to the EU include – in addition to the fulfilment of political criteria – a functioning market economy, as well as the ability to withstand the competitive and market forces within the Community. Moreover, each country has to demonstrate its ability to discharge the duties of membership. In add-

1 Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia.
2 Bulgaria, Latvia, Lithuania, Malta, Romania and the Slovak Republic.

ition, the negotiation process has to have been brought to a successful conclusion.

Principles for joining monetary union

At a seminar held jointly in Helsinki in November 1999 by the Eurosystem and the central banks of the accession candidates, the preconditions for participation in monetary union were spelled out in detail for the first time. The EU assumes that the accession countries, upon joining the EU, will also enter Stage Three of EMU, but only as "member states with a derogation". That means they will not become full members of monetary union immediately upon entering the EU. However, the future EU member states will not be granted an opt-out clause enabling them to refrain indefinitely from introducing the euro despite meeting the conditions for joining the euro area. At all events, the new members, upon entering the EU, will be required to regard their exchange-rate policies as a matter of common interest. With regard to joining monetary union, those countries are required to aim at both nominal and real convergence as soon as possible, i.e. to pursue a monetary policy geared to price stability and buttressed by appropriate fiscal policy and corresponding structural reforms.

Preparing the EU for enlargement

In order to prepare the Union for enlargement, at the special meeting of the European Council in Berlin in March 1999, fundamental decisions were taken on the Community's future financial resources and on reforming agricultural and structural policy ("Agenda 2000"). The Treaty of Amsterdam, which entered into force on May 1, 1999, envisaged agreement on the institutional reforms necessary for enlargement. However, the only major result has been a streamlining of the legislative procedure and increased involvement of the European Parliament in the Community's decision-making process as well as a strengthening of the position of the President of the Commission. To resolve the outstanding institutional questions, the Cologne European Council of June 1999 and the Helsinki European Council of December 1999 decided to convene another intergovernmental conference. That conference was opened in February 2000 and is to address, in particular, the following topics: the size and composition of the Commission, the weighting of votes in the Council and the possible extension of qualified majority voting. Other necessary amendments to the Treaty regarding European institutions may also be examined. The aim of the reform is to strengthen the ability of an enlarged Union to take decisive action.

Central rate of the Greek drachma raised

On January 15, 2000, the governments and central banks cooperating in the European exchange rate mechanism, by mutual agreement, raised the central rate of the Greek drachma by 3.5 % against the euro. The fluctuation band remained unchanged at ± 15 %. The intention was to bring the central rate more into line with the market rates, which have been above the central rate for quite a long time. Greece saw this move as a step in preparation of its planned accession to the euro area.

2. International debt problems have been defused, but only fundamental reforms will enable the financial markets to function better in the long run

Favourable economic developments in industrial countries facilitated the containment of the crisis

The international debt problems of the emerging economies, which once again came top of the international agenda in the second half of 1998, were distinctly defused over the course of 1999. That owed something to industrial countries' increased demand for imports, the renewed rise in commodity quotations and, in some cases, the depreciation of the emerging economies' own currencies. As a result, those countries' external financing terms improved. With capital inflows generally increasing again, many countries were able to replenish their monetary reserves. Measured in terms of an index of all emerging market bonds, risk premiums are now standing only about 200 basis points above the level prevailing prior to the outbreak of the new crisis in the summer of 1998. At the same time, there is now a marked differentiation by region and country, of a type not seen before the latest spate of crises. This trend is a first sign that international investors have begun to take better account of differences in country risk.

Russia is profiting from the rise in oil prices

The general defusing of the debt problems also owes something to the very divergent trends and reform efforts in the individual emerging economies. In Russia, export revenue went up sharply as a result of the considerable increase in oil prices. The continuing slide in the value of the rouble, in addition, encouraged a process of imported goods being replaced by domestic products. Altogether, since mid-1999 the Russian economy has been moving back on to a growth path thanks to rising exports. The fiscal situation has also improved, aided by more efficient tax collection methods. The urgently needed restructuring of the banking system, however, has not advanced beyond initial steps. Structural reforms continue to be a precondition to Russia being able to undergo a lasting process of economic recovery. Russia's official and private creditors, through the reschedulings in August 1999 (Paris Club) and February 2000 (London Club) of debts arising from loans extended to the former Soviet Union, have made a considerable contribution not only towards easing the strain on the Russian balance of payments but also towards solving one of the country's main problems, i.e. the restructuring of public finances.

Risk premiums for Asian emerging economies have decreased most

It was in the Asian emerging economies, which had already suffered a crisis of confidence in 1997, that the economic revival made the greatest headway. On the whole, that region appears to have seen real economic growth of over 5 % in 1999. Those countries' current account surpluses were therefore not quite able to maintain their high level of 1998, which had been achieved primarily by curbing imports. The characteristic feature of the Asian region, as a whole, is that the risk premiums payable by public sector borrowers on the international markets have gone down to a level not merely below that of summer 1998 but actually quite close to that prior to the beginning of the east Asian crisis (the latter being exceeded by an average of around 100 basis points). It is precisely in east Asia that most emerging economies need to restructure and recapitalise their banking systems. In many cases, corporate restructuring is a prerequisite. Those unavoidable reforms are, however, making only sluggish headway in some cases. The creditable economic recovery should be seen as an opportunity to surmount the existing opposition to fundamental restructuring more easily.

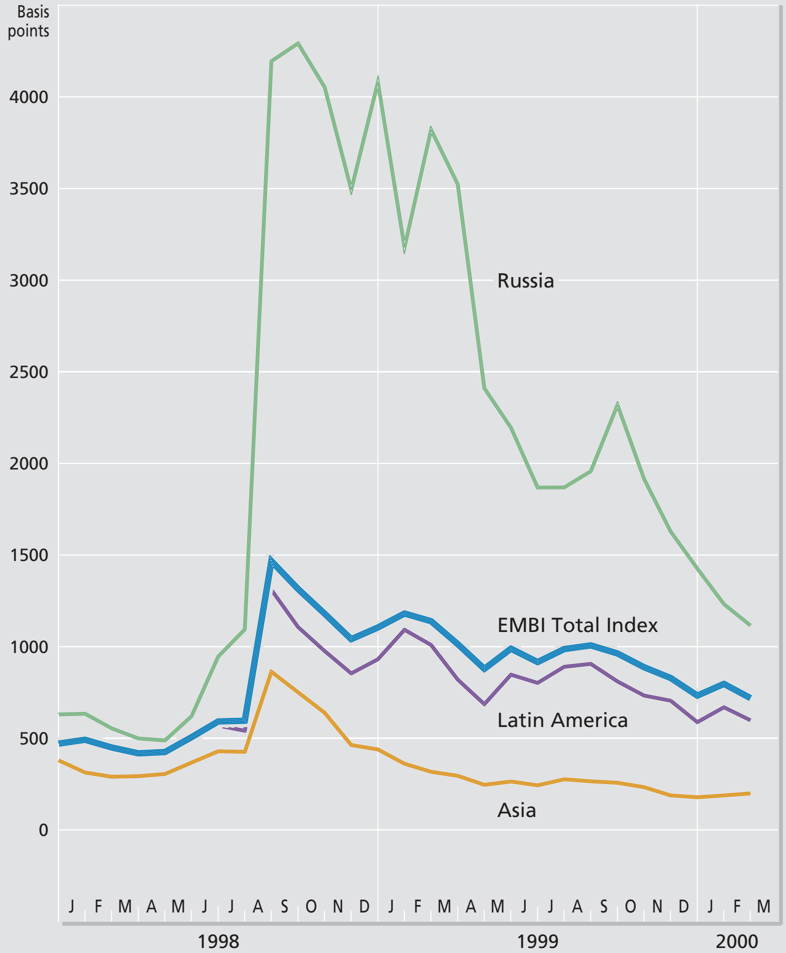
Relaxation in Latin America overshadowed by persistent current account problems

In Latin America, the Brazilian economy, in particular, has regained its footing with the help of the sharp depreciation of the real and the success in preventing an inflationary surge. Although progress has been made in reforming the public administration and the pension system, as well as in the privatisation of state-owned enterprises, the very large budget and current account deficits continue to cause concern. The deficit reductions envisaged in the draft budget are to some extent based on expectations of falling interest rates in that country's own financial market. However, there is considerable uncertainty as to whether that will happen, in the light of the economic recovery and the ongoing risks to prices. Any lasting gain in confidence in Brazil therefore depends on how successful the government is in consolidating public finances by means of structural reforms, thus durably counteracting the current account deficit. Argentina, Latin America's third-largest economy, faces current account problems of similar gravity to those of Brazil. Unlike Brazil, though, the Argentine current account deficit reflects a considerable loss of competitiveness. That is a result of Argentina having pegged its currency to the US dollar, and of the depreciation of most Latin American currencies (particularly the Brazilian real). The concomitant severe recession has, moreover, dampened imports in an unsustainable fashion. In order to convince foreign investors, in these circumstances, that the current account problems can be solved on the basis of the existing rate of exchange, radical

Risk premiums on emerging market government bonds*

Chart 19

End-of-month values



* Foreign-currency-denominated issues compared with long-term US government bonds. Source: J.P. Morgan, Emerging Markets Bond Index Global — Sovereign Spreads.

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internal adjustments seem inescapable. In keeping with this situation, the risk premiums for bonds issued by Latin American borrowers have gone down markedly less than those of bonds issued by Asian countries.

Initial findings of the Financial Stability Forum

The Financial Stability Forum, set up in April 1999 on the initiative of the G-7 countries, will make major contributions to pushing forward as comprehensively and quickly as possible the necessary stabilisation of the emerging economies' financial market systems, on top of the outstanding macroeconomic tasks. By improving cooperation among all important bodies and agencies, the Forum will endeavour to implement tried-and-tested rules so that financial markets function satisfactorily around the world. If appropriate, the Forum is also to propose improvements to the existing pattern of rules. To that end, the Forum monitors, on an ongoing basis, developments in the financial markets, paying particular attention to potential vulnerabilities which could have international significance. The Forum encompasses all international organisations and bodies addressing financial market issues, as well as the governments and central banks of the G-7 countries and also representatives of some other countries or territories with major international financial centres.[1] Initially, the Forum focused on studying more closely the problems posed by hedge funds and offshore financial centres as well as the challenges presented by volatile capital movements. The reports drafted by special working groups, along with detailed recommendations, were approved and published by the Forum in spring 2000. As regards the question of whether hedge funds and similar financial market players can be subjected to a sort of control in the interests of systemic stability, Germany advocated making bank lending to such institutions more transparent by setting up an international credit register similar to the German domestic credit register. In addition, the German representatives suggested subjecting such institutions to certain prudential supervisory regulations (particularly with a view to limiting the raising of outside funds). However, it has so far not been possible to gain sufficient support for this move. The Forum's recommendations have hitherto been confined to urging the lending banks to improve their risk management with respect to their lending to hedge funds (the indirect approach).

Progress in private sector involvement in crisis resolution

To be able to derive maximum benefit from international capital movements, it must be clear that, in the event of balance-of-payments crises, debtors and creditors must not expect the international community to bail them out. Otherwise, markets would not accurately reflect the real risks, which might increase risk potential and the probability of further crises. To reduce this danger of moral hazard, the G-7, in particular, continued to work last year towards elaborating clear principles on how to include the private sector in the resolution of financing problems in the event of international crises of confidence. The G-7 finance ministers provided important guidance in their report, presented in June 1999, on strengthening the international financial architecture. They reaffirmed the strict obligation upon all debtors to service their financial liabilities completely and in good time, but also stressed that creditors themselves must bear the consequences of the risks they have incurred. The G-7 countries therefore insisted

1 The Forum is based on a report by former Bundesbank President Dr Hans Tietmeyer. That report, entitled "International cooperation and coordination in the area of financial market supervision and surveillance", was published in the May 1999 edition of the Monthly Report.

Statement by the Federal Government on the admissibility of including collective action clauses in foreign sovereign bond issues subject to German law *

1. With a view to enhancing the international financial system's functionality, the IMF, the Group of Seven and the Group of Ten all strongly advocate that the terms and conditions of sovereign bond issues should include clauses that, in the event, would enable a bondholder majority to modify bond contracts. On various occasions the view has been expressed that German law would be at odds with such clauses in foreign bond issues. The Federal Government and the Deutsche Bundesbank, however, maintain that German law does not preclude the use of collective action clauses in foreign bond issues.
2. German law, as set out in the Act on the Joint Rights of Bondholders (Bondholders Act) of December 4, 1899, provides for amendment of the terms of bond issues by stipulating, under certain conditions, binding majority decisions. The Bondholders Act contains the technical provisions for convening bondholders' meetings and appointing a joint representative. It also sets out specific requirements for majority decisions which authorise a three-quarter majority at a bondholders' meeting, convened for this purpose, to temporarily waive or restrict bondholders' rights, particularly by reducing interest rates or granting respites in debt service, in order to avert payment terminations or insolvency proceedings and thereby to safeguard the bondholders' joint interests. Only the right to waive principal is reserved to regular insolvency proceedings.
   The Bondholders Act applies to private domestic debtors (but to that extent applies to bond issues denominated in either Deutsche Mark and euro or to foreign currency bonds). The Bondholders Act, by virtue of its designated purpose of preventing debtors' insolvency, does not apply to public entities as these are not subject to insolvency proceedings in Germany.
3. Since the Bondholders Act does not apply to bonds of foreign issuers, bonds issued under German law by foreign debtors are subject to the general principle of freedom of contract, which equally applies to private and sovereign foreign bonds. Since German statute law contains only a few basic principles concerning bonds, the contracting parties are basically at liberty to determine among themselves the terms and conditions under which bonds are issued, and consequently may also agree to include collective action clauses.
4. As no doubt is the case in all legal systems, the principle of freedom of contract is not limitless in Germany. The judicial benchmark for the terms of bond issues is the German Standard Contracts Act *(Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen)* of December 9, 1976, according to which a clause is void if it places one contracting partner (i.e., the bondholder) at an undue disadvantage to such an extent as to be incompatible with the principle of good faith. Owing to the suspected legal uncertainties, bond issues by non-residents under German law have hitherto, as a rule, not been furnished with collective action clauses. Hence there are no court rulings on the question of whether such clauses might lead to an undue disadvantage within the meaning of the Standard Contracts Act. In legal writings, however, it is acknowledged that no undue disadvantage would exist if collective action clauses were modelled on the principles of the Bondholders Act. That would require observance of the following rules:
   - The bondholders' meeting has to be convened by the debtor. It is summoned on the motion of a 20% quorum or by a joint representative appointed by the bondholders. The meeting can only be convened after having been publicly announced twice. At least two weeks' notice must be given after the second announcement.
   - A majority of at least 75 % is required for decisions that restrict or waive the rights of bondholders.
   - This majority is calculated according to the outstanding principal of the bonds. A minimum of one-half of the par value of the outstanding bonds must be achieved. The debtor is not entitled to vote with respect to the bonds he owns himself.
   - Majority decisions are binding on all bondholders provided they were passed with the intention of safeguarding the joint interests of bondholders (this prevents decisions to the detriment of individual bondholders).
5. Regarding the contents of majority decisions, it is permissible, without more ado, for bonds issued under German law by non-residents to incorporate clauses which match the Bondholders Act's provisions for bonds of domestic private issuers (without requiring any contractual arrangement to this effect). This applies to clauses which permit majority action with respect to a temporary reduction of interest payments or a respite in debt service payments. Beyond the scope of the Bondholders Act, it also might indeed be permissible to furnish bonds of foreign issuers with clauses which, for the purpose of safeguarding the interests of the bondholders, permit majority decisions on partial reductions of principal. In the case of German domestic bonds, the rationale of the law is that decisions to waive principal should be exclusive to standard insolvency proceedings. Since foreign debtors are not subject to German insolvency law, there is no reason to curtail freedom of contract with regard to domestic insolvency proceedings. On the contrary, in cases of imminent or actual insolvency, the joint interests of bondholders may be best served if bondholders participate, in an overall effort to resolve crises, in debt restructurings on the basis of majority decisions that include, as events warrant, a partial debt cancellation.
6. In summing up, according to the Federal Government's judgement, no legal impediments exist to incorporating collective action clauses in the bonds of foreign issuers issued under German law, provided that the debt restructuring serves to safeguard the joint interests of all bondholders.

***** Statement issued by the Federal Ministry of Finance, Berlin, on February 14, 2000.

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that, in a crisis scenario, private creditors must not be given preferential status vis-à-vis public sector creditors. At the same time, they recommended that the debtor countries should treat all groups of private creditors with sizeable claims in a comparable manner. This agreement, though, must be complemented by practical guidelines on how, in a specific case, the interaction between the debtor country, the IMF, bilateral public sector creditors and private debtors can be managed so as to ensure adequate private sector involvement in crisis resolution. The key here is to reach agreement on rules for private sector involvement not just in cases where formal debt rescheduling seems unavoidable owing to debt-service obligations that cannot be met over the longer term (the cases of Ecuador, Pakistan and Ukraine are recent examples of such unavoidable debt rescheduling). The principle of private sector involvement should also be applied to bridging solutions, i.e. to cases where the overall situation gives reason to expect that the debtor country will be able to re-enter the financial markets as a borrower on acceptable terms after a fairly short time. To ensure this, it is vital that the official community, in all circumstances, keep its own financial aid within relatively tight limits.[1]

No restrictions on collective action clauses for foreign bonds issued under German law

Important international bodies and organisations have been demanding for a long time that emerging economies include in their international bond issues contractual provisions which, in severe crises, would enable the creditors to take collective action on rescheduling bad debt, by majority vote, in binding fashion for all creditors, as an ex-ante measure to foster effective private sector involvement in crisis management. This has long been standard practice for emerging-market bonds governed by English law, but such bonds so far account for only about one-fifth of the market. Bond issues governed by US, German or Japanese law, however, do not follow this practice. In February 2000 the German Federal Government issued a press release stating that certain doubts expressed by German market participants as to the compatibility of such clauses with German law were unwarranted.

3. Recent developments in international financial institutions

IMF lending on the decline

Owing to the gradual defusing of international debt problems, the IMF granted distinctly fewer new loans in 1999 than in the two preceding years. This fall was accompanied by a sharp increase in repayments, reflecting both the massive vol-

1 See also: Deutsche Bundesbank, Recent approaches to involving the private sector in the resolution of international debt crises, Monthly Report, December 1999.

Purchases, repurchases and total credit outstanding under IMF facilities

Table 12

SDR billion

Item	1995	1996	1997	1998	1999
Purchases					
Credit tranches 1	14.4	2.5	13.3	12.1	7.5
Extended Fund Facility 1	2.0	2.6	2.7	6.3	1.8
Compensatory and Contingency Financing Facility	0.0	0.2	0.1	2.2	0.7
Systemic Transformation Facility 2	0.6	–	–	–	–
Structural Adjustment Facility 3	1.4	0.7	0.7	0.9	0.7
Total purchases	18.4	6.0	16.8	21.5	10.7
Repurchases	7.1	5.6	6.3	7.3	20.0
Net purchases	11.3	0.4	10.5	14.2	– 9.3
Total IMF credit outstanding 4, 5	41.6	42.1	52.6	66.8	57.5
of which					
Europe	11.4	13.9	15.7	19.6	17.4
Asia	4.8	3.7	15.5	24.2	17.9
Latin America	18.0	16.6	13.8	15.6	14.9
Africa	7.1	7.5	7.1	6.8	6.6

Source: IMF. — **1** Including purchases under the Supplemental Reserve Facility (SRF). — **2** Temporary facility for transitional countries; purchases were possible until the end of 1995. — **3** Including the Structural Adjustment Facility (SAF) and the Poverty Reduction and Growth Facility (PRGF; formerly the Enhanced Structural Adjustment Facility, or ESAF); both facilities are financed out of special accounts administered by the Fund and are available only to countries whose per capita income is particularly low. — **4** Level as at the end of the year. — **5** Delineation of regions according to IMF definitions; "Europe" includes, *inter alia,* the regions of the former Soviet Union.

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ume of lending in earlier years and the shorter maturities of some of those loans. Altogether, the IMF's outstanding credit went down from the all-time high of SDR 66.8 billion it had reached at the end of 1998 to SDR 57.5 billion at the end of 1999. The bilateral credits to Brazil coordinated with the aid of the BIS and granted as a complement to IMF financing operations were also repaid. The temporary Y2K facility, set up as a precaution to deal with any balance-of-payments difficulties caused by the transition to the year 2000, was not used.

Contingent Credit Lines have come into effect

On the initiative of the G-7 countries, the Contingent Credit Lines (CCL) were introduced in April 1999 as a complement to the Supplemental Reserve Facility (SRF). The CCL are intended to be granted, subject to certain conditions, as a confidence-boosting measure to countries with fundamentally sound economic policies which appear to be threatened by contagion effects. Like the SRF, the CCL, in case of need, enable distinctly higher credit volumes to be disbursed faster than the Fund's standard facilities; against this, the repayment deadlines are shorter and the loan costs higher. From the German standpoint, the large volumes of credit and their more rapid disbursement are problematic, however, since they may lead to private creditors being bailed out by public financial resources. Without adequately involving private creditors in crisis management, there is a danger of the functioning of the markets being increasingly impaired. Hence the Bundesbank is, at the very least, opposed to demands for softening the terms of access to the CCL and to reducing the rate of interest charged for recourse to the CCL.

Debate on the IMF's future role

The continuing discussion on the CCL is part of a fundamental debate on reforms aimed at redefining the IMF's role in the international monetary system. The key demands being made in this debate on reform include the refocusing of the Bretton Woods institutions on their real mandates and, accordingly, reviewing the numerous IMF facilities. In the view of the Bundesbank, the IMF should focus more on financial aid to combat short-term balance-of-payments problems. The task of financing longer-term structural adjustment processes would then have to be assumed by the development banks. Moreover, the IMF, in keeping with its role as a catalyst, should only provide a limited part of the necessary balance-of-payments assistance. Refocusing the IMF on its core tasks would logically imply distinctly cutting back its financing facilities. Initial steps have already been taken in that direction.

Reform of the Interim Committee

In autumn 1999 the IMF Board of Governors decided to transform the Interim Committee (IC), created as a temporary measure in 1974, into a permanent International Monetary and Financial Committee (IMFC). The core tasks of the IMFC correspond to those of the former IC. The Committee is intended primarily to monitor the international monetary and financial system, to discuss proposals by the Executive Board on amending the IMF Articles of Agreement, and to respond to crises of international significance. The IMFC's role was upgraded. To that end, its meetings – usually semi-annual – are preceded by a preparatory meeting of the deputies of the IMFC members. In addition, the President of the World Bank and other important observers take part in the Committee's deliberations and, if necessary, the IMFC and the Development Committee of the IMF and World Bank are to meet jointly. The newly established informal group of major industrial countries and emerging economies (G-20), whose finance ministers and central bank governors convened in Berlin in December 1999 for their first meeting, will likewise serve as an additional forum for discussing issues relating to the international financial system. Between the IMFC and the informal groups, it must be ensured that all countries are adequately represented in the resolution of the relevant issues. In particular, this means that the significance of the IMFC, as a forum with global representation and official legitimation, must not be undermined.

Encouraging market transparency and good practices

As part of the general effort to foster financial market stability by improving lenders' information base and encouraging borrowers to behave in a sound manner, the IMF has made further headway in its field of operations. After a "Code of Good Practice on Fiscal Transparency" was adopted back in 1998, a further "Code of Good Practice on Transparency in Monetary and Fiscal Policies" was adopted in July 1999. Such codes rest on the conviction that the transparency of government action is one of the key prerequisites for good governance and therefore, in the end, for stability and growth. Compliance with these codes is to be monitored by the IMF in conjunction with other institutions; it is to be expected that the transparency requirement will at the same time provide the essential leverage for pressing on with the implementation of sound behaviour rules. In parallel with the work on the codes, the disclosure requirements included in the Special Data Dissemination Standard (SDDS) were expanded, particularly with respect to foreign exchange reserves and external debt. A data template developed in cooperation with the G-10 central banks and used by the Bundesbank since mid-1999 is applied to foreign exchange reserves and short-term government liabilities denominated in foreign currency. In addition, the IMF is providing greater access to its own analyses. The outcomes of general strategy debates, among other things, are being published, as are the hitherto confidential reports on annual economic policy consultations with member countries – as part of a pilot project in which Germany is a participant. Germany, in principle, welcomes the increased transparency of the Fund. However, such publications must also take care to ensure that the openness and frankness of debate in the Executive Board, or between the IMF and its members, are not thereby impaired.

The PRGF as a tool for fighting poverty

The IMF and World Bank decided in 1999 to transform the Extended Structural Adjustment Facility (ESAF) into a Poverty Reduction and Growth Facility (PRGF), with the aim of combating poverty. This explicitly expanded the goals of the former ESAF – strengthening balance-of-payments positions and promoting growth – to include the objective of reducing poverty. PRGF credits must be based on appropriate economic programmes and poverty-fighting strategies. The strategy papers should be drafted by the authorities of the recipient countries, with broadly-based consultation of both the civilian society of the affected developing countries and the bilateral donors and multilateral financial institutions. Altogether, the PRGF resembles a quasi-development-aid facility, having little in common with the IMF's monetary mandate. From the Bank's vantage point, this therefore raises the question as to whether this facility – at least over the medium term – should not be transferred completely to the World Bank.

Incidentally, a problem is posed by calls to make as many countries as possible eligible for debt-reduction aid and therefore to reach agreements on a large number of the PRGF programmes necessary to this end. The success of PRGF programmes will hinge, in particular, on their being well-prepared. Only "high-quality" strategies can ultimately contribute to achieving lasting reductions in poverty.

Enhancement of the debt initiative

Owing to the decisions of the Cologne Economic Summit of June 1999, the Development Committee and the Interim Committee approved an enhancement of the debt initiative for heavily indebted poor countries (HIPC) in autumn 1999. Reductions of the targets for a sustainable debt burden and faster disbursement of assistance, depending on the progress achieved in adjustment, are meant to ensure that debt relief can be granted earlier and more comprehensively to a larger number of countries. To finance its part of the enhanced debt relief, the World Bank will probably need to rely much more than in the past on its HIPC Trust Fund being replenished by means of bilateral donations. Yet that would probably also make it possible to use this trust fund to finance some of the debt relief granted by regional development banks. To cover the costs incurred by the IMF, in autumn 1999 the Fund members approved an aid package of just under SDR 4 billion, or US$ 5½ billion, which, however, comprises not only the IMF contribution to the HIPC debt initiative but also interest subsidies for continuing PRGF operations from 2001 to 2004. SDR 2½ billion of this package is to come from the IMF's own resources, and SDR 1½ billion is to be financed through bilateral contributions.

Use of IMF gold for the enhanced debt initiative

The IMF's own financial contribution to the enhanced debt initiative will be raised, in addition to the use of special interest income from Fund credits, primarily by having recourse to undisclosed reserves in the Fund's gold holdings and interest income derived from their investment. For that purpose, the IMF will use up to 14 million ounces of its gold holdings, which total 103 million ounces. To liquidate the undisclosed reserves, the gold, having a balance-sheet value of SDR 35 per ounce, will first be sold to selected debtors at the higher market value. The purchasers will then use the gold to repay their debts to the IMF, leaving the Fund's gold holdings unchanged but leading to valuation gains from these transactions, which the IMF will then invest at interest to fund the HIPC initiative. For the bilateral contributions to funding the IMF's share of the enhanced debt initiative, most countries are using their share of recently liquidated IMF reserves. Germany, however, has chosen instead to grant the PRGF-HIPC trust fund a ten-year interest-free loan totalling € 300 million. The present value of the "interest-rate advantage" of the IMF roughly corresponds to the German share of the liquidated reserves (SDR 85 million). The Bundesbank's loan, however, is being granted only subject to the condition that the burdens are spread equitably among the major bilateral donors, that the sales of IMF gold are limited to a maximum of 14 million ounces, and that the separation of the Fund's general financial resources and the long-term, quasi-development-aid funds of the PRGF remains intact.

Massive lending commitments by multilateral development banks

Lending commitments by multilateral development banks in 1999 were characterised largely by aid for those countries which were hit particularly hard by debt crises. The lending commitments by the International Bank for Reconstruction and Development (IBRD) went up slightly, from US$ 21.1 billion in the 1998 financial year to US$ 22.2 billion in 1999; the IBRD's outstanding loans increased over the course of the 1999 financial year from US$ 107 billion to somewhat over US$ 117 billion. Of those commitments, nearly US$ 5 billion was accounted for by Indonesia, Korea and Thailand, mostly in the form of adjustment loans that can be disbursed quickly. The 1999 lending commitments by the Inter-American Development Bank (IDB) (excluding concessional loans), at some US$ 9.1 billion (US$ 9.4 billion in 1998), likewise remained at a relatively high level. That is mainly because over one-half of these loan commitments are accounted for by an emergency programme for countries whose balance-of-payments situations are particularly critical. That emergency programme gave the IDB a much wider scope for lending which ultimately constitutes balance-of-payments assistance. In contrast to the aforementioned multilateral development banks, the lending commitments of the Asian Development Bank (ADB) in 1999 reverted more or less to the lower lending volumes of the years before the onset of the Asian crisis. The lending commitments by the ADB on market-related terms, totalling some US$ 4.0 billion in 1999, corresponded roughly to the comparable figure for 1997, if the loan of just over US$ 4 billion granted to Korea in that year is disregarded.

Operations of the Deutsche Bundesbank

I. Processing cash payments and cashless payments

1. Cash payments

Banknotes and coins in circulation

The value of banknotes in circulation at December 31, 1999, at DM 274.1 billion, was DM 18.8 billion, or 7.4 %, higher than at the end of 1998. However, the value of coins in circulation rose by no more than 1.2 %. At the end of 1999, 94.5 % of all currency in circulation consisted of banknotes, and 5.5 % of coins.

Currency in circulation and its pattern

Table 13

Trends over time

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
1995	263,510	248,363	15,147
1996	275,744	260,390	15,353
1997	276,242	260,686	15,556
1998	270,981	255,335	15,646
1999	289,972	274,133	15,839

Pattern at the end of 1999

Banknotes in circulation			Coins in circulation		
Notes of DM	DM million	Percentage of total	Coins of DM	DM million	Percentage of total
1,000	93,485	34.1	10.00	2,632	16.6
500	27,828	10.2	5.00	5,677	35.8
200	8,014	2.9	2.00	2,363	14.9
100	106,371	38.8	1.00	2,321	14.7
50	23,027	8.4	0.50	1,135	7.2
20	9,538	3.5	0.10	1,069	6.7
10	5,571	2.0	0.05	324	2.0
5	299	0.1	0.02	151	1.0
			0.01	167	1.1
Total	274,133	100	Total	15,839	100

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At the end of the period under review approximately 2.8 billion notes were in circulation. The comparatively high level of circulation is likely to have been due mainly to the desire for liquidity in the form of banknotes in order to be armed against possible shortages – for technical reasons – in the currency supply (millennium date change).

Destruction of banknotes

The following banknotes have been destroyed in the past few years:

	1995	1996	1997	1998	1999
Number (million)	739	659	1,466	1,475	795
Value (DM billion)	50.6	27.7	118.9	96.2	43.0

The sharp decline in the volume of notes destroyed in 1999 is mainly due to the fact that the destruction of DM 50, DM 100 and DM 200 notes of the old type had been largely completed in 1998. In 1997 and 1998, the issuing of banknotes in the above-mentioned denominations with enhanced security features and the resulting removal from circulation of the old notes had led to a very high volume of destroyed notes.

Coins

The stock of German coins held by the Bank at the end of 1999 amounted to DM 1,704 million (end-1998: DM 1,955 million). The Federal Government was redebited for the amount exceeding 10 % of the total coins in circulation. In 1999 about DM 137 million was credited to the Federal Government in respect of coins received from the mints and about DM 195 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1999 the Bank – acting for the account of the Federal Government – received coins amounting to DM 19,993 million and redeemed coins which were no longer fit for circulation or which had been called in, equivalent to DM 2,450 million. At the end of 1999 coins totalling DM 15,839 million were in circulation, equivalent (given 82 million inhabitants) to around DM 193 per head of the population.

Counterfeits

The number of counterfeit banknotes and coins detained in payments and appraised by the Bundesbank was significantly down on the previous year; there was, however, an increase in counterfeit coins.

Counterfeits detained in payments, as recorded by the Bundesbank — Table 14

	Banknotes		Coins	
Year	Number	DM thousand	Number	DM thousand
1995	31,148	4,919	24,201	111
1996	25,769	3,839	35,352	169
1997	33,873	3,933	14,983	67
1998	36,139	4,129	19,990	98
1999	22,532	2,316	26,813	132

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Counterfeits of the DM 50, DM 100 and DM 200 of the type without the new security features, which are now encountered very rarely in payments, made up 56 % of the total. Counterfeit DM 5 coins accounted for 98 % of all coin counterfeits.

2. Cashless payments

Downward trend in payments through the Bank

In 1999 the introduction of the euro and the "competition" which this initiated among the various payment systems in the euro area had a strong impact on the volume and the total amount of payments settled through the Bank. Overall, 2.2 billion payments totalling € 64,913 billion were submitted in the reporting year. This represented a decline of 3.6 % in the number of items processed. The fall in the total value, at almost 46 %, was much more severe, however, and was mainly due to the loss of "market shares" of Euro Access Frankfurt (EAF).

Paperless processing as a precondition for the introduction of the euro

1999 was the first reporting year in which all interbank payments were processed in paperless form. The adoption of the necessary data processing structure was a prerequisite for the introduction of the euro and avoiding rounding differences in cashless payments. Since January 1999, both the original amount (for example, in euro) and the corresponding amount calculated by conversion (in this case, the DM amount) can be passed on without further intervention or conversion to the beneficiary's bank by means of a second amount field in the data record (in addition to one field for recording the currency in which the order was originally submitted). Each bank is then able to choose the appropriate amount for the debit and credit entries on the relevant customer accounts.

Implications of paperless processing for the Bank's procedures

The Bank now accepts paper-based orders in retail payments only from its own non-bank customers (such as the public sector) and passes them on in paperless form. The only orders that credit institutions may now present in paper form are cheques to the amount of DM 5,000 or more for the large-value cheque collection (GSE) procedure, which is processed technically using the retail payment procedures, and for the large-value payment procedure Euro Link System (ELS) restricted to payments with the highest priority (Prior 1).

Changes to operating and settlement times in large-value payments

The new environment within the Eurosystem has brought major changes to operating and settlement times in the Bank's cashless payments. In the reporting year, domestic Prior 1 payments and cross-border TARGET payments delivered by data telecommunication were accepted in the period between 7 a.m. and 6 p.m. (i. e. also outside normal working hours at the branch offices), including on certain public holidays, such as Good Friday and Easter Monday. The payments are booked through the new central account management system in a special "high-availability computer centre".

The Bank's cashless payments — Table 15

Item	1998		1999			
	Number (million)	€ billion	Number (million)	Change in %	€ billion	Change in %
Retail payments						
Paper-based settlement						
Cheques	11.1	76	–	–	–	–
Credit transfers	–	–	–	–	–	–
Total	11.1	76	–	–	–	–
Paperless settlement (RPS) 1						
Direct debits, cheques	1,499.6	1,523	1,398.0	– 6.8	1,508	– 1.0
of which: Conversions	66.1	970	59.2	– 10.5	970	0.1
Prior 3 payments	739.7	669	778.2	5.2	733	9.6
of which: Conversions	2.8	7	1.8	– 35.7	8	13.1
Total	2,239.3	2,192	2,176.2	– 2.8	2,241	2.3
Grand total	2,250.5	2,267	2,176.2	– 3.3	2,241	– 1.1
Large-value payments						
Gross settlement procedures						
ELS	13.5	20,129	16.0	19.1	22,375	11.2
Other 2	0.9	1,175	0.4	– 61.1	1,255	6.8
Total	14.4	21,304	16.4	13.8	23,630	10.9
Net settlement procedures (Daily local clearing system)						
Collection items 3 (conventional)	0.1	44	0.0	– 98.2	0	– 99.0
EAF	22.5	96,253	12.1	– 46.3	39,041	– 59.4
Total	22.6	96,298	12.1	– 46.4	39,041	– 59.5
Grand total	37.0	117,602	28.5	– 22.9	62,671	– 46.7
Cashless payments	2,287.4	119,869	2,204.7	– 3.6	64,913	– 45.8

1 Including payments submitted in paper-based form which were converted and passed on in a paperless form by the Bundesbank's units. — **2** For example, special procedures for public authorities. — **3** Settled delivery envelopes (clearing items).

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Continuing rise in the number of items processed in the Euro Link System (ELS)

The real-time gross settlement system, Euro Link System (ELS), is also settled using the "high-availability computer centre". Under the ELS procedure, orders are sorted by priority. Prior 1 payments are executed individually and in real time, whereas Prior 2 payments are settled in batch mode. Prior 1 payments are executed on a same-day basis. Prior 2 payments are also settled on a same-day basis if the payment orders can be delivered by data telecommunication as well as sent out electronically to the receiving bank, and are covered by 4.30 p.m. In the year under review, almost 6 million Prior 1 payments (+ 18.5 %) and somewhat more than 10 million Prior 2 payments (+ 19.4 %) were processed. Of the total 16 million orders under the ELS procedure, 13 million were placed by means of data telecommunication and 0.6 million on diskette.

Considerable decline in Euro Access Frankfurt (EAF)

Following the loss of its "home advantage" in the settlement of foreign exchange market activities in Deutsche Mark/US dollar, Euro Access Frankfurt (EAF) was unable to maintain its former position in the Bank's payments. Overall, the number of items processed as well as the total amount declined by roughly one-half. Foreign banks made greater use of other payment systems for passing on their large-value payments in euro to German credit institutions and for settling them with those institutions.

RTGS^{plus}: a new system produced by the integration of ELS and EAF

The Bank has responded to the changes that have occurred in European large-value payments since the start of 1999 and, together with the banking industry, has designed a new liquidity-saving euro-area large-value payment system, "RTGS^{plus}" and, in doing so, is also incorporating earlier strategic proposals for optimising its systems. The new system will utilise and integrate the advantages of the existing large-value payment procedures ELS (real-time gross settlement and access to the European TARGET system) and EAF (liquidity-saving settlement). RTGS^{plus} will thus become a competitive euro-area individual payment system which is intended to set new standards in terms of its scope of performance and availability.

3. Notable developments in domestic and cross-border payments

(a) TARGET – the cross-border real-time gross settlement system for the euro

TARGET: euro-area large-value settlement system with the highest turnover

The TARGET (Trans-European Automated Real-Time Gross Settlement Express Transfer) system comprises the 15 national real-time gross settlement (RTGS) systems and the ECB Payment Mechanism. From the outset, it has gained a high degree of acceptance and established itself as the euro-area large-value payment system with the largest turnover. Around 28,800 payments amounting to € 360 billion were processed on a daily average in 1999. An average of more than one-third of all orders (10,300 payments) and more than one-quarter of the total amount (just under € 95 billion) were submitted by Germany for passing on to other countries.

Start-up problems

Although the start of TARGET operations was, on the whole, successful, there were some difficulties – especially during the first week of operation – in applying the special technical regulations and specifications that pertain to TARGET. This led to higher-than-expected rejection rates, causing problems in processing and booking.

Temporary extension of operating hours

From January 11 to 29, 1999 the cut-off time for interbank payments in the TARGET system was extended from 6 p.m. to 7 p.m. (Frankfurt local time) in order to give the banks time to get used to the new TARGET environment. The cut-off time for customer payments (5 p.m.) remained unchanged, however. Concurrently during that period, access to the Eurosystem's deposit facility was made available for one hour (rather than 30 minutes) after the close of the TARGET system.

TARGET holidays in 2000

Experience of the first half-year of 1999 had shown that all TARGET business days were regarded as value dates for financial market activities processed in euro. Consequently, the volume of TARGET payments processed was comparatively high even on days that were holidays, such as Good Friday and Easter Monday. Cross-border payments on those days amounted to two-thirds and one-half, respectively, of the normal volume. Given the financial and social cost resulting from the operation of the TARGET system on days that are traditionally (bank) holidays in the majority of EU countries, and by virtue of a request in this matter by the European banking industry, on July 15, 1999 the Governing Council of the ECB increased the number of TARGET holidays from two (New Year's Day and Christmas Day) to six for the year 2000 (additionally, Good Friday, Easter Monday, May 1 and December 26). On those days, no cross-border TARGET payments will be processed. The national RTGS systems in countries of the euro area where such a day is a national holiday will likewise remain closed. Central banks in euro-area countries where there is no national holiday are to close their national RTGS systems if this is feasible. If this is not possible (on legal grounds, for example), the central bank concerned should restrict national activities to the greatest possible extent.

Users' survey

In the first quarter of 1999, the Eurosystem conducted a users' survey in order to ascertain whether the reliability of the TARGET system and the range of services provided meets the banks' expectations. The findings appeared in the report "Cross-border payments in TARGET: A users' survey", which was published in November 1999. The report is based on a questionnaire that was submitted to the European banking associations and the national TARGET user forums as well as other parties.

Survey findings

The findings of the survey reveal that TARGET is recognised *de facto* as the standard system for cross-border large-value payments in euro. The banks do not regard TARGET as a central bank instrument that they are obliged to use, but rather as a service – not least for reducing the risks associated with their operations. The banks nevertheless pointed out a number of shortcomings in areas such as the technical availability and harmonisation of the services provided by TARGET, in which they expect further improvements. The report also gives an account of these issues from the point of view of the Eurosystem and highlights the measures that have already been taken (for example, the use of emergency procedures in the event of extended interruption to operations for the purpose of processing a small number of especially important interbank payments) or have been tested (such as improved information management in the event of interruptions to operations).

(b) Electronic money

EU Commission's proposed directives

The EU Commission's proposals for the amendment of the First Banking Co-ordination Directive and for the e-money directive were approved as joint standpoints by the ECOFIN Council in November 1999 and are now being debated in the European Parliament. As things stand at present, Article 1 of the First Banking Co-ordination Directive will be amended to include e-money institutions in its definition of credit institutions. This proposal is largely consistent with the provisions of the Banking Act in force since January 1, 1998, pursuant to which the issuance of e-money in Germany is restricted to banks. The e-money directive stipulates *inter alia* that the First and Second Banking Co-ordination Directives are to be applied generally to e-money institutions and that, notwithstanding this, owing to the special nature of e-money business, the provisions contained in the directive, such as the legal obligation to convert e-money into central bank money, requirements pertaining to the initial capital and current capital and reserves, restrictions on investment for e-money institutions as well as provisions on exemption from them are to apply. The monetary policy requirements of the Eurosystem have largely been met by e-money institutions being accorded the status of credit institutions and by the legal obligation to convert e-money into central bank money. Owing to international integration beyond the euro area, especially in the field of e-commerce, questions pertaining to the supervision of issuers of e-money and the security of payments over the Internet are also to be coordinated worldwide, for example, within the group of G-10 central banks.

Still no breakthrough in Germany

There are no signs so far of a sustained move to a more widespread use of the German banking industry's prepaid card system *GeldKarte.* As before, this is being attributed to the charges, which the retail trade feels to be too high, insufficent awareness on the part of potential users and a lack of additional applications.

Possible outlook

A particular factor that argues in favour of e-money being used more widely, however, is its convenience: fairly small amounts can be paid exactly at all times without using small change. As an additional function on debit and credit cards, the electronic purse extends the range of payments to small amounts, with the future possibility – following the implementation of appropriate security standards – of these cards being used for e-commerce on the Internet. It is precisely the forecast sharp growth in e-commerce which will depend on secure and efficient settlement and payment systems. Furthermore, it is becoming apparent that the additional applications on the electronic purse chip, for use in local public transportation, in car parks, or for phoning, for example, will promote the use of e-money. The planned cross-border use of electronic purses could also enhance the attractiveness of e-money, above all, in the euro area.

(c) Activities at the G-10 level

Foreign exchange settlement risks

The Committee on Payment and Settlement Systems of the Group of Ten Countries (CPSS) at the Bank for International Settlements (BIS) has continued its work on foreign exchange settlement risks. Following on from the Allsopp report (March 1996), which not only contained an analysis of the procedures for settlement in forex trading payments but also presented a strategy for reducing the settlement risk, and the 1998 report, which assessed the progress made in the interim, the CPSS is currently cooperating closely with groups in the banking industry on initiatives for providing risk-reducing multi-currency services. In this area, particular attention is being focused on the CLS project, in which big international banks are making intensive preparations through Continuous Linked Settlement Services Ltd., London, to settle foreign exchange payments in the near future on the PVP (payment versus payment) principle via the CLS Bank established in New York. Initially, this is likely to be for the currencies US dollar, Canadian dollar, euro, pound sterling, Swiss Franc, Australian dollar and Japanese yen. Additionally, the CPSS is supporting the Basle Committee on Banking Supervision in the preparation of prudential guidelines for credit institutions concerning the management and control of settlement risks. In July 1999, the Basle Committee published draft guidelines for consultation and initiated the final work on this paper. In order to achieve a further reduction in the settlement risk in forex trading, the CPSS has also stepped up work in collaboration with central banks of countries which are not members of the Group of Ten.

Retail payment systems

In September 1999, the CPSS published an initial report on retail payments entitled "Retail payments in Selected Countries: A Comparative Study". The report aims to contribute to a better understanding of retail payment systems in the G-10 countries and in Australia. It focuses on the markets which are relevant to consumers and enterprises, and deals mainly with the technical and economic aspects of retail payment instruments. The working group commissioned by the CPSS is currently preparing a second report which is concerned with the systems for processing and settling payments in the above-mentioned countries.

Core principles for systemically important payment systems

In December 1999, the CPSS published a consultation paper, which was approved by the G-10 central bank governors, entitled "Core Principles for Systemically Important Payment Systems". The consultation paper is the first part of a two-part report by an international task force of the CPSS. Its aim is to create secure and efficient payment systems as a precondition for the stability of the financial systems. In support of this aim, the report sets out ten core principles for the organisation and operation of systemically important payment systems (SIPS) to be applied worldwide and, additionally, states four central bank responsibilities describing the competence and the oversight function of the central banks in the application of the core principles. The task force is currently engaged in preparing the second part of the report. This will mainly deal with the issues and practical aspects which may arise when implementing the principles. Furthermore, it will give interpretative assistance and provide guidelines for applying the principles under differing economic circumstances and conditions from country to country.

II. The Bank's international operations

Cheque collection, items on a commission basis and dealings in foreign banknotes

During the year under review, the Bank sold 26,612 cheques payable to order and drawn on non-residents amounting to € 54 million (compared with 28,593 cheques totalling € 79 million in the previous year). Moreover, 43,242 cheques worth € 60 million were presented in 1999 under the simplified collection procedure for foreign cheques; in 1998 38,756 cheques worth € 40 million had been so presented. In addition, in 1999 the Bank accepted for realisation 6,789 items (mainly bills of exchange and cheques) on a commission basis; in the preceding year 5,861 such items had been accepted. Dealings in foreign banknotes expanded strongly on account of the Bank's offer to buy banknotes issued by the central banks of the Eurosystem from anybody. During the year under review, more than 250,000 purchases of foreign banknotes and almost 18,500 banknote-collection orders were processed, compared with only about 13,000 purchases and 4,000 collection orders in 1998.

III. The Bank's money-market and refinancing operations as part of the Eurosystem

Transition to EMU

In order to foster a smooth operational transition to EMU, in December 1998 the Bank endowed the two securities-repurchase transactions spilling over into monetary union with roughly equal volumes, since the aim was to have approximately equal amounts maturing under overlapping refinancing transactions of the national central banks on the first two main tender dates of the Eurosystem. Moreover, since traditional German discount credit was abolished upon the transition to monetary union, up to the end of 1998 the Bank bought only bills of exchange which fell due not later than January 14, 1999 (the value date of the Eurosystem's first longer-term refinancing operations – known as "basic tenders").

However, a number of procedural and legal modifications were required as well. In particular, it is worth mentioning that the collateralisation of refinancing operations in Germany is now being effected on the basis of pledges. That is to say, the collateral eligible for refinancing operations is added to a "collateral pool" which is applied "en bloc" to the collateralisation of all refinancing credits granted by the Bank. Unlike the conditions applying to the Bank's former securities-repurchase transactions, the financial instruments included in the collateral pool are no longer earmarked for specific refinancing operations.

By contrast, the Bank's lombard-loan facility required very little adjustment for the transition, since the Eurosystem's marginal lending facility resembles the former lombard-loan facility in both operational/technical and legal respects. Spilling-over recourse was confined to the transition weekend (up to January 3, 1999).

Counterparties ...

The prime condition for participating in the monetary policy operations of the Eurosystem is that an institution has the status of a "counterparty". In principle, the term encompasses all institutions which are required to hold minimum reserves pursuant to Article 19.1 of the ESCB Statute, and which are financially sound. Initially, those conditions were fulfilled by 3,238 institutions in Germany, although that figure fell to 2,992 in the course of the year as a result of ongoing mergers in the banking industry. Accordingly, at the end of 1999 Germany accounted for about 40 % of the total number of counterparties in the euro area (just under 7,900).

... in regular open market operations

In order actually to have access to monetary policy operations, counterparties must satisfy certain operational conditions. For instance, for participation in regular open market operations, the Bank requires a pledge account and connection to the Automatic Bidding System (ABS). The number of German institutions thus entitled to participate rose in the course of last year from 1,472 to 1,550 (in the Eurosystem as a whole, there were about 2,550 such institutions at the end of 1999). Recourse to the marginal lending facility requires both a giro account at a Land Central Bank and a pledge account. In this case, the number of eligible institutions declined in the course of the year from 2,270 to 2,132 (in the Eurosystem as a whole: about 3,200 institutions at the end of 1999). For access to the deposit facility, finally, only an account at a Land Central Bank is needed. In this respect, too, Germany registered a decline in the course of the year, viz. from 2,772 to 2,668 institutions (Eurosystem as a whole: roughly 3,750 institutions at the end of 1999).

... in standing facilities

... in fine-tuning operations

On account of the higher operative and technical requirements, only a small number of institutions can be considered for fine-tuning operations. A major selection criterion here is a credit institution's activity in the money or foreign exchange market. At present, the Bank could call, if required, on a maximum of 47 counterparties for money-market operations and on 18 for foreign-exchange-market transactions (Eurosystem as a whole: about 200 and 100 institutions, respectively, at the end of 1999).

Main refinancing operations

The prime instrument of money-market management by the Eurosystem is main refinancing operations, with a normal maturity of two weeks, which are offered weekly, and through which, on an annual average, around three-quarters of central-bank-money requirements were met. Altogether, 52 open market operations were conducted in 1999 in the form of fixed-rate tenders at the pre-announced fixed interest rate of 3 % or 2.5 %. € 138.4 billion (annual average) was allocated in the Eurosystem last year, about one-half of that sum (€ 66.3 billion) being accounted for by German banks. The large German share is primarily due to the substantial amount of Deutsche Mark currency in circulation.

Longer-term refinancing operations

In order to steady the money market, and as a contribution to facilitating the liquidity management of banks that are less active in the money market, longer-term refinancing operations with maturities of three months were also offered at monthly intervals. With respect to maturity and volume, those operations include features which are reminiscent of the Bank's former discount credit. Altogether, 14 so-called "basic tenders" were conducted in 1999 in the form of variable-rate tenders of pre-announced size. The first four such operations were carried out in the shape of Dutch-style variable-rate tenders, and the rest – after all banks had gained sufficient experience of bidding – in the form of US-style variable-rate tenders. On an annual average, the amount allotted came to € 47 billion, i.e. one-quarter of the aggregate refinancing requirements. The German share averaged approximately 60 % of the sums allotted.

Fine-tuning operations

In 1999 the Eurosystem managed without any short-term assistance measures in the money market. This was due to the buffer function played by the minimum reserves, to smoothly functioning payment systems and to professional liquidity management by money-market players.

Marginal lending facility

The marginal lending facility is designed to provide overnight liquidity, which counterparties can obtain at any time on their own initiative, and in amounts limited only by the collateral available to them (a so-called "standing facility"). As a daily average of last year, this facility in the Eurosystem was drawn on to the extent of only € 1.0 billion, the Bank's share of which amounted to € 0.6 billion. Especially in the first few weeks of monetary union, however, there were some relatively heavy calls on the marginal lending facility because cross-border liquidity adjustment in the market was not yet properly warmed up. In the Eurosystem as a whole, the highest level of recourse was recorded on January 4, 1999, at € 27.7 billion, and at the Bank on January 5, 1999, at € 16.2 billion.

Deposit facility

The deposit facility, the second standing facility of the Eurosystem, constituted an instrumental innovation for German credit institutions. In effect, it is designed as the mirror-image of the marginal lending facility, and enables credit institutions to lodge excess liquidity overnight with the central bank at an interest rate running below the main tender rate. As a daily average of last year, recourse amounted to € 0.8 billion for the Eurosystem as a whole, and to € 0.4

billion for the Bank. Rather like the marginal lending facility, the deposit facility was much and frequently utilised, especially in the early weeks of monetary union. But once cross-border liquidity adjustment had duly warmed up, recourse focused on the ends of the minimum reserve periods. A significant factor here was that the ECB tended to supply the money market with comparatively plentiful liquidity towards the end of a reserve period. For the Eurosystem as a whole, the highest level of recourse, at € 16.1 billion, was reached on September 23, 1999; for the Bank, at € 7.4 billion each time, on January 4 and June 23, 1999.

Range of assets eligible as collateral for refinancing operations

The range of assets that the Bank accepts as collateral for the monetary policy operations of the Eurosystem is broad. Two categories are distinguished: tier-one assets comprise only marketable debt instruments which satisfy uniform euro-area-wide eligibility criteria specified by the ECB. Tier-two assets include additional marketable assets and non-marketable debt instruments which are of special importance to national financial markets and banking systems, and whose eligibility criteria are specified by the national central banks on the basis of ECB minimum eligibility standards. The Bank has put on the list of eligible tier-two assets, in particular, non-marketable debt instruments in the form of trade bills and bank loans. The residual maturity of such assets, when accepted by the Bank, must be not less than one month, and must not exceed six months in the case of bills, or two years in the case of bank loans. The debtors of the bills or loans must be enterprises of the non-financial sector or self-employed persons whose registered office is in Germany. Their eligibility for central bank assistance is checked by the Bank by reference to their annual accounts.

List of eligible assets

The eligible assets are published on the Internet by the ECB. The list specifies every type of eligible asset – provided that it is marketable – in detail. The outstanding amount of such marketable eligible assets came to some € 5,700 billion at the end of 1999. Just over two-fifths of this sum was accounted for by assets held in Germany.

Volume of underlying assets pledged to the Bank

At the end of 1999, counterparties had lodged eligible assets totalling € 434 billion in their collateral pools at the Bank to collateralise refinancing operations and intra-day credits. That figure included € 40 billion of assets held in another member state and made available across national borders for refinancing purposes at the Bank.

At about 55 %, the greater part of the assets pledged to the Bank was made up of covered bank debt securities (mortgage bonds). Government bonds accounted for just under 30 % of the total, uncovered bank debt securities for about 10 %. The remaining 5 % was made up of other marketable assets and lending to enterprises (roughly 52,000 bills of exchange and 1,100 bank loans, amounting in all to € 10 ½ billion).

IV. The Bank's participation in the issuing of Federal securities and in the management of the pension reserves of the Federal and Länder Governments

Pursuant to section 20 (2) of the Bundesbank Act, under which the Federal Government, Federal special funds and Länder Governments should issue their debt securities and Treasury bills primarily through the Bank, the Bank acts as the "fiscal agent" of the public authorities. Besides issuing securities and engaging in price-management operations, such duties include advisory and coordinating functions. The Bank is therefore represented in the Committee for Public Sector Credit Issues and the Central Capital Market Committee, i. e. in the bodies in which the bond-issuing requirements of the central, regional and local authorities are coordinated, and in which recommendations are made by the banks on the planning of public sector issues and the techniques to be used. The Bank also plays an active part in a number of other bodies which address capital-market and stock-market issues in the broader sense.

Issuers

In 1999 the Bank was involved solely in the issuing of Federal Government securities. On the strength of powers included in the Federal Budget Act, the Federal special funds were able to arrange the follow-up financing of their impending redemptions under the name of the Federal Government; such issues totalled € 11.5 billion. The Federal Government therefore arranged for the joint borrowing as the sole issuer.

After the incorporation of the debt of the Redemption Fund for Inherited Liabilities, the Federal Railways Fund and the "Use-of-Hard-Coal" Equalisation Fund in Federal debt by means of the act of June 21, 1999, the joint borrowing encompasses only the "German Unity" Fund and the ERP Special Fund.

The Indemnification Fund, which pays compensation for assets lost in the territory of the former GDR under the Indemnification and Compensation Act, continued to allocate debt securities to eligible persons on a larger scale in 1999. By the end of the year, € 135.7 million of such compensatory debt securities were outstanding.

Issuing procedures

After the disbanding of the Federal Bond Consortium at the end of 1997, since January 1998 Federal bonds and five-year special Federal bonds (after the conclusion of sales of a series on market terms), Federal Treasury notes and Treasury discount paper have all been issued uniformly by auctions through the "Bund Issues Auction Group". Resident credit institutions and the domestic branches of foreign institutions may join this group, provided that they engage in underwriting business and have sufficient placing power. In 1999 those requirements were considered to be met if, on average, at least 0.05 % of the issue volume sold by auction, and weighted by type of securities, was taken up. In 1999 allotments were weighted as follows: Treasury discount paper: factor 1, Federal Treasury notes: factor 4, five-year special Federal bonds: factor 8, ten-year Federal bonds: factor 15 and 30-year Federal bonds: factor 25. When determining the relative placing power, the weighting factors are intended to reflect the differing capital commitments and interest exposures involved in the various maturities of the Federal issues; they remained unchanged throughout the calendar year, and will also be applied in the year 2000.

A ranking list of the auction group members, classified by the size of their shares in the issue volume allotted (without specifying percentages), on the basis of weighted allotments, is published annually.

In 1999, Federal securities amounting in all to € 101.6 billion (DM 180.6 billion, equivalent to € 92.3 billion, in the previous year) were issued through the auction group in 22 auctions. After taking account of the merging of three institutions, the voluntary retirement of one institution and the retirement of ten institutions at the end of the year for lack of sufficient placing power, the number of members of the auction group decreased from 72 at the beginning of 1999 to 59 at the beginning of 2000.

In addition to the issuing of Federal securities through the auction group, the amounts set aside for market-management purposes continue to be placed by the Bank through the stock exchanges.

Issuing of Federal bonds

In 1999 the Bank participated in the launching of four ten-year and one 30-year Federal bond issue with a total volume of € 62.0 billion (DM 112.0 billion,

Bund Issues Auction Group
List of members, ranked according to their 1999 shares in the weighted amounts allotted

Table 16

Ranking		Ranking	
1	Deutsche Bank Aktiengesellschaft	33	Credit Suisse First Boston Aktiengesellschaft
2	Dresdner Bank Aktiengesellschaft	34	Hesse Newman & CO. (AG & Co.) Kommanditgesellschaft
3	Bayerische Hypo- und Vereinsbank AG	35	Barclays Bank PLC Frankfurt Branch
4	Bayerische Landesbank Girozentrale	36	WGZ-Bank Westdeutsche Genossenschafts-Zentralbank eG
5	Westdeutsche Landesbank Girozentrale	37	Istituto Bancario San Paolo di Torino – Istituto Mobiliare Italiano SpA Zweigniederlassung Frankfurt am Main
6	Morgan Stanley Bank AG	38	BHF-Bank Aktiengesellschaft
7	Norddeutsche Landesbank Girozentrale	39	Vereins- und Westbank Aktiengesellschaft
8	Goldman, Sachs & Co. oHG	40	Landesbank Hessen-Thüringen Girozentrale
9	Deutsche Genossenschaftsbank	41	Landesbank Sachsen Girozentrale
10	Bankgesellschaft Berlin Aktiengesellschaft	42	Hamburger Sparkasse
11	Landesbank Baden-Württemberg	43	Nomura Bank (Deutschland) GmbH
12	Paribas Zweigniederlassung Frankfurt am Main	44	GZB-Bank Genossenschaftliche Zentralbank AG Stuttgart
13	Salomon Brothers Aktiengesellschaft	45	Coöperatieve Centrale Raiffeisen-Boerenleenbank b.a., Zweigniederlassung Frankfurt am Main
14	Landesbank Berlin – Girozentrale –	46	BfG Bank AG
15	ABN AMRO Bank (Deutschland) AG	47	Warburg Dillon Read AG
16	Société Générale S.A. Zweigniederlassung Frankfurt am Main	48	HSBC Trinkaus und Burkhardt KGaA
17	Commerzbank Aktiengesellschaft	49	Landesbank Saar Girozentrale
18	Banque Nationale de Paris Niederlassung Frankfurt am Main	50	Bank of America, National Association Frankfurt Branch / Filiale Frankfurt
19	J.P. Morgan Securities Limited Zweigniederlassung Frankfurt am Main	51	Bank of Tokyo-Mitsubishi (Deutschland) Aktiengesellschaft
20	Banca Monte dei Paschi di Siena S.p.A. Niederlassung Frankfurt am Main	52	Kreissparkasse Köln
21	Merrill Lynch Capital Markets Bank Limited Zweigniederlassung Frankfurt a.M.	53	Stadtsparkasse Köln
22	Lehman Brothers Bankhaus Aktiengesellschaft	54	Merck, Finck & Co.
23	Landesbank Rheinland-Pfalz – Girozentrale –	55	National-Bank Aktiengesellschaft
24	ING Bank N.V. Deutschland Branch, Frankfurt	56	M.M. Warburg & CO Kommanditgesellschaft auf Aktien
25	Hamburgische Landesbank – Girozentrale –	57	Banca Commerciale Italiana Niederlassung Frankfurt am Main
26	Landesbank Schleswig-Holstein Girozentrale	58	Reuschel & Co.
27	Bremer Landesbank Kreditanstalt Oldenburg – Girozentrale –	59	Schmidt Bank Kommanditgesellschaft auf Aktien
28	Baden-Württembergische Bank Aktiengesellschaft		
29	Deutsche Apotheker- und Ärztebank eG		
30	Deutsche Siedlungs- und Landesrentenbank		
31	DGZ DekaBank Deutsche Kommunalbank		
32	SGZ-Bank Südwestdeutsche Genossenschafts-Zentralbank AG		

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equivalent to € 57.3 billion, a year before). By reopening issues using the auction procedure and by sales of amounts set aside for market-management purposes, issue volumes ranging between € 11.0 billion and € 20.0 billion were reached. Efforts to increase the outstanding amount of bonds in order to achieve large liquid issue volumes were thus successfully continued.

Stripping

With a view to improving the terms and conditions, and enhancing the competitiveness, of the German financial market, the Federal Government has been authorising the separation of the principal and interest payments (stripping) of newly issued ten-year and 30-year bonds, all with coupon dates of January 4 and July 4, since July 1997. It has also made this possible retrospectively for the 30-year bond issue launched at the beginning of 1994, and for the two ten-year issues launched in the first half of 1997. At the end of last year, the volume of strippable bonds totalled € 171.4 billion, around € 3.1 billion (or 1.8 %) of which were held in stripped form. The highest stripped share, at 19.4 %, was accounted for by the 30-year bond issue of July 1997, which suggests significantly greater interest in long-dated principal and coupon strips.

Five-year special Federal bonds

In 1999, too, five-year or 5 ¼-year special Federal bonds, which were initially sold on tap on market terms, were offered for sale by auction at quarterly intervals (February, May, August, November). Of the total issue volume, amounting to € 27.0 billion (1998: DM 56.6 billion, equivalent to € 28.9 billion), allotments under the auction procedure accounted for € 18.0 billion and sales in the open market for € 3.4 billion.

Federal Treasury notes

Of the two-year Federal Treasury notes (*"Schätze"*), which have been offered for sale since September 1996, a total of € 23.0 billion (1998: DM 42.0 billion, equivalent to € 21.5 billion) was sold by auction at quarterly intervals (March, June, September, December) and by reopening issues.

"Bubills"

The Bank has also been issuing debt securities running for less than one year by auction since July 1996. In the year under review, the issue volume (gross value) of such securities, which are likewise issued at quarterly intervals (January, April, July, October) in the form of discount paper (*"Bubills"*) with a maturity of six months, came to € 19.8 billion (1998: DM 40.1 billion, equivalent to € 20.5 billion). In 1999 the maximum amount outstanding was limited to € 10.0 billion.

"Cash bills"

In November 1999, the Bank was involved for the first time in the sale of Bund cash-management bills (cash bills, *"Bundeskassenscheine"*) newly created by the

Bonds issued by the Federal Government in 1999

Table 17

Issue	Amount issued or increased (€ billion)			Terms				
	Total	Amount allotted by auction	Market-management amount	Nominal interest rate (% p.a.)	Maturity (years/months)	Weighted average price (%)	Average yield (% p.a.)	Date of issue
Federal Government (WKN 113 508)								
Increase	1.0	–	1.0	4.75	29/6	–	–	Jan. 8
Increase	5.0	4.4	0.6	4.75	29/5	101.51	4.65	Jan. 20
Total volume	1 6.0							
Federal Government (WKN 113 510)	8.0	7.3	0.7	3.75	10/0	100.34	3.71	Jan. 6
Increase	5.0	4.5	0.5	3.75	9/11	100.71	3.66	Jan. 27
Increase	1.0	–	1.0	3.75	9/10	–	–	March 11
Total volume	14.0							
Federal Government (WKN 113 511)	5.0	4.0	1.0	4.00	10/3	100.17	3.98	March 24
Increase	5.0	4.3	0.7	4.00	10/2	101.11	3.86	April 28
Increase	1.0	–	1.0	4.00	10/0	–	–	June 11
Total volume	11.0							
Federal Government (WKN 113 512)	9.0	8.2	0.8	4.50	10/0	98.25	4.72	July 7
Increase	5.0	4.1	0.9	4.50	9/11	98.80	4.65	July 21
Increase	6.0	4.0	2.0	4.50	9/11	98.75	4.66	July 28
Total volume	20.0							
Federal Government (WKN 113 513)	5.0	4.6	0.4	5.375	10/2	99.61	5.42	Oct. 20
Increase	6.0	4.4	1.6	5.375	10/1	101.93	5.12	Nov. 24
Total volume	2 11.0							

1 Total amount issued: € 11.1 billion. — **2** Total amount issued, including subsequent increase in January 2000: € 20 billion.

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Issues of five-year special Federal bonds in 1999

Table 18

Issue	Amount issued (€ million): Total	Amount issued (€ million): Sales in the open market	Amount issued (€ million): Amount allotted by auction	Amount issued (€ million): Market-management amount	Terms: Sales in the open market: Issue prices (%)	Terms: Sales in the open market: Yields (% p.a.)	Terms: Auction procedure: Weighted average price (%)	Terms: Auction procedure: Average yield (% p.a.)	Start of sales in the open market/ date of stock exchange listing
3.75 % series 128 of 1998 (2003)									
Increase	1 1,000	–	–	1,000	–	–	–	–	–/Jan. 8
3.50 % series 129 of 1998 (2003)	2 5,435	465	4,462	508	99.55 – 102.20	3.00 – 3.60	100.57	3.36	Jan. 4/ Feb. 19
3.25 % series 130 of 1999 (2004)	8,000	750	5,682	1,568	100.00 – 101.40	2.93 – 3.25	99.72	3.31	Feb. 16/ May 21
3.25 % series 131 of 1999 (2004)	1,500	1,377	–	123	96.00 – 100.65	3.11 – 4.19	–	–	May 18/ Aug. 26
4.125 % series 132 of 1999 (2004)	5,000	–	3,854	1,146	–	–	100.02	4.12	–/Aug. 27
4.25 % series 133 of 1999 (2004)	6,000	674	4,045	1,281	98.40 – 101.10	4.01 – 4.60	99.13	4.44	Aug. 24/ Nov. 19
4.25 % series 134 of 1999 (2005)	3 ... 96	96	3 ...	3 ...	98.60 – 99.60	4.33 – 4.55	3 ...	3 ...	3 Nov. 16/ ...

1 Total amount issued: € 6,624 million. — **2** Sales of this series began on November 10, 1998; total amount sold in the open market: € 1,030 million, total amount issued: € 6,000 million. — **3** Sales were not completed at the end of the year.

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Issues of Federal Treasury notes in 1999

Table 19

Issue	Amount issued (€ million): Total	Amount issued (€ million): Amount allotted by auction	Amount issued (€ million): Market-management amount	Terms: Nominal interest rate (% p.a.)	Terms: Maturity (years/ months)	Terms: Weighted average price (%)	Terms: Average yield (% p.a.)	Terms: Date of issue
Federal Government (WKN 113 684) Increase	1 1,000.0	–	1,000.0	3.00	1/10	–	–	Jan. 25
Federal Government (WKN 113 685)	5,000.0	4,063.4	936.6	3.00	2/0	100.14	2.93	March 17
Federal Government (WKN 113 686)	5,000.0	4,754.3	245.7	3.00	2/0	100.02	2.99	June 16
Increase	2,000.0	–	2,000.0	3.00	1/11	–	–	July 7
Total volume	7,000.0							
Federal Government (WKN 113 687)	5,000.0	4,179.6	820.4	3.50	2/0	99.65	3.69	Sep. 15
Federal Government (WKN 113 688)	5,000.0	4,273.0	727.0	4.00	2/0	99.86	4.07	Dec. 15

1 Total amount issued: € 6,112.9 million.

Issues of Federal Treasury discount paper ("Bubills") in 1999 Table 20

Issue	Amount issued (€ million)	Date of issue	Terms: Maturity (months)	Terms: Weighted average price (%)	Terms: Average yield (% p.a.)
January 1999 (WKN 111 429)	4,869	Jan. 13	6	98.553	2.90
April 1999 (WKN 111 430)	5,033	Apr. 14	6	98.767	2.47
July 1999 (WKN 111 431)	4,933	July 14	6	98.756	2.49
October 1999 (WKN 111 432)	4,962	Oct. 13	6	98.487	3.04

Memo item: € 9,895 million outstanding on December 31.

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Federal Government. Such discount paper with a maturity of normally about one month only serves the purpose of the Federal Government's cash management. Around € 1.5 billion was allotted in the first auction.

Issue calendar

The annual preview of planned Federal issues, which was published for the first time, and the concrete issue calendars, which are published regularly for the quarter ahead, attracted substantial attention. The latter encompass the Federal securities to be issued at quarterly intervals and the Federal bonds issued not quite so regularly, but always with the fixed coupon dates of January 4 and July 4. Moreover, they show the redemptions and interest payments due in the relevant quarter.

Redenomination into euro

With the exception of Federal savings bonds, Treasury financing paper and Bubills, all securities outstanding issued by the Federal Government and its special funds were redenominated into euro, exact to the nearest cent, as of January 1, 1999. Since then, the smallest tradable unit has been € 0.01. For the sake of uniform market conditions, the former minimum denomination has been abandoned for new issues, too, so that now any amount in euro and cent, or Deutsche Mark and pfennigs (for Federal savings bonds and Treasury financing paper), can be purchased and traded. For tap issues, however, minimum order amounts have been introduced, specifically € 100 for five-year special Federal bonds, DM 100 for Federal savings bonds and DM 1,000 for Treasury financing paper.

Market-management operations

Of the listed Federal securities issued in 1999, a total amount of € 23.5 billion (1998: DM 59.5 billion, equivalent to € 30.4 billion) was set aside for successive sales through the stock exchanges for market-management purposes, specifically, € 12.2 billion in the case of Federal bonds, € 5.6 billion in the case of special five-year special Federal bonds and € 5.7 billion in the case of Federal Treasury

Issues of Federal savings bonds in 1999

Table 21

Issue	Sales period 1999	Gross sales (DM million) Total	Federal savings bonds, Type A	Federal savings bonds, Type B	Nominal interest rate (% p.a.)	Final yield (% p.a.) Type A	Type B
1998 / 15 + 16	1 Jan. 4 – Jan. 14	212	180	32	2.50 – 4.00	3.39	3.50
1999 / 1 + 2	Jan. 14 – May 3	459	361	98	2.25 – 3.50	2.98	3.07
1999 / 3 + 4	May 3 – July 1	219	180	39	2.25 – 3.50	2.98	3.07
1999 / 5 + 6	July 1 – Aug. 10	167	132	35	2.25 – 4.75	3.49	3.71
1999 / 7 + 8	Aug. 10 – Nov. 5	477	396	81	2.25 – 5.25	3.94	4.17
1999 / 9 + 10	2 Nov. 5 – Dec. 31	452	352	100	2.75 – 6.00	4.50	4.78

1 Sales began on December 9, 1998; total sales, issue 1998/15: DM 253 million, issue 1998/16: DM 47 million. — **2** Sales were not completed at the end of the year.

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notes. Of the amounts set aside for market-management purposes, € 22.7 billion (1998: DM 60.9 billion, equivalent to € 31.1 billion) was sold through the stock exchanges in 1999.

Price-management operations

As in previous years, the Bank conducted (for the account of the issuers) price-management operations on the German stock exchanges for officially listed securities issued by the Federal Government, its special funds, the former *Treuhand* agency, the former *Deutsche Bundespost*, and for securities issued by the *Kreditanstalt für Wiederaufbau* and the *Deutsche Ausgleichsbank*. The Bank also conducts price-management operations for the bonds issued by the Land of Lower Saxony listed on the stock exchanges in Frankfurt am Main and Hanover.

Federal savings bonds and Treasury financing paper

In the year under review, the Bank, acting for the account of the Federal Government, continued to be involved in the selling (through credit institutions and its own offices) of Federal savings bonds and Treasury financing paper issued on tap. With gross sales amounting to DM 2.0 billion, Federal savings bonds running for six and seven years with annually rising yields, which are sold only to natural persons and non-profit-making institutions, made only a small contribution to budget financing in 1999 (1998: DM 7.3 billion). Treasury financing paper, which is issued in the form of discount paper with maturities of one year and two years, was sold to the total value of DM 2.3 billion (in 1998: DM 3.8 billion).

In order to safeguard pension payments to civil servants, which are going to rise sharply (especially from 2014 onwards) against the background of the looming

Pension reserves of the Federal and Länder Governments

demographic changes, Parliament had decided, by adopting the 1998 Pension Reform Act, to build up pension reserves for the Federal and Länder Governments in the form of special funds based on contributions from the recipients of civil servants' pay and pensions. The "Act on a Pension Reserve of the Federal Government" (*Gesetz über eine Versorgungsrücklage des Bundes*) came into effect at the beginning of 1999 on the basis of the above decision, under which a special fund named "Pension Reserve of the Federal Government" (*Versorgungsrücklage des Bundes*) and managed by the Federal Ministry of the Interior was set up for the purpose of safeguarding pension expenditure. Under the Pension Reserve Act, the Bank has been entrusted with the management of the resources of this special fund.

The first transfers of assets to the "Pension Reserve of the Federal Government" special fund were made as from June 1999 by way of payments on account; they totalled some DM 64.3 million in 1999. In accordance with the investment guidelines issued by the Federal Ministry of the Interior and the Federal Ministry of Finance, and in agreement with the Federal Ministry of Labour and Social Affairs, these funds were invested by the Bank in marketable Federal debt securities.

The Länder Governments are likewise required to build up pension reserves in the form of special funds. Some Main Offices of the Bank (Land Central Banks) have likewise been entrusted with the management of the resources of such pension reserve funds under various regulations.

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

1. International harmonisation of banking supervision

The development of existing markets and products and the emergence of new ones necessitate an adjustment of the banking supervisory setting, too. In the year under review the Bank was involved through numerous bodies and committees in the further development of banking supervision.

(a) Activities in connection with the Basle Committee on Banking Supervision

Revision of the 1988 Capital Accord

The process of internationalisation and globalisation that has been going on for some years now has led to lasting changes in the financial markets. To this end the Basle Committee presented a consultation paper in mid-1999 with the aim of revising the Basle Capital Accord of 1988. That Capital Accord, which was initially geared solely towards internationally active banks, has developed into a generally accepted capital standard for banks and is meanwhile in application in more than one hundred countries. The Basle Capital Accord is also the basis of the capital requirements at EU level and hence of Principle I in Germany.

Recognition of new instruments

The planned revision of the Basle Capital Accord is intended both to take due account of the structural change in the financial markets and the development of new hedging and risk management instruments (such as credit derivatives) and to eliminate weaknesses identified in the existing regulatory system. The new rules will lay down capital charges for banks' business which are more commensurate with the specific risks than hitherto and will create incentives for credit institutions to improve their risk management. A high priority will be given to the goal of ensuring a level playing field and suitability of the rules for banks of different size and with different business profiles. Against this background, the new concept envisages an approach consisting of three pillars.

First pillar: minimum capital requirements

The first pillar is formed by the prudential minimum capital requirements for banks. One of the most important aims in this connection is improving the methods of measuring and recording credit risk. Under the standard approach it is intended to introduce a greater degree of differentiation into the classification of borrowers in the various prudential risk categories, in part by using external ratings – such as those of rating agencies. In addition, banks are to be allowed in future to use their own internal rating procedures if these satisfy certain qualitative and quantitative requirements, which have still to be defined. It is also envisaged in future to recognise new risk management and securitisation techniques which banks now use (especially credit derivatives, netting of balance sheet positions) for prudential purposes with a view to bringing regulatory capital and economic capital – i.e. the amount of capital which banks themselves deem adequate according to their own estimation of their outstanding risks – more closely in line with one another.

Avoidance of undesired consequences

A more differentiated calibration of credit risks is expected to result in an absolute decrease in the overall level of capital in the banking system. From a prudential perspective this is undesirable, as the financial system is certainly not becoming less risk-prone. The consultation paper therefore envisages the possibility of stipulating an explicit capital charge for other banking risks – particularly interest rate risks arising from the banking book and operational risks (e. g. computer-related risks or legal risks) – which at the moment are taken into account implicitly only.

Second pillar: supervisory review process

As a bank's overall risk profile can be captured only approximately, even with improved methods for measuring credit risk, the new concept contains a second pillar in the form of a continuous supervisory review process. By means of more intensive contacts with institutions, banking supervisors are to be enabled to form their own impression of a bank's individual risk situation and risk management. Negative assessments made in the course of such reviews would normally result in the supervisory authorities ordering prudential remedial measures. In individual cases, however, they might also prescribe a higher minimum capital coefficient for the institution.

Basic shift of focus towards more quality-oriented banking supervision

Elements of on-site supervision already exist in Germany with the audits of compliance with the minimum requirements for the trading activities of credit institutions and the procedure for licensing the use of internal models for measuring market price risk (the Bank currently employs around 70 auditors for these purposes). The supervisory review process contained in the new Basle capital standard will reinforce this tendency by shifting the focus of supervisory activities from what is now primarily a quantitative analysis increasingly towards the evaluation of the individual risk situation of credit institutions.

Third pillar: strengthening of market discipline through enhanced transparency

The third pillar of the new capital rules is aimed at strengthening market discipline by means of extended disclosure requirements. Timely availability of meaningful information is vital if the market is to be capable of exerting a disciplining force. It should be remembered, however, that disclosure requirements are usually laid down in commercial regulations or rules relating to the publication of the annual accounts, which lie within the competence of other regulators. As a rule, the banking supervisory authorities have only limited direct influence in these matters; they can merely formulate the requirements which then would have to be taken up and implemented by the responsible bodies. The first concrete proposals for disclosure principles concerning the amount of capital available and the risks incurred, formulated as part of the "third pillar" of the revised capital standard, were contained in the consultation paper "A New Capital Adequacy Framework: Pillar 3 – Market Discipline" published in January this year. The further development of the proposals aimed at revising the Capital Accord will make it necessary to amend these disclosure requirements.

Necessary consultations

Following the conclusion of a first round of consultations at the end of March this year the Basle Committee will submit a further consultation paper. It will seek, firstly, to incorporate the results of the first phase of negotiations and, secondly, to clarify areas that are unclear at the moment. One of the key issues from a European point of view is the development of criteria governing the prudential recognition of internal rating procedures for as large a number of credit institutions as possible in order to avoid competitive disadvantages both for banks and for small and medium-sized enterprises which have no external rating.

Accounting and transparency

In July 1999 the Basle Committee had already presented accounting and disclosure recommendations for traditional credit business, on the one hand, and credit risk in the wider sense, on the other, with the final version of the document "Sound Practices for Loan Accounting and Disclosure" and the consultation paper "Best Practices for Credit Risk Disclosure". Following the conclusion of the consultation procedure, it additionally published the "Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms" in October 1999. They replace and update the recommendations of the Basle Committee and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) from the year 1995, which have contributed to improving the disclosure of information by banks concerning their trading and derivatives business. The aforementioned documents can be called up on the Internet at www.bis.org.

Core Principles Methodology

In October 1999 the Basle Committee on Banking Supervision published a methodology ("Core Principles Methodology") for assessing compliance with the "Core Principles for Effective Banking Supervision" which it had issued in September 1997. The experience of assessing compliance with the Principles, gained both by countries themselves and by the IMF, has shown that these Principles leave considerable room for interpretation. The aim of the Methodology is to ensure objective and uniform interpretation so as to render the results of the assessments comparable. The Basle Committee intends to adjust the Principles and their Methodology in the near future in the light of further developments.

Experience gained with risk models in the G-10

In the third quarter of 1999 the Models Task Force of the Basle Committee presented a report on the use and suitability of market price risk models in the G-10 countries in the second half of 1998. During that period, in which certain crisis-like distortions and increased market volatility occurred, the capital charges for market price risks calculated using the prudential parameters were sufficient at all the institutions examined on all trading days to cover the negative changes in the value of the trading book resulting from fluctuations in market prices. An important contribution to this positive result was made, in particular, by the weighting factor, which had been introduced as a safety precaution; the risk values as computed by the institutions have to be multiplied by this weighting factor in order to arrive at the overall prudential capital charge for market price risks. Nevertheless, the supervisory authorities – also owing to the many simplifying assumptions on which the value-at-risk concept is based – believe that the further development and supplementary application of stress tests to simulate crisis scenarios and the ongoing monitoring of the suitability of the mathematical-statistical methods used, *inter alia* with the aid of sophisticated analyses of the backtesting results, would be advisable.

(b) Harmonisation in the European Union

European consultation paper on the revision of capital requirements

In parallel with the activities of the Basle Committee on Banking Supervision, work has also begun at European level on revising the capital requirements. The Banking Advisory Committee of the European Commission set up a Technical Subcommittee at the end of 1998 to oversee this work; six working groups are meanwhile reporting to it. As the outcome of these efforts, the European Commission published its own consultation paper at the end of November 1999. Its content and structure conform closely to the Basle paper of June, although the Brussels consultation paper pays greater attention to the banking structure in the European Union. From Germany's point of view, a key requirement of the further work at the European level is ensuring that it remains congruent with the activities going on in Basle, in both content and timing, so as to minimise the burden of duplication for those credit institutions which are subject to both regulatory regimes.

Supervision of financial conglomerates

In November 1999 the European Commission set up a new working group – the Mixed Technical Group – in which banking, insurance and securities trading supervision authorities of the EU member states are represented. This working group is continuing the work of an expert group for financial conglomerates which years ago looked at regulatory issues concerning financial conglomerates without, however, making any proposal for a Directive. Four sub-groups have been set up – on capital adequacy, the exchange of information between supervisory authorities at sectoral and cross-border level and the suitability and trustworthiness of managers and owners, on coordination between supervisory authorities, on intra-group transactions and links, and on the concentration of risks. They are to examine the results to date of the work of the Joint Forum – which remains active on behalf of the Basle Committee, IOSCO and the IAIS – to see whether they offer rules which can be translated into European supervision legislation. The main objective of the investigations is to achieve greater transparency within financial conglomerates and improve collaboration between the different supervisory authorities.

Banking Supervision Committee of the ESCB

The ESCB has the task of contributing to the smooth conduct of policies pursued by the competent national authorities relating to the prudential supervision of credit institutions and the stability of the financial system. It is assisted in this task by the Banking Supervision Committee (BSC), composed of representatives of central banks and supervisory authorities of all 15 EU member states. In 1999 numerous reports and analyses were once again produced on issues of banking supervision and the stability of the EU banking systems, part of which were made available to the public. The multilateral cooperation between central banks and banking supervisory authorities within the BSC not only facilitates the EU-wide monitoring of systemic stability but also makes the task of cross-border crisis prevention easier.

2. Amendments of national banking supervision legislation

Implementation of the Basle Principles for Effective Banking Supervision

There were no fundamental changes last year in national banking supervisory legislation. Amendments to the Banking Act were necessitated by the entry into force of the Insolvency Code and the implementation of the Directive on settlement finality in payment and securities settlement systems (98/26/EC of May 19, 1998). Whenever institutions or other enterprises intend to introduce such a settlement system, they must report this immediately to the Federal Banking Supervisory Office and the Bank, giving the names of the participants. In addition, discussions began on the Fourth Financial Market Promotion Act which *inter alia* provides an opportunity to incorporate into current law the lessons gained so far from the supervision of financial services institutions by way of a further amendment of the Banking Act. The amendments will focus on bringing the Banking Act into line with the above-mentioned Basle Principles for Effective Banking Supervision. These Principles represent an internationally recognised standard for prudent banking supervision; compliance with them is to be monitored worldwide in the coming years, notably by the IMF.

3. Ongoing banking supervision operations

Intensified concentration in German banking

At the end of 1999, 3,212 credit institutions were subject to banking supervision in Germany compared with 3,438 at the end of 1998 (in both cases excluding branches of foreign securities trading firms). With 226 fewer institutions, the trend towards concentration in the banking sector has thus intensified (in 1996 a drop by 101, in 1997 by 113 and in 1998 by 167). The credit cooperative sector again bore the brunt of this trend – of the total of 246 closures of credit institutions, it accounted for 217 (mostly due to mergers) – while the savings bank sector recorded only ten due to mergers. These closures contrasted with only 20 new registrations, 11 of which concerned branch offices of foreign banks and seven related to the establishment of investment companies. In addition, almost 1,500 financial services institutions held licences at the end of the year to provide financial services.

Ongoing banking supervision operations

Table 22

Number of operations conducted

Item	1996	1997	1998	1999
Individual reports pursuant to section 13 of the Banking Act	71,951	72,303	66,491	59,517
Single borrowers included in the summary reports submitted pursuant to section 13 of the Banking Act	59,759	79,063	63,956	332,486
Reports on loans of DM 3 million or more pursuant to section 14 of the Banking Act	1,382,914	1,751,974	1,863,012	1,862,191
Reports pursuant to sections 24 and 24a of the Banking Act	40,339	56,327	39,868	43,091
Monthly returns pursuant to section 25 of the Banking Act	45,913	44,770	46,319	46,301
Reports on the volume of foreign lending	303	293	296	271
Annual accounts of credit institutions	4,054	3,788	3,477	3,401
Auditor's reports on annual accounts	2,647	2,746	2,798	2,690
Reports on the auditing of safe custody accounts	501	602	449	511
Routine, special and deposit guarantee fund auditor's reports	812	1,119	1,333	1,510
Audits pursuant to				
section 44 (1) of the Banking Act	29	25	30	57
section 44 (2) of the Banking Act	34	31	24	35
Reports under the Capital Accord of the Basle Committee on Banking Supervision	97	96	23	92

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Cooperation in banking supervision

Table 22 provides details of selected activities above all of the Land Central Banks in connection with supervising German credit institutions. Only five credit institutions categorised as "special-purpose banks", which perform central tasks nationwide, are supervised directly by the Bank's Central Office.

Volume of work largely unchanged

Quantitative changes compared with previous years mainly concern reports made pursuant to section 13 of the Banking Act. The Regulation governing large exposures and loans of three million Deutsche Mark or more replaced the previous requirement to submit a list of all reportable large exposures once a year plus *ad hoc* reports on changes by the requirement to submit a summary report four times a year on the large exposures which were outstanding in the preceding quarter. Furthermore, the concept of what constitutes a loan or an exposure has been widened somewhat. In the year under review there were again the customary four reporting dates in connection with the Basle Committee's Capital Accord, whereas in 1998 only one report had to be submitted at the end of the year.

Credit register for loans of DM 3 million or more

The number of loans of DM 3 million or more to be reported quarterly under section 14 of the Banking Act increased in the twelve months from September 30, 1998 to September 30, 1999 by just over 4 % to more than 484,000 reports. The total volume of loans of DM 3 million or more reported went up during this period from approximately DM 9.4 trillion to almost DM 11 trillion on the reporting date, September 30, 1999. As at that reporting date, 3,355 institutions, 626 insurance enterprises and 900 financial enterprises had submitted reports on loans of DM 3 million or more.

The Bank's central credit register ascertains each borrower's aggregate debt on the basis of the reports submitted and discloses this figure to the individual lending institutions in a notification. The number of borrowers notified to lenders at the reporting date September 30, 1999 increased by 19 % compared with 1998 to nearly 374,000 borrowers. Just under two-thirds of the borrowers were amalgamated into 70,581 single borrower units pursuant to section 19 (2) of the Banking Act. At the end of September 1999, 73 single borrower units had debts exceeding DM 3 billion; the aggregate indebtedness of those borrowers amounted to over DM 477 billion, which represents slightly more than 4 % of the total credit volume reported. Just under two-thirds of the total credit volume reported (over DM 7 trillion) was taken up by domestic borrowers. Table 23 shows the trend since 1994.

Use of pre-loan inquiry facility

The facility introduced at the beginning of 1998 allowing lenders, subject to certain conditions, to request information from the central credit register about the level of indebtedness of potential borrowers prior to granting a loan was used in 435 cases in 1999.

Credit register of loans of DM 3 million or more

Table 23

Third quarter	Volume of loans of DM 3 million or more		Number of loans of DM 3 million or more reported		Number of reporting		
	DM billion	Change (%)	Number	Change (%)	insti-tutions 1	financial enterprises	insurance enterprises
1994	2,613	+ 6.9	284,568	+ 3.2	2,429	–	398
1995	2,791	+ 6.8	307,544	+ 8.1	2,500	–	383
1996 2	6,695	+ 139.9	405,983	+ 32.0	3,667	874	551
1997	8,056	+ 20.3	446,146	+ 9.9	3,635	893	584
1998	9,368	+ 16.3	464,507	+ 4.1	3,496	963	607
1999	10,973	+ 17.1	484,449	+ 4.2	3,355	900	626

1 Credit institutions and financial services institutions. — **2** Extension of the concept of loan and enlargement of the range of lending institutions required to report as from the reporting date September 30, 1996.

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Insolvencies

In 1999 the credit register recorded a total of 1,316 insolvencies of enterprises and individuals which or who, at the date when the insolvency became known, had loans of DM 3 million or more outstanding. This was 25 cases fewer than in 1998 (– 1.9 %). The volume of loans of DM 3 million or more reported for insolvent borrowers amounted to approximately DM 10.8 billion, which was roughly DM 1.8 billion less than in 1998 (– 14.3 %).

International cooperation between European credit registers

Cooperation between the existing European credit registers (in Austria, Belgium, France, Germany, Italy, Portugal and Spain) was continued in 1999. As part of a study by the Working Group on Credit Registers, a working group of the Banking Supervision Committee, a survey was conducted in Germany and the other countries listed above among selected credit institutions and the banking supervisory authorities on the current and future level of utilisation of the data stored in the national credit registers. The survey showed, in particular, that credit institutions' interest in cross-border information on the indebtedness of their borrowers has increased considerably following the introduction of the euro and the concomitant elimination of foreign exchange risks when extending credits within the euro area. The present cooperation between the seven existing credit registers in Europe is therefore to be intensified so that the legal and organisational prerequisites may be created in all seven countries as soon as possible to give credit institutions access to the information on the indebtedness of borrowers stored by foreign credit registers.

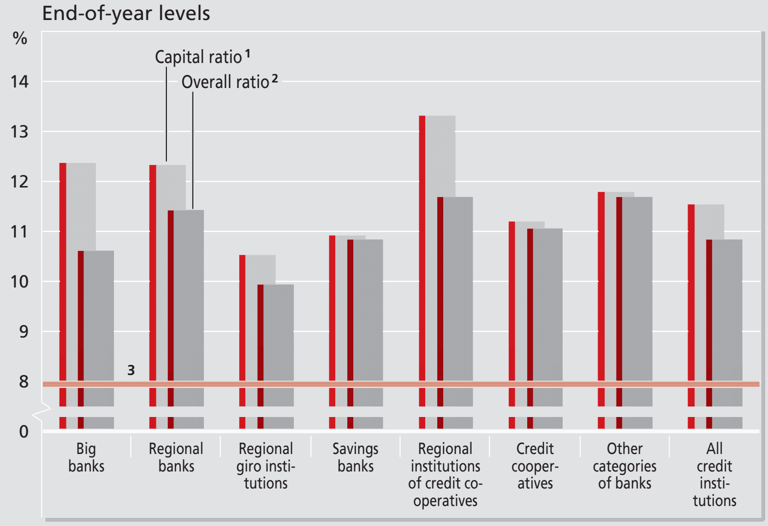
Principle I

Under the German prudential capital rules (Principle I), both individual institutions and groups of institutions/financial holding groups must ensure that at least 8 % of their credit risks (counterparty risks) and market price risks are backed by liable own funds. Credit risks have to be backed by core capital and

Chart 20

Ratio of the liable capital and liable own funds of individual institutions filing Principle I reports *

End-of-year levels



* Credit institutions and financial services institutions on a non-consolidated basis. — **1** Capital ratio = (liable capital : weighted risk assets) x 100. — **2** Overall ratio = (own funds : (weighted risk assets + capital charges for market risk x 12.5)) x 100. — **3** The minimum percentage for both ratios under Principle I is 8%.

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additional capital, while tier 3 funds can also be used to back market price risks. Credit risks clearly predominate among the sum total of positions subject to capital charges, accounting for a share of around 92 %. The average capital ratio of all individual institutions for backing their credit risk as at December 31, 1999 was 11.5 % (1998: 11.3 %). On a consolidated basis this ratio stood at 11.3 % at the end of December 1999 (1998: 10.6 %). At the end of 1999 the overall ratio of the individual institutions (i. e. including market price risk) came to 10.8 % (1998: 10.5 %), and the corresponding consolidated overall ratio was 10.4 % (1998: 9.6 %). The average overall ratios in relation to the average capital ratios of the various categories of banks are shown in the chart above.

Principle II

The new liquidity standard (Principle II), which will replace the existing Liquidity Principles II and III by July 1, 2000 via flexible transitional arrangements, is based on the idea that an institution's liquidity is determined primarily by the extent of its maturity transformation and its stock of highly liquid assets. Under normal circumstances an institution's liquidity is deemed to be adequate if the liquidity inflows available up to the end of the next calendar month at least cover the expected liquidity outflows during the same period (liquidity ratio ≥ 1). As at the reporting date December 31, 1999, the new liquidity standard was already being used by 793 institutions; the average liquidity ratio was 1.42 %.

Participation in audits

The audits of trading activities pursuant to section 44 of the Banking Act carried out by the Bank on the behalf of the Federal Banking Supervisory Office take account of the growing importance of trading business for credit institutions and of the resulting risks. The bulk of these audits, which are conducted alternately by the Bank and by private external auditing companies, showed that, in the majority of cases, the minimum requirements for the trading activities of credit institutions published in 1995 are being properly implemented and complied with. As part of the task of prosecuting unauthorised banking business or financial services, the Bank continues to carry out investigations at the instruction of the Federal Banking Supervisory Office pursuant to section 44c subsection (1) of the Banking Act and takes part in the on-site inspections directed by the Federal Banking Supervisory Office pursuant to subsection (2). The documents are normally evaluated by the Land Central Banks which then pass on their findings to the Federal Banking Supervisory Office for further action.

Auditing of internal risk measurement and management models

The auditing activities to test whether banks' internal risk management models could be licensed for prudential purposes were continued last year in cooperation with the Federal Banking Supervisory Office. After a number of institutions had been granted a licence in 1998 for their internal models for calculating the capital charge for market price risks pursuant to Principle I Part VII, follow-up checks pursuant to Principle I section 32 (3) took place predominantly last year. The aim of these follow-up checks is to review compliance with the suitability requirements after a confirmation of the model's suitability has been granted and to assess the adequacy of the institution-specific add-on factors for determining the amount of own funds required. Besides carrying out audits in Germany, on-site inspections were also carried out at foreign branches of German banks licensed to use internal models – depending on the scope of the original application and the licence for the model. In summary it can be said that the institutions have made further improvements to their risk measurement and management systems in relation to market price risks and that, in general, the "risk-combating culture" has improved.

VI. UN/EC financial sanctions: new developments

EC sanctions Serbia

On June 19, 1999 the EC promulgated a new regulation on financial sanctions against the Federal Republic of Yugoslavia (EC Regulation No. 1294/1999 of June 15, 1999, Official Journal L 153/63 of June 19, 1999). This regulation replaces Regulation Nos. 1295/1998 and 1607/1998. As was the case with these two previous regulations, the new regulation contains a blocking of accounts and a ban on investment. The tightening consists in the fact that the accounts of all institutions controlled by the governments of the Federal Republic of Yugoslavia or the sub-republic Serbia have now been frozen (prior to this regulation, only government accounts had been frozen). Exceptions can be approved only by the EC Commission. Applications concerning payment transactions have to be made to the EC Commission via the locally responsible Main Office (Land Central Bank) of the Deutsche Bundesbank.

UN sanctions Taliban

The UN imposed financial sanctions (and other embargo measures) on the Taliban/Afghanistan by Resolution No. 1267/1999. This resolution entered into force on November 14, 1999 but became legally effective in the EC only after a corresponding regulation had been adopted (EC Regulation No. 337/2000 of February 14, 2000, Official Journal L 43/1 of February 16, 2000). In compliance with the UN resolution, the accounts of institutions controlled by the Taliban have to be blocked. The United Nations Sanctions Committee decides on exceptions. Applications have to be filed with the locally responsible Main Office (Land Central Bank) of the Deutsche Bundesbank, which will grant formal permission.

Iraq

The UN financial sanctions imposed on Iraq continue to apply unchanged (sections 52 and 69 e of the Foreign Trade and Payments Regulation).

Libya

The UN sanctions imposed on Libya (section 69 n of the Foreign Trade and Payments Regulation) were suspended with effect from April 5, 1999, which means that they do not have to be observed at the moment. No decision has been taken on their definitive repeal.

VII. The Economic Research Group

The Economic Research Group and its tasks

The Bank has had its own economic research group since October 1994. Members of the Bank staff may be exempted from their usual obligations for a limited period of half a year in order to work as part of the group on a larger research project. As is the case in other central banks within and outside Europe, this arrangement is intended to promote the acquisition of scientific knowledge and to make this knowledge fruitful for normal central banking operations. At the same time, the Bank is intent on making significant scientific contributions to the academic field. Thus a series of discussion papers were prepared and published in 1999, as in the preceding years. The research group also organised conferences and workshops as well as regular course seminars, whose lecturers included external academics and Bank staff members.

Discussion papers ...

The discussion papers cover a wide variety of topics, many of which owe their inspiration to the Bank's activities within the ESCB. In 1999 four papers were devoted to issues which may be considered monetary in nature. One study sought to contribute to the analysis of monetary developments in EMU by examining the past relationship between the money stock and its balance sheet counterparts in the countries participating in monetary union. Another study was concerned with the relationship between interest rates in the German and US capital markets. A third work endeavoured to identify the determinants affecting the future spread of Internet money. The last paper bearing on monetary policy offered a theoretic explanation, using models, of why banks may sometimes exhibit undesirable herd behaviour. Other discussion papers dealt with the adjustment of fiscal policies within European monetary union and with methodological questions concerning seasonal adjustment. Finally, a comparative study written jointly with staff members from the Banque de France analysed the borrowing behaviour of German and French enterprises. These discussion papers have been the subject of increased interest in the academic world and have resulted in the authors' being invited to numerous academic conferences in Germany and abroad.

... and other responsibilities

In March 1999 the Bank sponsored an international conference on the topic "The monetary transmission process: recent developments and lessons for Europe", which was held under the aegis of the Economic Research Group. Academics and central bank decision-makers discussed unsettled issues concerning how monetary policy in general functions and how it functioned at the start of

European monetary union. In addition, several workshops were arranged for academics from universities and economists from other central banks and institutions. At these conferences, issues such as inflation measurement and the seasonal adjustment of time series were discussed. It is important for central banks, whose task it is to maintain price stability, to identify biases in the statistical measurement of inflation rates and to keep them to a minimum. The proper estimation of seasonal influences allows for a better assessment of the economic situation at the current end of the relevant time series. A wide variety of economic topics were discussed in the course of 38 seminars, ranging from financial market issues to problems on the labour markets.

VIII. Technical central bank cooperation by the Bank

Considerable interest in cooperation with the Bank continues

In 1999 the Bank assisted more than 50 central banks in countries in transition, developing nations and emerging markets through training and advisory activities. The Bank's technical central bank cooperation was more or less as extensive as in the previous year. There were 177 training programmes, in which more than 1,700 foreign central bank staff took part. The total number of foreign central bank staff that have participated in the Bank's training programmes in Germany and abroad since 1993 is therefore just under 9,000. The purpose of these activities is to foster the development of modern, efficient central bank systems and the economic stabilisation that will serve as the basis for strong economic growth in the partner countries. The Bank's technical central bank cooperation is free of charge and based on cooperation between partners. It covers all economic, banking and legal instruments of modern central bank management. Subjects range from central bank legislation, via payments, accounting, cash and personnel issues, organisation, data processing, statistics, lending operations and foreign exchange transactions to banking supervision, monetary and foreign exchange policies and European issues.

European issues become increasingly important

Issues concerning the enlargement of the European Union have recently become increasingly important. All 13 accession countries seem to have great expectations about rapidly acceding to the European Union (EU) and to European monetary union (EMU). EU accession, however, does not automatically mean that these countries will soon participate in EMU. This applies both to the countries of the first round (Estonia, Poland, Hungary, the Czech Republic, Slovenia and Cyprus) and to those of the second round (Bulgaria, Latvia, Lithuania, Malta, Romania, Slovakia and Turkey). With the exception of Malta and Cyprus, the Bank has advised and supported these countries intensively during the past few years. In the year 2000 the Bank will concentrate more on the accession countries and the practical questions arising there. Hence, additional special seminars are being held exclusively for these countries. Advice is particularly necessary on the convergence of legal systems in the course of the accession process, on payments within the European System of Central Banks, on statistical issues and, last but not least, on problems arising from the implementation of monetary policy within the Eurosystem. The aim is to advise and support all accession countries in the same way and at the same time. Efforts are made to coordinate the strategy with other EU central banks and the European Central Bank in order to avoid unnecessary duplication.

Many different forms of cooperation

There are a number of ways in which the Bank gives advice and training to executive and other members of the staff of foreign central banks. For example, relevant seminars normally lasting one week are held in Germany and abroad, foreign central bank staff are invited to Germany to gather information, and experts from the Bank are sent on advisory missions abroad. For reasons of cost, seminars intended for fairly large groups of interested staff are mostly staged in their respective countries, and only smaller groups are invited to visit the Bank. The Technical Central Bank Cooperation Division, located at the Central Office, coordinates all activities throughout the Bank, and experts from the Bank as a whole (that is to say, including those from Land Central Banks) carry out the work of advising and training. The Bank's training college is also successfully involved in the technical central bank cooperation scheme; this can be seen not least in the fact that in the past few years some larger partner countries have established banking schools based on the German model which means that they apply the dual training system with theoretical and practical training phases.

Growing importance of standard seminars

In previous years the Bank's main objective had been to adjust the technical central bank cooperation to comply as far as possible with the specific needs and wishes of the beneficiary central banks, which means that it tried to find a tailor-made solution in each case. Although this approach proved to be the right one on the whole, the growing number of requests from partner central banks made it necessary, for reasons of cost efficiency, to concentrate activities by extending the standard seminars conducted at the Bank. Twenty-five to 30 foreign central banks send one of their employees to these standard seminars, which are held in English and take place at monthly intervals. In 1999 a total of more than 300 foreign central bank staff took part in these standard seminars. Most of these participants were relatively young, already well trained and with appropriate development potential. Central-banking-related topics, which have been subject of bilateral information visits and seminars during the past few years, can now be offered to a larger circle of participants. The seminars benefit not only central banks from traditional partner countries in central and eastern Europe but, increasingly, also Latin American, African, Arab and East Asian central banks, which now regularly take part in standard seminars organised by the Bank. In addition to imparting expert knowledge and experience, the seminars also provide central bank staff from all parts of the world with a forum for exchanging knowledge gained from their own experience.

More than 50 advisory missions abroad

Fifteen foreign central banks called on the short advisory sessions held by Bank experts on more than 50 occasions in 1999. Sometimes Bank advisory staff also joined international expert groups. The advisory sessions normally lasted approximately one week, which, in the Bank's experience, is a thoroughly efficient length of time. In exceptional cases, however, a longer advisory session may also be appropriate. In any case, a certain degree of continuity is necessary if good results are to be achieved under the technical cooperation scheme.

The Bundesbank's ongoing readiness to cooperate

Although a multitude of partner countries were successful in making further progress in their transformation process, lasting success was lacking in some others. This applied especially to some countries of the former Soviet Union. Although the central banks of these countries played a largely positive role, the efforts to achieve monetary stabilisation were undermined in the extremely difficult economic and political environment, which is still characterised by structural problems. It is therefore important in these countries that stagnating or insufficient transformation processes and structural reforms are actively fostered. The Bank is always ready to cooperate and to support this development by imparting knowledge and experience.

IX. Organisation and staff

In the year under review the Bank again responded to the continual fall in the private banking sector's demand for central banking services and closed a further two branch offices. Another ten closures will follow by the end of March 2000; only branch offices in western Germany will be affected. The number of branch offices will then be reduced from 147 to 135.

Further reduction in branch office network

Staff numbers decline further

The number of staff in the Bank as a whole declined again slightly in the year under review (minus 41 persons). At 108, or 1.3 %, there was an above-average reduction in the number of branch office staff although a detailed analysis shows movements in both directions. A significant increase in the cash handling area (plus 132) was more than offset by the reduction in staff in the other areas of the branch offices.

By contrast, the situation at the Central Office and the Main Offices was characterised by a further rise in the workload owing to the preparations for European monetary union and the year 2000 problem. This was reflected in a slight increase in staff (the number of staff in the Central Office rose by 39 and in the Main Offices by 28).

Training places again increase

In 1999 the Bank further increased the number of trainees to 297. The number of civil service candidates and officials entering a civil service career rose by 34 from 361 to 395.

Total staff numbers remain unchanged

Given the contrary trends in permanent staff and trainees, the total number of staff remained virtually unchanged from the previous year, at 15,905 (plus 14).

Part-time ratio

The Bank endeavours to comply with wishes of employees regarding part-time work, as long as operational requirements allow it. At 12.9 %, the ratio of part-time employees rose slightly compared with the previous year. Whereas in the case of civil servants and other salaried staff the number of part-time employees rose by 51, or 3.7 %, the number of part-time wage earners declined (minus 14) again as a result of staff reductions. Compared with full-time employees, part-time employees work an average of 58.1 % (previous year: 57.6 %). If full-time and part-time employees are taken together statistically on the basis of their contractual working hours, the Bank had 14,404 (full-time) employees in 1999 compared with 14,458 in the previous year.

Age-induced part-time work

The regulations governing age-induced part-time work agreed in the wage settlement for public sector employees in 1998 are also applied at the Bank. The statutory provisions approved in the autumn of 1998 apply to civil servants. Overall, 495 age-induced part-time agreements have been concluded so far,

Trends in staff levels at the Bundesbank

Table 24

	Staff level at the beginning of 2000				Changes from the beginning of 1999			
	Total 1	Land Central Banks	Branch offices	Central Office of the Bank 3	Total 1	Land Central Banks	Branch offices	Central Office of the Bank 3
Civil servants	6,718	2,404	3,286	1,028	– 25	33	– 62	4
Other salaried staff	8,346	2,289	4,593	1,464	59	17	– 3	45
Wage earners	841	250	425	166	– 20	– 14	– 9	3
Total	15,905	4,943	8,304	2,658	14	36	– 74	52
of which Trainee civil servants/ other trainees 2	665	207	328	130	55	8	34	13
Permanent staff	15,240	4,736	7,976	2,528	– 41	28	– 108	39

	Beginning of 2000	Beginning of 1999
1 Of which, part-time employees: Civil servants and other salaried staff	1,429	1,378
Wage earners	540	554
The following are not included in the staff figures: persons who are seconded to work for 12 months or more for other public employers or for international organisations or who are otherwise employed abroad	93	82
members of the Bank's staff on leave without pay	727	695
2 Other members of staff undergoing training: civil servants switching to other departments	31	34
3 Including the Bank's training college.		

Deutsche Bundesbank

477 of which (or 96 %) are based on a "phase model", which means that a phase of full-time employment is followed by a phase in which the employee does not work. The first 26 employees have now entered this latter phase.

New training scheme for university graduates successfully introduced

Candidates for the Bank's Higher Service started their training under new training and examination regulations for the first time in 1998. It already appears likely that the Bank will achieve the two main objectives of the reform, which are to concentrate the training of the junior executive staff more than hitherto on central-bank-specific requirements and to take account of the Bank's incorporation into the European System of Central Banks.

Reshaping selective procedure

The basic reshaping of the selective procedure for the recruitment of new staff, which is now being geared more to the potential of an applicant, has also to be seen in this context. The reshaping of the selective procedure for the Bank's

Higher Service was completed in the year under review. This acknowledged the growing importance of competence in core subjects in the selection of junior executive staff.

Training focuses on improving communication skills

In 1999 the training of Bank staff was again one of the major aims of the Bank's personnel policy. Above all, efforts were made to improve the internal communication between supervisors and employees as well as to develop employees' management skills. Improving the ability to negotiate successfully on an international basis was another of the main objectives. This is especially important with regard to the Eurosystem where the Bank is represented in numerous committees.

The total number of staff participating in internal and external courses was virtually unchanged from the previous year (approximately 13,000 employees). The number of courses in the training programme jointly organised by the Central Office and the Land Central Banks rose by approximately 10 %. With approximately 800 participants, management seminars showed an increase of 50 %. About 30 seminars on the subject "Holding talks with staff" were one of the main events here.

X. Smooth transition to the year 2000

Preparations focused on ensuring the Bank's own year 2000 compliance

In 1999 the Bank stepped up the efforts it had commenced in 1997 and concentrated its resources towards ensuring a smooth transition to the year 2000. The preparations were focused on achieving its own year 2000 compliance. As in previous years, the Bank was also active in various national and international Y2K committees throughout.

All year 2000 tests successfully completed

Following the timely completion of the necessary preparatory work at the Bank, in-house tests and external interface and processing tests were carried out. Passing the Global Street Test, the worldwide Y2K test of the major international payment and clearing systems which took place on June 12-13, 1999, represented an important milestone. In addition, the Bank participated successfully in EU-wide tests of the TARGET payment system. After having ensured the year 2000 compliance of its own IT systems and applications largely on schedule by July 1, 1999, the Bank decided as a preventive measure to neither change existing procedures nor introduce new ones which would affect customer interfaces in the second half of 1999. Furthermore, the contingency plans for the central bank's core areas of operation were fine-tuned in the second half of last year.

Successful transition to the year 2000

Thanks to thorough preparations, the Bank's IT systems and applications successfully coped with the Y2K roll-over. On January 3, 2000 the Bank resumed business operations as usual. The weekend before saw internal test runs, connectivity tests involving market participants and ESCB-wide central bank tests. All those tests were completed successfully, as was the trial run of the Euro Access Frankfurt clearing system ("EAF Y2K Premiere") on January 2, 2000, during which no year 2000 problems were encountered. The measures taken by the Bank with respect to currency supply likewise proved to be completely adequate.

Participation in national and international communications networks during the transition from 1999 to 2000

During the transition from 1999 to 2000 and a few days before and after the roll-over, the Bank – via a Central Communication Point based at the Central Office – was integrated into the Federal Government's communications network managed by the Federal Ministry of Finance as the national coordinator for the financial sector and was in constant touch with the Federal Banking Supervisory Office and the national banking industry. In addition, the Bank was involved in the international project "Market Authorities Communication Services (MACS)", which was set up by the Joint Year 2000 Council at the Basle-based Bank for International Settlements. Thus, the Bank was actively contributing to an in-depth exchange of information among financial market authorities and central banks during this critical period.

German banking supervisors closely monitored Y2K preparations of the German banking industry

The banking supervisors closely monitored the year 2000 preparations of the German banking industry. In cooperation with the Federal Banking Supervisory Office, the Bank continued the surveys and the one-on-one talks with the project managers of large internationally operating credit institutions and computer centres of the savings bank and credit cooperative sectors which it had initiated in the preceding years. Thus, the Bank was able to see for itself that the German banking industry was well-prepared and to provide assistance wherever necessary. Together with the Central Office and the Land Central Banks, the Federal Banking Supervisory Office agreed on a Y2K prudential reporting procedure with the credit institutions and set up a communications network. The Central Communication Point, based at the Central Office, ensured the constant availability of German banking supervisors before, during and after the transition to the year 2000.

Annual accounts of the Deutsche Bundesbank for 1999

I. Balance sheet of the Deutsche Bundesbank as at December 31, 1999

Assets

			€ million	1.1.1999 € million
1	Gold and gold receivables		32,287	29,312
2	Claims on non-euro-area residents denominated in foreign currency			
	2.1 Receivables from the IMF	8,332		(8,461)
	2.2 Balances with banks, security investment, external loans and other external assets	52,422		(56,113)
			60,754	64,574
3	Claims on euro-area residents denominated in foreign currency		—	—
4	Claims on non-euro-area residents denominated in euro		9,149	128
5	Lending to financial sector counterparties of euro area denominated in euro			
	5.1 Main refinancing operations	48,396		(83,121)
	5.2 Longer-term refinancing operations	32,745		(24,698)
	5.3 Fine-tuning reverse operations	—		(—)
	5.4 Structural reverse operations	—		(—)
	5.5 Marginal lending facility	9,417		(2,598)
	5.6 Other claims	13		(5)
			90,571	110,422
6	Securities of euro-area residents denominated in euro		—	—
7	Claims on the Federal Government		4,440	4,440
8	Intra-Eurosystem claims			
	8.1 Participating interest in the ECB	1,225		(1,225)
	8.2 Claims arising from the transfer of foreign reserves to the ECB	12,247		(—)
	8.3 Other claims within the Eurosystem (net)	26,274		(—)
			39,746	1,225
9	Items in course of settlement		17	284
10	Other assets			
	10.1 Coins	823		(811)
	10.2 Tangible and intangible fixed assets	2,179		(2,162)
	10.3 Other financial assets	51		(51)
	10.4 Off-balance sheet instruments revaluation differences	—		(—)
	10.5 Accruals and deferred expenditure	1,361		(799)
	10.6 Sundry items	752		(453)
			5,166	4,276
			242,130	214,661

Liabilities

				1.1.1999
			€ million	€ million
1	Banknotes in circulation		140,150	130,551
2	Liabilities to euro-area financial sector counterparties denominated in euro			
	2.1 Current accounts	39,774		(29,325)
	2.2 Deposit facility	2,122		(—)
	2.3 Fixed-term deposits	—		(—)
	2.4 Fine-tuning reverse operations	—		(—)
			41,896	29,325
3	Liabilities to other euro-area residents denominated in euro			
	3.1 General government deposits	79		(149)
	3.2 Other liabilities	448		(707)
			527	856
4	Liabilities to non-euro-area residents denominated in euro		6,167	8,094
5	Liabilities to euro-area residents denominated in foreign currency		17	10
6	Liabilities to non-euro-area residents denominated in foreign currency		2	0
7	Counterpart of special drawing rights allocated by the IMF		1,653	1,458
8	Intra-Eurosystem liabilities			
	8.1 Liabilities to the ECB arising from promissory notes	—		(—)
	8.2 Other liabilities within the Eurosystem (net)	—		(5)
			—	5
9	Items in course of settlement		14	36
10	Other liabilities			
	10.1 Off-balance-sheet instruments revaluation differences	—		(38)
	10.2 Accruals and deferred income	42		(32)
	10.3 Sundry items	58		(86)
			100	156
11	Provisions		7,636	5,441
12	Revaluation accounts		34,953	25,322
13	Capital and reserves			
	13.1 Capital	2,556		(2,556)
	13.2 Statutory reserves	2,556		(2,556)
			5,112	5,112
14	Profit for the year (unappropriated profit at January 1, 1999)		3,903	8,295
			242,130	214,661

II. Profit and loss account of the Deutsche Bundesbank for the year 1999

				1998
			€ million	€ million
	– Interest income	6,218		(7,074)
	– Interest expense	– 1,206		(– 298)
1	Net interest income		5,012	6,776
	– Realised gains/losses arising from financial operations	3,214		(927)
	– Write-downs on financial assets and positions	– 1,052		(– 69)
	– Transfer to/from provisions for general risks, foreign exchange risks and price risks	– 2,030		(117)
2	Net result of financial operations, write-downs and risk provisions		132	975
	– Income from fees and commissions	79		(61)
	– Expense relating to fees and commissions	– 7		(– 6)
3	Net income from fees and commissions		72	55
4	Income from participating interests		21	10
5	Net result arising from allocation of monetary income		– 72	—
6	Other income		191	110
7	**Total net income**		5,356	7,926
8	Staff costs		862	868
9	Other administrative expenses		290	238
10	Depreciation on tangible and intangible fixed assets		173	214
11	Banknote printing		89	127
12	Other expenses		39	32
13	**Profit for the year**		3,903	6,447

Frankfurt am Main, February 23, 2000

DEUTSCHE BUNDESBANK
The Directorate

Welteke Dr Stark

Haferkamp Hartmann Meister Prof. Dr Remsperger Schieber

III. External auditors' report

We have audited the annual accounts, including the bookkeeping, of the Deutsche Bundesbank for the financial year from January 1, 1999 to December 31, 1999. The bookkeeping and the presentation of the annual accounts in accordance with generally accepted accounting principles and the principles for the accounting of the Bundesbank approved by the Central Bank Council pursuant to section 26 (2) of the Bundesbank Act are the responsibility of the Directorate of the Deutsche Bundesbank. Our task has been to submit an evaluation of the annual accounts, including the associated bookkeeping, on the basis of the audit we have undertaken.

We have carried out our audit of the annual accounts in accordance with section 317 of the Commercial Code *(Handelsgesetzbuch)* and in conformity with the principles laid down by the Institute of Auditors (IDW) for auditing annual accounts. According to these principles, the audit has to be planned and implemented in such a way that errors and malpractices which materially affect the picture of the Bank's assets and liabilities, financial position and profitability given in the annual accounts in line with generally accepted accounting principles are identified with sufficient certainty. When the audit is being arranged, account is taken of the auditors' knowledge of the Bank's operations and of its economic and legal environment and the likelihood of possible errors. In the course of the audit the effectiveness of the internal control system and documentary evidence for the figures in the accounts and the annual accounts are assessed largely on the basis of samples. The audit comprises the evaluation of the accounting principles applied and of the major estimates made by the Directorate as well as the assessment of the overall presentation of the annual accounts. We are of the opinion that our audit provides a sufficiently sound basis for our judgement.

Our audit has not revealed any discrepancies.

We are convinced that the annual accounts conform to generally accepted accounting principles and to the principles for the accounting of the Bundesbank and present a picture of the Bank's assets and liabilities, financial position and profitability which is consistent with the actual state of affairs.

Frankfurt am Main, March 22, 2000

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Prof. Dr Wiedmann
Wirtschaftsprüfer
(chartered accountant)

Rönnberg
Wirtschaftsprüfer
(chartered accountant)

PwC Deutsche Revision
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Prof. Windmöller
Wirtschaftsprüfer
(chartered accountant)

Langen
Wirtschaftsprüfer
(chartered accountant)

IV. General information on annual accounts

Legal basis

As part of the preparations for the introduction of the euro, German central banking legislation was adjusted, by means of the Sixth Act Amending the Bundesbank Act of December 22, 1997 (Federal Law Gazette I, page 3274), to the precepts of Community law for Germany's participation in stage three of European economic and monetary union (EMU). At the same time the provisions governing the Bank's accounting, as laid down in section 26 (2) sentences 2 and 3 of the Bundesbank Act, were amended as follows with effect from January 1, 1999:

The annual accounts shall be drawn up with due regard to the duties of the Deutsche Bundesbank, in particular, those deriving from its being an integral part of the European System of Central Banks, and shall be published with appropriate notes; contingencies need not be disclosed. Unless sentence 2 above entails any deviations, valuation shall be governed by the provisions of the Commercial Code relating to incorporated enterprises *mutatis mutandis*.

Principles for the accounting of the Bundesbank

This amendment enabled the Bank to adopt the accounting principles of the ECB, which are issued by the ECB Governing Council. On December 1, 1998 the ECB Governing Council adopted principles governing the annual accounts of the ECB, in accordance with Article 26.2 of the ESCB Statute. On that basis the Central Bank Council of the Deutsche Bundesbank decided to adopt those principles as far as possible as the "accounting principles of the Deutsche Bundesbank" [1]. In line with a decision taken by the Central Bank Council, the annual accounts relating to financial years ending after December 31, 1998 are to be drawn up in accordance with those accounting principles (see the overview below on the principles for the accounting of the Deutsche Bundesbank).

As a result of the data obtained on the basis of these accounting principles, the Bank is also fulfilling its reporting requirements, pursuant to Article 26.4 of the ESCB Statute.

Breakdown

Like the opening balance sheet in euro as at January 1, 1999, the balance sheet as at December 31, 1999 is drawn up in line with the accounting principles. The figures from the euro-denominated opening balance sheet of January 1, 1999

1 Published in Bundesbank Notice no. 10001/2000 of April 3, 2000.

are given in the balance sheet as at December 31, 1999 for comparison purposes instead of the previous year's figures.

In accordance with the accounting principles, the profit and loss account is no longer to be laid out horizontally, as was formerly the custom, but vertically. To safeguard its comparability with that of the previous year as far as possible the income and expenditure accounts of the previous year are rearranged to comply with the new breakdown and are converted into euro. Nevertheless, the previous year's figures are still based on the Bank's accounting rules up to the end of 1998.

Audit and approval of the annual accounts

The annual accounts of the Bank for 1999 were audited by KPMG Deutsche Treuhand-Gesellschaft AG Wirtschaftsprüfungsgesellschaft, Berlin and Frankfurt am Main, and PwC Deutsche Revision AG Wirtschaftsprüfungsgesellschaft, Frankfurt am Main, which the Central Bank Council had appointed to be auditors in accordance with section 26 (3) of the Bundesbank Act. The auditors confirmed without qualification that the Bank's annual accounts for 1999 and bookkeeping comply with German law and present an accurate picture of the Bank's assets and liabilities, finacial position and profitability. The Central Bank Council approved the annual accounts for 1999 on April 6, 2000.

Overview of the principles for the accounting of the Deutsche Bundesbank

General accounting principles

Record of economic reality, thus reflecting the Bank's assets and liabilities, financial position and profitability;
prudence;
account to be taken of post-balance-sheet events;
materiality;
going-concern principle;
accruals principle (income and expenditure to be recognised in the accounting period in which they are earned or incurred);
consistency and comparability.

Cash/settlement approach

Recording of spot transactions in gold, foreign currency instruments and securities in the Bank's accounts shall be based on the date of payment (settlement date).

Balance sheet valuation rules

Valuation of gold, foreign currency instruments, securities and financial instruments shall be performed at mid-market rates and prices on the balance sheet date.
No distinction shall be made between price and currency revaluation differences for gold, but a single gold revaluation difference shall be accounted for, based on the euro price per defined unit of weight of gold derived from the euro/US dollar exchange rate on the balance sheet date.
Revaluation shall take place on a currency-by-currency basis for foreign exchange (including off-balance-sheet transactions).
In the case of securities revaluation shall be on a code-by-code basis (same ISIN number/type).

Repurchase agreements

A repurchase agreement (repo) shall be recorded as a collateralised inward deposit on the liabilities side of the balance sheet while the item that has been given as collateral remains on the assets side of the balance sheet. A reverse repurchase agreement (reverse repo) shall be recorded as a collateralised outward loan on the assets side of the balance sheet for the amount of the loan. In the case of security lending transactions the assets shall remain in the balance sheet of the transferor.

Income recognition

Realised gains and realised losses shall be taken to the profit and loss account. Unrealised gains shall not be recognised as income but shall be transferred directly to a revaluation account.
Unrealised losses shall be taken to the profit and loss account if they exceed previous revaluation gains registered in the corresponding revaluation account.
Unrealised losses recorded in the profit and loss account in previous years shall not be reversed in subsequent years in the event of new unrealised gains. There shall be no netting of unrealised losses in any one security, in any currency or in gold holdings against

unrealised gains in other securities, currencies or gold.
Premiums or discounts arising on purchased securities shall be treated as part of interest income and shall be amortised using either the straight line method or the implicit rate of return method. The implicit rate of return method shall be used in the case of zero-coupon bonds with a residual maturity of more than one year at the time of acquisition.
The average cost method shall be used on a daily basis for calculating the acquisition cost in the case of assets that are subject to exchange rate and/or price movements. The average cost price or rate of the assets shall be reduced by unrealised losses taken into the profit and loss account at the end of the year.

Accounting rules for off-balance-sheet instruments

Foreign exchange forward transactions, forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date shall be included in the foreign currency position.
Interest rate swaps, futures, forward rate agreements and other interest rate instruments shall be accounted for and revalued on an item-by-item basis.
Gains and losses arising from off-balance-sheet instruments shall be recognised and treated in a similar manner to on-balance-sheet instruments.

Intra-Eurosystem balances

Intra-Eurosystem balances with the ECB (other than participating interests in the ECB, claims arising from the transfer of foreign reserves to the ECB and liabilities arising from promissory notes in connection with the issue of ECB debt certificates) and with the national central banks of other member states participating in the Eurosystem are to be shown in the balance sheet as a net position.

Transitory rules

The assets and liabilities shown in the closing Deutsche Mark balance sheet of December 31, 1998 shall be revalued on January 1, 1999. Unrealised gains arising on or before January 1, 1999 are to be recorded separately from the unrealised gains which arise after January 1, 1999. The market rates/prices applied by the Bank in the euro-denominated opening balance sheet of January 1, 1999 shall be deemed to be the average acquisition rates/prices as at January 1, 1999. The revaluation items for unrealised gains accruing on or before January 1, 1999 shall be dissolved only in connection with decreases in value and in the event of disposals after January 1, 1999.
Account has to be taken of gains and losses vis-à-vis securities prices that arise from the transfer of foreign reserves to the European Central Bank. Gains and losses arising from foreign currency instruments and from gold holdings have likewise to be realised if the claims on the ECB arising from the transfer are denominated in euro.

V. Notes on the individual balance sheet items

1. Assets

Gold and gold receivables

The Bank holds 112 million ounces of fine gold (ozf). The gold is valued at market prices at the end of the year (1 ozf = € 289.518). No gold changes were recorded in 1999 other than the transfer of 7 million ozf gold to the ECB at the beginning of January 1999.

Claims on non-euro-area residents denominated in foreign currency

The claims on the International Monetary Fund (IMF) as well as balances with banks, security investment, loans and other claims on non-euro-area residents are shown in this item.

Receivables from the IMF

This sub-item contains the claims on the IMF which are financed and held by the Bank and which arise from the Federal Republic of Germany's membership of the IMF. The claims, which total € 8,332 million (SDR 6,104 million), consist of drawing rights within the reserve tranche and special drawing rights.

The drawing rights within the reserve tranche correspond to the amounts actually paid to the IMF in gold, special drawing rights (SDRs) and national currency under the German quota. The IMF Executive Board agreed on a further rise in the quota in December 1997. Germany's share of the rise in the quota amounted to SDR 4,767 million and was paid in by the Bank on February 12, 1999. At the end of 1999 drawing rights held amounted to € 6,384 million (SDR 4,676 million) compared with € 6,225 million (SDR 5,168 million) on January 1, 1999. They represent the difference between the German quota of SDR 13,008 million and the euro balances amounting to € 11,372 million (SDR 8,332 million) at the disposal of the IMF at the end of the year. Holdings of drawing rights declined by SDR 492 million net in 1999 mainly as a result of payments in connection with the quota increase as well as euro drawings and euro repayments by other member countries.

Special drawing rights, by means of which convertible currencies can be obtained at any time, were originally allocated free of charge to the extent of SDR 1,211 million. The counterpart is shown on the liabilities side. The level of special drawing rights held at the end of 1999 amounted to € 1,948 million (SDR 1,427 million). Increases totalling SDR 1,629 million owing, in particular, to standing arrangements to buy SDRs in voluntary transactions and to interest credited were accompanied by decreases amounting to SDR 1,528 million, primarily as a result of payments in connection with the quota increase.

The loans granted by the Bank to the IMF as a result of special borrowing arrangements under both the General Arrangements to Borrow and the New Arrangements to Borrow were repaid in full in the year under review.

SDR-denominated drawing rights within the reserve tranche, special drawing rights and the counterpart of special drawing rights allocated are shown in the balance sheet on the basis of the exchange rate calculated by the ECB at the end of the year for all central banks participating in the Eurosystem (SDR 1 = € 1.364976).

Balances with banks, security investment, external loans and other external assets

The balances, security investment, loans and other foreign currency claims, which are almost exclusively in US dollars and interest-bearing, amounted to € 52,422 million at the end of 1999 compared with € 56,113 million on January 1, 1999. The decline was primarily due to the transfer of foreign reserves to the ECB at the beginning of January 1999 (see sub-item 8.2 "Claims arising from the transfer of foreign reserves to the ECB"). The US dollar items were valued at the end-of-year market rate of € 1 = US $ 1.0046 compared with € 1 = US $ 1.16675 on January 1, 1999.

Claims on non-euro-area residents denominated in euro

The Bank's balances arising from the settlement of TARGET payments and held with the four ESCB central banks not participating in the Eurosystem are shown in this item.

Lending to financial sector counterparties of euro area denominated in euro

This item reflects the volume and pattern of the Bank's refinancing of the financial sector in the euro area.

Most of it is composed of the main refinancing operations used as part of the flexible money market management. These operations are regular weekly transactions with a two-week maturity (until the end of 1998 open market transactions in securities under repurchase agreements), the purpose of which is to provide liquidity. In the year under review the main refinancing operations were conducted without exception as volume tenders with a fixed rate.

The longer-term, and in terms of value smaller, refinancing operations are used to provide additional longer-term liquidity at monthly intervals and with a maturity of three months (until the end of 1998 German and foreign bills of exchange were purchased); they were held as variable rate tenders.

Fine-tuning reverse operations and structural reverse operations were not conducted in the year under review.

The marginal lending facility (overnight liquidity) is the equivalent of the former lombard credit facility.

Sub-item 5.6 contains claims, especially in the form of balances with correspondent banks in the euro area.

Claims on the Federal Government

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

Intra-Eurosystem claims

The Bank's claims within the Eurosystem, both on the ECB and on the other euro-area central banks, are combined in this item.

Sub-item 8.1 is the Bank's participating interest in the ECB. Pursuant to Article 28 of the ESCB Statute, the national central banks are the sole subscribers to the capital of the ECB. Subscriptions depend on capital shares, which are fixed in accordance with Article 29 of the statute and revised, and if necessary adjusted, every five years. The Bank currently has a 24.5 % share (= € 1,225 million) of the ECB's capital of € 5 billion; this is equivalent to a 31.0 % share of the total capital paid in by the 11 central banks in the Eurosystem.

Sub-item 8.2 contains the Bank's claims arising from the transfer of foreign reserves to the ECB. In accordance with Article 30 of the ESCB Statute, the 11 central banks participating in the Eurosystem transferred foreign reserves amounting to the equivalent of € 39,469 million (15 % in gold and 85 % in foreign exchange) to the ECB in the first week of January 1999. The Bank's share of the foreign reserves transferred amounts to € 12,247 million. As the transferred gold does not earn interest, the claim is remunerated at 85 % of the present main refinancing rate.

The sub-item "Other claims within the Eurosystem (net)" contains the net assets resulting from the settlement of TARGET payments and from the traditional correspondent banking operations within the Eurosystem (balance of assets and liabilities). The Bank's net liabilities would have been shown in the sub-item 8.2 "Other liabilities within the Eurosystem (net)" on the liabilities side.

Items in course of settlement

This item contains the asset items arising from payments still being processed within the Bank (notably the float stemming from collections).

Other assets

The amount of coins which the Bank itself holds as a reserve for use in payments is shown in sub-item 10.1. The Bank, acting for the account of the Federal Government (which holds the coinage prerogative), receives new coins from the state mints at face value. The value of the coins recorded increased by 1.5 % compared with the value on January 1, 1999.

The sub-item "Tangible and intangible fixed assets" comprises the Bank's land and buildings, furniture and equipment and computer software. The balance sheet value of the land, offices and residential buildings showed a slight increase from January 1, 1999 of € 5 million to € 1,957 million. Net additions of € 100 million were accompanied by depreciation amounting to € 95 million. In the year under review the value of the Bank's furniture and equipment rose to € 200 million after net additions of € 77 million and depreciation totalling € 67 million. In the case of computer software there was a total balance sheet value at the end of 1999 of € 22 million after taking account of depreciation amounting to € 11 million and net additions of € 13 million.

The sub-item "Other financial assets" contains the Bank's participating interests in the Liquiditäts-Konsortialbank GmbH, Frankfurt am Main, the Bank for International Settlements, Basle, and the cooperative society SWIFT, La Hulpe (Belgium). The 30 % interest in Liquiditäts-Konsortialbank entails for the Bank an unchanged maximum additional commitment of € 285 million.

The sub-item "Accruals and deferred expenditure" contains the accrued and prepaid expenditure identified at December 31, 1999. These chiefly consist of interest income which is due in the new financial year from securities denominated in US dollars, loans and other assets which were acquired or transacted in the financial year just ended.

Among the "Sundry items" are the Bank's holdings of banknotes issued by other central banks in the Eurosystem, whose equivalent values have not yet been settled.

2. Liabilities

Banknotes in circulation

In the year under review the volume of Deutsche Mark banknotes in circulation increased by € 9,599 million (7.4 %) to € 140,150 million; in 1998 it had declined by € 2,736 million (2.1%). The relatively large increase from the previous year is due mainly to the special situation obtaining at the millennium change. By the end of January 2000 the volume of banknotes in circulation had declined to € 131,669 million.

Liabilities to euro-area financial sector counterparties denominated in euro

The sub-item "Current accounts" contains the deposits of the financial sector amounting to € 39,774 million (1.1.99: € 29,325 million), which are used to meet the minimum reserve requirement and settle payments. The main criterion for inclusion in this item is that the respective business partners appear in the list of institutions which are subject to the minimum reserve regulations in the Eurosystem.

The sub-item "Deposit facility" (€ 2,122 million) contains overnight deposits at a predetermined interest rate (standing facility).

In the year under review no fixed-term deposits were received and no fine-tuning reverse operations were conducted.

Liabilities to other euro-area residents denominated in euro

The sub-item "General government deposits" encompasses the balances of the Federal Government, its special funds, the Länder Governments and other public depositors. The special funds principally include the Equalisation of Burdens Fund. The deposits of other public depositors constitute balances held by social security funds and local authorities. At December 31, 1999 general government deposits amounted to € 79 million in all (1.1.99: € 149 million).

The deposits of euro-area financial sector counterparties that are not subject to the minimum reserve regulations and the deposits of enterprises, individuals and other depositors are shown in the sub-item "Other liabilities". At the end of 1999 these deposits amounted to € 448 million compared with € 707 million on January 1, 1999.

Liabilities to non-euro-area residents denominated in euro

This balance sheet item, amounting to € 6,167 million (1.1.99: € 8,094 million) contains primarily the fixed-term deposits of central banks and the working balances of monetary authorities, commercial banks and international organisations.

Liabilities to euro-area residents denominated in foreign currency

This item contains mostly the US dollar deposits of commercial banks and of branches domiciled in the euro area that are owned by banks domiciled outside the euro area.

Liabilities to non-euro-area residents denominated in foreign currency

The foreign-currency liabilities to banks outside the euro area are recorded in this item.

Counterpart of special drawing rights allocated by the IMF

The counterpart of the special drawing rights allocated by the IMF free of charge and shown as sub-item 2.1 on the assets side of the balance sheet corresponds to the allocations of SDRs to the Federal Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,211 million.

Intra-Eurosystem liabilities

The "Liabilities to the ECB arising from promissory notes" shown as sub-item 8.1 arise in connection with the issue of ECB debt certificates. There were no such issues during the year under review.

Sub-item 8.2 "Other liabilities within the Eurosystem (net)" is for any net liabilities arising from TARGET payment settlements and from the traditional correspondent banking operations within the Eurosystem. A balance on the assets side, which is shown as the assets sub-item 8.3 "Other claims within the Eurosystem (net)", is derived from the claims and liabilities at the of the year.

Items in course of settlement

This item contains the liabilities items arising from the settlement transactions circulating within the Bank (notably the collection of bills of exchange) and from amounts available to cover certified cheques.

Other liabilities

The sub-item "Accruals and deferred income" contains the accrued and deferred income identified at December 31, 1999. These consist almost exclusively of interest expenditure which is due in the new financial year and which arose in the financial year just ended.

Provisions

The Bank's provisions are as follows:

	31.12.1999	1.1.1999
	€ million	€ million
Provisions for		
– general risk	3,395	3,381
– pension commitments	2,023	1,945
– any waiver of claims on the ECB	2,016	–
– other	202	115
	7,636	5,441

The provisions for general risks, pursuant to the regulations governing the Bank's annual accounts contained in section 26 (2) of the Bundesbank Act, are created in view of the unchanged foreign currency risks, especially in the case of the Bank's US dollar and SDR positions.

Following an increase of € 3 million, the provisions for pensions amount to € 1,948 million; they are based on an actuarial expert opinion. Indirect pension liabilities arising from the Bank's obligation to act as guarantor for pension payments out of the supplementary pension funds for government employees amounted to € 298 million at December 31, 1999. € 74.5 million of this sum is recorded in the pensions provisions at December 31, 1999. It is planned to set the remaining € 223.5 million aside in equal amounts in the annual accounts for 2000, 2001 and 2002.

The provision for any waiver of claims on the ECB exists in connection with the transfer of foreign reserves to the ECB. There is still not an adequate financial buffer to cover the risk of any large valuation losses that may arise at the ECB as a result of foreign exchange risks in the event of a falling gold price or of a strong euro. A contingency regulation approved by the ECB Governing Council for this eventuality stipulates that the central banks participating in the Eurosystem have to assume the ECB's exposure risk up to 20 % of the equivalent euro value of the transferred foreign reserves at the time of the transfer (in the case of the Bundesbank, to a maximum of € 2,449 million). To cover such a waiver of claims this year's annual accounts contain a provision amounting to € 2,016 million, which takes account of the current exchange rate levels of the US dollar and the yen and the current price of gold and is equivalent to the profit realised at the time the foreign reserves were transferred to the ECB. The assumption of the exposure risk is restricted to the period from 1999 to 2001.

The actual profit on the transferred foreign reserves cannot be determined until the end of this period. Any waiver of claims is restricted to uncovered unrealised exchange rate losses or gold price losses arising from the foreign reserves transferred to the ECB. There were no such losses in 1999 (for the cover of other ECB losses see the profit and loss item "Net result arising from the allocation of monetary income").

The other provisions created primarily for anticipated losses and doubtful liabilities increased by € 87 million net to € 202 million at December 31, 1999.

Revaluation accounts

This item contains the disclosed hidden reserves from the initial valuation at the time of the changeover to market-valuation on January 1, 1999 (revaluation items "old") and the resultant unrealised gains arising from market-valuation on December 31, 1999 (revaluation items "new"). The "Revaluation accounts" item was made up as follows at the end of the year:

	Revaluation items "old" € million	Revaluation items "new" € million	Revaluation accounts, total € million
Gold	19,275	4,812	24,087
Foreign exchange	3,193	7,673	10,866
of which			
SDRs	(181)	(690)	(871)
US dollars	(3,012)	(6,968)	(9,980)
Securities	–	0	0
	22,468	12,485	34,953

Revaluation items "old"

Revaluation items were created for gold, SDRs, US dollars and securities during the changeover to market-valuation. Although the valuation gains arising from the initial valuation on January 1, 1999 are not eligible for distribution, they are available for offsetting valuation losses. Valuation losses did not arise from the valuation on December 31, 1999 in any balance sheet item for which there was a revaluation item at the end of the year as a result of the initial valuation; to that extent there was no dissolution.

Besides a dissolution in the case of valuation losses, a dissolution takes place only in the case of reductions in the corresponding assets. The Central Bank Council of the Bundesbank decided in this connection that in the event of reductions in the holdings of gold, SDRs and US dollars there would be a last-in first-out dissolution on an annual basis. Accordingly, all disposals would first be offset against the acquisitions in the year under review. A proportionate dissolution of the revaluation items "old" concerned would follow only if disposals exceeded acquisitions on an annual basis, i.e. the end-of-year holdings were smaller than those at the beginning of the year. Reductions in holdings of SDRs and US dollars were recorded at the end of 1999 with the result that a partial dissolution amounting to € 34 million (in the case of SDRs) and € 108 million (in the case of US dollars) had to be undertaken. The separate transfer of foreign reserves to the ECB resulted in a reduction in holdings with a realised profit of € 2,016 million. In line with the large turnover in securities holdings the revaluation item "old" for securities was dissolved to the full value of € 696 million in a simplified procedure at December 31, 1999. In all, the revaluation items "old" were reduced by the dissolution amount, namely € 2,854 million, to € 22,468 million (1.1.99: € 25,322 million).

Revaluation items "new"

In the case of gold holdings, the net positions in each foreign currency and the securities portfolio the positive difference between their market value and their value in terms of the average acquisition costs carried forward from January 1, 1999 is shown in the revaluation items "new" at the end of the year.

Owing to the strength of the dollar, the market values of the gold, SDR and US dollar positions at the end of the year were above the respective acquisition values with the result that revaluation items amounting to € 12,471 million were created. There were only slight valuation gains in the case of the other foreign currencies and the securities.

Capital and reserves

The Sixth Act amending the Bundesbank Act of December 22, 1997 (Federal Law Gazette I page 3274) increased the liable capital to DM 5 billion (€ 2,556 million) with effect from December 31, 1998 and laid down the sum of DM 5 billion (€ 2,556 million) as the upper limit for the statutory reserves.

Profit for the year

The profit and loss account for the year 1999 closed with an annual surplus of € 3,903 million. Pursuant to section 27 of the Bundesbank Act, it will be transferred in full to the Federal Government as the statutory reserves are at their maximum level of € 2,556 million.

VI. Notes on the profit and loss account

Net interest income

This item shows interest income less interest expenditure. The net interest income of € 5,012 million was € 1,764 million down on that of the previous year.

Despite the strengthening of the US dollar, net interest income in foreign currency declined from € 3,663 million in 1998 to € 2,700 million. This fall is mainly the result of the decrease in US dollar holdings as a consequence of the transfer of foreign reserves to the ECB in January 1999. Interest income in euro increased slightly compared with 1998, rising from € 3,411 million to € 3,517 million.

Total interest expenditure rose by € 908 million to € 1,206 million compared with 1998. This was due primarily to the expenditure of € 844 million which arose for the first time in 1999 owing to the remuneration of minimum reserve balances.

Net result of financial operations, write-downs and risk provisions

The realised gains and losses arising from the disposal of gold, foreign currency and securities are recorded in the first sub-item. Gains arising from the foreign reserves transferred to the ECB accounted for € 2,016 million of the total sum of € 3,214 million and gains from the dissolution of the revaluation item "old" for securities that was created on January 1, 1999 accounted for € 696 million of that total.

Valuation losses on securities denominated in US dollars because of the rise in the interest rate level since the beginning of 1999 are the main constituent of the sub-item "Writedowns on financial assets and positions".

The sub-item "Transfer to/from provisions for general risks, foreign exchange risks and price risks" is mainly the allocation of the reserve for a possible waiver of claims on the ECB arising from the foreign reserves transferred (€ 2,016 million).

Net income from fees and commissions

Net income from fees and commissions rose by a total of € 17 million to € 72 million compared with the previous year. The rise was due mainly to commissions for the assumption of guarantees vis-à-vis the BIS (€ 30 million). Net income arising from the handling of payments and from securities trading and safe custody account business declined by € 13 million to € 42 million compared with 1998.

Income from participating interests

This item contains the Bank's profit from its participating interests in the Liquiditäts-Konsortialbank GmbH and the Bank for International Settlements.

Net result arising from allocation of monetary income

The outcome of the allocation of monetary income among the national central banks in accordance with Article 32 of the ESCB Statute is shown in this item; the amount shown includes the contribution made by the Bank to cover the loss incurred by the ECB in 1999, pursuant to Article 33.2 of the ESCB Statute.

In accordance with Article 32.5 of the ESCB Statute, the sum of the national central banks' monetary income is allocated to the 11 participating national central banks in proportion to their paid-up shares in the capital of the ECB, subject to any decision taken by the Governing Council pursuant to Article 33.2.[1] The allocation of monetary income resulted in a net liability of € 3 million for the Bank. This was due to a transfer of € 14 million from monetary income to the common pool and to a claim by the Bank on the common pool of € 11 million, which is in proportion to its capital share in the ECB.

Pursuant to Article 33.2 of the statute, a loss incurred by the ECB may, if the Governing Council so decides, be offset against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks in accordance with Article 32.5. The ECB Governing Council has decided that the monetary income, the Bank's share of which amounts to € 11 million, will be used to cover part of the loss incurred by the ECB in 1999. The national central banks will then assume responsibility for the ECB's remaining loss in proportion to their capital share. The Bank will bear € 57 million of this additional amount to cover the ECB's loss. This means that the Bundesbank's total share of liability for the loss incurred by the ECB in 1999 amounts to € 68 million.

Other income

The remaining income increased by € 81 million from the previous year to € 191 million. This was primarily due to repayments by the IMF which amounted to € 115 million and which flowed back to the Bank as a result of the dissolution of an IMF reserve account.

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1 The ECB Governing Council has decided that in the years 1999 to 2001 the monetary income to be transferred by the national central banks will be calculated by paying interest on the monetary base (defined as the liabilities items "Liabilities to financial sector counterparties denominated in euro: current accounts, deposit facility, fixed-term deposits, fine-tuning operation" and "Liabilities to the ECB arising from promissory notes") at a reference interest rate (defined as the respective current main refinancing rate). All interest expenditure which a national central bank has had to pay on the liabilities items mentioned is deducted from the amount calculated in this way.

Staff costs

Expenditure on staff declined slightly in 1999, falling by € 7 million (0.8 %) to € 862 million. However, if the transfer to the provisions affecting this item, which was smaller than in 1998, is excluded, expenditure increased by 1.9 % compared with the previous year. This increase was due mainly to rises in the pay of wage and salaried staff and of civil servants in 1999. The number of persons employed by the Bank remained virtually unchanged from the previous year.

Retirement pensions accounted for € 191 million of aggregated expenditure on staff (1998: € 225 million). This sum includes the transfers to provisions for pensions, owing to revisions and to indirect pension commitments, as well as payments made to staff of the former Deutsche Reichsbank to whom Article 131 of the Basic Law applies and to other persons for whom the Bank is required to provide, in accordance with section 41 of the Bundesbank Act.

Payments to serving members of the Bank's Directorate and of the Executive Boards of Land Central Banks amounted to € 5,223,751.12 in the year under review. Former members of the Bank's Directorate, of the Board of Directors and Board of Managers of the Bank deutsche Länder, and of the Executive Boards of Land Central Banks, including their surviving dependants, received payments totalling € 7,714,013.85.

Other administrative expenses

The other (non-staff) operating expenditure increased by € 52 million compared with 1998 to € 290 million. The main reason for the increase was the expenditure of € 35 million on major structural changes to the Bank's premises. Until the end of 1998 this expenditure was shown on the assets side during the year and then written off in full at the end of the year (see the decline in the profit and loss item "Depreciation on tangible and intangible fixed assets").

Depreciation on tangible and intangible fixed assets

The depreciation of land and building, of furniture and equipment and of computer software is explained in balance sheet item 10 "Other assets".

Banknote printing

In the year under review expenditure on banknote printing declined by € 38 million (30 %) to € 89 million. The reason for this was the smaller volume of Deutsche Mark banknotes supplied, on the one hand, and the start of production of euro banknotes, on the other.

Other expenses

Other expenses are principally expenditure on residential buildings and transfers to the provisions for unspecified liabilities.

Branch Offices of the Deutsche Bundesbank

on April 1, 2000

Locality number	Bank place	Land central bank[1]
390	Aachen	NRW
614	Aalen	BW
653	Albstadt	BW
765	Ansbach	BY
464	Arnsberg	NRW
795	Aschaffenburg	BY
720	Augsburg	BY
662	Baden-Baden	BW
532	Bad Hersfeld	H
560	Bad Kreuznach	RS
710	Bad Reichenhall	BY
770	Bamberg	BY
855	Bautzen	STH
773	Bayreuth	BY
100	Berlin	BBB
480	Bielefeld	NRW
430	Bochum	NRW
380	Bonn	NRW
270	Braunschweig	BNS
290	Bremen	BNS
292	Bremerhaven	BNS
663	Bruchsal	BW
257	Celle	BNS
870	Chemnitz	STH
180	Cottbus	BBB
241	Cuxhaven	BNS
508	Darmstadt	H
741	Deggendorf	BY
805	Dessau	BNS
440	Dortmund	NRW
850	Dresden	STH
395	Düren	NRW
300	Düsseldorf	NRW
350	Duisburg	NRW
820	Erfurt	STH
763	Erlangen	BY
360	Essen	NRW
611	Esslingen	BW
215	Flensburg	HMS
500	Frankfurt/M.	H
170	Frankfurt/O.	BBB
680	Freiburg	BW
530	Fulda	H
703	Garmisch-Partenkirchen	BY
420	Gelsenkirchen	NRW
830	Gera	STH
513	Giessen	H
260	Göttingen	BNS
478	Gütersloh	NRW
450	Hagen	NRW
268	Halberstadt	BNS
800	Halle	BNS
200	Hamburg	HMS
254	Hameln	BNS
410	Hamm	NRW
506	Hanau	H
250	Hannover	BNS
672	Heidelberg	BW
620	Heilbronn	BW
259	Hildesheim	BNS
780	Hof	BY
217	Husum	HMS
721	Ingolstadt	BY
222	Itzehoe	HMS
540	Kaiserslautern	RS
660	Karlsruhe	BW
520	Kassel	H
733	Kempten	BY
210	Kiel	HMS
324	Kleve	NRW
570	Koblenz	RS
370	Köln	NRW
690	Konstanz	BW
320	Krefeld	NRW
548	Landau	RS
743	Landshut	BY
285	Leer	BNS
860	Leipzig	STH
266	Lingen	BNS
683	Lörrach	BW
604	Ludwigsburg	BW
545	Ludwigshafen	RS
230	Lübeck	HMS
240	Lüneburg	BNS
810	Magdeburg	BNS
550	Mainz	RS
670	Mannheim	BW
840	Meiningen	STH
731	Memmingen	BY
490	Minden	NRW
310	Mönchen-gladbach	NRW
362	Mülheim	NRW
700	Munich	BY
400	Münster	NRW
150	Neubranden-burg	HMS
574	Neuwied	RS
760	Nürnberg	BY
365	Oberhausen	NRW
505	Offenbach	H
664	Offenburg	BW
280	Oldenburg	BNS
265	Osnabrück	BNS
472	Paderborn	NRW
740	Passau	BY
666	Pforzheim	BW
160	Potsdam	BBB
650	Ravensburg	BW
426	Recklinghausen	NRW
750	Regensburg	BY
640	Reutlingen	BW

Locality number	Bank place	Land central bank[1]
403	Rheine	NRW
711	Rosenheim	BY
130	Rostock	HMS
590	Saarbrücken	RS
593	Saarlouis	RS
793	Schweinfurt	BY
140	Schwerin	HMS
386	Siegburg	NRW
460	Siegen	NRW
603	Sindelfingen	BW
600	Stuttgart	BW
673	Tauber-bischofsheim	BW
585	Trier	RS
641	Tübingen	BW
258	Uelzen	BNS
630	Ulm	BW
694	Villingen-Schwenningen	BW
602	Waiblingen	BW
753	Weiden	BY
356	Wesel	NRW
510	Wiesbaden	H
282	Wilhelmshaven	BNS
587	Wittlich	RS
790	Würzburg	BY
330	Wuppertal	NRW

1 Abbreviations

BW = Baden-Württemberg (Baden-Württemberg)
BY = Freistaat Bayern (Free State of Bavaria)
BBB = Berlin und Brandenburg (Berlin and Brandenburg)
BNS = Freie Hansestadt Bremen, Niedersachsen und Sachsen-Anhalt (Free and Hanseatic City of Bremen, Lower Saxony and Saxony-Anhalt)
HMS = Freie und Hansestadt Hamburg, Mecklenburg-Vorpommern und Schleswig-Holstein (Free and Hanseatic City of Hamburg, Mecklen-burg-Western Pomerania and Schleswig-Holstein)
H = Hessen (Hesse)
NRW = Nordrhein-Westfalen (North Rhine-Westphalia)
RS = Rheinland-Pfalz und Saarland (Rhineland-Palatinate and Saarland)
STH = Freistaaten Sachsen und Thüringen (Free States of Saxony and Thuringia)