Deutsche Bundesbank
Annual Report 1996

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on April 1, 1997

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The current monetary policy regulations and the Principles Concerning the Capital and Liquidity of Credit Institutions are included in the following special publications, which are available to interested parties free of charge:
Deutsche Bundesbank, Monetary policy regulations,
Banking regulations 3,
Frankfurt am Main, April 1997;
Deutsche Bundesbank, Banking Act,
Banking regulations 2,
Frankfurt am Main, October 1996.

Abbreviations and symbols

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	Figure unknown, not to be published or not meaningful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

Discrepancies in the totals are due to rounding.

Foreword
by the President
of the Deutsche Bundesbank

Foreword

In terms of their monetary objectives, monetary policy makers can look back on a successful year. In 1996 a higher degree of price stability was reached than at any time since the late eighties or late sixties. In other respects, too, there were a number of changes for the better last year. For instance, the marked misalignments in the global monetary system, which adversely affected the international competitiveness of German enterprises in 1995, completely disappeared. Moreover, expansionary forces regained the upper hand, both in Germany and in other continental European countries.

However, the German economic situation was overshadowed by intractable employment problems, which increased in severity despite the improvement of the overall economic environment. There are various reasons for this: it owes something to structural problems and inflexibility on the labour market, as well as to the stronger competitive pressure to which the German economy is exposed, given the growing globalisation of the financial and goods markets. In this changing international economic setting, the tax and administrative conditions underlying investment decisions, and thus determining the viability of existing jobs and the creation of new ones, have increased in significance. Furthermore, in Germany some provisions of the social security system are putting excessive pressure on labour costs and providing too little incentive for searching for new employment. The priority need is therefore permanently to eliminate the structural causes of the employment problems, und thus to reinforce the basis of Germany's future economic prosperity.

Those responsible for economic policy, as well as the parties to wage agreements, have recognised these challenges, and are increasingly taking steps to enhance the flexibility of the goods and labour markets. With the planned reforms in the areas of corporate taxation and social security, other major measures to strengthen the competitiveness of German business are in preparation. In view of the rigidities and pressures that have emerged over a longish period of time, however, it will be difficult to make any rapid progress along the road to more employment. What are required are therefore considerable staying power and the firm determination to revitalise the market economy and modernise the welfare state. Ultimately, it is a return to the proven basic principles which made the social market economy a model of a successful economic and social system, acknowledged throughout the world, that is called for.

For the Bundesbank, with the approach of the transition to the European monetary union, the preparatory work necessary to this end has become an even greater focus of interest in practically all areas. That work involves a broad range of central banking operations, including both technico-organisational and conceptual problems. Specifically, it ranges from agreements on the organisation and processing of payments in the upcoming euro area, via the preparation of euro banknotes and the administration of the monetary reserves of the future European System of Central Banks, to the clarification of major problems of monetary law and of questions arising in connection with issuing and trading in securities. In addition, key conceptual issues arising from the future single monetary policy of the countries participating in EMU and from the preparation of the arsenal of monetary policy instruments for the European Central Bank, and of the statistics which are essential for monetary policy, must be addressed. In all these fields, substantial headway has already been made, even if many details have had to be left unsettled for the time being. In any case, the final decisions can only be taken by the Governing Council of the future European Central Bank.

But above and beyond all technical and organisational preparatory work, one must not lose sight of the fundamentals that have to be established and safeguarded in order to ensure confidence in the lasting stability of the single European currency. These include, first and foremost, the consolidation of the high degree of price stability already achieved and of lasting, sound public finance. In the view of the Bundesbank, it is especially important that savers in this country and international investors alike should entertain no doubts as to the enduring determination to combat inflation on the part of all those responsible for the euro and its future.

The present Annual Report analyses the monetary policy of the Bundesbank last year, against the background of overall macroeconomic developments. At the same time, the Bank hereby presents its annual accounts for 1996, which have been audited (and certified) by two firms of auditors, and were approved by the Central Bank Council of the Bank on April 17, 1997.

Acting on behalf of the Central Bank Council, as well as speaking for myself, I should like to take this opportunity of thanking all the staff members of the

Bank for the strong commitment with which they performed their duties in 1996. I also wish to express my gratitude to the staff representative bodies for their cooperation in a spirit of mutual trust.

Frankfurt am Main, April 1997

Prof. Dr Dr h.c. Hans Tietmeyer
President, Deutsche Bundesbank

The currency and the economy

I. International economic fundamentals

Global economic activity becoming more buoyant ...

Last year was marked by an overall improvement in the global economic setting. At 4%, growth in output picked up again slightly in global terms compared with the previous year, and expansion in world trade was once more considerable, at over 5½%. From the spring onwards, economic growth also gained momentum in those countries in continental Europe which had experienced a slowdown in their recovery during 1995. It was chiefly the resilience of economic activity in the United States and in the other Anglo-Saxon countries which stimulated the cyclical upturn. This upward trend was bolstered further by the unbroken dynamism of growth in many emerging economies. The slight slowdown in the fast pace of expansion in the Asian and Pacific region has been largely offset by a sustained recovery in Latin America and the continuing reform successes in a large number of central and east European countries. Finally, Japan, too, imparted new stimuli to the world economy, particularly in the first few months of 1996, although their intensity declined perceptibly later in the year.

... while the employment situation in Europe remains unsatisfactory

Unemployment nevertheless remained at an unacceptably high level in many countries. In the European Union (EU), the unemployment rate has been at almost 11% since as long ago as 1993; there was yet another marked rise last year, particularly in Germany and France. Although this unwelcome situation on the labour market might be alleviated slightly by a continuing revival in business activity, lasting progress in overcoming the pressing problems of employment can only be expected if there is an accelerated reduction in structural impediments and rigidities on the labour market.

Favourable economic trends in the United States

The growth of the US economy continued to be in line with the potential in 1996 and was hence largely free of tensions; at the same time, unemployment decreased further. The preconditions for this were, to a large extent, created by an employment-friendly wage policy interacting with flexible labour market structures – safeguarded and underpinned by a vigilant monetary policy which, at an early stage, countered the signs of overheating that had emerged in the preceding year. It was only after the economy had been steered on to a calmer course again in 1995 that the Federal Reserve Bank relaxed its stance on interest rate policy. Later on, the US economy gained renewed momentum, which was principally reflected in a faster growth in industrial output. That led to the emergence of new concerns about inflation in the financial markets, which were also reflected in rising US capital market rates. Together with the recovery of the

Key macroeconomic variables in selected industrial countries *

Table 1

Country	Real gross domestic product		Consumer prices 1		Financial balance of the public sector 2		Unemployment rate 3	
	1995	1996 p	1995	1996 p	1995	1996 p	1995	1996 p
	Change from previous year in %				as % of GDP		in %	
Industrial countries	2.0	2.3	2.5	2.3	– 3.5	– 3.0	7.5	7.6
of which								
European Union	2.5	1.7	3.0	2.5	– 5.3	– 4.5	10.8	10.9
of which								
France	2.2	1.3	1.8	2.0	– 5.0	– 4.1	11.6	12.3
Germany	1.6	1.3	1.8	1.5	– 3.5	– 3.9	8.2	9.0
Italy	3.0	0.8	5.2	4.0	– 7.1	– 7.4	11.9	12.0
United Kingdom	2.5	2.1	3.4	2.4	– 5.5	– 4.0	8.8	8.2
United States	2.0	2.4	2.8	2.9	– 2.0	– 1.4	5.6	5.4
Japan	1.4	3.6	– 0.1	0.1	– 3.7	– 4.6	3.1	3.4
Canada	2.3	1.4	2.2	1.6	– 4.1	– 2.1	9.5	9.7

Sources: IMF, OECD and national statistics. — * EU countries and United States, Japan, Canada, Switzerland, Norway, Iceland, Australia and New Zealand. — 1 Consumer price index. — 2 As defined in the national accounts. — 3 Standardised unemployment rate as calculated by the OECD, excluding Iceland.

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US dollar, this in turn tended to counteract inflationary expectations. As a result, the Federal Reserve Bank perceived no reason for a further change of course in interest rate policy until recently. Overall, at a rate of 2½%, growth in the US economy was higher in 1996 than in 1995.

Contrasts in western Europe

Western Europe did not present a uniform cyclical picture last year. The overall positive trend in the United Kingdom continued, where the upswing is now entering its fifth year. The dynamic growth in domestic demand is, however, now being accompanied by retarding influences in foreign trade due to the perceptible appreciation of the pound sterling. Given falling unemployment rates, the outlook (which is still quite positive in other respects) is being clouded more by worries about inflation. At 7%, Ireland once again achieved the highest economic growth of all the industrial countries in 1996. Despite the fact that most of the other countries in the EU had notably lower growth rates than the United Kingdom and Ireland, the economies of the continental European countries largely returned to a sounder footing during 1996. It was mainly in Germany (but also in France) that the forces of growth prevailed again. Foreign trade proved to be the main driving force, whereas domestic demand did not generate any major stimuli. Italy was at the lower end of the growth scale, at just under 1%. Besides the increases in taxes and levies for households, this weak growth was probably mainly due to the disappearance of the competitive advantage which had temporarily arisen from the rapid fall in the Italian lira's external value. The Italian economy appears to have adjusted to the new underlying conditions in the meantime, however.

Stronger growth in Japan

Japan has been burdened for a number of years by significant structural problems in the financial sector, which make it difficult for the economy to regain the successes in growth to which it was formerly accustomed. Following trends that were previously rather disappointing overall, growth picked up appreciably in the winter half-year 1995-6 under the impact of large-scale programmes to stimulate the economy. The initial momentum began to wane, however, when these fiscal stimuli started to peter out. Despite that, Japanese gross domestic product (GDP) grew by a total of 3 ½ % in 1996. Both the reversal in the preceding sharp appreciation of the yen and the distinctly low domestic interest rate level have opened up more favourable growth prospects for Japan of late. Nevertheless, Japan – like the vast majority of industrial countries in Europe – is faced with pressing tasks of consolidation in the area of public finance: the public sector budget has slid into considerable deficit since 1993 following the numerous expansionary fiscal packages; there has been a sharp rise in the level of public debt, and the demographic trends, too, point to significant challenges ahead.

Emerging economies continue to be a major centre of growth

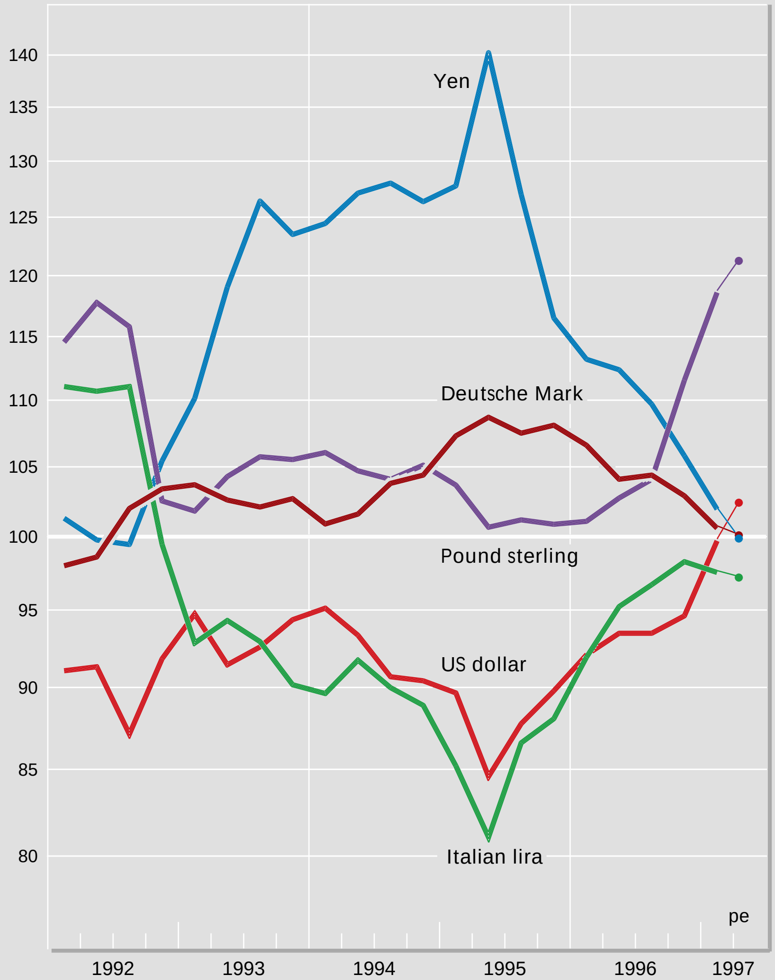
The emerging economies in Asia remain one of the most important centres of growth in the world economy. Although the pace of expansion in that region has slackened, with an 8 % growth rate, that slowdown was the intended outcome of a restrictive economic policy stance which resolutely counteracted the looming risks of overheating. Most of the economies in Latin America, on the other hand, have made a marked recovery from the economic downturn which followed the Mexican currency crisis. After the contraction of the economy in a number of large Latin American countries and an overall expansion in that region of less than 1%, growth accelerated to 3 % in 1996.

Differences in central and eastern Europe

Moreover, trade with several countries in transition in central and eastern Europe supported growth in the west European industrial countries last year. Because of their geographical proximity, these economies are also of particular importance for Germany. Although the progress they have made in creating a competitive economy is at most somewhat variable, those countries which resolutely initiated the necessary reforms at an early stage of transition have already reaped the benefits of their efforts. In particular, the central European countries, Real external values of selected currencies *

Chart 1

1st qtr of 1987 = 100, log. scale



* Nominal external values against the currencies of 18 industrial countries after adjustment for the differing macroeconomic price movements (as measured by the prices of total sales). — ● = Latest position: average April 1 to 15, 1997.

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some of which recorded growth rates of more than 5 % in the preceding years, now appear to have managed to make the crucial breakthrough. By contrast, the large successor states to the Soviet Union are still experiencing great difficulty in going beyond the stage of half-hearted reforms.

Foreign exchange markets characterised by increasing relaxation

Following the exchange rate misalignments of 1995, more favourable prospects for growth – above all, for many countries in continental Europe – emerged last year as a result of the continuing relaxation in the international monetary system. The situation improved markedly in terms of international price competitiveness – especially for Germany, France, Austria and the Benelux countries – with the exchange rate relationships having become more consistent with the fundamentals in the course of last year. That was as true of exchange rates against the US dollar and the yen as it was against the currencies of European partner countries.

Normalisation in the relationship between the US dollar and the yen …

A stimulus to this was given by the fact that the fiscal policy stance in the United States became clearer in the course of 1995. Following a period of pronounced uncertainty, this provided the markets with the prospect of a lasting consolidation of the budget over the next few years. Above and beyond that, the settlement of the protracted trade dispute with Japan in the autumn of 1995 led to a relaxation vis-à-vis the yen. In 1996 expectations of an appreciation of the US dollar were further encouraged by the differences in the pace of growth in the economies involved. Accordingly, the weighted real external value of the US dollar recovered perceptibly from its downward slide in spring 1995; conversely, the weighted real external value of the yen dropped back to its initial level following its surge between 1992 and spring 1995.

… and in the European foreign exchange markets

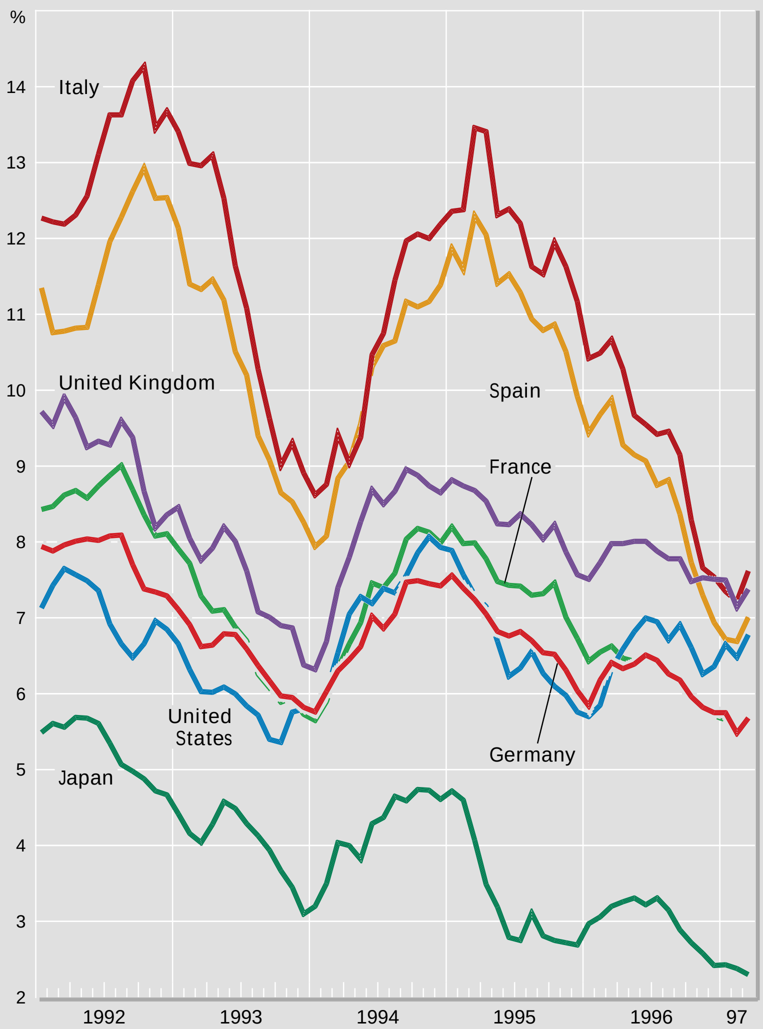
The misalignments in exchange rate patterns have lessened in Europe, too. That is particularly true of the Italian lira, which had already begun to recover in the summer of 1995 after radical consolidation and reform measures had been announced. The upward trend of the Italian lira was interrupted only for a time by the renewed emergence of doubts on the part of the market players concerning the continuation of the consolidation process that had been initiated. Not only does that reveal the high sensitivity with which the foreign exchange markets react to new information about announced or expected consolidation measures, it also illustrates how important durably sound fundamentals are for the stability of exchange rates. Speculation that Italy might be taking part in European economic and monetary union (EMU) from the outset played an important part in that respect and fostered sizeable capital imports to Italy. Apart from the Italian lira, the Spanish peseta, too, benefited from large capital inflows. At times, this had made the peseta the strongest currency within the European exchange rate mechanism. During the second half of last year, however, this place was taken by the Irish pound. The trend in the Irish pound is probably related to the pound sterling, which had likewise recovered appreciably since last summer with continuing strong economic growth in the United Kingdom and the associated interest rate expectations.

High degree of price stability …

The encouragingly high degree of price stability that has now been achieved in the industrial countries presents a favourable basis for the continuation of large-

Capital market rates in selected industrial countries *

Chart 2



* Government bonds with maturities of approximately ten years.

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ly tension-free growth in the world economy. At scarcely more than 2 %, the inflation rate on an average of the western industrial countries since the mid-nineties has been at levels which come close to the goal of price level stability.

... as a prerequisite of sustained growth

In the emerging economies of East Asia, greater account was taken last year of the looming signs of overheating and inflationary pressure by appropriate measures to slow down the economy. Many Latin American countries are likewise able to look back on conspicuous successes in stabilisation, and there was a further sharp fall in the inflation rate in most of those countries in transition in central and eastern Europe which have been particularly successful in pursuing a policy of reform. They are nevertheless still far away from price stability in many cases. It will be important for them not to falter in their stabilisation efforts so that the international competitiveness of their economies is not put at risk. The countries in transition in central and eastern Europe are particularly striking examples of the fact that combating inflation and economic growth are not incompatible; rather, success on the inflation front is a precondition for securing sustained economic growth.

Scope for lowering interest rates utilised

The stability policy successes of the industrial countries have reaped rewards in the form of globally low interest rates; these, in turn, fostered growth. At least, the monetary policy of most industrial countries used this additional scope to take further steps to reduce interest rates. That was true in the case of the Federal Reserve Bank at the start of 1996, after the risks of overheating in the economy appeared to have been effectively averted for the time being. It was, above all, the central banks in continental Europe, however, which were presented with additional opportunities for lowering interest rates during the year. As a result, central bank rates in a number of countries fell to historical lows in the autumn months. It was only in isolated cases that central banks were prompted to tighten interest rate policy during 1996 – in the United Kingdom, for instance, where future risks of inflation increased in the light of the upswing that had already persisted for several years.

Change in the international term structure

In 1996 interest rate movements in the international capital markets were also shaped more strongly than before by the discrepancy in growth between the United States and the United Kingdom, on the one hand, and the countries of continental Europe, on the other; this increased the interest rate advantage of the US capital market significantly during the year. Measured by the difference between the rates of return on ten-year dollar government securities and the rate of interest on debt securities with a comparable maturity issued by the German Federal Government, the slight advantage of Deutsche Mark paper in early 1996 had shifted within a year to US dollar bonds; at the beginning of 1997 the yield advantage of dollar paper amounted to almost 1 percentage point.

Interest rate convergence in Europe ...

Within Europe, there was a marked reduction in the interest rate differential vis-à-vis the Deutsche Mark capital market. The decline in interest rates in various European partner countries last year went significantly further than was prefigured by international market trends. As a result, the capital market yields of the countries concerned approached the comparable Deutsche Mark yields. The interest rate gap between the French and the German capital markets (which in 1995 had amounted to more than ½ percentage point in the ten-year maturity range) flattened out completely. The sharp contraction in the yield differential between the Spanish and the German markets is likewise striking; at just over 1 percentage point, the interest rate differential was latterly around 2½ percentage points lower than at the end of 1995. The yield advantage of long-term lira bonds also became considerably smaller as these bonds met with buoyant demand in the international financial markets, especially in the second half of last year, on account of the price gains expected from the narrowing spread of capital market rates. Firstly, this is likely to have been a reflection of the advances made in the European convergence process. Secondly, this trend probably also reflects speculation on whether the countries in question will take part in EMU.

... calls for strict continuation of anti-inflation policy

Ultimately, this was to a certain extent a case of "foreshadowing effects" of EMU which were quite similar to those reflected in the strengthening of the south European currencies in the foreign exchange markets. The stock of confidence in the continuation of the convergence process, which is being advanced by the markets, admittedly harbours a notable setback potential in the event of unexpected undesirable developments or disappointments. It will therefore be all the more important to secure the requisite degree of lasting convergence by consistently pursuing the non-inflationary policies that have been initiated in those countries.

Fiscal policy consolidation indispensable

A sound fiscal policy will have a key role to play in this. The deficit ratio fell slightly last year on an average of the western industrial countries. At more than 3% of GDP, however, their current level of new borrowing cannot be sustained in the long run. That applies particularly to the member countries of the European Union, whose government deficits, taken together, amounted to 4½% of GDP. It is true that individual member countries (above all, some Scandinavian countries and Ireland) were able to reduce their deficits significantly or even to show notable surpluses. Budget deficits in most European countries are still far too high, however, for them not to impede the forces of growth in the private sector. "Window-dressing" will not bring any progress in the task of consolidation, however. That can neither create new fiscal policy room for manoeuvre nor strengthen private sector competitiveness. In the final analysis, that is what will be important if the highly developed European industrial countries wish to meet the key economic challenges they are facing in an effective manner.

II. Economic trends in Germany and central bank policy

1. The German economy on a path of growth again

Mixed overall economic performance

As in other European partner countries, Germany's overall economic record was marked by light and shade last year. A positive factor is that, in the spring of 1996, the German economy returned to the path of growth from which it had veered in the second half of 1995. Towards the end of last year, however, the economic recovery was again interrupted. In 1996 as a whole real gross domestic product (GDP) increased by 1½ %. However, the decline in employment did not come to a halt, and there was a further rise in unemployment. At the end of 1996, 4.16 million persons were registered as unemployed (after elimination of seasonal influences), which was 360,000 more than a year earlier. At the same time, the share of unemployed in the total labour force amounted to 10.9 %. On the other hand, the fact that price movements have come very close to the goal of price level stability is to be rated as a positive development.

Strong foreign demand, weak domestic demand

The fact that the economic slowdown was overcome is primarily attributable to foreign demand, which picked up as early as the turn of 1995-6 and gained increasing momentum during the course of last year. So far, however, this failed to give an initial boost to domestic demand. Although private consumption was quite buoyant, this was due less to endogenous expansionary forces than to the fiscal relief which came into force at the beginning of the year. Above all, however, investment activity in Germany, the lasting weakness of which essentially shaped the economic picture in 1996, has not taken off on a sustained basis.

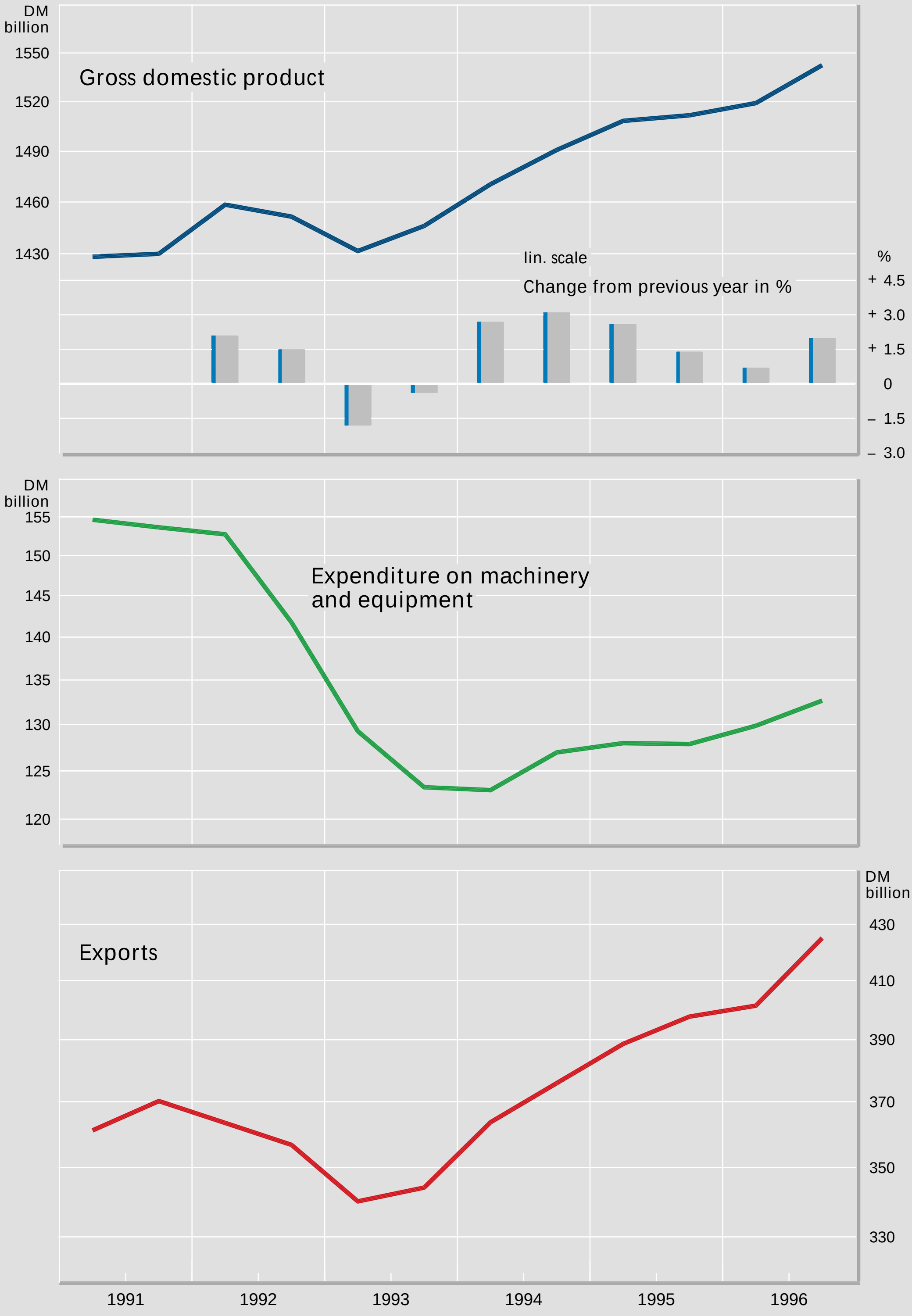
Industrial production

The recovery of foreign demand was mainly a reflection of the fact that the manufacturing sector in western Germany, which accounts for the major part of exports, expanded its output significantly in the course of last year; in the final quarter of 1996 manufacturing output exceeded the 1995 level by 1½ %. In the new Länder, by contrast, industry benefited much less from foreign demand. Its output declined after the stimuli provided by the construction industry had abated; it was nevertheless 6 % higher on an annual average than the figure for 1995. Since the end of the downward slide in 1991, which followed the collapse of the centrally planned economy, industrial production in the new Länder has increased by over one-half, i.e. by an average of 9 % per year. The fact that the rise was lower in 1996 is due not least to a normalisation after the (at times) surging increases in the years before.

Gross domestic product and selected expenditure components

Chart 3

At 1991 prices, seasonally adjusted, half-yearly, log. scale



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Capacity utilisation

Another sign that the economic slowdown has been overcome is the fact that manufacturing capacity in the old Länder was utilised to a greater extent again. In the second half of last year, it moved closely around the standard level. One significant factor behind the increase in the degree of utilisation, however, was the comparatively small rise in industry's fixed assets, due probably not least to plant being closed down in order to improve competitiveness.

Declining construction activity

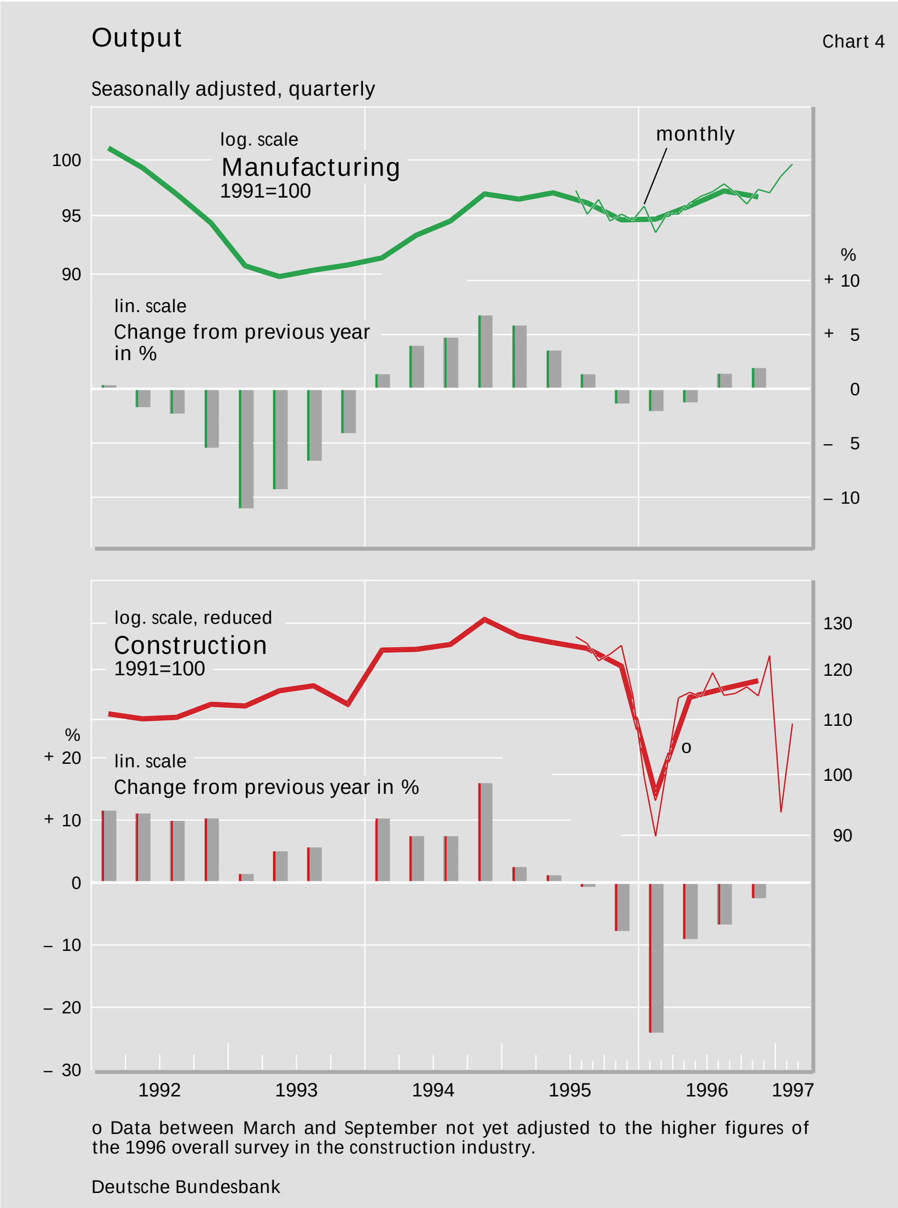
The construction industry had a retarding influence on overall economic developments in Germany in 1996, both in the west and in the east. This is most clearly reflected in the fact that real construction investment was 2½% lower than in 1995. In western Germany it declined by 3%, and in eastern Germany by 1½%, following a rise of 7½% a year earlier. In the past few years construction activity expanded exceptionally sharply in the new Länder – not least as a result of strong government incentives. The degree of expansion can be seen from the fact that the construction sector's share of value added in GDP is now more than three times higher than in western Germany. It was probably not to be expected that this trend (which made the construction sector the most important mainstay of growth in the east German economy) would continue during the following years. Owing to the mushrooming of growth in many submarkets in the past few years, the supply of buildings of all kinds overshot demand, which, *inter alia,* created vacant properties. In this light, the setback in 1996 was to be expected. Nevertheless, the cut-back in government incentives which came into force at the beginning of this year is fundamentally justified. The curbing of construction activity contributed much to the increase in east German real GDP being much lower, at 2%, in 1996 than a year before (5½%).

Sustained expansion in the services sector

In contrast to the construction industry, services enterprises in Germany were again able to raise their value added significantly in 1996. Their contribution to the growth of real GDP amounted to nearly 1 percentage point. In this context, it has to be borne in mind that the overall economic weight of the tertiary sector has continued to increase in the last few years and is now much greater than that of the total producing sector. This sustained shift in weight is, however, partly due to the fact that, in the wake of rationalisation measures, the industrial sector outsourced activities, opening up new fields for services enterprises.

Disappointing labour market trends ...

The general public linked the cyclical recovery with the expectation of a rapid improvement in the situation on the labour market. That hope was disappointed, but was also largely unfounded. Judging by past experience, employment – in macroeconomic terms – responds with a considerable time lag to a change in



the pace of growth. The sharp fall in employment in Germany as a whole of around 405,000, or 1.2 %, on an annual average was, not least, a belated consequence of the economic setback in the second half of 1995. Moreover, the decrease in employment owes something to the fact that the cyclical boost in export business did not spread to domestic demand, which is largely based on comparatively labour-intensive production, and that construction activity declined significantly.

... especially in eastern Germany

The fall in employment affected both the old and the new Länder, where employment had continued to increase in the two preceding years. In eastern Germany the decline was, in fact, sharper in relative terms (– 1½ %) than in the west (– 1%). One factor behind this was that, unlike in the previous years, the construction industry (which is of greater macroeconomic importance in the new Länder) reduced the number of its employees in 1996. Another factor was that the number of participants in labour market policy measures was no longer rising but decreasing slightly. The manufacturing sector cut back its personnel level further, namely by 3 ½ % in the old Länder and by 5 % in the new Länder.

Further increase in unemployment

On an annual average in 1996, the number of unemployed rose by 355,000, i.e. to almost the same extent that employment declined. At 3.97 million, 10.4 % of the total labour force was unemployed in Germany. In western Germany registered unemployment amounted to 2.80 million persons, and the unemployment rate came to 9.1%; in eastern Germany the respective figures were 1.17 million and 15.7 %. The fact that, on the whole, the decrease in employment and the increase in unemployment were largely the same in terms of numbers, i.e. that the size of the labour force remained almost unchanged from the previous year, is by no means inevitable. Many persons who lost their jobs either retired from the labour force or withdrew from it temporarily and are therefore not counted as unemployed. On the other hand, especially in the old Länder, the number of unemployed increased because there was a further rise in the inflow of persons into the labour market who were not employed previously.

Structural features of unemployment

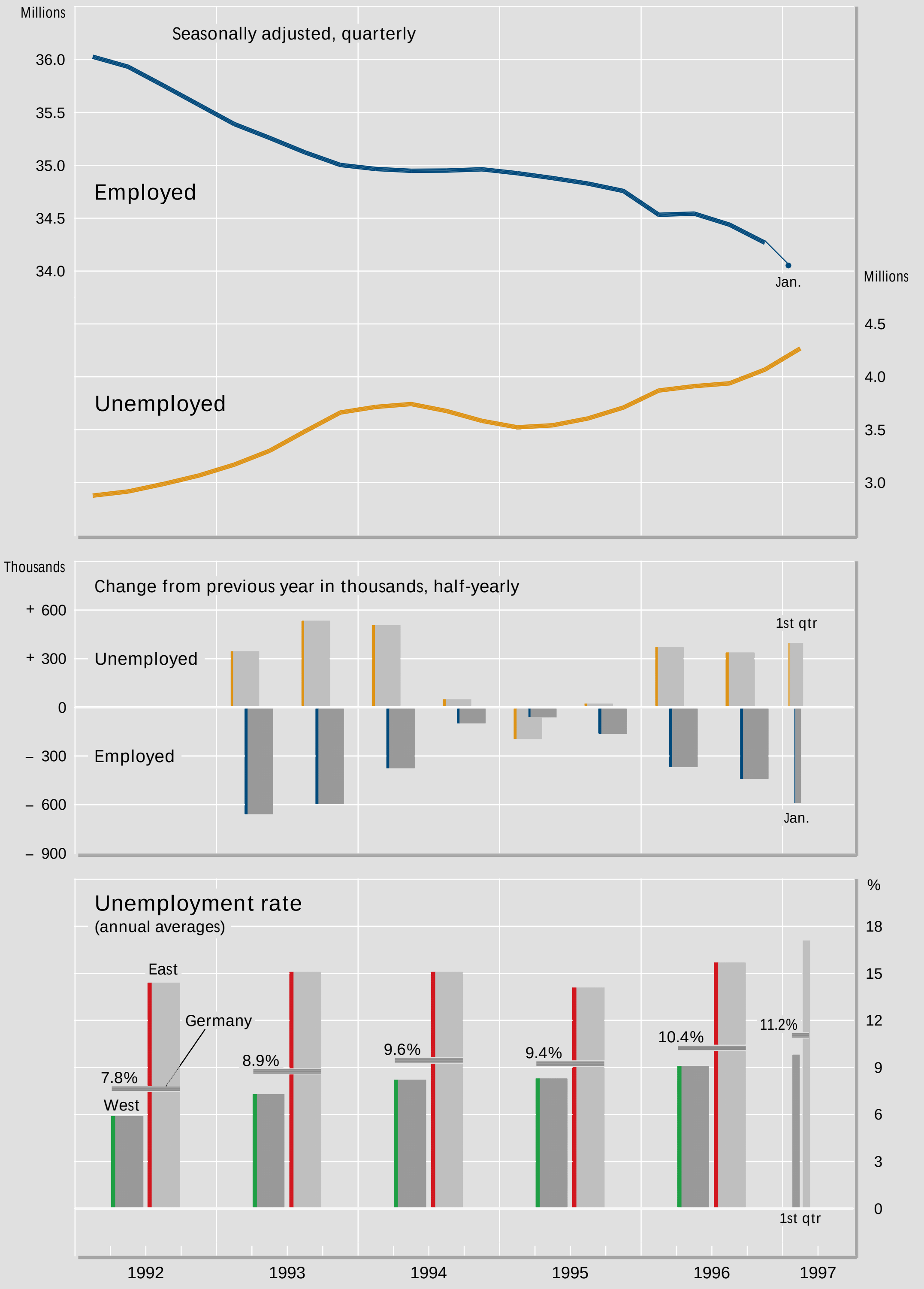
A relatively large part of unemployment must be considered to be structural. One indication of this is that, on an annual average in 1996, around 30 % of all unemployed – or nearly 1.2 million persons – were among the long-term unemployed; this share has almost trebled compared with the sixties and seventies. Being one year without employment generally implies a perceptible loss of skills, which noticeably reduces later employment opportunities. This applies all the more if a number of characteristics impairing placement are combined. For example, the share of unemployed aged 55 years or older was almost twice as high in 1996, at over one-fifth, as the corresponding ratio for the total labour force. At an advanced age it is likely to become increasingly difficult to cope, in particular, with the rapid sequence of innovations in the fields of data processing and communications, for example.

Supply conditions

These ratios show that there is a considerable discrepancy between the structures of demand and supply on the German labour market. This cannot, of

Labour market

Chart 5



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course, be divorced from another cause of structural unemployment, namely the excessively high labour cost level and inadequate wage differentiation. There were some steps in the right direction in wage policy in 1996. At rates of increase of 2 % or less, the pay settlements were moderate – a trend which has continued so far in the 1997 pay round. However, this cannot be expected to have a directly positive effect on the labour market. For that to happen, moderate wage increases over several years are necessary. Furthermore, wages would have to be differentiated more strongly by region, industry and qualification. In addition, it is important that the effects of wage restraint on labour costs are not undermined in other respects. If anything, 1996 was a setback in this regard: for example, the contribution rates to the social security funds were raised considerably; employers' contributions, which amount to roughly one-quarter of total gross wages and salaries, rose by an average of 2 ½ %.

East-west wage ratio

In eastern Germany the process of gradually adjusting pay rates to the remuneration paid in western Germany continued last year. In several economic sectors – say, in the metal-working and electrical engineering industry, in the iron and steel industry and in parts of the printing industry – basic pay rates have now reached the level in the old Länder; in other sectors full adjustment has already been agreed in the pay settlements for this or the coming year. On average, basic pay rates in eastern Germany at the end of 1996 amounted to almost 90 % of the western level, whereas actual earnings came to 77 %. One of the causes of this discrepancy is that negotiated additional benefits, such as holiday and Christmas bonuses, are not paid on the same scale in eastern Germany as in the old Länder. The main reason, however, is that (according to surveys) many manufacturing and construction enterprises in eastern Germany pay their employees at rates below the agreed scale, either because employers are not subject to pay settlements or because this was agreed at company level to bring wage costs more closely into line with productivity and hence improve enterprises' competitive opportunities. Besides the sharp reduction in employment, it may have been the gradual relaxation of strict adherence to pay settlements in the manufacturing sector (which is subject to particularly heavy international competitive pressure) which contributed to the distinct narrowing of the wage cost gap vis-à-vis the old Länder. In 1991 wage costs per nominal unit of value added in the east German manufacturing sector exceeded the west German level by 89 %; this disparity had narrowed to 26 % by 1996.

Export demand, which passed its trough at the end of 1995, rose appreciably in the course of last year; in the last quarter of 1996 export orders were 10 %

Key economic variables in Germany

Table 2

Item	1993	1994	1995	1996
	Change from previous year in %			
Growth (real) 1				
Private consumption	+ 0.3	+ 1.0	+ 1.8	+ 1.3
Government consumption	– 0.0	+ 1.3	+ 2.0	+ 2.4
Fixed capital formation	– 5.6	+ 4.2	+ 1.5	– 0.8
Expenditure on machinery and equipment	– 14.1	– 1.2	+ 2.0	+ 2.4
Buildings	+ 0.9	+ 7.7	+ 1.2	– 2.7
Stockbuilding (in DM billion)				
in absolute terms	(– 5.2)	(+ 23.4)	(+ 31.7)	(+ 23.9)
Change	(– 5.2)	(+ 28.6)	(+ 8.3)	(– 7.8)
Domestic demand	– 1.3	+ 2.8	+ 2.1	+ 0.8
Foreign balance (in DM billion) 2				
in absolute terms	(– 12.8)	(– 11.0)	(– 14.9)	(+ 2.4)
Change	(+ 6.8)	(+ 1.8)	(– 3.9)	(+ 17.3)
Exports	– 4.9	+ 8.0	+ 5.9	+ 4.9
Imports	– 5.7	+ 7.6	+ 6.4	+ 2.6
Gross domestic product	– 1.1	+ 2.9	+ 1.9	+ 1.4
Western Germany	– 1.9	+ 2.2	+ 1.6	+ 1.3
Eastern Germany	+ 8.9	+ 9.9	+ 5.3	+ 2.0
Contribution to GDP growth in %				
Domestic demand	– 1.3	+ 2.8	+ 2.0	+ 0.8
Foreign balance	+ 0.2	+ 0.1	– 0.1	+ 0.6
Employment				
Employed 3	– 1.7	– 0.7	– 0.3	– 1.2
Average working time per employed person	– 0.9	– 0.3	– 1.2	– 0.3
Total number of hours worked	– 2.6	– 1.0	– 1.5	– 1.5
Unemployed (in thousands)	3,419	3,698	3,612	3,965
Western Germany	2,270	2,556	2,565	2,796
Eastern Germany	1,149	1,142	1,047	1,169
do. as % of the total labour force	8.9	9.6	9.4	10.4
Western Germany	7.3	8.2	8.3	9.1
Eastern Germany	15.1	15.2	14.0	15.7
Prices				
Consumer price index	+ 4.5	+ 2.7	+ 1.8	+ 1.5
Western Germany	+ 3.6	+ 2.7	+ 1.7	+ 1.4
Eastern Germany	+ 10.5	+ 3.7	+ 2.1	+ 2.2
Producer prices of industrial products 4	+ 0.2	+ 0.6	+ 1.8	– 0.5
Overall construction price level	+ 4.3	+ 2.0	+ 2.1	– 0.1
Import prices	– 1.5	+ 0.8	+ 0.4	+ 0.5
GDP deflator	+ 3.8	+ 2.2	+ 2.2	+ 1.0
Value added and labour costs				
GDP per hour worked by employed persons 1	+ 1.5	+ 3.9	+ 3.5	+ 2.9
Gross wage and salary income per hour worked by employees 3	+ 5.5	+ 3.8	+ 4.9	+ 3.0
Labour costs per unit of value added in the economy as a whole 5	+ 4.0	– 0.1	+ 1.4	+ 0.1

Sources: Federal Statistical Office; Federal Labour Office. — **1** At 1991 prices. — **2** Balance of transactions in goods and services with the rest of the world. — **3** Work-place concept. — **4** Domestic sales. — **5** Gross wage and salary income 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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Buoyant demand for exports ...

higher than 12 months earlier, or 5 % higher on an annual average. The revival in export business is due to several factors. On the one hand, the external conditions for German enterprises' activities on international markets changed markedly compared with 1995. The sharp appreciation of the Deutsche Mark, which peaked in the spring of 1995, has largely reversed since then. At present, the (weighted) external value against the currencies of 18 major trading partners is, in fact, about 2 ½ % below the level reached at the end of 1994. In addition, cyclical conditions improved last year in most European countries, too. On the other hand, domestic economic conditions for a more competitive supply of exports have likewise improved. This owed something to the overall quite moderate pay settlements in the 1996 pay round. Another factor was that enterprises made considerable efforts to strengthen their competitive position through rationalisation and modernisation; the sustained reduction of manpower in the manufacturing sector is likewise to be seen against this background.

... especially for capital goods

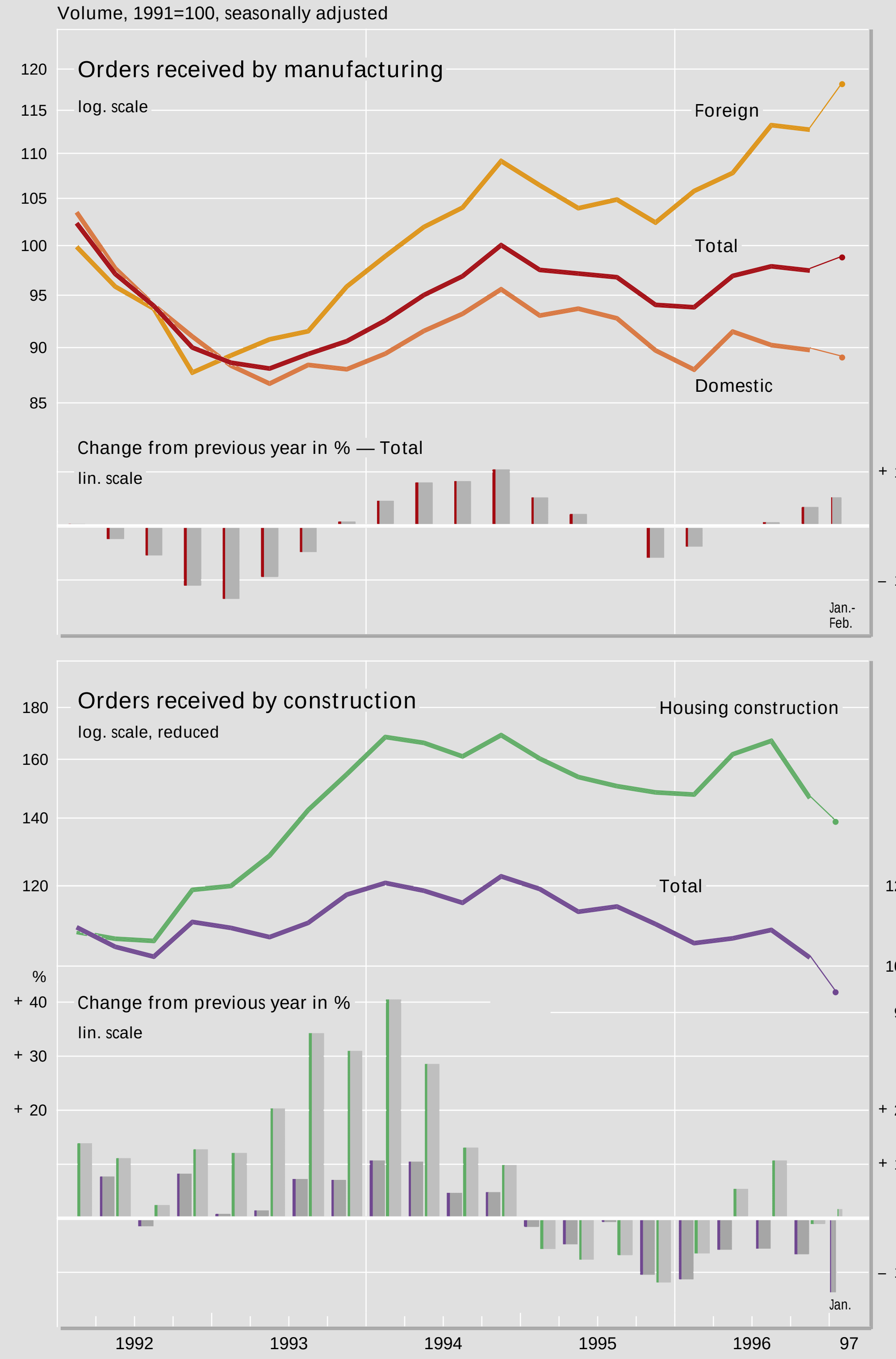
Foreign demand for capital goods rose sharply in 1996. Domestic capital goods producers booked 6 ½ % higher export orders than a year earlier. This suggests that the propensity to invest and investment activity are relatively buoyant in other countries.

Causes of low investment activity by enterprises ...

In Germany investment was, by contrast, weak overall in 1996. Producing enterprises' gross fixed capital formation stagnated at the level of the preceding year in both nominal and real terms (machinery and equipment: + 2 ½ % in each case, industrial buildings: – 5 ½ % and – 4 ½ %, respectively). This unsatisfactory result had a whole series of causes. After the cyclical slowdown had been overcome, it was probably of importance that, on the one hand, the recovery of demand was initially not considered to be permanent and that, on the other, existing capacity provided sufficient scope for expanding production for the time being. In addition, in the new Länder (where a modern capital stock of considerable size had been built up in the past few years with the active assistance of many west German enterprises) the economy was affected by the slowdown in business activity, which resulted in production reserves becoming larger in eastern Germany. Finally, uncertainties about profit expectations, caused by the sharp appreciation of the Deutsche Mark in 1995 in conjunction with high wage increases, are likely to have affected the low propensity to invest in 1996. These reasons, admittedly, no longer applied last year, and the overall earnings position continued to improve, although the improvement was not nearly as marked as in 1995, being predominantly focused on enterprises active in export business. This was a long way from being able to effect a complete reversal of

Trends in demand

Chart 6



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the deterioration in profit expectations, as reflected, *inter alia*, in the assessments of business prospects in the ifo business survey, which have been sceptical for a long time.

... and by the housing industry and the public sector

The housing industry and the public sector, too, showed restraint in investment – albeit for quite different reasons. In the case of the public authorities, whose construction investment declined by 7½% in value and by almost 7% in real terms, this was primarily due to the strained financial position. In 1996 no more was invested in residential buildings than a year earlier. Behind this is a distinct decline in new housing construction in western Germany; nearly 450,000 housing units were completed, which was roughly one-tenth fewer than a year earlier. This decline is probably to be assessed as a return to normal conditions following the exceptionally high level of new construction in the preceding years, which was also connected with the heavy inflow of immigrants and resettlers. In the new Länder, by contrast, the number of new dwellings rose again by nearly two-fifths to almost 145,000, and thus to a level which had not been achieved during the time of the GDR (given a much larger population figure).

Private consumption

Private consumption proved to be a major mainstay of business activity last year. In 1996 households' expenditure on consumption grew by 3½% in value and by 1½% in volume and thus at the same pace as real GDP. Just as in the previous years, the retail trade was unable to participate in this expansion; in price-adjusted terms, its turnover was no higher than in 1995. By contrast, there was a further rise in purchases of services, not least from banks and insurance enterprises; their significance in private expenditure budgets continued to grow in 1996, too.

Households' income

As expected by many quarters, the relief that came into force at the beginning of the year imparted expansionary stimuli to consumption in 1996. As a result of the tax exemption of the subsistence level, the improvement in the children's benefit system and the abolition of the coal penny, households' disposable income was about ½ percentage point higher last year, even after taking into account the increase in social security contributions. Despite moderate wage rises and declining employment, it went up by 3½%, and by 2% after adjustment for the rise in consumer prices.

Private saving

In view of the parallel movement of income and consumption, households' saving ratio remained unchanged in 1996, and hence for the second year in a row. As in the preceding years, about one-fifth of private investable funds was provided through building and loan associations for the purchase of housing property; however, this is only an incomplete reflection of the preference for the acquisition of fixed assets. The propensity to purchase a home of one's own was probably enhanced by falling construction and house prices and by the exceptionally low interest rates on borrowed funds – despite the lower level of new construction. Within the acquisition of financial assets, short-term and risk-free investment was preferred in the light of low interest rates and labour market uncertainties. This led to a substantial increase in private cash holdings, above all, in cash reserves and short-term savings deposits on special terms. It is also likely that sizeable funds were shifted, *inter alia*, at the expense of longer-term financial investment with banks and in the bond market. On the other hand, households have significantly increased purchases of shares by actively participating in Deutsche Telekom going public. Contractual saving through building and loan associations and insurance enterprises likewise gained ground; the reasons for this were, firstly, the expansion in the promotion of saving with building and loan associations and, secondly, in view of the pension debate, the propensity to increase provision for old age.

Relaxed price climate

In 1996 the goal of price level stability in Germany was achieved more successfully than in the years before. At the consumer level, on which public attention usually focuses in connection with the trend in monetary value, price increases remained within narrow bounds. Nor was there any significant inflationary pressure at the preliminary stages. Although the prices of imported raw materials rose sharply, this was absorbed by the overall moderate cost trend in Germany.

Price trends at the preliminary stages

The dollar quotations for crude oil and mineral oil products on the international markets increased steeply, particularly after the middle of 1996; on the other hand, world market prices for other raw materials declined last year. Nevertheless, the HWWA index, which comprises raw materials and sources of energy, was 6½ % higher on an annual average in 1996 than a year earlier. In addition, the US dollar firmed; calculated in Deutsche Mark, the prices of raw materials (including sources of energy) rose by 12 %.

Industrial producer prices

Despite that, the overall import price level was only ½ % higher than in 1995; at the end of 1996 the increase came to 2 %. A considerable part of this increase in Deutsche Mark prices for raw material imports was, however, offset by the fact that imports of industrial goods became cheaper. On the relevant markets this meant correspondingly keener price competition, which left no significant scope for price rises for domestic producers of industrial goods. However, there was no major pressure for price increases on the cost side either. Owing to the abolition of the coal penny at the beginning of 1996, industrial producer prices even declined slightly (by ½ %) against the preceding year. The prices of construction work remained stable overall, not least because of the weakness of construction activity.

Consumer prices

The rate of increase in consumer prices in Germany as a whole came to 1.5 % last year; in the two previous years it had amounted to 1.8 % and 2.7 %, respectively. If it is borne in mind that the statistical change in the consumer price index tends to overstate the actual increase in the cost of living,[1] this means that the goal of stability has largely been achieved. This favourable result owed much to the fact that – due, *inter alia,* to the changed situation on the housing market – the rise in rents continued to slow down (+ 3.4 %) and the upward thrust of prices for services again declined (+ 1.9 %). The prices of foodstuffs and manufactured goods went up only slightly (+ 1.0 % and + 0.6 %, respectively), as had been the case a year earlier. In terms of energy prices, consumers benefited from the abolition of the coal penny; the result of this was that, despite sharp price increases for mineral oil products, inflation in this area remained within narrow limits, at 0.7 %.

Economic prospects for 1997

After the break in growth around the turn of 1996-7, which was at least partly due to the cold winter and the attendant impairment of construction activity, the expansionary economic forces are likely to prevail again. The conditions for this seem to be quite favourable overall, even though considerable structural problems continue to exist which hinder a broader development of the upswing.

Moderate domestic cost trends

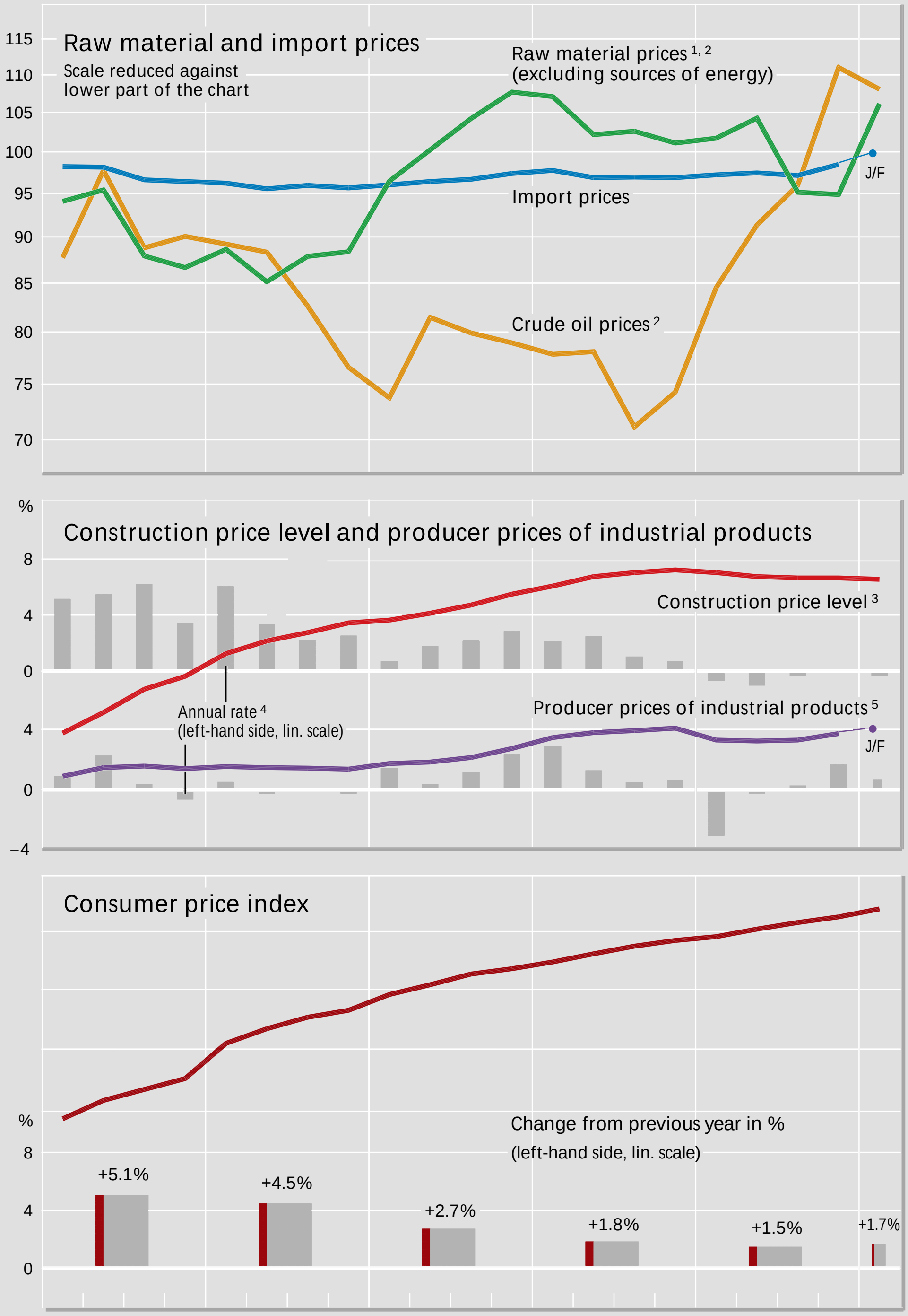
The favourable external conditions primarily include the normalisation of the exchange rate, the low interest rates and, not least, the moderate trend in wages. The tendency to conclude fairly low pay settlements has continued so far in the 1997 wage round. For example, in the metal-working industry, an increase in pay rates of 1.5 % was agreed from April 1, 1997 (after a lump-sum payment for the first three months of this year); from April next year (with effect to the end of 1998) negotiated wages and salaries will be raised by a further 2.5 %. Wages and salaries in the chemical industry will be increased by 1.5 % in the spring (under a one-year agreement). If the agreements concluded so far in the current wage round and earlier arrangements which become effective in 1997

1 For details, see page 80 f. of this Report.

Prices

Chart 7

1991=100, seasonally adjusted, quarterly, log. scale



1 HWWA index of raw material prices; DM basis. — 2 Not seasonally adjusted. — 3 Calculated by the Bundesbank. — 4 Seasonally adjusted change from previous quarter, expressed as an annual rate. — 5 Domestic sales.

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(for example, for the public sector) are combined, the west German overall negotiated wage and salary level will probably rise by 1½ % on an annual average this year.

1997 wage round

Judging by the results of the 1997 wage round, the increase in labour costs remains within narrow bounds. An additional burden is the renewed rise in the contribution rate to the statutory pension insurance scheme which came into force at the beginning of the year. Moreover, no significant progress was made in the direction of a wider spread of wages. Instead, the wage round largely occurred in "convoy", i.e. without any major differentiation in the rates of increase by industry, region or qualification. In eastern Germany, further steps towards a complete adjustment of negotiated basic pay rates to west German levels have already been agreed for this and the coming year (for the employees in the banking industry and the retail trade, for instance). Earlier agreements of this kind for the construction industry have been terminated by the employers, however, because of the difficult situation in that sector. Such steps towards a further adjustment of basic pay rates to west German levels will, even more than before, tend to contribute to a relaxation of strict adherence to pay settlements.

Hope for an initial boost by export business ...

In 1997, too, foreign demand will probably provide the most important stimuli to business activity. In the first two months of the current year at least, orders increased again sharply and exceeded the level reached at the beginning of 1996 by 12 %, at constant prices. By contrast, orders received from the home market remained subdued; in January-February they were only 1% higher than a year earlier. The longer the favourable export business can be sustained, the better the prospects will be on the demand side that a combination of this, the encouraging supply conditions and the improvement in general tax conditions (which will hopefully materialise soon) will act as an initial boost to enterprises' propensity to invest. This would not only benefit the core area of cyclical fluctuations – the manufacturing sector – itself but, as a result of rising industrial construction orders, the construction sector as well; in the other two subsectors of construction – residential and public construction – demand will, however, remain weak in 1997.

... and repercussions on the labour market

A stronger growth of the German economy may be expected to have a gradual stabilising impact on the labour market situation. In the first few months of 1997, however, employment fell markedly, and there was a perceptible rise in unemployment. The main reasons for this were both the onset of cold winter weather at the start of the year and the lack of acceptance of the new regulations on bad weather allowances in the construction industry. At a seasonally adjusted 34.06 million, the number of employed in January dropped by almost 600,000 below its 1995 level. On an average of the first quarter, unemployment, at 4.29 million, or 11.2 % of the total labour force, reached a very high level. Even if a pronounced cyclical recovery in the course of this year were to bring an end to the downward trend in employment and result in an upward movement, it cannot be expected that this would be followed by any sharp decline in unemployment. On an annual average in 1997, the number of unemployed in Germany is therefore likely to be higher than last year's average.

Prospects for the price trend

After the turn of 1996-7, the rate of price increases at the consumer level, at 1.7 % on an average of the first quarter, was slightly higher than at the end of last year. This was partly due to the fact that the prices of heating oil and foodstuffs rose particularly sharply on account of the weather; these special factors had receded by March, and the year-to-year rate of increase declined to 1.5 %. In the long run, however, the rise in television and radio licence fees which came into force at the start of this year has raised the consumer price level. Even if there tend to be cost-pushing stimuli on the external side owing to the appreciation of the US dollar, which particularly affects the Deutsche Mark prices for raw materials and sources of energy, this does not necessarily mean that the high measure of price level stability that has now been achieved is in jeopardy again. On the one hand, such influences are countered by the moderate cost trend in Germany and, on the other, by the continuing restrained level of domestic business activity, which will probably ensure that the scope for price increases will remain strictly limited.

2. Fiscal policy against the background of essential budgetary consolidation

(a) Trends in 1996

Tax revenue much lower than estimated

Last year the finances of the central, regional and local authorities experienced a pronounced weakness in receipts. The budgets provided for shortfalls of about DM 21 billion, owing to the 1996 Annual Tax Act (which, among other things, raised the basic allowance and improved the child benefit system), but even then tax revenue was far lower than expected. Once the effects of the Annual Tax Act have been taken into account, the figure provided for in the official tax estimate of autumn 1995 was undershot by almost DM 32 billion. The reasons for this were primarily of a macroeconomic nature. In spite of the economic recovery which began in the spring, the growth in gross domestic product (GDP) was about 1 percentage point lower in real terms and about 2 percentage points lower in nominal terms than expected in the autumn of 1995; in addition, the improvement in the economic situation was fuelled to a relatively large extent by exports, which do not yield any turnover tax receipts. Furthermore, as in 1995, the unfavourable result also has other reasons, particularly the substantial recourse to tax-related concessions and deductions; the interrelation between the economic tax base and revenue has loosened perceptibly in the past few years.

Overall tax ratio decreased

Overall tax revenue declined last year by 1.7 %, compared with 1995. Given a nominal economic growth rate of 2.4 %, the overall tax ratio thus declined by 1 percentage point to 22.6 % of GDP. However, one-half of this decline in the ratio was attributable to the revision of the child benefit system, which is now recorded as a tax-reducing factor, instead of as expenditure; if this revision is not taken into account, tax revenue grew by 0.7 %.

Higher contribution rates in respect of the social security scheme

In contrast to the measures provided for in the 1996 Annual Tax Act, there were increases in the contribution rates in respect of the pension insurance, the health insurance and the nursing insurance schemes. (In the case of the nursing insurance scheme the increase was due to the introduction of the second stage on July 1, 1996.) Taken together, the social security contributions came to 40.9 % of eligible income in the second half of 1996, compared with 39.3 % a year previously. In 1996 as a whole, the contribution receipts of the social security scheme grew by 4.6 %. However, they, too, developed more sluggishly than originally assumed, particularly owing to the decline in employment.

Overall burden of levies continues to be high

It is true that, according to the national accounts, the overall taxes and social security ratio relative to GDP for 1996, at 43.0 %, was 0.6 percentage point lower than for 1995. If it is adjusted for the impact of the revision of the child benefit system, however, the taxes and social security ratio persisted at the high level reached in the previous year, since the increase in the social levy ratio was similar in proportion to the decrease in the tax ratio. The remaining public sector revenue came to 3.4 % of GDP.

Efforts at expenditure cuts

The budgetary burdens arising from the 1996 Annual Tax Act and the trend in tax receipts, which was already disappointing in the course of 1995, forced the

Public sector finance *

Table 3

Item	1994	1995 pe	1996 pe	1994	1995 pe	1996 pe
	DM billion			Change from previous year in %		
Central, regional and local authorities						
Expenditure						
Expenditure on personnel	358.8	369.5	372	+ 5.8	+ 3	+ 0.5
Other operating expenditure	159.1	160	161.5	+ 1.4	+ 0.5	+ 0.5
Transfers 1	347.4	358	353.5	+ 3.4	8 + 2.5	− 1.5
Interest paid	114.2	129	130	+ 11.7	+ 13	+ 1
Fixed capital expenditure	99.7	95	90.5	− 3.6	− 4.5	− 5
Financial aid 2	82.2	82	76	− 0.3	− 0.5	− 7
Total expenditure 3	1,164.1	1,198	1,186	+ 3.8	+ 3	− 1
of which						
Federal Government 4	478.9	489.5	489.5	+ 3.5	+ 2	+ 0
West German Länder Governments 5	375.6	389	397.5	+ 1.8	+ 3.5	+ 2
East German Länder Governments	99.1	105.5	108.5	+ 3.7	+ 6.5	+ 2.5
West German local authorities	266.8	270	265.5	+ 2.0	+ 1	− 1.5
East German local authorities	67.8	68.5	66	+ 0.5	8 − 1	− 3.5
EC 6	41.0	40	39.5	+ 10.9	− 2	− 1.5
Receipts						
Tax revenue	786.2	814	800	+ 4.9	+ 3.5	− 1.5
Other receipts	276.7	276.5	270.5	+ 14.5	+ 0	− 2
Total receipts 3	1,058.0	1,086	1,064.5	+ 7.0	+ 2.5	− 2
of which						
Federal Government 4, 7	439.6	439	411	+ 9.4	− 0	− 6.5
West German Länder Governments 5	347.6	355	362.5	+ 1.5	+ 2	+ 2
East German Länder Governments	82.4	92.5	96.5	+ 3.8	+ 12.5	+ 4
West German local authorities	260.9	257.5	261.5	+ 3.3	− 1.5	+ 1.5
East German local authorities	63.1	66.5	63.5	− 0.1	8 + 3	− 4.5
EC	41.0	40	39.5	+ 10.9	− 2	− 1.5
Deficit (–)	− 106.1	− 112	− 121.5	.	.	.
of which						
Federal Government	− 39.4	− 50.5	− 78.5	.	.	.
West German Länder Governments 5	− 28.0	− 34	− 35.5	.	.	.
East German Länder Governments	− 16.7	− 13	− 12	.	.	.
West German local authorities	− 5.9	− 12.5	− 4.5	.	.	.
East German local authorities	− 4.7	− 2	− 2.5	.	.	.
“German Unity” Fund	− 3.0	+ 2.5	+ 2.5	.	.	.
Redemption Fund for Inherited Liabilities	.	+ 7.5	+ 9.5	.	.	.
ERP Special Fund	− 2.1	− 2.5	+ 1	.	.	.
Federal Railways Fund	− 5.4	− 7	+ 0	.	.	.
Social security funds						
Expenditure	704.9	755.5	797	+ 5.2	+ 7	+ 5.5
Receipts	706.0	745	784	+ 4.9	+ 5.5	+ 5
Surplus (+) or deficit (–)	+ 1.1	− 10.5	− 13	.	.	.
Public sector, total						
Expenditure	1,775.9	1,860	1,879	+ 4.9	+ 4.5	+ 1
Receipts	1,670.9	1,737.5	1,744.5	+ 6.8	+ 4	+ 0.5
Deficit (–)	− 105.0	− 122.5	− 134.5	.	.	.
Memo item						
Deficit of the Treuhand agency	9 − 37 .1	.	.	.	.	.

* As defined in the financial statistics; including hospitals keeping commercial accounts, and other 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 are included here on a gross basis. — **5** Including Berlin. — **6** EC expenditure financed out of EC revenue in Germany. — **7** Up to 1994 the Bundesbank’s profit transfer is included in full in the figure; for 1995 and 1996, the figure includes the amount of DM 7 billion provided for in the budget. The amount in excess of this was booked as revenue of the Redemption Fund for Inherited Liabilities. — **8** Adjusted for the inclusion of Landeswohlfahrtsverband Sachsen (charitable association of the state of Saxony), which was covered for the first time in 1995. — **9** Including the transfers to the Debt-Processing Fund which are not provided for in the budget.

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central, regional and local authorities to budget for as low a level of expenditure as possible. In view of the gradual emergence of additional shortfalls in receipts, the efforts at retrenchment had to be reinforced in the implementation of the budget. In many cases budget freezes were decreed. In addition, the "Programme for more growth and employment" adopted by the coalition government in the spring already contained some retrenchment measures that will be effective over the short term, both in respect of the central, regional and local authorities and in the field of social security.

Overall expenditure of the central, regional and local authorities grew only moderately ...

The budget expenditure of the central, regional and local authorities grew by no more than just over ½ % in 1996 – calculated without taking account of the impact of the revision of the child benefit system, which reduces both the volume of expenditure and receipts. The wage agreement in the public sector, which was moderate, compared with that of the previous year, slowed down the expansion of expenditure on personnel; the rise in this type of spending slackened to ½ %. Interest expenditure also grew only moderately (1 %), since the consequences of the sharp increase in the debt level were mitigated by the sustained low level of interest rates. Nevertheless, in the case of transfers there arose considerable additional burdens, particularly as a result of the labour market situation, but these burdens were accompanied in the case of the local authorities' social assistance payments by relief from the introduction of the second stage of the nursing insurance scheme; adjusted for child benefit, which a year previously had still been recorded here, transfer expenditure grew by 4 ½ %. Investment expenditure continued to be considerably reduced, owing to the pressure of the budget situation (just under 6 %). From fiscal and macroeconomic points of view, this is indicative of a perceptible deterioration in the budget structure.

... but expenditure of the social security institutions expanded considerably

As far as the social security institutions are concerned, however, expenditure again grew steeply, viz. by a total of 5 ½ %. In view of the increase in unemployment, the expenditure of the Federal Labour Office overshot the level reached a year previously by just over 8 ½ % (which affected the Federal budget through the higher transfer necessary for financing). The expenditure of the wage and salary earners' pension insurance scheme grew by 4 %, not least as a result of the continuing increase in the number of pension recipients. Regarding the statutory health insurance institutions, spending overshot the level reached in 1995 by 3 %. In the nursing insurance scheme the payments which were made in the first stage (in force since April 1995) were extended from mid-1996 to cover the cost of in-patient nursing care as well.

Indebtedness of the central, regional and local authorities

Table 4

DM billion

Item	1995	1996 pe	1995	1996 pe
	Level at end of year		Change from previous year	
Borrowers' note loans	809.2	884.5	+ 131.9	+ 75.5
Securities	1,084.3	1,149.5	+ 188.2	+ 65
Other debt	102.5	100	+ 13.7	– 2.5
Total indebtedness	[3] 1,996.0	[3] 2,134	[4] + 333.8	[4] + 138
Federal Government	756.8	840	+ 44.3	+ 83
West German Länder Governments	442.5	478	+ 27.5	+ 35.5
East German Länder Governments	69.2	81	+ 13.5	+ 12
West German local authorities [1]	159.6	165.5	+ 3.9	+ 6
East German local authorities [1]	37.0	39	+ 4.6	+ 2
"German Unity" Fund	87.1	83.5	– 2.0	– 3.5
Debt-Processing Fund [2]	–	–	– 102.4	–
ERP Special Fund	34.2	34	+ 6.2	– 0
Federal Railways Fund	78.4	78	+ 7.2	– 0.5
Redemption Fund for Inherited Liabilities [2]	328.9	332	+ 328.9	+ 3
Equalisation Fund for Safeguarding the Use of Coal	2.2	3	+ 2.2	+ 1
Indemnification Fund	.	0	.	+ 0

1 Including municipal special-purpose associations. — **2** At the beginning of 1995 the debt of the Debt-Processing Fund and the Treuhand agency was transferred to the Redemption Fund for Inherited Liabilities. — **3** In the definition relevant for compliance with the EMU convergence criterion, the indebtedness comes to DM 2,009 billion in 1995 and DM 2,148 billion in 1996. — **4** The increase in the debt level is higher than the net borrowing for financing the deficits, since it includes the assumption of the debt of the Treuhand agency (1995) and of old debt.

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Government spending ratio and deficit ratio

Given the declared fiscal objective of restoring the government spending ratio to the level reached before German unification (about 46 %), the public sector budgets have not made any progress. The government spending ratio, i. e. the ratio of government expenditure (as defined in the national accounts) to GDP, declined in 1996 by 0.4 percentage point (to 50.2 %), compared with the previous year. If it is adjusted for the revision of the child benefit system, however, it increased by 0.2 percentage point and thus, calculated in this way, reached a new peak. In 1996 the government deficit grew by 0.3 percentage point to 3.8 % of GDP; the 3 % reference value laid down in the Maastricht Treaty was thus overshot even more clearly than in 1995. The deficit of the central, regional and local authorities, as defined in the budget, came to DM 121 ½ billion, compared with DM 112 billion in 1995, and the deficit of the social security institutions amounted to DM 13 billion, compared with DM 10 ½ billion a year previously.

(b) Outlook and fiscal requirements

Budgets for 1997

The reduction of the general government deficit at least to the limit of 3 % of GDP laid down in the Maastricht Treaty, and its continued reduction in the next few years, is the primary fiscal objective in Germany. According to the state of budget planning in the autumn of 1996, a reduction of the deficit to 2.5 % of GDP was envisaged for 1997. On the receipts side, according to the result of the official tax estimate of November 1996, tax revenue was expected to grow by about 3 %; in 1997 it will be affected only slightly, on balance, by the changes in respect of taxes and child benefit which came into force at the beginning of the year. Apart from lower budget deficits in the case of the central, regional and local authorities, a pronounced reversal from deficits to surpluses is to be expected in the field of social security. However, this is based not only on the retrenchment of benefits but also, to a large extent, on the raising of the contribution rate in respect of the statutory pension insurance scheme which was necessary, in accordance with the regulatory mechanism applicable here; the reserves which had dwindled have to be replenished to their statutorily prescribed level of a month's expenditure. In spite of the continuing decline expected in the tax ratio, the ratio of overall taxes and social security contributions to GDP might increase somewhat in the current year, owing to the fact that social security contributions were raised once again.

Need to continue retrenchment efforts

The prospects for this year's budget trends have developed less favourably than assumed in the autumn of last year. Thus, in 1996 tax revenue on balance undershot the figures forecast at that time by DM 5 billion. In addition, the Federal Government's 1997 Annual Economic Report expects a somewhat lower nominal growth of GDP than estimated in the autumn forecast; in addition, the number of unemployed persons is no longer expected to remain more or less at the same level as in 1996 but, instead, to rise by about 200,000 on an annual average. In view of the changed circumstances, the prospective public sector deficit was put at 2.9 % of GDP in the Annual Economic Report. Moreover, the possibility that in the course of the year additional – as yet unforeseen – budgetary burdens will arise from the receipts side or from some expenditure categories cannot be ruled out. Efforts will therefore have to be made to achieve further retrenchments. Incidentally, the reduction of the deficit is necessary not only in view of the reference value provided for in the Maastricht Treaty. It is also imperative to foster confidence in the ability of financial policy makers to consolidate the budget, which represents an important element of the strategy for improving conditions for economic growth and employment in Germany.

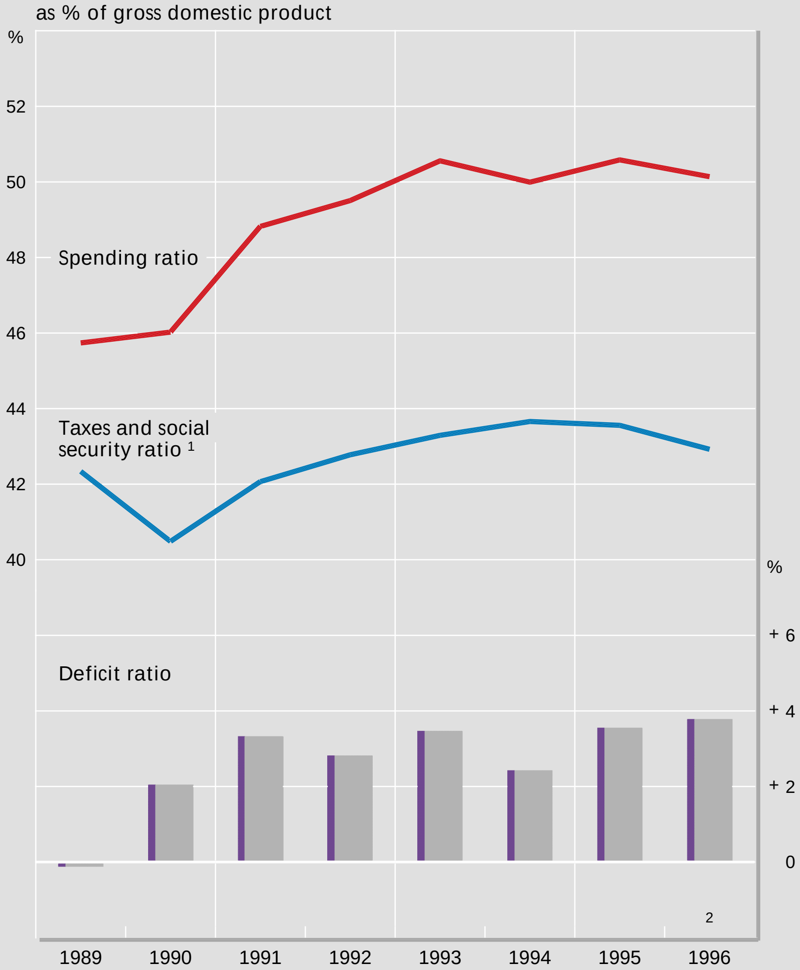
Fundamental tax reform

The Federal Government has set itself the medium-term target of reducing the ratio of government expenditure to GDP by the year 2000 to the level achieved before German unification (about 46 %), using the "symmetric financial policy"

Ratios of public sector budgets *

Chart 8

as % of gross domestic product



* As defined in the national accounts. From 1991, including the new Länder. — 1 Taxes and social security contributions; the other revenue of the public sector budgets is not included here (1996: 3.4% of GDP). — 2 Trends in the spending ratio and in the taxes and social security ratio in 1996 were influenced by the net recording of child benefit.

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approach as a guide; in this way it intends, on the one hand, to reduce the general government deficit to 1½ % of GDP and, on the other hand, to curb the burden of levies in order to improve the macroeconomic framework conditions on a sustained basis. The fundamental reform of income taxation is intended to reduce the burden of taxes by up to DM 30 billion and, in addition, to improve the tax structure. On the one hand, the statutory tax rates are to be reduced dramatically in some cases, and, on the other hand, the existing assessment basis is to be broadened. The reduction of the income tax burden is to be linked to an increase in indirect taxes in order to reduce the share of direct taxes (which have a particularly unfavourable effect on performance and the propensity to invest) in total revenue and to keep shortfalls in receipts within bounds.

Lower tax rates planned

The envisaged lower income and corporation tax rates are an important step towards realising the necessary improvement in Germany's position as an industrial location. Together with the reduction of tax concessions previously granted, they also counteract the further erosion of the tax base, which, in turn, improves the allocation of the factors of production, since corporate planning is distorted less than hitherto by tax saving possibilities. Some of the tax-related changes, together with the envisaged reduction of the solidarity surcharge, are to come into force as early as 1998. The tax reform will have to be accompanied by additional steps towards limiting the increase in public sector expenditure, in order to ensure that the progress needed in budget consolidation is not jeopardised; it is not possible to rely on the "self-financing effects" of the tax reform alone.

Reform of the pension insurance scheme

Not only the tax burden but also the burden of social security contributions (which considerably increases the cost of labour) must be effectively limited in order to improve perceptibly growth and employment prospects in Germany over the long term. In this context, it is particularly the reform of the statutory pension insurance scheme which is of major importance. This branch of the social security system, which is the most important one for quantitative reasons alone, cannot be disregarded when making efforts to reduce the government spending ratio and the overall burden of levies. Initial steps towards further reforms were taken in the pension insurance scheme in 1996 by adopting the Act to Promote the Gradual Transition to Retirement and the Growth and Employment Promotion Act. Nevertheless, it can now be assumed that the contribution rate, following the sharp increase to 20.3 % at the beginning of 1997, will persist more or less at that level over the medium term. However, particularly the change in the ratio of pension recipients to contribution payers, which appears likely to occur in the next few decades and which will have serious consequences for the financing of the pension insurance scheme, makes it imperative to continue the pension reform of 1992, which over the long term will bring about only a partial solution. By the year 2030, the necessary contribution rate, according to the present forecasts, will rise to about 26 % of eligible income, under existing law.

In its "Programme for more growth and employment" adopted in the spring of 1996 the Federal Government set itself the target of formally approving another pension reform act by the end of 1997. The commission established to prepare

Government commission's proposals on the future pension adjustment ...

this reform submitted its proposals in January 1997. Its most important recommendation is to supplement the pension adjustment scheme by including a demographic factor, which takes into consideration the prolonged period of receipt of pensions resulting from the increase in life expectancy and divides the consequent burdens equally between contribution payers and pensioners. The "life expectancy factor" is expected to have an equal effect on both the number of persons who become recipients of pensions and the number of existing pension recipients. As a result, the annual pension adjustments would be lower than under the existing procedure and be less than the increase in the net earnings of employed persons. It is forecast that the "basic pension", i.e. the pension of an average wage or salary earner after 45 years of insured employment, would gradually decrease from about 70 % of the average net earnings of employed persons at present to 64 % in the year 2030.

... and on additional reform measures

In addition, new regulations are to be introduced on pensions granted in the case of reduced working capacity. One of the measures provided for is to bring these pensions into line with early retirement pensions, from which certain deductions are made; another measure is to disregard the labour market situation when the granting of such pensions is being considered. Yet a further proposal made by the commission is the establishment of a family scheme which would make regular contributions to the pension insurance scheme for future periods of child-rearing. Since this scheme has been conceived as a pay-as-you-go system, it would immediately provide a direct source of financial relief for the pension insurance scheme. To that extent, this would be tantamount to tax-financing so-called non-insurance-related payments. This could reduce the additional wage components even though the employment of labour would be more profitable only if any tax-induced rise in the price level did not entail sharper wage increases. Another point is that such refinancing measures alone would not help to reduce the overall burden of levies – which is an essential objective if the conditions in Germany as an industrial location are to be improved.

Urgency of political decisions

The process of political decision-making initiated by the commission's proposals concerning the design of the reform has made progress since that time. Rapid political decision-making for implementing the tax and pension reforms could contribute substantially to reducing uncertainties concerning the future prospects for investment and production in Germany. In addition, it is imperative to ensure, as far as possible, that the population is clearly aware of the future level of contributions to and benefits of the statutory pension insurance scheme. This is essential if employed persons are to be able to take appropriate steps in good time to ensure that they are adequately covered by privately funded pension schemes, which in future will increase in significance.

Statutory health insurance and unemployment insurance schemes

The trend towards mounting costs has to be counteracted in the field of the statutory health insurance, too. The large deficits which have emerged in the past two years have made early legislation essential here. As a first step, the Contribution Relief Act, which provides for a series of retrenchment measures, was passed in the autumn of 1996. The first Act on the New Regulation of the Statutory Health Insurance System adopted by the Bundestag in November 1996 is to combine increases in contribution rates with higher contributions paid by the insured persons for certain types of benefits; the legislative procedure has not yet been finalised. The second New Regulation Act was adopted by the Bundestag in March 1997 and has now to be discussed in the Bundesrat. It provides for higher personal contributions to the costs and, particularly, for a new regulation of doctors' earnings and the introduction of guidelines on the amount of medicines which each medical practice may prescribe. A reform of the Work Promotion Act concerning the financial relief granted to the Federal Labour Office came into force on April 1, 1997.

Necessary revision of the social security system

Finally, several reform acts concerning social assistance and unemployment assistance came into force last year. In all, initial steps have been taken to provide for the revision of the social security system, which is inevitable in view of the extremely tight public sector budgets and the associated macroeconomic problems; however, serious longer-term problems will still have to be dealt with.

3. Foreign trade and payments as an economic motor

Normalisation in the foreign exchange markets

The external economic environment was characterised in 1996 by a period in which tensions eased gradually and conditions normalised. Especially the significant distortions in the international exchange rate pattern, which had impaired Germany's competitiveness in 1995, were being unravelled again in the course of last year. For example, those currencies, in particular, which had been under considerable pressure to depreciate in the spring of 1995, recovered discernibly during 1996. It was only against the yen that the Deutsche Mark firmed after the exaggerated strength of the Japanese currency had begun to normalise in the previous year. The upshot was that the excessive appreciation of the Deutsche Mark in the spring of 1995 was completely reversed. This is illustrated particularly clearly in the trend in the weighted external value of the Deutsche

Mark against the currencies of 18 industrial countries. After eliminating the differences in price trends in Germany and its partner countries, the external value declined by just over 10 % between its peak in the spring of 1995 and the time this Report went to press and is once again equivalent to its long-term average.

Strengthening of the dollar

The exchange rate of the Deutsche Mark to the dollar, which in April 1995 had fallen to a historical low of DM 1.36, eased the most. Since that time the US currency has increasingly gained ground again. In the course of 1996 alone the dollar appreciated by 8½ % against the Deutsche Mark and had recovered to DM 1.55 by the end of the year. This strengthening of the dollar continued during the first few months of 1997, with the result that the US currency was recently being quoted at DM 1.73. This is essentially a reflection of the robust cyclical trend in the United States, where the economic environment is largely devoid of tension. This trend is probably also a sign that, as a result of the urgent consolidation tasks in Germany and Europe, international investors are no longer placing so much importance on the negative structural factors in the United States (such as the persistent current account deficits and the corresponding domestic imbalances in saving).

Relaxation of exchange rate patterns in Europe

The relationship of the Deutsche Mark to most European partner currencies was fairly steady last year. In view of the considerable progress made in convergence, no substantial exchange rate shifts or fluctuations could be observed, particularly in relation to currencies such as the Dutch guilder, the Austrian schilling and the Belgian franc, to which the Deutsche Mark, traditionally, is closely linked. The French franc, too, varied only very slightly against the Deutsche Mark.

Change in the exchange rates of major European currencies

At the same time, the significant appreciation of the Deutsche Mark against those European currencies which had become subject to severe pressure in the spring of 1995 was completely reversed. The Italian lira had already recovered by last autumn, reaching the psychologically important mark of DM 1 to L 1,000, after the Italian government had introduced consolidation programmes and thereby smoothed the way for the return of the lira to the European exchange rate mechanism in November. Thereafter the trend stabilised significantly here, too. The pound sterling has been gaining an appreciable amount of ground. At the end of the year it was being quoted at DM 2.63. Since then the UK currency has strengthened further against the Deutsche Mark, with the result that at the time this Report went to press the pound sterling stood at DM 2.81. The trends in these two currencies have largely been responsible for the correction in the temporary distortions in international competition. This meant that particularly serious burdens on German exporters, which would have been difficult to bear in the long term, disappeared again after the excesses of the spring of 1995, but their after-effects should not be underestimated.

Dynamic growth in exports ...

With the change in circumstances, export business last year generated the strongest and most sustained growth stimuli to the German economy. As early as the turn of 1995-6, foreign demand began to revive considerably, and the business situation of exporters improved. It took a certain amount of time before the upward trend was reflected in the exports of goods by German firms. In the end, the value of German exported goods in 1996 was 4½ % higher than in the previous year. This meant that the annual growth rate was still appreciably lower than in 1995 (8 %). However, in the course of 1996 there was considerable acceleration in this development, with the result that in the second half of 1996 exports exceeded their 1995 value by 7 %.

... to non-European industrial countries ...

However, the thrust of export growth was not in Germany's traditional export markets in continental Europe but in regions enjoying a more rapid rate of economic growth. For example, fairly dynamic stimuli were received from non-European industrial countries, notably the United States, which increased its imports of German goods by just over 10 % in 1996. The significant increases in export business with Japan were also remarkable (12½ %), even if Japan's share in Germany's total exports is still relatively small.

... and rising markets in central and eastern Europe as well as in South-East Asia

In the past few years the highly absorptive markets of the central and east European countries in transition, where, at 17½ %, the highest growth rates for German exports were recorded, have been of much greater significance. By contrast, exports to the growth regions of South-East Asia have lost some of their momentum following the introduction there of somewhat tighter anti-inflationary measures; with a 6 % increase in turnover, however, German exporters achieved above-average results here, too. It is precisely in these up-and-coming regions that in the next few years, too, there will be a considerable untapped sales potential, which is likely to be of particular interest to suppliers in Germany in view of the structure of demand in these countries. At all events, the manufacturers of capital goods, especially mechanical engineering firms, achieved above-average rates of growth in their export business.

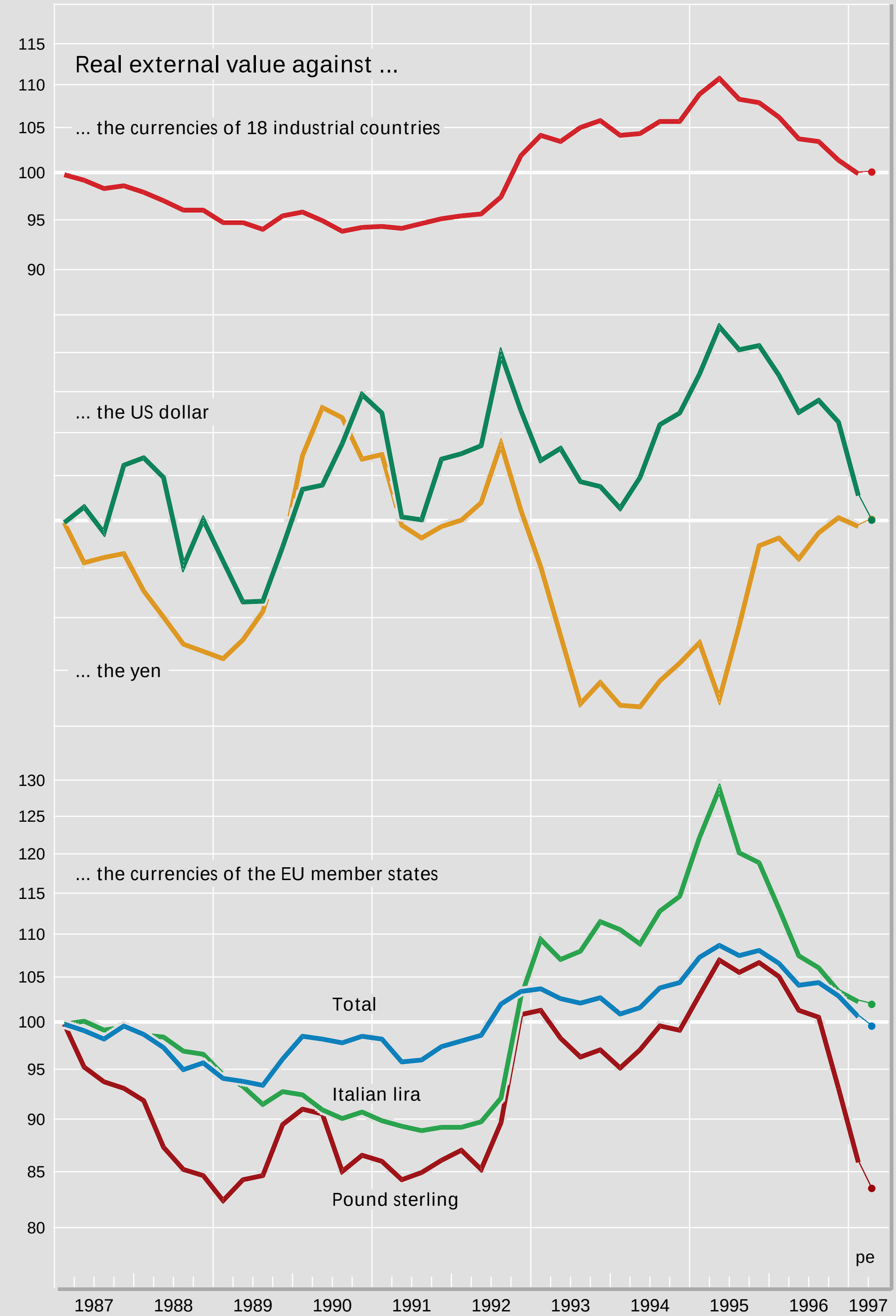
More sluggish rise in imports

In the case of imports, by contrast, a revival did not emerge until near the end of the year. The value of imported goods in 1996 (on an f.o.b. basis) exceeded

Real external value of the Deutsche Mark *

Chart 9

1st qtr of 1987 = 100, log. scale



* Nominal external value after adjustment for the differing macroeconomic price movements (as measured by the prices of total sales). —● = Latest position: average April 1 to 15, 1997.

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the level of the previous year by 3 %. Part of the increase in the value of imports, however, is due to the sharp rise in the price of petroleum last year, which resulted in the bill for energy imports being substantially inflated. For example, the value of imports from the OPEC countries alone rose by 13 %. The steep increase in imports from the countries in transition in central and eastern Europe (6 ½ %) is likewise to be seen against the background of higher imports of petroleum and natural gas from Russia. Furthermore, the persistent strength of the dollar, especially towards the end of the year, was another reason for the substantial increase in the prices of other imported goods. Not least the sudden rise in the value of imports from the United States (9 %) was probably due to a considerable extent to such exchange-rate-induced increases in import prices in terms of the Deutsche Mark. Imports from other EU countries rose by no more than 2 ½ % last year.

Substantial overall decline in the current account deficit ...

The favourable trend in exports and the moderate rise in imports in 1996 resulted in a further improvement in the trade surplus, which (on an f.o.b./f.o.b. basis)[1] rose by DM 15 billion to DM 110 billion. Consequently, the surplus on Germany's trade account has almost regained the levels recorded towards the end of the eighties, that is to say, before German unification. By contrast, the other current transactions with non-residents were almost unchanged. In view of the considerable improvement in Germany's foreign trade position, the total current account deficit in 1996 declined considerably, falling by DM 12 ½ billion to DM 21½ billion.

... despite high interest payments to non-residents

As far as negative factors affecting the current account are concerned, the most important of these were the interest payments on German bonds held by non-residents. A number of reasons, notably the continued decline in Germany's net external assets as a result of the persistent current account deficits and the longer-term maturity pattern of German external liabilities compared with that of its external assets, probably contributed to this. To some extent, however, the reporting gaps which for some time have been apparent in Germany's interest income generated abroad are also reflected in the deficit on investment income account, and these are presenting the investment income account in too unfavourable a light.

1 In line with international practice, the freight and insurance costs incurred in the case of imports are allocated to services in this calculation.

Balance of payments

Table 5

DM billion

Item	1993 [1]	1994 [1]	1995 [1]	1996 [1]
I. Current account	– 23.4	– 34.2	– 33.8	– 21.5
1. Goods	+ 69.1	+ 83.8	+ 95.0	+ 109.9
Exports (f.o.b.) [2]	632.4	696.0	749.4	782.9
Imports (f.o.b.) [2]	563.3	612.2	654.4	673.0
2. Services	– 54.4	– 65.2	– 66.4	– 68.0
of which				
Foreign travel	– 42.8	– 49.2	– 49.0	– 50.1
3. Factor income	+ 20.4	+ 10.0	– 3.7	– 8.5
of which				
Investment income	+ 21.1	+ 11.1	– 1.0	– 5.8
4. Current transfers	– 58.5	– 62.8	– 58.7	– 54.8
of which				
Net contributions to the EC budget [3]	– 26.7	– 31.0	– 29.3	– 27.2
Other official current transfers to non-residents (net)	– 16.1	– 15.4	– 12.8	– 10.6
II. Capital transfers	+ 0.8	+ 0.3	– 0.9	– 0.0
III. Financial account (capital exports: –)	+ 14.0	+ 64.9	+ 74.0	+ 18.2
1. Direct investment	– 22.2	– 25.2	– 37.9	– 46.7
2. Portfolio investment [4]	+ 182.9	– 40.1	+ 56.5	+ 77.9
Equities	+ 0.3	– 10.7	– 0.2	+ 0.4
Investment fund certificates	– 14.6	– 17.0	– 1.9	– 7.6
Bonds and notes	+ 198.8	– 4.7	+ 62.0	+ 75.6
German investment abroad (increase: –)	– 12.5	– 27.3	– 24.1	– 21.7
Foreign investment in Germany (increase: +)	+ 211.4	+ 22.6	+ 86.1	+ 97.2
Other portfolio investment [5]	– 1.7	– 7.7	– 3.4	+ 9.5
3. Credit transactions [4]	– 144.1	+ 131.8	+ 60.6	– 9.0
Credit institutions	– 87.6	+ 141.8	+ 43.5	– 4.3
Long-term	+ 12.0	+ 15.9	+ 39.9	+ 23.8
Short-term	– 99.7	+ 125.8	+ 3.6	– 28.2
Enterprises and individuals	– 51.2	– 16.8	+ 22.3	– 7.5
Public authorities	– 5.3	+ 6.9	– 5.2	+ 2.9
4. Other investment	– 2.6	– 1.6	– 5.1	– 4.0
IV. Balance of unclassifiable transactions	– 27.2	– 18.7	– 21.6	+ 1.7
V. Change in the Bundesbank's net external assets at transaction values (increase: +) [6, 7]	– 35.8	+ 12.2	+ 17.8	– 1.6
Memo item				
Change in the Bundesbank's net external assets at balance sheet rates (increase: +) [7, 8]	– 34.2	+ 8.6	+ 15.1	– 1.5

1 Figures subject to major uncertainty owing to changes in the method of data collection in foreign trade. — **2** 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. — **3** Excluding collection expenses, EAGGF (Guidance Fund) and Regional Fund. — **4** Excluding direct investment. — **5** Money market instruments, warrants and the balance of other payments in financial derivatives. — **6** Excluding SDR allocation and changes due to valuation adjustments. — **7** From March 1993 to March 1995 including the Treasury discount paper (liquidity paper) held by non-residents during that period. — **8** Including SDR allocation and changes due to the end-of-year revaluation.

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But smaller deficits on other invisibles

In the other sectors of invisible current transactions which also had a detrimental effect on Germany's external position last year, by contrast, developments stabilised in 1996 or even took a turn for the better. This applies to services, which have been recording rapidly growing deficits since the beginning of the nineties owing to the rising expenditure of German business travellers and tourists. In 1996 the deficit remained virtually unchanged, despite the fact that some of the major currencies used by travellers had appreciated considerably. At the same time, the deficit on current transfers actually declined markedly as somewhat lower net payments had to be made to the EC budget.

Larger net inflows in portfolio transactions

In 1996 financial transactions with non-residents were largely determined by the fact that interest rates were expected to fall worldwide, and this stimulated the imagination of investors in the international financial markets throughout the year. Together with the favourable assessment of the business sector's earnings prospects, this had a particularly beneficial effect on the German capital market last year. For example, in portfolio transactions alone, which are normally the clearest indication of investors' preferences, there were distinctly larger net inflows, at DM 78 billion, than in the previous year (DM 56½ billion) when currency speculation had been a major investment motive.

Shifts of emphasis in favour of bank bonds and equities

Non-residents alone invested DM 138½ billion in German securities in 1996, which was approximately 60 % more than in 1995. As usual, most of this, namely DM 97 billion, was invested in bonds and notes; issues by German credit institutions (mainly foreign currency bonds) were preferred to public bonds. Of the public sector paper it was the Federal Government's new short-term issues (*Schätze* and also the *Bubills* which count as money market paper) which aroused great interest among non-residents; it is likely that foreign central banks figured among the purchasers. However, the German equity market, which attracted a remarkably large share of non-residents' portfolio investment, also enjoyed particular favour among internationally operating investors in 1996. German enterprises' improved earnings prospects and the flotation of Deutsche Telekom shares resulted in foreign purchases amounting to DM 21½ billion net, whereas in 1995 non-residents had actually reduced their investment in the German equity market (– DM 1½ billion).

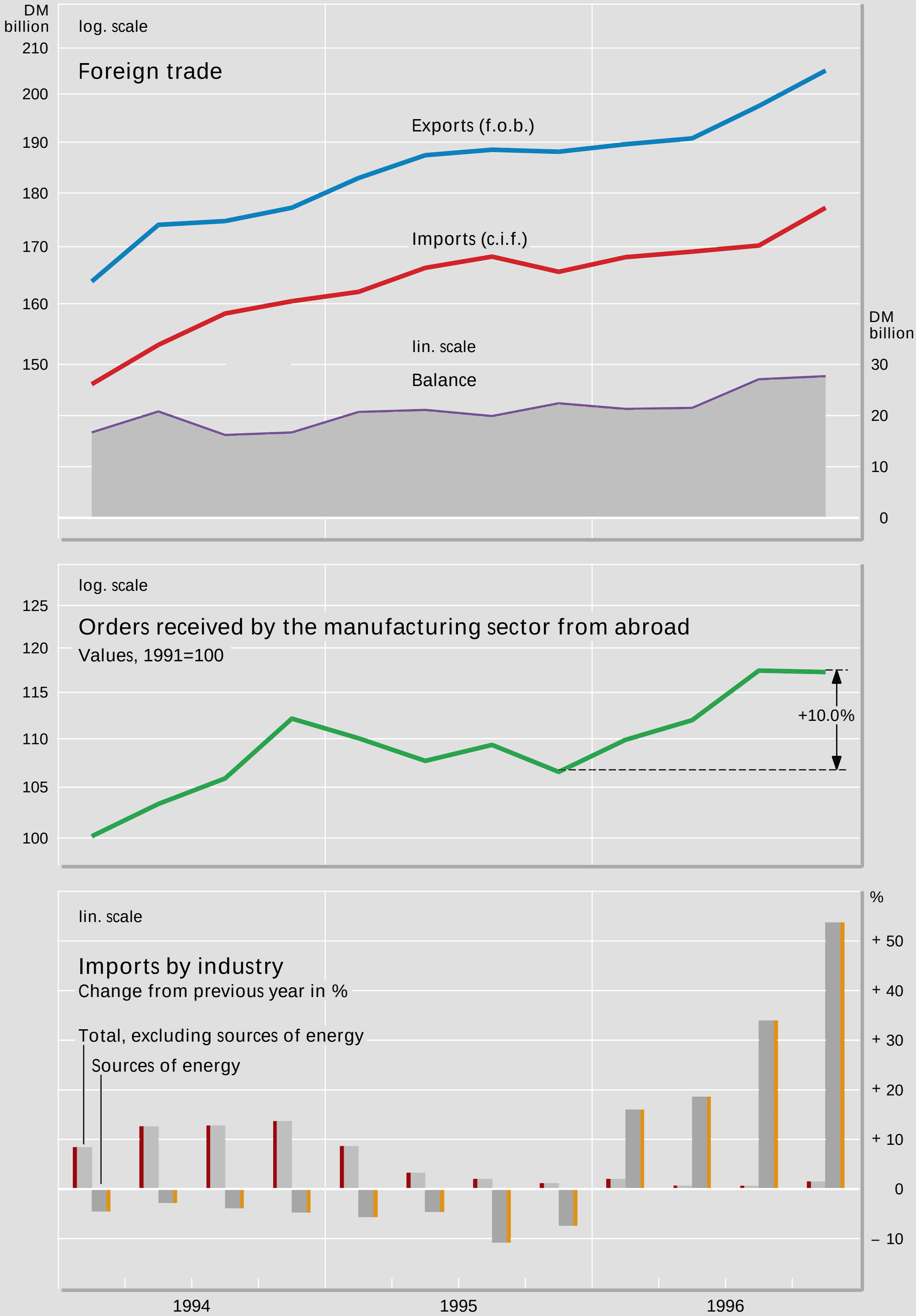
Foreign equities in demand by German investors

On the other hand, the market situation also seemed to be such that German residents, too, were encouraged to diversify their investment more strongly in favour of other currencies. At DM 60½ billion, they invested, at any rate, a greater amount in foreign securities last year. While their purchases of bonds

Trend in foreign trade

Chart 10

Seasonally adjusted, quarterly



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and notes (DM 21½ billion) were only just under the preceding year's level, on balance, their demand for money market paper (DM 5 billion) and particularly for foreign equities (DM 21 billion) increased sharply. The bullish foreign stock exchanges and the prospect of exchange rate gains apparently combined to increase their interest in foreign equities. With respect to equities it was particularly non-banks that invested in foreign paper; in the case of interest-bearing paper, by contrast, it was primarily the credit institutions that were responsible for the outflows of funds.

Deficit on direct investment

In stark contrast to developments in portfolio investment were the large outflows of funds arising from direct investment last year. The declining investment by foreign enterprises in Germany was particularly striking; these enterprises reduced their investment in their German subsidiaries by DM 5 billion net. The main reason for this was the liquidation of revenue reserves and loan repayments to foreign shareholders. This suggests that intra-group credit operations are part of the reason for the outflows of funds recorded. Incidentally, the level of foreign acquisitions of participating interests in Germany, which has been decidedly low for years, could also be due to some extent to statistical definition and recording problems. At all events, the statistical data on direct investment in Germany provided by other countries have for several years been significantly higher than the capital inflows reported in this field for the German balance of payments statistics.

But less German direct investment abroad

At DM 42 billion, German enterprises also invested less abroad in 1996 than in the year before, but this should not be taken to mean that the trend towards internationalisation by German enterprises is declining. The bunching of relatively large one-off transactions in 1995 clearly indicates that a certain normalisation is likely after the then "record volume" of German participating interests abroad (DM 55 billion). The decline is essentially at the expense of those European countries (France and the United Kingdom) which had accounted for several of these large-scale transactions in 1995. In 1996, by contrast, the United States was among those countries which attracted distinctly more investable funds from Germany than in 1995. The deficit on direct investment ultimately amounted to DM 46½ billion.

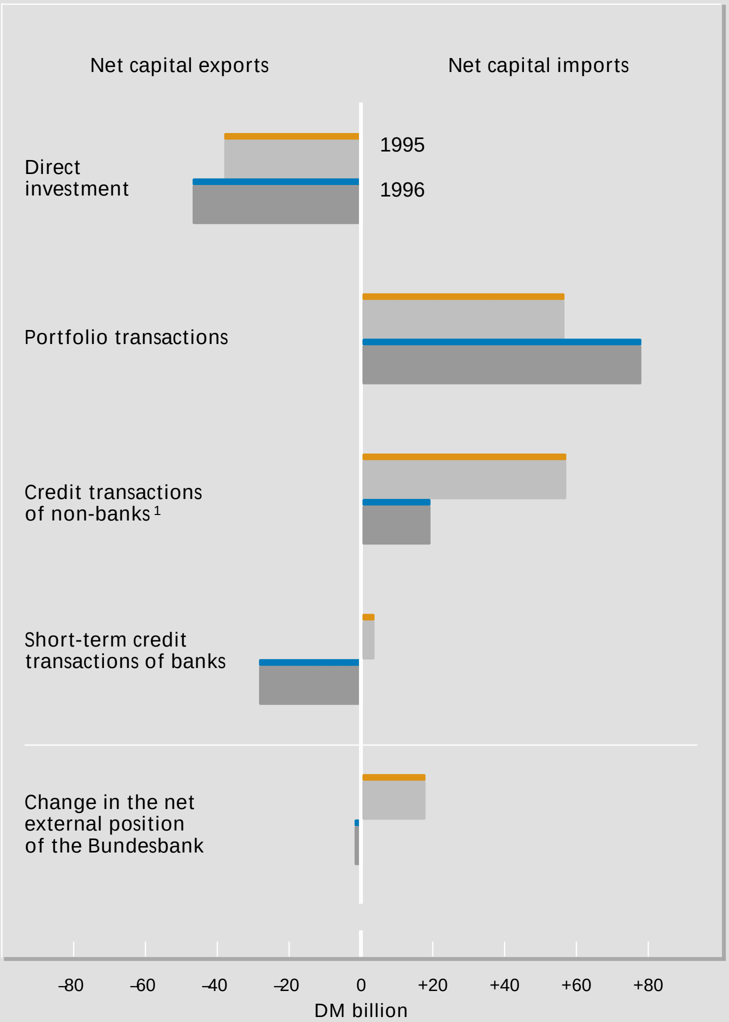
Credit transactions of non-banks largely in balance

With the increasing securitisation of borrowing, the traditional (unsecuritised) credit operations with non-residents have recently lost ground – at least, in terms of the overall balance. In the credit operations of the non-banks, in particular, structural factors such as the cash situation of the public authorities, the

Financial transactions and reserve movements

Chart 11

Balances in DM billion



1 Including long-term credit transactions of banks.

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rationalisation of liquidity management by internationally operating enterprises and the increasing spread of securities lending transactions even in the enterprise sector appear to have become more important than pure portfolio considerations on the basis of short-term interest rate and exchange rate expectations; the trends in 1996 also suggest this. For example, the credit transactions of enterprises and individuals resulted in only minor net outflows of funds; there has, however, been a sharp rise in intra-group assets and liabilities, but this is partly due to the securities lending transactions mentioned above and partly to the increased centralisation of liquidity management at the parent company concerned. The international financial operations of the public authorities, by contrast, led to a small influx of funds as the social security funds, among others, drew on their balances in the Euro-market in view of their strained financial situation.

Credit transactions of banks

In the banking sector, too, the expansion in direct financial operations was fairly modest, on balance, when compared with earlier years. Inflows of DM 24 billion (net) at the long end of the market were accompanied by outflows of a similar amount at the short end, with the result that the total (unsecuritised) external position of the credit institutions increased only slightly in 1996. The decline in the banks' direct borrowing at the long end of the market is particularly striking. Approximately DM 39 billion was raised here in 1996, compared with DM 60½ billion in the previous year. The funds involved are mostly those obtained by foreign financial subsidiaries of German institutions through issues in the international market and are forwarded as loans to the German parent companies. It is possible that the decline can be seen in connection with the sharp rise in sales of (domestic) bank bonds of German credit institutions abroad; these sales have partly replaced the refinancing through foreign subsidiaries. Together with the proceeds from the sales of their own bonds abroad, the long-term funds accruing to German credit institutions from abroad increased from DM 89 billion to DM 93½ billion last year. In the banks' short-term lending and deposit business, which is largely determined by the settlement of other current and financial transactions, DM 28 billion net flowed abroad.

External position of the Bundesbank

There was little change in the external position of the Deutsche Bundesbank in 1996. Both the external assets (– DM 2½ billion) and the external liabilities (– DM 1 billion) declined slightly last year. At transaction values, the net external assets therefore fell by DM 1½ billion.

Revaluation of the external position

The usual revaluation of the monetary reserves at the end of the year virtually made no change to this result – even when calculated at balance sheet rates – because the most important valuations for the balance sheet – the rates of the dollar and the ECU – remained unchanged at DM 1.3620 per dollar and DM 1.83408 per ECU. Only special drawing rights were shown at a somewhat higher value in the balance sheet, namely at DM 2.23145 per SDR, than previously (DM 2.13088 per SDR).

Holdings at the end of 1996

On the basis of these valuations, the monetary reserves of the Bundesbank amounted to approximately DM 119½ billion at the end of December 1996. Ex-

Changes in the net external position of the Deutsche Bundesbank *

Table 6

DM billion; inflow of foreign exchange: +

Period		Net external position, total	Operations in the foreign exchange market 1			Other transactions			
			Total	Deutsche Mark/ dollar market	EMS inter-vention and debt settle-ment 2	Total	US dollar interest income and US dollar receipts from US troops	Public author-ities (net)	Other foreign ex-change move-ments (net)
1996	Jan.	+ 0.7	–	–	–	+ 0.7	+ 0.9	+ 0.0	– 0.3
	Feb.	– 0.1	–	–	–	– 0.1	+ 1.1	– 0.5	– 0.8
	Mar.	+ 0.5	–	–	–	+ 0.5	+ 1.0	– 0.2	– 0.4
	Apr.	+ 1.0	–	–	–	+ 1.0	+ 0.8	– 0.3	+ 0.6
	May	– 2.5	–	–	–	– 2.5	+ 1.4	– 0.2	– 3.7
	June	+ 0.6	–	–	–	+ 0.6	+ 0.8	+ 0.5	– 0.7
	July	– 2.7	–	–	–	– 2.7	+ 1.2	– 0.2	– 3.6
	Aug.	+ 0.5	–	–	–	+ 0.5	+ 1.1	– 0.7	+ 0.2
	Sep.	+ 2.4	–	–	–	+ 2.4	+ 1.1	+ 0.3	+ 1.1
	Oct.	+ 0.6	–	–	–	+ 0.6	+ 1.3	– 0.5	– 0.2
	Nov.	+ 1.4	–	–	–	+ 1.4	+ 1.1	– 0.1	+ 0.4
	Dec.	– 4.1	–	–	–	– 4.1	+ 1.3	+ 0.1	– 5.6
	Total	– 1.6	–	–	–	– 1.6	+ 13.2	– 1.8	– 13.1
1997	Jan.	– 0.5	–	–	–	– 0.5	+ 1.0	+ 0.7	– 2.1
	Feb.	– 1.2	–	–	–	– 1.2	+ 1.1	– 0.3	– 2.0
	Mar.	– 0.2	–	–	–	– 0.2	+ 1.0	– 0.4	– 0.7

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

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cluding the dollar reserves contributed to the European Monetary Institute (EMI), dollar assets, at DM 72½ billion, accounted for about 60 % of these. This was equivalent to an increase of approximately DM 4 billion compared with the previous year. On the other hand, the Bundesbank's ECU-denominated balances at the EMI declined appreciably (DM 22 billion compared with DM 29 billion) because foreign central banks repurchased the rest of the reserve ECUs which had been transferred to the Bundesbank in connection with earlier intervention operations within the EMS. At DM 13½ billion, the gold reserves remained unchanged. The reserve position in the IMF (including the special drawing rights accepted by the Bundesbank) came to DM 11½ billion at the end of 1996, and the credits to and other claims on the rest of the world which do not count towards the monetary reserves amounted to DM 1½ billion. The external assets were accompanied by liabilities arising from external transactions of DM 15½ billion. This means that the net external assets of the Bundesbank on the 1996 balance sheet day amounted to DM 105½ billion, compared with just under DM 107 billion at the end of 1995.

Record of domestic and external monetary policy measures

March 8, 1996
The more refined Frankfurt Electronic Clearing System (EAF 2) starts operation at the Frankfurt branch office of the Land Central Bank in Hesse. Through the incorporation of major features of a gross settlement procedure, the credit and systemic risks involved in payments are significantly reduced, while the liquidity advantages of the old Electronic Clearing with File Transfer System (EAF) are largely retained.

April 18, 1996
The Central Bank Council lowers the discount and lombard rates by 0.5 percentage point each to 2.5 % and 4.5 %, respectively, with effect from April 19. The next two securities repos are announced in the form of fixed-rate tenders at an unchanged rate of 3.3 %. By this decision, the Bundesbank takes due account of the consistently favourable price outlook. Furthermore, it postulates a slowdown in monetary expansion in the near future. By keeping the securities repo rate unchanged, the Bank retains some leeway for its open-market policy in the period ahead. At the same time, the Central Bank Council approves the annual accounts for the financial year 1995; DM 10.32 billion of the net profit is paid over to the Federal Government.

June 13, 1996
The Federal Ministry of Finance presents a number of measures which have been prepared in conjunction with the Bundesbank, and which are intended to raise the Federal Government's standing as a benchmark issuer and to enhance Germany's competitiveness as a financial centre. In future the Federal Government will issue securities running for less than one year at quarterly intervals (for the first time in July 1996) in the form of Treasury discount paper ("Bubills") with a standard maturity of six months. The outstanding amount of such paper is not to exceed DM 20 billion in 1996 or 1997. In this way, the Federal Government's budgetary interests, Germany's requirements as a financial centre and the Bundesbank's persistent reservations about the increasing short-termism of financial relations are all taken into account. In addition, the Federal Government widens its range of capital market issues by launching Federal Treasury Notes running for two years (*"Schätze"*), and envisages reactivating the 30-year maturity category once a year in future, insofar as this is warranted by capital market conditions.

July 25, 1996
The Central Bank Council reaffirms the 1996 monetary target, which provides for an increase of 4 % to 7 % in the money stock M3 between the fourth quarter of 1995 and the fourth quarter of 1996. By its decision to abide by the monetary target, the Bundesbank underlines the fact that it continues to regard the money stock M3 as its key benchmark variable for monetary policy. The increased short-term volatility of monetary growth is making it more difficult to meet annual monetary targets. The Bundesbank takes due account of that fact by gearing its policy to medium-term objectives.

August 22, 1996
The Central Bank Council decides to offer the next two securities repos at a fixed rate of interest of 3.0 %, i.e. reduced by 30 basis points. This decision is mainly attributable to the movement of the money stock M3. The consistently favourable price outlook is an additional factor. Moreover, the interest rate reduction fits in well with the overall international setting.

October 14, 1996
Finland joins the exchange rate and intervention mechanism of the European Monetary System with a fluctuation margin of +/– 15 %.

November 6, 1996
The first convergence examination pursuant to Article 109j of the EC Treaty (by the European Monetary Institute and the European Commission) finds that a majority of the member states at present fail to fulfil the criteria necessary for introducing a single currency.

November 25, 1996
The Italian lira rejoins the exchange rate and intervention mechanism of the European Monetary System with a fluctuation margin of +/– 15 %.

December 5, 1996
The Central Bank Council decides to exempt liabilities arising from "genuine sale and repurchase transactions" (repos) running for up to one year in marketable securities from minimum reserve requirements. The exemption comes into force with effect from January 1, 1997. This measure enhances the efficiency and competitiveness of the German financial market. It is acceptable in monetary policy terms since credit institutions' required minimum reserves will be reduced only marginally in consequence. Hence the buffer function of minimum reserves and their stabilising effect on the demand for central bank money remain in place.

December 13-14, 1996
The European Council (composed of the European Heads of State or Government, and meeting in Dublin) affirms that the Community will not enter the third stage of EMU in 1997 and that the procedure for examining which member states fulfil the criteria for entering the final stage of EMU will be performed as early in 1998 as possible, on the basis of the actual figures for 1997. The Council draws particular attention to the fact that the four criteria for lasting convergence and the required independence of central banks must be applied strictly. This is of paramount importance, so as to safeguard the underlying stability of the future monetary union and to ensure that the euro is assigned the status of a hard currency. In addition, the basic features of the stability and growth pact proposed by the Federal Minister of Finance are approved after a few amendments; the pact is designed to ensure budgetary discipline in stage three of European monetary union.

December 19, 1996
The Bundesbank extends the time-horizon of its monetary targeting strategy to two years. It thereby takes due account, in particular, of the changed conditions governing German monetary policy in the run-up to stage three of European monetary union. The Bundesbank points out that it will continue to conduct its monetary policy in such a way as to safeguard price stability and, at the same time, to satisfy the monetary conditions for lasting economic growth. To this end, the Bundesbank regards it as appropriate for the money stock M3 to expand at a rate of about 5 % per annum in the course of 1997 and 1998 alike. In order to give the markets a guideline for the pace of monetary expansion that is acceptable in the shorter run, the Bundesbank also specifies a target corridor of 3 ½ % to 6 ½ % for the year 1997 (i.e. from the fourth quarter of 1996 to the fourth quarter of 1997). At the end of 1997 the Bundesbank will define in more detail the scale of the envisaged M3 growth rate during 1998.

April 17, 1997
The Central Bank Council approves the annual accounts for the financial year 1996; DM 8.83 billion of the net profit for that year is paid over to the Federal Government.

Record of general economic and fiscal policy measures

January 1, 1996
Major Acts of Parliament regulating fiscal policy come into effect: the 1996 Tax Act (raising of the basic tax allowance, increase in child benefit and in the tax allowance for children); the Act Restructuring the Promotion of Owner-Occupied Dwellings in Tax Terms (income-related basic promotion under section 10e of the Income Tax Act is superseded by an allowance not related to income); the Act Modifying the Use of Coal for Generating Electricity as from 1996 (abolition of the "coal penny" and inclusion of the subsidies financed by it in the Federal Budget); raising of the contribution rate to pension insurance from 18.6 % to 19.2 %.

January 30, 1996
In the shape of an "action programme to foster investment and employment", the Federal Cabinet approves a host of measures – which still have to be fleshed out in detail – to improve economic conditions in Germany.

January 31, 1996
In its Annual Economic Report, the Federal Cabinet expects that, despite a rather unsatisfactory start, an average annual increase of 1½ % in aggregate output is within reach. Stable prices, low interest rates, a further upturn in global economic activity and tax relief for households constitute favourable underlying conditions for the return to a growth path. However, a radical improvement in labour market conditions likewise presupposes the elimination of structural rigidities.

April 25, 1996
In continuation of the "action programme" it approved at the end of January, the Federal Cabinet unveils its "programme for more growth and employment": relief of the public sector budgets in 1997 amounting to almost DM 70 billion (*inter alia* by means of further economies in the Federal and Länder Governments' budget planning, zero-increase wage rounds for public sector employees in 1996 and 1997 and cuts in social security spending, with the aim of reducing social security contributions to less than 40 % of eligible earnings); announcement of an income tax reform at the beginning of 1999, aimed at considerably reducing tax rates and simultaneously broadening the basis of assessment, along with a pension reform designed to take due account of demographic trends; in the field of labour law, limitation of the continued payment of salaries during sickness, which is regulated by statute, as well as of dismissal protection in smaller enterprises; promotion of the setting-up of businesses and easier access to risk capital.

May 10, 1996
The parliamentary groups of the governing coalition introduce the bills implementing the measures envisaged in the "programme for more growth and employment" in the Bundestag. Besides bringing forward the payment dates of social security contributions and subjecting the social security funds to an obligation to step up their sales of assets, major budget relief measures comprise: the reduction of eligible periods of training, the introduction (ahead of schedule) of

the gradual raising of the age limit for early retirement, cutting spending on health cures; cutbacks in and the abolition of the legal right to payments under the work promotion scheme, the reduction of sickness benefits, the limitation of benefits and higher payments for medical services by patients.

May 22, 1996
The Federal Cabinet approves the 1997 Tax Bill, which primarily takes account of the constitutional requirements governing property tax and inheritance tax, as well as of the tax measures announced in the "programme for more growth and employment": the abolition of property tax; the restructuring of inheritance tax regulations with a higher assessment of real property, higher tax allowances and some lower tax rates; gradual reduction of the solidarity surcharge to 5.5 % from 1998 onwards; improved tax promotion of household employment contracts; postponement of the raising of child benefit, of the tax allowance for children and of the basic tax allowance, which had been formally approved for 1997. Moreover, the implementation of the trade tax reform, which has been deferred so far, was reaffirmed for 1997, and a bill amending motor vehicle tax in 1997 (and making that tax dependent on the emission of pollutants) was approved.

June 21, 1996
The Bundestag passes the Act Fostering a Gradual Transition of Older Employees to Retirement. The age limit for claiming pension payments after a period of unemployment is raised (including a transitional arrangement) from 60 to 63 years; any earlier claiming of such payments results in pension deductions. Simultaneously, a new payment by the Federal Labour Office is introduced, which (under certain conditions) provides for an increase in the net earnings of older employees when changing to part-time work.

July 1, 1996
The second stage of the nursing care insurance scheme, adding in-patient treatment to the range of benefits and including an increase in the contribution rate from 1.0 % to 1.7 %, comes into force.

July 10, 1996
The Federal Cabinet approves the draft Federal budget for 1997, involving an expenditure volume of DM 440.2 billion (2.5 % below the amount budgeted for in 1996) and a deficit of DM 56.6 billion. According to the medium-term financial plan, which is submitted simultaneously, the annual growth rate of expenditure is to be limited to just over 2 % between 1998 and 2000, and the deficit to be reduced to DM 49 billion in the year 2000.

July 23, 1996
The Bundestag approves the Social Assistance Reform Act: the rise in the standard rates is limited to 1% from July 1, 1997; in the subsequent two years these rates are to go up in line with the trend in net wages and salaries; from 1996 to 1998 nursing charges are to increase by not more than 1% in western Germany and not more than 2 % in the new Länder; the entitlement to payment of the standard rate is reduced if a reasonable job offer is turned down; on the other hand, new benefits to foster the commencement of work are offered.

September 13, 1996
After overruling the Bundesrat's objection, the Bundestag approves the Acts (not subject to Bundesrat approval) of the "programme for more growth and employment" (Act to Promote Economic Growth and Employment, Contribution Relief Act, Labour Act to Foster Economic Growth and Employment).

November 15, 1996
The Bundestag approves the First Act on the Restructuring of the Statutory Health Insurance System, which provides *inter alia* for the linking of insured persons' payments to the movement of their health insurance institution's contribution rates and for a right to give notice whenever contribution rates are increased.

November 18, 1996
The Council of Economic Experts forecasts that real GDP will grow by just under 2 ½ % in 1997. As before, expansionary stimuli are to be expected mainly from foreign demand; domestic demand is likely to remain subdued, by contrast. The economic growth rate in the new Länder will no longer be significantly above that in western Germany.

November 29, 1996
The Bundestag approves the Federal budget for 1997, with an expenditure volume of DM 439.9 billion. At DM 53.5 billion, the deficit is DM 3 billion below the figure of the draft, although an additional, mainly

Record of general economic and fiscal policy measures
(continued)

cyclical gap of DM 13 billion had to be closed in the course of the deliberations. Further spending cuts, higher other receipts and new estimates of privatisation gains not realised in 1996 helped to achieve this.

December 12, 1996
Following a mediation procedure, the Bundestag approves the 1997 Tax Act. Compared with the bill, the postponement of the raising of child benefit and of the tax allowance for children was relinquished, and the formal abolition of the Property Tax Act was abstained from. The shortfalls due to the "non-levying" of property tax as a result of the ruling by the Constitutional Court were offset by additional receipts from inheritance tax and by the raising of the tax on the acquisition of land and buildings. Nor will the solidarity surcharge be lowered from the beginning of 1997; now, it is to be reduced from 7.5 % to 5.5 % from the beginning of 1998.

January 1, 1997
Major Acts of Parliament regulating fiscal policy come into effect: the 1997 Tax Act, the raising of child benefit and of the tax allowance for children, the increase in the pension insurance contribution rate from 19.2 % to 20.3 %.

January 15, 1997
According to preliminary budget figures, the deficit in the Federal budget for 1996 amounts to DM 78.5 billion, and is thus DM 18½ billion above the envisaged sum, mainly because of cyclically-induced tax shortfalls and additional spending requirements due to labour market conditions.

January 23, 1997
The parliamentary groups of the governing coalition approve the proposals of a commission established by the Federal Cabinet to elaborate a fundamental reform of income taxation. The centrepiece of the reform proposals consists of lowering the rates of income tax to between 15 % and 39 % (for an annual income of DM 90,000 and more), or to 35 % for commercial earnings, and the rate of corporation tax to 35 % and 25 %, respectively, for retained and distributed profits, as well as a broadening of the basis of assessment by the abolition of tax concessions. The net relief afforded to tax-payers, including the increase in indirect taxes, is expected to amount to as much as DM 30 billion.

January 29, 1997
In its Annual Economic Report, the Federal Cabinet postulates a continuation of economic growth in 1997 that will result in a 2½ % rise in real GDP. Activity will continue to be fuelled mainly by the demand for exports, whereas hardly any stimuli will be imparted by domestic investment or private consumption. Conditions in the labour market will pick up only in the further course of the year; on average, however, the year will see another decline in employment and an increase in unemployment. Prices will remain substantially stable.

4. Monetary policy marked by price stability and strong monetary growth

(a) Further relaxation of interest rate policy up to the summer, thereafter unchanged stance

Low level of central bank rates

The Bundesbank continued its policy of lowering interest rates, which it had adopted in the autumn of 1992, up to the summer of 1996. In April 1996 it brought down the discount rate from 3.0 % to 2.5 % and lowered the lombard rate from 5.0 % to 4.5 %; in August it reduced the securities repurchase rate from 3.3 % to 3.0 %. Thereafter it kept central bank rates unchanged. Some of them have hence fallen to all-time lows. The discount rate had previously dropped only once, in the wake of the stock market crash of 1987, to 2.5 %, while the securities repurchase rate had reached a low of 3.25 % at that time. Compared with the level in the autumn of 1992, when the latest period of gradual interest rate reductions began, the discount rate was lowered by 6.25 percentage points, the lombard rate by 5.25 percentage points and the securities repurchase rate by 6.7 percentage points. As German capital market rates have likewise fallen to a historical low, financial conditions are highly conducive to a revival of economic activity at present.

Interest rate policy geared to monetary trends and inflation outlook

The Bundesbank's policy, which was initially aimed at further interest rate reductions and then a "steady-as-she-goes" approach to the money market in 1996, was in line with monetary policy requirements. It took account both of monetary and macroeconomic conditions. As the short-term swings in monetary growth persisted, the Bundesbank, however, geared its interest rate policy more strongly to the medium-term monetary trends. There was a further easing of the price climate in 1996; no clouding of the outlook for inflation was to be expected in the light of the trend in economic activity and the wage settlements that were achieved. On balance, the reversal in trend in the exchange markets, which began in the latter part of the year, did not generate any major risks of inflation either. It represented a normalisation of exchange rate relations but was not an indication of any sustained weakness of the Deutsche Mark. Finally, in its interest rate decisions, the Bundesbank had to take account of the increased volatility and expectation bias in the financial markets. This did not imply, however, that monetary policy makers had to follow short-term market movements, but rather that they had to stabilise expectations by pursuing a consistent and cautious policy, thereby giving guidance to the markets.

Switch from variable to fixed-rate tenders

In the past year the Bundesbank therefore preferred to use fixed-rate tenders (which give a clearer indication of its monetary policy intentions than variable-rate tenders) for its money market management through securities repurchase transactions. It switched to fixed-rate tenders as early as the beginning of February, since sustained expectations of interest rate reductions had emerged in the market following a cut in interest rates in December 1995, and the impact of the worsening economic conditions has led to progressive large falls in the allotment rate applied to the securities repurchase transactions offered in the form of variable-rate tenders. It adhered to fixed-rate tenders up to the time this Report went to press. Moreover, following the pattern of the Central Bank Council meetings, in all cases it announced the terms of the forthcoming securities repurchase transactions in advance. With this steady-as-she-goes approach to interest rate policy, the Bundesbank gave the market clear signals and guidance in an unsettled environment. Overall, the fluctuations in short-term money market rates remained fairly small, and financial market players' expectations about the future course of monetary policy were stabilised. The preventative limitation of uncertainty of expectations likewise seemed appropriate to counteract the increased volatility in the capital market and its adverse implications for the stability of the monetary transmission process.

Lowering of discount and lombard rates in mid-April ...

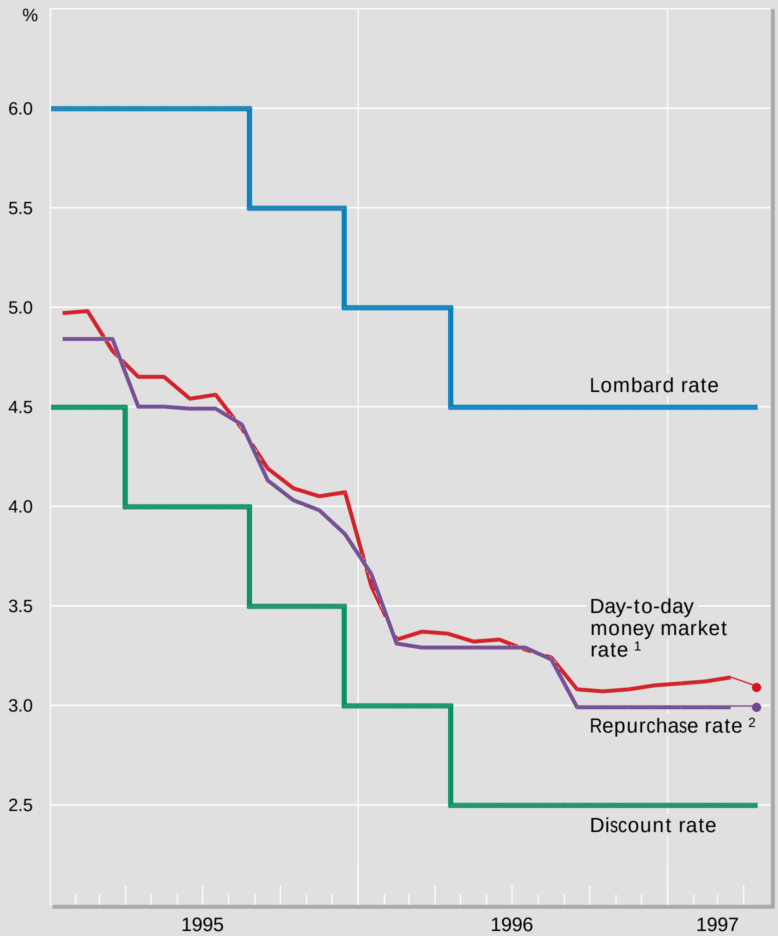
The main reason for the lowering of the discount rate and the lombard rate by half a percentage point to 2.5 % and 4.5 %, respectively, in April 1996 was the favourable outlook on inflation. Monetary conditions tended to be unsatisfactory following the vigorous growth of M3 in the spring of 1996, it is true. But as monetary capital formation was very weak at the time, current money supply figures overstated the underlying monetary trend. This was evidenced, for example, by the medium-term growth of the money stock or the banks' assets-side business. A thorough analysis of monetary conditions therefore showed that these did not stand in the way of an interest rate reduction. On the other hand, it did not seem advisable to sound the "all clear" regarding monetary growth. That is why the Bundesbank left the securities repurchase rate, as the key rate for determining interest rate formation in the money market, unchanged at 3.3 % for the time being, while at the same time announcing that it was exploring its room for manoeuvre in open market policy in the light of

... and the repurchase rate at the end of August

further monetary expansion. The money stock successively approached the target corridor in the ensuing period, after which the Central Bank Council reduced the fixed-rate tender rate to 3.0 % at the end of August.

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

Chart 12



1 Monthly averages. — 2 Average rate during month applied to securities repurchase agreements with two-week maturities; uniform allotment rate (fixed-rate tender) or marginal allotment rate (variable-rate tender). — ● = Latest position: April 16, 1997.

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Since then "steady-as-she-goes" approach to the money market

Since then, central bank rates have remained unchanged. One factor arguing in favour of a "steady-as-she-goes" policy in the money market was the slight acceleration in monetary growth, in particular, at the turn of the year 1996-7. Another reason was that the monetary policy setting did not indicate any need for action in interest rate policy either. Capital market rates dropped to their lowest level in the post-war period; at the same time, there was a fall in the external value of the D-Mark. Underlying monetary conditions thus continued to ease without any action on the part of the Bundesbank. Against the backdrop of exceptionally low capital market rates and a sustained exchange rate correction, it was essential not to give rise to any doubts concerning the Bundesbank's anti-inflationary stance. A monetary policy geared more closely to stimulating economic activity, which the Bundesbank has occasionally been advised to pursue in order to overcome the weakness in investment activity, might easily have turned out to be counter-productive, since this would have entailed the risk of losing credibility, a rise in inflation spreads included in the long-term interest rate, and a depreciation of the D-Mark which would have pushed up prices. Another factor arguing against such a policy was that Germany's current labour market and growth problems are predominantly structural. They cannot be resolved by monetary policy means.

Money market rates

The lowering of central bank interest rates last year caused a more or less simultaneous decline on a similar scale in forward-rate quotations at the short end of the market whereas longer-term money market rates did not edge down markedly until the late summer. Ultimately, the Bundesbank's interest rate policy, which is aimed at stabilisation, led to a notable flattening of the yield curve in the money market by the beginning of 1997. This indicates that, in the short run, market players tended to expect central bank rates to remain unchanged.

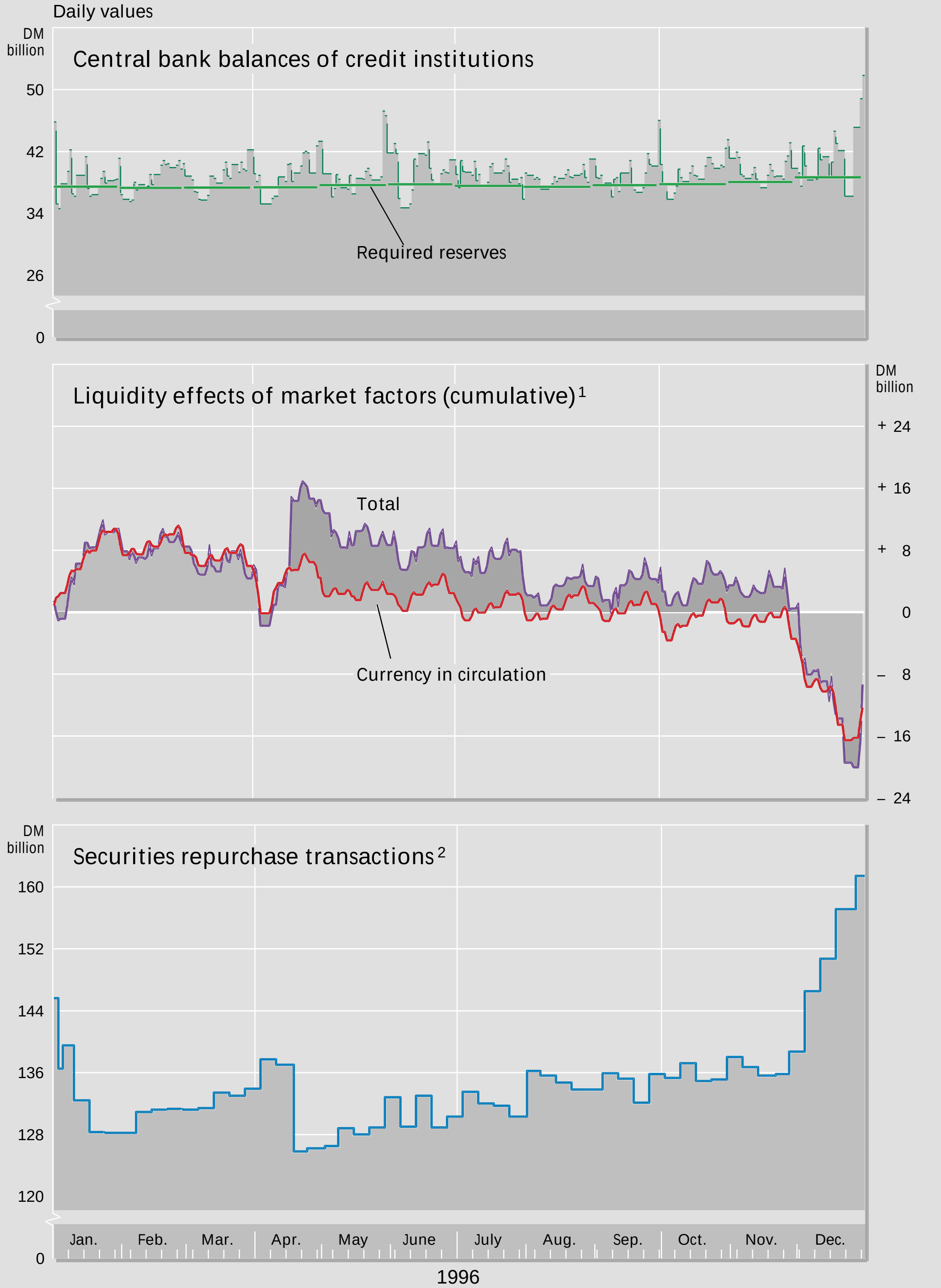
The Bundesbank's decisions to cut interest rates were accompanied by parallel measures on the part of other European central banks. Even so, Deutsche Mark money market rates continue to be in the lower range of the international interest rate spectrum, which has tended to narrow since the beginning of 1996 on account of appreciable falls in the rates of countries with a relatively high interest rate level.

Money market management in a stable monetary setting

Underlying conditions for ongoing money market management remained virtually stable last year, whereas they had been changed in several respects in the preceding three years. That applies to the revision of the minimum reserve regulations between March 1993 and August 1995, the abolition, at the beginning of 1994, of the central and regional public authorities' obligation to deposit their funds at the Bundesbank, and changes in the Bundesbank's payment system aimed at reducing the level and margin of fluctuation of the processing-period-based float (at the end of 1994 and in mid-1995). As a consequence of these institutional changes, there has been a sharp fall not only in the banks' minimum reserve balances but also in their voluntary working balances. However, minimum reserve requirements continue to exceed the banks' working balances that are needed in any case for payment purposes; the stability of the demand for central bank money and the buffer function of the minimum

Liquidity management by the Bundesbank

Chart 13



1 Currency in circulation, external position of the Bundesbank, cash items in the process of settlement and other factors; provision (+) or absorption (–) of central bank balances. — 2 Including quick tender of January 5 to 9, 1996.

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reserves in the money market were therefore preserved. Nevertheless, the gap between required reserves and working balances has narrowed distinctly, and the reserve compliance profile in the course of the month sought by credit institutions has shown a marked flattening. The Bundesbank adjusted its money market management to these changes in 1996. As part of its interest rate policy, which is geared to stabilisation, it tried to keep the money market in equilibrium at all times. For this purpose, it gauged its liquidity provision in such a way that the credit institutions' central bank balances remained as close as possible to the current level of required reserves.

Minimum reserve exemption of repos

The minimum reserves' function of smoothing out fluctuations in the money market is unlikely to have been adversely affected by the fact that liabilities arising from genuine sale and repurchase transactions (repos) with maturities of up to one year in marketable securities have been exempted from minimum reserve requirements since January 1997. This measure was designed to improve the competitiveness and efficiency of the German financial market. It seemed justifiable in terms of monetary policy as it was not expected to have any major impact on the level of the required reserves.

Liquidity management by means of securities repurchase transactions

As usual, the Bundesbank's ongoing liquidity management relied last year on regular, weekly securities repurchase transactions with a two-week maturity. Essentially, it had to take into account the changes in the demand for currency and isolated swings in the cash items in the process of settlement in the Bundesbank system. Above and beyond that, the Bundesbank offset the increase in liquidity resulting from the transfer of the Bundesbank profit to the Federal Government as of April 18 by a same-day reduction of the volume of repurchase transactions on a similar scale. Finally, in setting the volume of the regular tenders it took into consideration the temporary marked fall in the volume of credit institutions' bills discounted ahead of the discount rate cut in April and again at the end of the year.

Cancellation of the last special rediscount facility

The cancellation of the special rediscount facility for the Export Credit Company (*AKA Ausfuhrkredit-Gesellschaft mbH* (Limit B)) at the end of May 1996 had only a minor impact on liquidity since the borrowing under this facility still outstanding will be repaid only gradually. This measure completed the cancellation of special refinancing facilities which was started at the end of the eighties.

Very few short-term assistance measures

Very short-term assistance measures were required only on very rare occasions. Their use was confined to a small number of cases in which sharp liquidity fluctuations were unforeseeable and/or could not be absorbed solely by minimum

Monetary developments

Table 7

Changes during year

Item	1993	1994	1995	1996
	DM billion			
I. Central bank money requirements of banks and liquidy policy measures of the Bundesbank 1				
1. Provision (+) or absorption (–) of central bank balances by:				
Changes in central bank money 2 (increase: –)	– 21.5	– 15.0	– 9.8	– 14.3
Foreign exchange movements (excluding foreign exchange swaps)	– 16.6	+ 6.3	+ 9.0	+ 0.0
Changes in domestic non-banks' net balances with the Bundesbank (including shifts of Federal balances under section 17 of the Bundesbank Act 3)	– 9.2	+ 6.4	+ 0.1	– 0.1
Other factors	– 18.9	– 28.8	– 26.9	– 11.4
Total 1.	– 66.2	– 31.1	– 27.6	– 25.7
2. Lasting provision (+) or absorption (–) of funds:				
Change in minimum reserve ratios 4	+ 32.6	+ 29.5	+ 19.6	– 0.4
Change in refinancing facilities	+ 0.1	– 0.1	+ 0.0	+ 0.1
Recourse to unused refinancing facilities (reduction: +)	– 4.2	+ 2.7	+ 0.3	+ 0.4
Open market operations in liquidity paper and in the debt securities market	– 26.5	+ 11.9	+ 9.5	– 1.3
Transfer of the Bundesbank's profit to the Federal Government	+ 13.1	+ 18.3	+ 10.2	+ 10.3
Total 2.	+ 15.0	+ 62.2	+ 39.7	+ 9.1
3. Change in the banks' short-term liquidity gap (total 1 plus total 2, increase: –)	– 51.2	+ 31.1	+ 12.1	– 16.6
4. Meeting of remaining deficit (+) or absorption of surplus (–) by:				
Securities repurchase transactions	+ 46.6	– 27.2	– 12.6	+ 16.6
Very short-term assistance measures by the Bundesbank 5	+ 3.6	– 3.2	± 0.0	+ 0.2
Changes in lombard loans (increase: +)	+ 1.1	– 0.7	+ 0.5	– 0.3
	%			
II. Key monetary indicators 6				
Money stock M3 7	+ 8.8	+ 3.9	+ 3.4	+ 7.8
Money stock M3 extended 8	+ 11.9	+ 4.2	+ 3.2	+ 6.0
Credit volume 9, 10	+ 9.5	+ 8.3	+ 7.5	+ 7.6
	DM billion			
III. The money stock and its counterparts 9				
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 186.2	+ 31.9	+ 86.1	+ 174.0
Counterparts in the balance sheet:				
1. Credit volume 10	+ 333.9	+ 318.9	+ 310.5	+ 335.4
of which				
Lending by credit institutions to domestic non-banks	+ 339.8	+ 320.5	+ 312.8	+ 336.3
to enterprises and individuals 11	+ 242.3	+ 256.1	+ 223.0	+ 254.1
to public authorities	+ 97.5	+ 64.4	+ 89.8	+ 82.2
2. Net external assets 12	– 6.7	– 141.2	– 31.7	– 19.1
3. Monetary capital formation	+ 96.5	+ 166.8	+ 181.7	+ 120.9
of which				
Savings deposits at over three months' notice and bank savings bonds	+ 9.0	+ 1.5	+ 15.4	– 19.1
Time deposits for four years and more	+ 32.9	+ 62.1	+ 69.1	+ 69.1
Bank debt securities outstanding 13	+ 31.1	+ 73.5	+ 74.8	+ 45.4
4. Federal Government deposits in the banking system 14	+ 13.1	– 10.0	– 0.8	+ 4.5
5. Other factors	+ 31.4	– 11.1	+ 11.9	+ 16.9

1 Based on daily averages of the last month of the period. — **2** Currency in circulation in the hands of non-banks and minimum reserves on domestic liabilities at current reserve ratios; but excluding changes in required reserves due to changes in the reserve ratios. — **3** Under section 17 of the Bundesbank Act as amended up to July 15, 1994. — **4** Including changes in minimum reserves due to the growth of reserve-carrying foreign liabilities. — **5** Quick tenders, foreign exchange swaps and foreign exchange repurchase transactions, sales of short-term Treasury bills and shifts of Federal balances (under section 17 of the Bundesbank Act as amended up to July 15, 1994). — **6** Seasonally adjusted. — **7** Currency in circulation plus the sight deposits, time deposits for less than four years and savings deposits at three months' notice held at domestic credit institutions, computed as a monthly average. — **8** Money stock M3 extended to include deposits abroad, short-term bank debt securities and (from August 1994) the certificates of domestic and foreign money market funds held by domestic non-banks, less the bank deposits and short-term bank debt securities of domestic money market funds; average of end-of-month levels. — **9** Based on end-of-month figures. — **10** Credit institutions and the Bundesbank; including lending against securities. — **11** Including housing loans. — **12** Credit institutions and the Bundesbank. — **13** Excluding banks' portfolios. — **14** Until December 1993 central bank deposits of domestic public authorities.

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reserve balances or discreetely by regular repurchase transactions. In January 1996 and 1997 the Bundesbank concluded a quick tender, and at the end of May and the beginning of December 1996 provided additional liquidity by means of two-day foreign exchange swaps in order to steady movements in the day-to-day money market. These fine-tuning instruments were used to counteract, firstly, more marked contractionary fluctuations in the Bundesbank's external position and, secondly, liquidity shortages caused by unexpectedly high minimum reserve requirements. Finally, at the end of April 1996 the Bundesbank temporarily sold short-term liquidity Treasury bills when signs appeared of a marked easing in the day-to-day money market due to the market perception that the banks had an abundant supply of liquidity.

Lower lombard borrowing

In 1996 lombard borrowing, at an annual average of DM 0.4 billion, dropped to its lowest level for the past nine years. On most days, credit institutions' recourse to the lombard facility was below DM 100 million; it was only at the end of a month that major amounts were occasionally drawn.

Borrowing requirements increased

The banks' borrowing requirements went up for the first time again in 1996 following an appreciable decline in the two preceding years owing to the significant lowerings of the minimum reserve ratios (see table on page 67). The increase is chiefly due to the sharp expansion of central bank money and to current entries to the Bundesbank's profit and loss account. Another factor was that the Bundesbank sold all of its remaining securities portfolio at the beginning of 1996. The liquidity effects of the changes in the Bundesbank's external position cancelled each other out during 1996. Firstly, the Bundesbank resold some of the foreign exchange inflows from outside the market (in particular, dollar purchases from US military agencies) by means of commercial transactions. Secondly, the exchange position declined because of foreign central banks' final extensive repurchases of ECUs, which had previously been transferred to the Bundesbank as part of EMS payments. Liquidity was increased, above all, by the transfer of that part (DM 10.3 billion) of the Bundesbank profit for 1995 which is due to the Federal Government. The rise of DM 16.6 billion net in the banks' short-term liquidity gap was offset by an equally large increase in the volume of repurchase transactions. Against the background of virtually unchanged refinancing facilities, the share of securities repurchase transactions in overall central bank borrowing has therefore shown an increase again.

(b) 1996 monetary target overshot

Monetary target for 1996

In 1996 the Bundesbank continued its policy of monetary targeting. According to the target set by the Central Bank Council in December 1995, the money stock M3[1] was to grow by between 4 % and 7 % between the fourth quarter of 1995 and the fourth quarter of 1996. The derivation of the monetary target was impeded by two factors. Firstly, the 1995 target had been markedly undershot, raising the question of an addition to the target for 1996. Ultimately, the Bundesbank refrained from offsetting the underhang in this way as the liquidity supply to the economy was considered to be adequate by longer-term standards. Secondly, judging by recent experience, a high volatility of shorter-term monetary growth was to be expected in the immediate future, too. The Bundesbank therefore extended the target corridor from 2 to 3 percentage points as a precautionary measure against larger swings in monetary growth. This approach was in line with the practice of monetary targeting from the late seventies to the late eighties, at which time the Bundesbank had mostly formulated the monetary target in terms of a 3 percentage point target corridor in the light of the macroeconomic uncertainties then prevailing.

Persistent fluctuations in M3 growth

The fluctuations in monetary growth did, in fact, persist last year. In February and March 1996 growth of the money stock M3 was extremely strong as monetary capital formation came to a virtual standstill against a backdrop of volatile and rising capital market rates. Thereafter, when domestic non-banks' propensity to lock in funds at longer term at banks normalised again somewhat, growth of the money stock M3 was much more moderate. In the last quarter of 1996 monetary expansion accelerated again. On the one hand, investors' preference for liquidity increased temporarily ahead of the issue of Deutsche Telekom shares; on the other, the changes in the tax treatment of property acquisitions (which came into force in January 1997) led to pronounced anticipatory effects in private sector borrowing.

Monetary target overshot

In the fourth quarter of 1996 the money stock M3 exceeded its average level in the fourth quarter of 1995 by 8.1%; the target corridor of 4 % to 7 % was thus overshot. This overshooting of the target was due to the above-mentioned sharp M3 growth in February and March. Whereas the money stock M3 in-

1 The money stock M3 comprises currency, sight deposits, time deposits for less than four years and savings deposits at three months' notice. Since January 1997, the Bundesbank has also been including the amounts loaded on to debit cards in the monetary aggregates.

creased at an annual rate of 12 % in the first quarter of 1996, it grew considerably more slowly, at 6 ½ %, in the following nine months.

Sharp rise in short-term savings deposits

Of the individual components of the money stock, the sharpest growth last year was again recorded by savings deposits at three months' notice. By far the greater part of these deposits took the form of special savings facilities; while having a short period of notice in formal terms, these normally carry a higher yield – on top of the basic savings rate – only with a longer holding period.[1] Especially when capital market rates are low, these special savings facilities probably serve not only as a substitute for shorter-term time deposits but also for longer-term types of assets which are to be counted towards monetary capital. They thus take an intermediate position between money and monetary capital or to a large extent represent "disguised" monetary capital. To that extent, the statistical increase in the money stock M3 overstates the growth of liquidity that will be applied to spending in 1996.

Growth of the other money stock components

Sight deposits likewise grew vigorously last year. A main reason for this is likely to have been the generally low level of interest rates and thus of the opportunity cost involved in holding money in sight deposit accounts (which even now yield mostly no or little interest). Currency in circulation grew at a similar rate to that in 1995. This led to a steep rise in the money stock M1, which comprises both components. Shorter-term time deposits, on the other hand, were reduced further. The same amount invested currently yields interest at lower rates than special savings facilities. Such deposits hence hold little attraction in terms of yield, especially for households.

Moderate rise in M3 extended

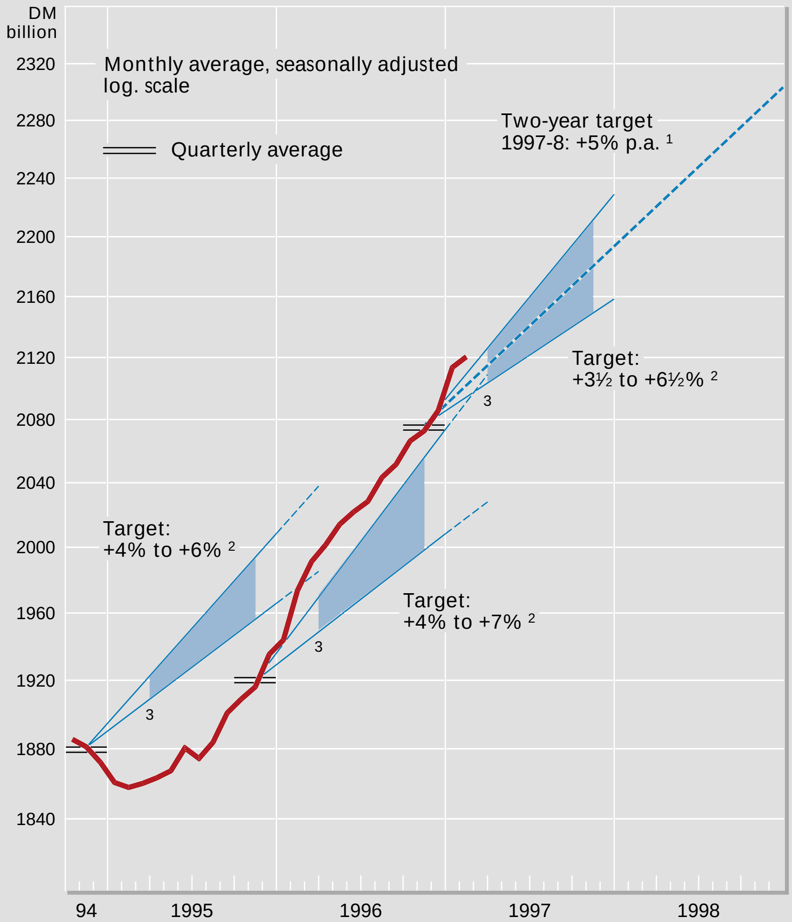
The Bundesbank's assessment of the liquidity in the economy is based not only on the money stock M3 but also on other monetary aggregates. A key role in this respect is played by the money stock M3 extended; in addition to the money stock M3, this includes Euro-deposits, the certificates of domestic and foreign money market funds and the short-term bank debt securities held by domestic non-banks. This broad money stock definition thus comprises the liquidity which is not included in M3. Analysis of the money stock M3 extended is essential in assessing monetary conditions, especially if there is a marked divergence in the trends of these two aggregates – as was the case last year. Between the end of 1995 and the end of 1996 the extended money stock

1 Data on the yield of special savings facilities and bonus-carrying savings deposits are now also collected as part of the revised interest rate statistics since November 1996.

Growth of the money stock M3 *

Chart 14

Target and movement to date



* Average of five bank-week return days; end-of-month levels included with a weight of 50%. — 1 Between the fourth quarter of 1996 and the fourth quarter of 1998. — 2 Between the fourth quarter of the preceding year and the fourth quarter of the current year. — 3 The target corridor has been left unshaded until March because M3 is normally subject to major random fluctuations around the turn of the year.

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expanded appreciably less, at 6 %, than M3 (just under 8 %). This discrepancy is all the more notable on account of the fact that the average growth of the money stock in the broader definition, at 7 %, was 1 percentage point faster over the past ten years than that of traditional M3 (6 %). The moderate increase in 1996 was mainly due to a sharp reduction in Euro-deposits, which were not very attractive given low money market rates. Furthermore, domestic non-banks reduced their portfolios of money market fund certificates by DM 11 billion in 1996. On balance, most of these assets were probably switched into components which are included in M3.

Overstating of liquidity by M3 growth

Overall, the rise in the money stock M3 in 1996 is likely to appreciably overstate the expansion of non-banks' liquidity which affected demand. This is suggested, firstly, by the fact that growth of the extended money stock M3 was consistent with the growth of production potential; this puts the target overshooting of M3 into perspective. Secondly, the strong increase in special savings facilities and the simultaneous weakness of monetary capital formation point to the great importance of domestic non-banks' asset formation behaviour in the buoyancy of monetary growth last year. A considerable part of monetary expansion is likely to be attributable to the store of value function rather than to the transaction function of money. Finally, growth of the money stock M3 does not seem to be inappropriate in the medium term. Between the fourth quarter of 1993 and the fourth quarter of 1996 the money stock M3 rose at an annual rate of almost 5 ½ %. On the basis of these observations, the Bundesbank came to the conclusion that the failure to meet the 1996 monetary target should not be identified with any risk of inflation.

Adherence to the strategy of monetary targeting

Despite the higher volatility of monetary growth, which increases the need for interpretation and explanation of monetary developments, monetary targeting remains a suitable basis for the Bundesbank's monetary policy. Monetary targeting continues to be based on empirical evidence. Most economic studies find that long-term demand for money in Germany is still sufficiently stable. The medium-term strategy of monetary targeting, which assumes that there is a longer-term link between the money stock and prices, therefore remains a suitable anchor for the Bundesbank's policy, which is aimed at maintaining price stability. Moreover, the strategy of monetary targeting has a number of advantages which are of major importance for conducting monetary policy. By announcing the monetary target, the central bank informs the general public, economic policy decision makers and financial market players of the monetary policy stance that is planned. It thereby facilitates the formation of expectations and the anchoring of inflation expectations at the level it envisages. Moreover, published monetary targets impose a self-commitment on the central bank. They have a disciplinary effect because the central bank has to justify departures from the target path. Finally, monetary targeting permits a clear-cut division of responsibilities. The central bank assumes responsibility for the monetary conditions determining the medium-term trend of inflation, but not for fiscal or wage policy decisions which affect price performance in the short term.

The Bundesbank has never seen monetary targeting as a mechanistic "autopilot" system. Rather, since adopting a strategy of monetary targeting in 1975, it

High degree of adaptability of the monetary targeting strategy

has always pursued a course which has sometimes been rightly termed "pragmatic monetarism". The remarkable success of German monetary policy – measured in terms of the degree of price stability achieved – probably owes a great deal not only to the Bundesbank's loyalty to its strategy but also to the flexible handling of this strategy given changing underlying conditions. In view of the large swings in monetary growth, the Bundesbank is currently paying particular attention to the analysis and assessment of the factors underlying monetary expansion. Moreover, it has shifted the focus more to medium-term monetary expansion. Finally, as in the past, its interest rate policy takes into account not only the money stock but also the entire monetary policy setting. On the basis of a broad range of information, it tries to obtain as precise a picture of the medium-term inflation outlook as possible and to examine the signals given by monetary developments using other indicators. In this comprehensive approach, the money stock M3 continues to be the central starting point for the internal analysis and public presentation of monetary policy.

Strategy of monetary targeting in 1997-8

The Central Bank Council therefore decided in December last year to abide by its strategy of monetary targeting up to the envisaged start of European economic and monetary union (EMU). In line with this decision, the money stock M3 is to grow by an annual rate of about 5 % in the course of 1997 and 1998. The Central Bank Council additionally set a target corridor of 3½ % to 6½ % for 1997. When deriving the monetary target, an average annual growth rate of just over 2 % was envisaged for all-German real production potential in 1997 and 1998. This is slightly higher than the increase in 1996. The medium-term price assumption was set at 1½ % to 2 %. By making this slight reduction the Bundesbank is responding to the continued progress in price stabilisation and the continuing favourable outlook for prices. Finally, an addition of one percentage point – a figure which has been used since 1993 – was made for the trend decline in the velocity of circulation of money.

Extension of the time horizon to two years

By extending the time horizon of monetary targeting to two years – and thus to the probable "remaining life of the D-Mark" – the Bundesbank is taking account, in particular, of the changed underlying conditions in the run-up to the third stage of EMU. Uncertainties in the financial and foreign exchange markets may increase, above all, in the so-called interim period, which will begin in the spring of 1998 with the decision on the participants in the third stage of EMU and will end with the start of EMU on January 1, 1999. Against that backdrop a clear and ambitious monetary target is chiefly intended to create confidence in the continuation of a stability-oriented policy stance. Furthermore, the two-year target could serve as a kind of reference variable for a closer coordination of monetary policy, which might be necessary in the interim period. Finally, the expansion of the time horizon in response to the present situation creates the conditions that will allow the European Central Bank to carry on as smoothly as possible from the Bundesbank's policy of monetary targeting.

Target corridor for 1997

The two-year target of about 5 % in the course of both 1997 and 1998 gives a clear stability signal. In the shorter run, however, it does not settle the question of the range within which the Bundesbank feels monetary growth to be tolerable. The Bundesbank therefore supplemented the two-year target by a target cone of between 3 ½ % and 6 ½ % for 1997. At the end of 1997 it will specify the monetary target for 1998. The corridor for 1997 has been slightly lowered in comparison with 1996 in line with the overall benchmark figures underlying the derivation of the target and the initial base. The widening of the target corridor to 3 percentage points in 1996 was retained in view of the higher volatility of shorter-term monetary growth, which is likely to continue.

Difficult start to the new target period

Entry to the new target period was difficult. One reason for this was a large statistical "overhang" at the end of the year. Other factors included sluggish monetary capital formation as a result of the low level of capital market rates and a rather high volatility in the bond market, and heavy public sector borrowing from banks at the beginning of the year. In February, the money stock M3 exceeded its level in the fourth quarter of 1996 by 2.2 %, or an annual rate of 9.1%. Since the fourth quarter of 1995 it has risen at an annual rate of 8.3 %. In the first few months of each year, the Bundesbank uses a comparison with the basis of the preceding year's monetary target as an additional reference variable for assessing monetary developments in order to reduce problems of interpretation caused by the changeover from the old to the new basis of the monetary target.

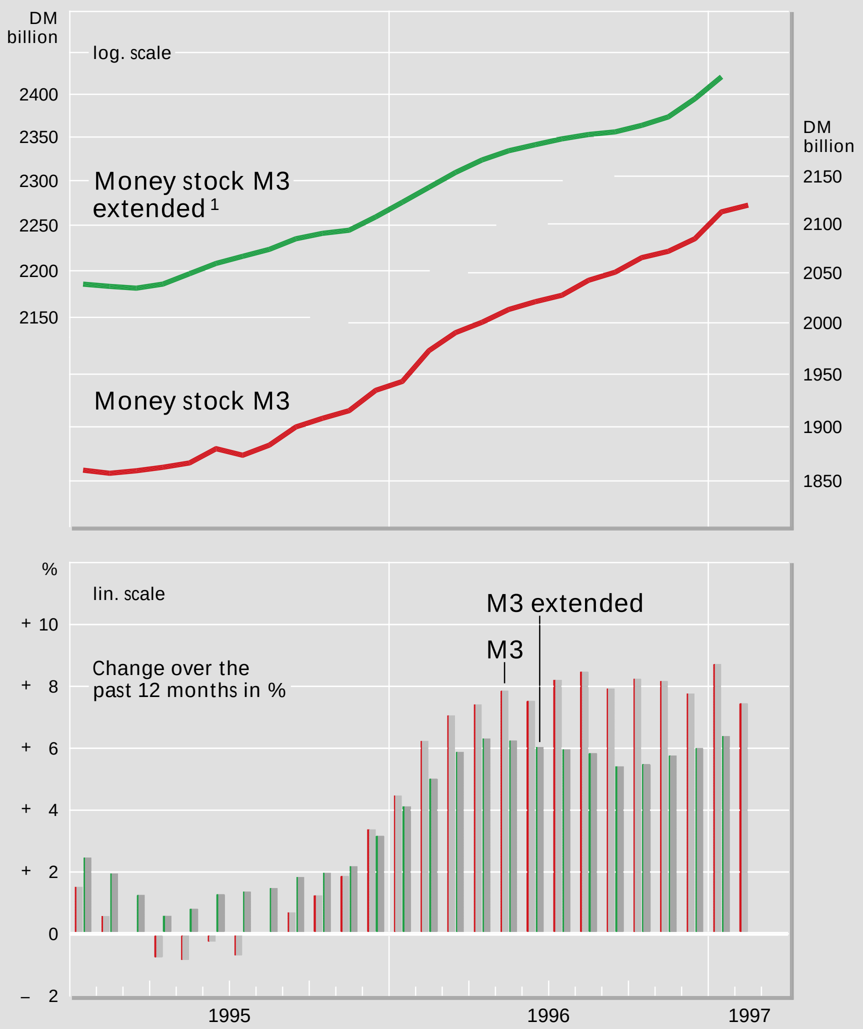
(c) Determinants of monetary growth

Weak monetary capital formation

As mentioned above, the buoyancy of monetary growth last year owed a great deal to domestic non-banks' low propensity to acquire longer-term financial assets at banks. Notably in the first quarter of 1996, when capital market rates and the volatility in the bond market temporarily increased, monetary capital formation was exceptionally weak. After fears of a reversal in interest rate movements in the capital market had disappeared, it normalised somewhat but remained generally subdued. In 1996 as a whole monetary capital at banks in-

Growth of the monetary aggregates

Chart 15



1 Derived from two end-of-month levels.

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creased by just over 4½% or DM 121 billion, and thus considerably less than in 1995 (over 7½% or DM 182 billion). Domestic non-banks' reluctance to lock in funds at banks at longer term was probably mainly due to the low level of long-term interest rates. Uncertainties surrounding the third stage of EMU may also have played a part.

Structure of monetary capital formation

The focus of investors' interest last year was on long-term time deposits (DM 69 billion); these include price-risk-free registered bank debt securities which are bought primarily by institutional investors. Credit institutions received DM 45½ billion from sales of bank debt securities to domestic non-banks. Holdings of bank savings bonds remained virtually unchanged and savings deposits at over three months' notice were reduced sharply (– DM 20 billion). In the final analysis, the structure of monetary capital formation also suggests that households shifted funds intended for longer-term investment into formally short-term savings deposits on a major scale.

Lending to the private sector continues at a high level

Lending to the private sector remained at a fairly high level in 1996. Lending to domestic enterprises and households increased by DM 254 billion or 7 ½ %, compared with 7 % or DM 223 billion in 1995. Compared with the first few years following German unification, credit expansion thus continued to normalise but – given the slackness of business activity – was by no means weak.

Housing loans well to the fore

Over one-half of direct lending was accounted for by housing loans. Lending for this purpose expanded by just under 10 % and thus slightly less than in 1995. The sustained fairly dynamic growth was probably mainly due to the historically low level of mortgage rates and the revision of income tax incentives for the construction of owner-occupied houses which came into effect at the beginning of 1996. Other factors at the end of the year were anticipatory effects caused by the reduction in special depreciation facilities for new rented housing in eastern Germany and the increase in land and buildings transfer tax from January 1997. Statistically recorded consumer credit grew by 5 % last year. This figure is too high, however, since, at the end of the year, loans which were ultimately intended for housing construction and, owing to the lack of time, could not be collateralised and processed as such were probably provisionally booked as consumer credit. Borrowing actually applied to consumption is therefore likely to have been only marginally higher than a year before. Households' propensity to borrow was depressed in particular by the continuing gloomy prospects for income and employment.

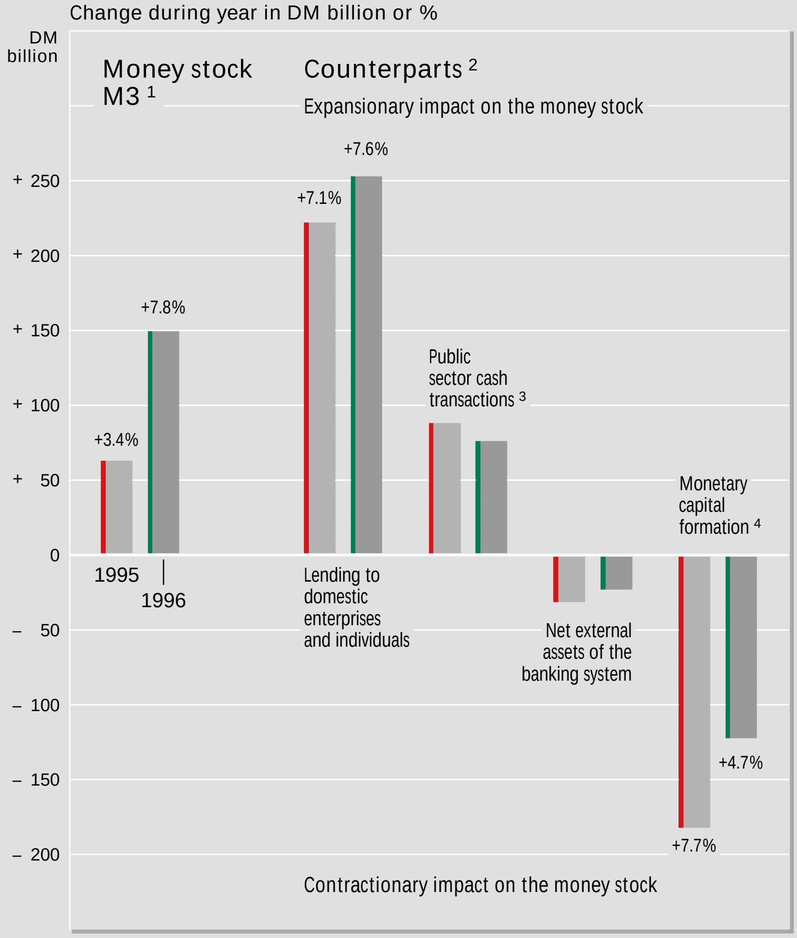
Moderate growth in lending to enterprises

Overall lending to the corporate sector – which grew by just under 6 ½ % – was slightly up on the year, although there were large differences between economic sectors. Borrowing by the services sector (including the professions), whose share in total lending to the corporate sector outstanding now amounts to 50 %, continued to increase markedly. Demand for credit by manufacturing, on the other hand, remained subdued, in line with the weakness of investment activity.

The money stock
and its principal counterparts

Chart 16

Change during year in DM billion or %



1 Calculated on the basis of monthly averages. — 2 Calculated on the basis of end-of-month levels. — 3 Lending by the banking system to the public sector less Federal Government deposits in the banking system. — 4 Monetary capital formation of domestic non-banks at domestic credit institutions.

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Preference for longer-term borrowing

The maturity structure of borrowing shifted its focus slightly last year from short to longer-term loans. While the expansion of longer-term loans was slightly faster than in the previous year, short-term borrowing slackened. This owed something not only to the low level of corporate working fund needs but also to the fact that borrowers consolidated their short-term debt, thus securing very favourable terms for themselves in the long run.

Public sector borrowing from domestic credit institutions in 1996 was virtually on the same large scale as it had been in 1995 and remained fairly strong, at

Sharp fluctuations in public sector demand for bank loans

DM 82 billion and an annual rate of growth of over 7½%, on account of the strained budget situation. It was subject to major fluctuations during the year. Whereas lending to the public sector grew at an annual rate of 15½% in the first four months of the year, it increased at an annual rate of only 2½% in the four months which followed; in the last four months of the year it accelerated again. These swings in the demand for bank credit were chiefly due to the fact that the Federal Government at times met most of its borrowing requirements outside the banking system from domestic private and foreign investors. Altogether, bank lending to the public sector accounted for one-quarter of bank lending to domestic non-banks; on balance, all such lending took the form of direct loans, whereas lending against securities declined slightly.

Smaller outflows of funds generated by external payments

On balance, domestic non-banks' external payments, taken as an isolated factor, had a slightly contractionary impact on monetary growth in 1996. The net external assets of the banking system, a fall in which mirrors outflows of funds generated by domestic non-banks' current and financial transactions with non-residents, decreased by DM 19 billion, compared with a fall of DM 31½ billion in 1995. One factor contributing to the smaller fall was that, given the sustained rise in prices in the German financial markets, foreign investors bought bonds and, in particular, shares on a larger scale than in 1995. During the year non-banks' external payments had a varying impact on the money creation process. Heavy outflows of funds in the first four months of the year stood in contrast to large inflows between May and September, when securities transactions with non-residents resulted in a large positive balance. This not only stimulated monetary expansion but also curbed lending – especially to the public sector. To that extent, the focal point of money creation shifted temporarily from the domestic to the external component. If the net external position and the total volume of credit is combined into the assets-side business of the banking system, this aggregate expanded at a rate of 7% in 1996; this equals the average growth over the last ten years.

5. The value of stable money

Progress towards stability on a broad front

Inflation rates have been on the decline worldwide for a number of years. In the G-7 countries, consumer price inflation fell from an average of 5½% in the eighties to an average of 2½% in 1996. In Germany, where the upturn in prices accelerated considerably in the wake of reunification, it declined from its latest high of just over 5% in 1992 to 1½% in 1996. The last time such a high degree of price stability had been exceeded in Germany was between 1986 and 1988; even compared with the favourable period of 1967-8, when consumer prices increased by an annual rate of about 1½ %, it becomes evident how close Germany has come to meeting the economic objective of price stability. Whereas the stability edge over other countries remained a large one at that time, the international setting is now marked far more strongly by monetary convergence and consistent progress towards low inflation.

Increasing stability awareness

The recognition that sound policies cannot be implemented with bad money has certainly gained ground in many countries, as has the perception that the highest possible degree of stability of the overall price level and institutional arrangements which are conducive to this objective are a prerequisite of lasting employment-promoting growth, and foster social cohesion. This conviction underlies the basic approach to the envisaged European economic and monetary union (EMU), with an independent European Central Bank which is committed, first and foremost, to the goal of price stability.

High degree of price stability instead of deflation

A markedly favourable price climate such as that which has existed for some time in Germany should not be confused with deflation or brought into disrepute by much-exaggerated concern about a general deflationary spiral. An easy price climate does not, however, rule out the possibility of occasional absolute price declines occurring in individual groups of goods or sectors, depending on the flexibility of relative prices. Particularly in periods of an abundant supply in the international markets (above all, the commodity markets) or given a high external value of the domestic currency – as, for instance, in 1995 and 1996 – such price corrections may occur. The same applies to periods of general or sectoral weak demand, when some suppliers – as seen at present in the construction industry, for instance – are prepared to accept price discounts at the expense of their profit margin.

Safeguarding what has been achieved

Taking a different line from the accusation of deflation, some ideas have the intention of trying to aim for an optimum (positive) inflation rate in the first place rather than the stability of the general price level; this approach more or less deliberately attempts to press moderate price increases into the service of promoting growth. Such considerations are based on the general assumption that a "limited qualification" of the goal of price stability is beneficial, or at least unharmful, to the attainment of other objectives, i. e. that it has no disadvantages compared with a stricter yardstick of price stability. An accommodating monetary policy and "a little more inflation" are regarded at least as tolerable in some quarters, precisely at times when a high degree of price stability has been achieved – especially if other economic policy objectives, such as adequate economic growth or a high level of employment, are not being met and therefore become the focus of attention. This attitude is consistent with the constantly recurring behavioural pattern of an objective – once it has been achieved – coming to be taken for granted after a while and being less and less appreciated. Bearing that in mind, it seems appropriate to place greater analytical emphasis on the value of stable money and – as is likewise the intention of this section – to put it in a broader perspective.

Problems involved in measuring prices

References to possible measuring errors in the price statistics are suitable only to a limited extent as an indication that the stability standards should be lowered, and only after thorough consideration of all the factors involved. This does not imply that such statistical inaccuracies in period-to-period price comparisons may be disregarded. In a market economy, the prices of goods are constantly changing to differing degrees and in differing directions. Flexible prices are actually a characteristic feature of dynamic economies. It is precisely this constant adjustment of relative prices which ensures that the markets operate efficiently. If only the relative prices change in accordance with supply and demand, the domestic price level, or – to put it in simple terms – the weighted average of individual prices, will remain stable; if, on the other hand, the average price level goes up over several periods, one generally speaks of inflation in the sense of a sustained reduction in the purchasing power of money, which in turn, of course, exerts an impact on supply and demand in the goods, financial and factor markets and on their efficiency.

Selection of the basket of goods

In line with the above, an index used to measure price stability must include or capture the prices of as large a number of goods as possible. The general public and policy makers – not only in Germany, but also in other countries – regard changes in the consumer price index as the key indicator of inflation and of the movement of the purchasing power of money. The German consumer price index summarises the prices of a broad range of selected goods and services (about 450,000 individual prices of around 750 items), which are considered to be representative of the purchases of consumers in a specified base period (currently 1991). The prices of the goods are collected every month from the same reporting agencies and the basic price rates weighted with the expenditure shares of the base year (fixed weighting pattern). The consumer price index captures only part of domestic price movements, but, in addition to its early availability, it does have the advantage of measuring the rise in the prices of those goods which are used for consumption, the ultimate object of all economic activity.

Problems involved in the weighting pattern

A price index with a fixed weighting pattern, such as is generally used, will, however, become less representative, the longer it is used, if the buying habits of consumers change. Consumers, for example, generally respond to relative price changes, particularly if these should turn out to be permanent. Demand for goods that have become more expensive typically declines; at least some of these goods are replaced by other, lower-priced products. As the consumer price index retains the consumption quantities of the base period for some length of time, goods whose prices have risen tend to be included at overly heavy weights over time when measuring inflation. The measuring of prices may also be distorted if discounts are increasingly granted or new market channels or buying facilities arise, unless price monitoring takes these changes into account. Furthermore, experience has shown that it is difficult to estimate the price equivalent of quality changes, no matter whether these are improvements or deteriorations.[1]

Statistical margin of uncertainty

For these reasons, in Germany the basket of goods used for computing the consumer price index is, as a rule, revised every five years. This revision not only takes account of changed consumption structures but also includes a review of the product selection. This is to keep the error in measuring inflation within narrow bounds. However, even a new basket of goods, when being introduced, is generally based on statistical surveys of consumer habits applying a considerable time before; extensive current family budgets provide major indications of whether the weighting pattern is up to date. It is mainly because of such statistical uncertainties that the Bank considers the goal of price stability to have been virtually reached even if an inflation rate of between 0 % and 2 % is measured.

Questionable cost arguments

It is often argued, against the advantages of a stable price level, that the cost of disinflation (i. e. of output and employment losses in the course of reducing inflation) is excessive.[2] This objection, which is currently the subject of lively debate, notably in the United States, basically oversimplifies matters.

1 For the problems posed by intertemporal price measurement, see also the report of the Advisory Commission to Study the Consumer Price Index set up by the Senate Finance Committee: "Toward a More Accurate Measure of the Cost of Living", Washington 1996.
2 See, for example, Akerlof, G.A., Dickens, W.T., Perry, G.L., The Macroeconomics of Low Inflation, Brookings Papers on Economic Activity, 1/1996, pages 1–59.

Firstly, distortions which may be caused by time lags in wage and price adjustments are not of a permanent nature, and, secondly, they should not be considered *a priori* as a fixed cost. It should also be borne in mind that inflation expectations, in particular, often lead to misallocations and additional costs. Furthermore, inflation expectations are all the easier to correct the sooner inflationary undesirable developments are counteracted, and the more convincing the stabilisation strategy and support from other policy areas prove to be.

Exploitation of money illusion?

Conversely, the exploitation of money illusion will, at most, be able to produce a short-lived economic upturn, as it cannot be assumed that there is a permanent and stable trade-off between the level of the inflation rate and the employment level. Using monetary policy to cover up structural distortions and bring about low real interest rates and real wage adjustments remains a fruitless endeavour. The errors of such a policy include the failure to make a distinction between money and capital, between liquidity and savings, or between transitory and permanent effects. As a result, the capacity of economic policy measures to control real processes is overrated and the problem of the controllability of inflationary processes set in motion underrated.

Equally unconvincing is the statement that a more or less distinct positive inflation rate is required to leave the central bank the option of using negative real interest rates to stimulate domestic demand if the cyclical conditions so require. Since the level of nominal interest rates must be positive or, in an extreme case, its lower limit is zero, that, so it is claimed, would also be the limit for the level of real interest rates in the event of price stability. Monetary policy would therefore lose any influence if the economy were facing a particularly dangerous situation.

This argument is invalid, however, since the central bank at all times retains the option of bringing about any desirable change in the money stock or liquidity by purchasing assets (securities, foreign exchange). On the other hand, the fundamental question arises of whether the central bank should assume such a responsibility for business cycle policy and rely on a “stop and go” policy. In the past, this often put an unduly heavy strain on monetary policy. An over-expansive interest rate policy frequently laid the foundation of a new surge in inflation which then had to be counteracted with interest rates that were all the higher. Negative real interest rates are unlikely to be conducive to a stabilisation strategy geared to the medium term.

Benefits of price stability ...

The benefits of price stability, on the other hand, can scarcely be overestimated, especially as these are, in principle, unlimited in duration and accrue year after year. This also applies in comparison with a low inflation rate when a further reduction is sometimes regarded as not being worthwhile.[1]

... saving scarce resources

One of these benefits is that scarce resources which are used to circumvent the effects of inflation can be saved and allocated to more productive purposes. Such costs are incurred even if a given inflation rate is fully anticipated by all economic agents and taken into account in their economic transactions. The smallest welfare loss is that which is caused by the economisation of cash holdings since inflation acts as a tax on cash holdings and reduces the utility of money. What is more important in quantitive terms is the expense associated with hedging financial transactions against inflationary risks. To this must be added the cost involved in the ongoing adjustment of prices and contracts.

... alleviating the problem of income distribution

In addition to saving these costs, a stable value of money also avoids the considerable inflation-induced effects on income and wealth distribution which harbour the risk of social conflict. Wage and salary earners and pensioners will, at least temporarily, incur losses because of discrepancies in the timing of price rises, wage increases and pension increases. Experience has shown that the holders of financial assets are particularly severely hit by the erosion of the value of money; their inflation losses are accompanied by corresponding undeserved and purely arbitrary gains accruing to debtors. In an inflationary process it is, in reality, anything but safe to assume that nominal interest rates will, on average, offer full compensation for the devaluation of assets; it is even more doubtful that this will be true of the whole interest rate spectrum. There are many indications that a considerable number of "small savers", in particular, are not fully in a position to protect themselves against inflation-induced financial losses. Indexation, which many see as a solution, gives rise to a number of new questions and problems and, as experience has shown, offers only a very inadequate protection against the social problems caused by an inflation-induced redistribution of wealth.

... reduction of uncertainty

The erosion of the value of money imposes costs on economic agents in the form of greater uncertainty. Rising inflation rates are, as a rule, accompanied by an increasing variability of the rate of inflation; this makes it more difficult to

1 On this general subject, see also the Bank of Canada (ed.), Economic Behaviour and Policy Choice under Price Stability, Proceedings of a Conference held at the Bank of Canada, October 1993.

forecast the future trend in inflation. This increases, in particular, the risk involved in long-term nominal contracts. That may lead to prudent investors using a long-term strategy being prepared to assume this risk only if they receive compensation in the form of a premium included in long-term interest rates. This may be reflected in a higher real rate of interest which, in the final analysis, will result in reduced growth of the capital stock and real incomes.

... prevention of distorted price signals

A rising price level also reduces the informative value of price relations to the extent that they no longer adequately mirror the changes in real supply and demand or make such changes difficult to discern. The distortion of price signals may entail real costs in the form of miscalculations and bad investment, which likewise ultimately imply a loss of wealth and growth.

Even if there is a stable and moderate trend loss of purchasing power – which is anything but easily achieved – a considerable margin of uncertainty may exist about the future price level. This is increasingly the case, the more non-monetary influences (of an asymmetrical or symmetrical nature) cause temporary price shocks. Judging from past experience, the element of uncertainty increases, depending on the growing distance from the price-neutral "zero" line and the width of the planning horizon.

The full advantages of competition are therefore realised only if the price level is stable in the long run; this also counteracts the inclination to gear action solely to short-term performance, promotes a well-balanced financing structure and assures more steady economic growth. Particularly at a time when the need for and advantages of supplementary private old age provisioning are emerging ever more clearly, long-term reliable underlying conditions in the monetary field, especially, are a key precondition for accumulating wealth which is stable in value and yields an attractive real return.

Tax system and value of money

Economically speaking, saving is fundamentally nothing else but a decision to shift consumption into the future. Any assessment of the optimum timing of saving and consumption, or of whether non-consumption is worthwhile at all at present, should take inflation into consideration – even in the absence of uncertainty and money illusion. In a tax system which is based on the nominal value principle, even a fully anticipated and moderate rate in inflation has the effect of an additional tax on investment income and produces considerable wealth losses.[1] The main reason for this is that inflation generally causes the effective tax burden to increase. In addition to "normal" taxation, inflation hence drives a further wedge between the real yield before tax and that after tax.

Real tax burden and the inflation wedge

The complex interaction of the tax system and inflation results, firstly, from what is known as a "cold progression", i.e. from the fact that an income tax scale with rising tax rates imposes an increasingly higher tax burden on the growth of income which is merely due to inflation. Secondly, nominally constant tax exemptions and other deductions from the tax assessment basis are devalued in real terms by the erosion of the value of money, which indirectly triggers a further progression effect. But even in the absence of a progressive tax scale, phantom profits and phantom earnings are taxed in different ways, thereby increasing the real tax burden.

Assuming – using a simple example to illustrate this – a nominal gross return on an investment of 6 % (which, given price stability, coincides with the real yield) and a marginal tax rate of 33 %, the real net return amounts to 4 %. If, at an annual inflation rate of 3 %, the nominal gross return increases to around 9 % in line with the monetary erosion (which, at the tax rate mentioned, is equivalent to a nominal net return of 6 %), no more than 3 % is left after deduction of the inflation rate. This is one-quarter less than with general price stability.

Inflation-induced taxation effects

Detailed computations show that, under the prevailing tax system and given an inflation rate of 3 %, the real return is indeed likely to be reduced on that scale. It should be noted that the reduction is not only due to the effect of taxation on households' investment income cited in the example. The interaction of inflation and taxation reduces profits in the corporate sector as well. The main reason for this is that, in calculating their tax depreciation, enterprises have to use the historical purchase price of the tradeable goods as a basis rather than their replacement cost which rises due to inflation. Inflation therefore reduces the present value of tax depreciation and thereby increases the effective tax burden imposed on corporate profits. This is offset to some extent, however, by the fact that enterprises are allowed to deduct their nominal interest cost (and not just their real equivalent), which in itself reduces the effective tax burden on profits.

1 See Feldstein, M., The Costs and Benefits of Going from Low Inflation to Price Stability, NBER, Working Paper 5469, 1966.

On balance, the inflation-induced net effect on the real return seems to be fairly moderate at first. But, in the final analysis, even seemingly relatively small yield changes produce major effects over the years. Thus one Deutsche Mark locked in at long term and saved for consumption in the period of retirement would, given an inflation rate of 3 % per annum and subject to certain conditions, yield an income which is about one-quarter lower on retirement. Even on a conservative estimate, it can be assumed that this will considerably reduce a saver's real scope for consumption in later retirement. The interaction of taxation and inflation thus results in distortions causing significant welfare losses for the saver even if inflation rates are moderate.

Such distorting effects would be even stronger if current saving were reduced on account of a lower real effective yield. Even on a conservative estimate of the interest elasticity of saving, it should be borne in mind that, over the years, even a slight deceleration in growth may produce an economically significant negative wealth effect in the form of real income losses.[1]

Debt servicing and value of money

Another dynamic aspect occurs in long-term borrowing, as typically encountered in housing construction. A higher nominal interest rate level resulting from a positive inflation rate increases the debt service burden in the initial phase of the occupancy period, even if the original real interest rate level remained unchanged. Inflation here has the effect of an advanced additional real redemption which has been brought forward, and which may cause considerable liquidity problems and strains for the investor. Even if this effect is reversed in the long term with the general price and income trend, higher interest rates which are due purely to inflation are likely to be a major obstacle to investment. Those particularly affected would be small and new enterprises as well as young families with children.

Such intertemporal considerations once again reveal:

The accrual concept

In analysing the effects of inflation, particular importance should be attached to a correct allocation of the partial effects occurring in different periods. It is only then that a complete picture can be obtained of the effects of action which is inconsistent with a policy of low inflation. In this context, accounting on an accrual basis means that the costs and benefits should be allocated to those peri-

1 See also Thornton, D.L., The Costs and Benefits of Price Stability: An Assessment of Howitt's Rule, Federal Reserve Bank of St. Louis Review, March/April 1996, pages 23–28.

ods in which they actually arise. The benefits of inflation, however questionable they may be, would then simultaneously have to be offset against the cost involved in lowering inflation, because the cost of reducing inflation is to be blamed on the preceding inflation. The fact that this is often not recognised must not be used retrospectively as an argument against the goal of zero inflation. Failure to compare the costs and benefits implies the risk of systematically underestimating the importance of price stability after the event.

The government – a winner by inflation?

For that reason, too, the argument that the government stands to benefit from inflation, which is repeatedly cited in this connection, is more than questionable. In the short run and in fiscal terms, the government might see itself as a winner; this assessment is, however, not only false, it also overlooks the fact that the government is a form of organisation which has to serve the community and that such gains are made at the expense of that very same community. Furthermore, the "revenue trick" using the inflation tax will become less productive over time. Finally, there is the objection that any inflationary easing of the government budget restriction would have to be reversed sooner or later (often at the expense of capital spending).

Price stability pays off

Any attempts at qualifying the importance of a high degree of price stability do not stand up to critical scrutiny. Nor is there any reason for playing down potential or effective inflationary risks. Inflation, seen as a continuing erosion of the value of money, implies nothing less than an elementary disruption to the operation of any money economy geared to competition and a high degree of specialisation. In terms of social policy, it is fundamentally the result of unresolved distribution conflicts, in economic terms largely an expression of the violation of the overall budget restriction, and in monetary policy terms the long-run result of a sustained oversupply of money.

The real costs in the form of a combination of reduced economic efficiency, lost employment opportunities, failure to achieve potential material welfare and undesirable or random distribution effects are the economic damage caused by not achieving the goal of stability and what gives rise to social problems in the long term. Stability is and will be the sole genuine seal of approval of a good currency. It is only on this basis that confidence in the monetary system can grow, that millions of efficient exchange transactions can be organised every day in the goods, factor and financial markets and that undisturbed long-term sustainable economic relations can be established. This benefits all, since price stability is a public good, which everyone can use without exception.

Maintain confidence

The confidence which residents as well as non-residents have in a stable currency in turn represents a major social asset yielding a high overall return. Favourable interest rates, a stabilisation of business activity and greater planning security always pay off – in both microeconomic and macroeconomic terms.

For that reason permanently stable money is, at the same time, both allocation and social policy; in this dual function it makes a major contribution to fostering social peace and prosperity. In this very practical sense, price stability is a central constituent pillar of the social market economy.

6. Financial markets heading for record highs

(a) Low capital market rates continue

Capital market yields at all-time low

In 1996 German capital market rates reached an unprecedented low in post-war history. The yield on domestic bonds outstanding hit new all-time lows, both on an annual average and in the course of the year. At the beginning of the year, however, the bond market suffered a setback; in the spring of 1996 yields rose by almost 1 percentage point to 6 % in the wake of the increase in yields in the US bond market. But between the middle of July and the beginning of December the yield on bonds outstanding declined by slightly more than 1 percentage point to approximately 5 %. It fell below this mark for the first time in January 1997 and declined further to 4¾ % by mid-February. Since money market rates also continued to fall, the yield curve remained steep. In the spring of 1997 the German bond market was again influenced more strongly by the short-term interest rate movements in the United States. In the middle of April the yield on bonds outstanding was slightly above 5 %.

International interest rate pattern

The level of German capital market rates remains low by international standards, but there were marked shifts in the international interest rate pattern in 1996. There was a turnaround in the interest rate differential vis-à-vis the United States. While at the beginning of 1996 ten-year US government bonds were still yielding ¼ percentage point less than comparable bonds issued by the Federal Government in Germany, the yield spread of US government bonds over Bunds was recently more than 1 percentage point. By contrast, most European partner countries – especially traditional “high-yielding countries” such as Italy and Spain – experienced a much sharper fall in yields than Germany, with the result that the previously large interest rate differential in Europe contracted significantly. In the spring of 1997, however, it expanded somewhat again.

Favourable stability prospects worldwide

The internationally low interest rate level stems largely from the fact that capital market players currently consider worldwide inflation risks to be low. This is partly due to cyclical factors – especially in Germany and other European countries where economic recovery was rather sluggish in some cases in 1996. However, another reason might be that market players think the risks to price stability are lower in the long term than in the past, partly as a result of the structural changes – such as deregulation measures and increasing international competition – in product and factor markets. This view is often substantiated by referring to the comparatively tension-free growth of the US economy over the past few years. In Europe many countries have finally made considerable progress in budget consolidation as a result of their economic efforts in the run-up to European economic and monetary union (EMU).

Fighting inflation is a permanent task

Despite the successes achieved in fighting inflation, however, it would be premature, if not downright wrong, to assert that inflation has been permanently contained or – as some claim – that it is "dead". In a world of increasingly competitive markets, market imperfections might trigger and reinforce inflationary processes less than before, but in the longer term inflation is a monetary phenomenon. A stability-oriented monetary policy and an expansion of the money stock consistent with an economy's potential therefore remain major preconditions for achieving long-term price stability. If regarded in this light, continued low capital market rates are proof of the success of a monetary policy which is consistently geared to stability. However, the current interest rate pattern also warrants caution. The still relatively steep yield curve in Germany rather suggests that market players are again anticipating a deterioration in the price climate. Furthermore, the fall in international capital market rates is probably a reflection not only of lower inflation expectations but also of declining risk premiums. This applies particularly to some European "high-yielding" countries where the fall in yields is more a reflection of expectations regarding EMU. Against this background, the most important task confronting monetary policy makers is to justify the confidence already shown by financial market players by sticking to a consistent stability course. This includes ensuring that in the run-up to monetary union no doubts emerge from the outset on the strict interpretation of the convergence criteria and the stability orientation of the future European Central Bank.

Capital market rates and economic growth

In view of the low capital market rates the financing terms for investment are favourable. This holds true not only in nominal but also in real terms. The yield on bonds outstanding, adjusted for the current rate of price increases at the consumer level, was 3 ¼ % in the first quarter of 1997 compared with about 4 ½ % during the past 15 years. However, assessing the development of real interest rates is made more difficult by the fact that the expected real interest rate, which determines saving and investment decisions, cannot be measured directly. If one assumes, for example, that the current rate of price increases is lower than long-term inflation expectations, the estimated real interest rate should be even lower. The fact that investment activity has not picked up so far is primarily due to investors' uncertainties about the framework for future labour market, fiscal and social policies. A safe planning environment for investors may only be achieved by economic reforms and not by monetary actionism for its own sake. In the end monetary policy can only support the necessary structural changes effectively by safeguarding a stable monetary framework.

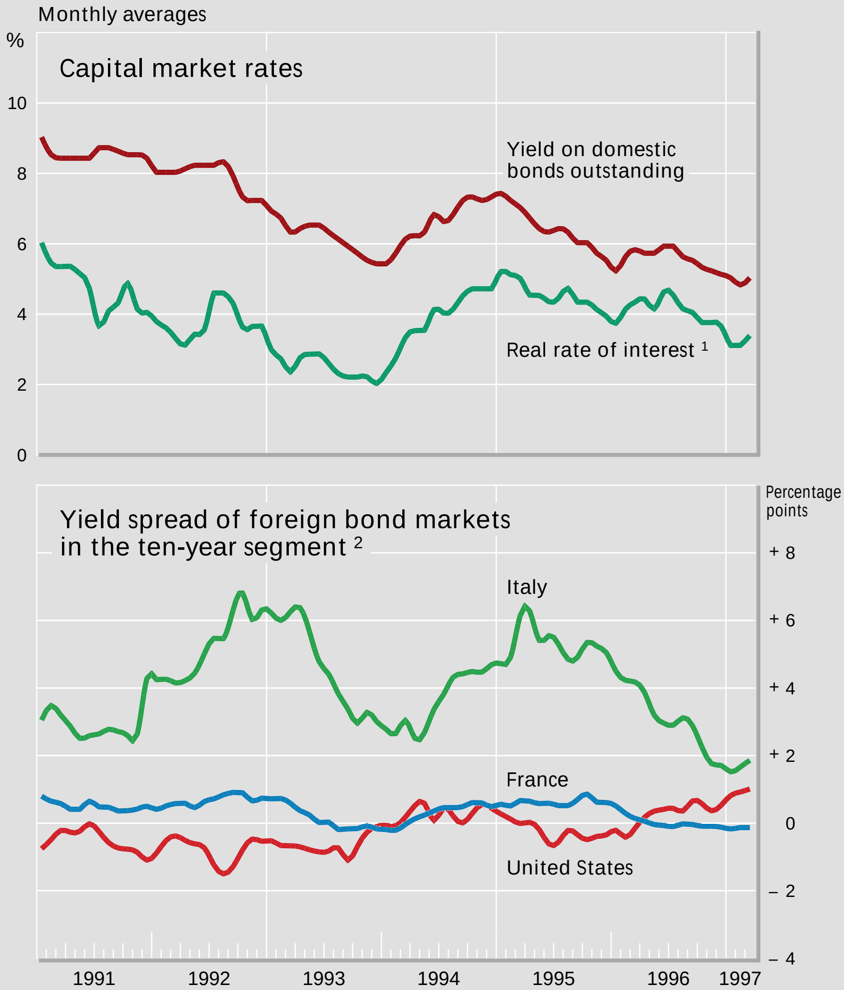
(b) Changes in the bond market

Issuing close to record level

Issuing in the German bond market was very buoyant in 1996; gross sales of domestic bonds reached DM 729 billion (market value), and therefore virtually regained the record level of 1993. Compared with the previous year when gross sales stood at DM 618 ½ billion, this corresponds to a rise of almost 18 %. There was a similar growth rate in the amount raised by sales of domestic bonds. After deducting redemptions and taking account of changes in the issuers' holdings of their own bonds, net sales were DM 233 ½ billion, compared with DM 203 billion in 1995. The bond market expanded its share of the macroeconomic financial flows somewhat. Domestic sectors raised approximately one-fifth of all funds through the issue of bonds. Credit institutions, in particular, increasingly used securitised refinancing, whereas the public sector increased its borrowing in the bond market only slightly. The level of bonds issued by German enterprises in the domestic market is still insignificant. When domestic enterprises do tap the bond market, they do so almost exclusively through financing companies located abroad – and then mostly for tax reasons. Regarding maturities, medium-term securities with maturities between four and six years remained a focus of investment, accounting for about one-third of all issues. The ten-year maturity segment, which has traditionally been strongly represented, suffered in particular from the temporary absence of the Federal Government. Foreign

Interest rate movements in the bond market

Chart 17



1 Yield on domestic bonds outstanding deflated by the current rate of price increases at the consumer level. — 2 Yield differential vis-à-vis domestic Federal bonds of foreign government bonds with a residual maturity of about ten years.

Deutsche Bundesbank

bonds worth DM 21½ billion net were sold in the German bond market in 1996 (compared with DM 24 billion the year before).

Public sector borrowing in the bond market virtually unchanged

At DM 41½ billion net, the level of own bonds issued by the public sector in 1996 was virtually unchanged from a year earlier. Sizeable new issues launched by the Federal Government were accompanied by fairly large redemptions of paper by various public debtors no longer acting as issuers. On balance, bonds of the Federal Post Office worth DM 9½ billion and of the "German Unity" Fund worth DM 9 billion as well as paper issued by the Treuhand agency and by the Federal Railways, worth DM 4½ billion each, were redeemed. The bond market indebtedness of the Federal Government, by contrast, rose by DM 60½ billion net compared with DM 39 billion in 1995. The Länder Governments borrowed DM 3½ billion net in the bond market; several Länder issued a bond jointly for the first time.

Federal Government's issue range expanded

The Federal Government's issue policy in 1996 aimed at further improving the competitiveness of its paper in view of the future single European capital market. Major steps in this direction were the expansion of the issue range by two-year interest-bearing Treasury paper and by Treasury discount paper with a maturity of less than one year (*Bubills*). The Federal Ministry of Finance and the Deutsche Bundesbank agreed that the issue of Treasury discount paper with a maturity of less than one year would amount to a maximum of DM 20 billion both in 1996 and 1997. This took account of the Federal Government's budget policy interests, on the one hand, and of the Bundesbank's fundamental reservations about the increasing short-term orientation in financial operations, on the other. The Federal Government's announcement that, provided the capital market situation allowed it, in future it would support the 30-year maturity segment once a year through a new issue or the reopening of an issue has also to be seen in connection with the rounding-off of its maturity range. Moreover, stripping of certain Federal Government bonds will be possible for the first time from July 1997.

Jumbo mortgage bonds continue to advance

The market for bank bonds continued to grow vigorously in 1996; net sales of this paper reached a record DM 191½ billion (1995: DM 162½ billion). The increase is due almost exclusively to public mortgage bonds where the amount outstanding grew by as much as DM 121 billion. This reflects the large amount of financing still required by public sector debtors. The Länder alone raised almost DM 40 billion net in 1996 through loans against borrowers' notes, which are refinanced through public mortgage bonds. Large-volume issues of this paper (amounting to DM 1 billion or more) continued to be successful; within one year the number of such jumbo mortgage bonds and the amount outstanding more than doubled. Net sales of other bank bonds stabilised at a high level, reaching some DM 54 billion, as in the previous year. The value of mortgage bonds outstanding rose by DM 11½ billion; bonds issued by specialised credit institutions were sold for DM 5 billion net.

The spate of issues in the market for foreign Deutsche Mark bonds continued last year. Overall, non-residents issued bonds denominated in Deutsche Mark to

Sales and purchases of bonds

Table 8

DM billion

Period	Sales				
		Domestic bonds 1			
			of which		
	Total	Total	Bank bonds	Public bonds	Foreign bonds 2
1990	244.8	220.3	136.8	83.6	24.5
1991	232.0	219.3	131.7	87.0	12.6
1992	291.8	284.1	106.9	177.4	7.7
1993	395.1	382.6	151.8	230.6	12.5
1994	303.3	276.1	117.2	158.9	27.3
1995	227.2	203.0	162.5	40.8	24.1
1996	255.2	233.5	191.3	41.5	21.7
1996 1st qtr	74.9	67.1	63.8	3.1	7.8
2nd qtr	60.7	55.9	36.4	19.7	4.8
3rd qtr	57.2	51.7	45.0	6.6	5.5
4th qtr	62.4	58.8	46.2	12.0	3.6
	Purchases				
		Banks (including the Bundesbank) 3	Non-banks 4		
	Total		Total	Domestic bonds	Non-residents 2
1990	244.8	91.8	133.3	121.1	19.8
1991	232.0	45.8	127.3	125.8	58.9
1992	291.8	133.5	37.4	45.6	120.9
1993	395.1	163.1	20.1	23.3	211.9
1994	303.3	125.3	154.7	134.0	23.3
1995	227.2	46.9	94.4	89.3	85.9
1996	255.2	116.5	37.5	40.1	101.2
1996 1st qtr	74.9	44.4	– 0.0	0.3	30.5
2nd qtr	60.7	30.5	15.6	16.0	14.6
3rd qtr	57.2	21.0	8.6	8.4	27.6
4th qtr	62.4	20.6	13.4	15.3	28.5

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

Deutsche Bundesbank

Unabated growth of foreign Deutsche Mark bonds

a nominal value of DM 112 ½ billion (compared with DM 102 ½ billion in 1995). Foreign Deutsche Mark bonds benefited from the strength of the Deutsche Mark, which was still pronounced at the beginning of the year, and, in particular, from the unusually low level of capital market rates. In addition to the typically strongly represented groups of issuers – financing companies of domestic banks and enterprises (DM 26 billion), public authorities of other industrial countries (DM 13 billion) und supra-national organisations (DM 8 billion) – south American and east European issuers likewise used the Deutsche Mark segment of the international capital market to a comparatively large extent in 1996. Favourable factors in this respect were the improved economic situation in most of their countries and investors' search for higher-yielding types of investment. Net sales of foreign Deutsche Mark bonds rose from DM 61 billion to DM 70 billion. At DM 7½ billion, the volume of paper sold in Germany roughly matched the level of the previous year.

Non-banks show little interest in bonds

The dominant feature on the buyers' side of the German bond market in 1996 was the lack of interest shown by domestic non-banks. Purchases of bonds by this group of buyers reached DM 37½ billion, which was less than half the previous year's level of DM 94½ billion. Demand for all bond categories was lower. Whereas non-banks bought bonds issued by German credit institutions worth as much as DM 38 billion net (against DM 73½ billion in 1995), net purchases of public bonds declined from DM 16½ billion to DM 1 billion. Non-banks' holdings of foreign bonds fell by DM 2½ billion. This development is not unusual considering the fact that non-banks' purchases of bonds also declined strongly in the past when capital market rates were below 6%. While private investors seem to consider such a yield unattractive, institutional investors cut back their bond purchases – apart from portfolio-oriented considerations – in order to avoid price losses. This is suggested by the considerable revival in net sales of registered bank bonds in 1996 (DM 51½ billion compared with DM 44 billion). Factors contributing to the restraint observed in entering into long-term investment in the bond market might have been the current interest rate situation as well as the continued discussion about EMU.

Brisk foreign buying continues

Purchases by non-residents in the German bond market continued to increase in 1996. Overall, foreign investors bought bonds of domestic issuers worth DM 101 billion. Interest shifted noticeably from public sector bonds (DM 40½ billion) to bank bonds (DM 61 billion). About two-thirds of those were foreign currency paper of domestic banks, which were often tailored to the specific requirements of various foreign institutional investor groups. Of the bank bonds denominated in Deutsche Mark jumbo mortgage bonds gained ground. Moreover, the new shorter-term issues by the Federal Government were also in great demand from foreign investors. *Bubills* were mostly sold to non-residents (DM 13½ billion) while foreign investors bought just over one-half (DM 10.5 billion) of the newly issued two- year Federal Treasury notes.

Strong bond buying by credit institutions

At DM 116½ billion, the bond holdings of credit institutions rose more than twice as strongly in 1996 as in the year before. Most of those holdings are domestic bank bonds (DM 92½ billion). In view of the preference of non-banks for shorter-term bank deposits and of the steep yield curve, the credit institutions undertook large-scale maturity transformation via the bond market. Especially savings banks and credit cooperatives, whose special savings schemes saw a sharp inflow of funds, bought a large number of the bonds issued by the mortgage banks – which were heavily involved in lending to the public sector – and by the regional giro institutions. The credit institutions' holdings of foreign bonds rose by DM 24½ billion.

(c) Buoyant mood in the equity market

All-time highs against backdrop of international bull markets

Amid the bullish mood on international equity markets and extremely low interest rates the German equity market, too, experienced a whole series of new all-time highs in 1996. The most important driving force behind the stock market rally was initially the improved earnings prospects of enterprises owing to the moderate wage agreements and the continued rationalisation efforts. Although capital market yields had increased temporarily, share prices had risen by almost 9 % by the beginning of June (measured by the composite DAX share price index).[1] With yields beginning to fall in the bond market, the rise in share prices gained momentum from the summer. Towards the end of the year the appreciation of the US dollar against the Deutsche Mark acted as an additional stimulus to share prices. The shares of the chemical and motor industries which export a large percentage of their output and which are thus sensitive to foreign exchange rate fluctuations, benefited, in particular, from this. They considerably outperformed the market with rises in share prices of 61% and 43 %, respectively, in 1996 compared with the market average of + 20 %. Following the continued sharp upward trend until the middle of March 1997, share prices recently exceeded their level at the end of 1995 by 39 %. This rapid rise in share prices mainly represents a process of catching up with other countries – especially the United States where share prices have been rising for several years. On the other hand, the spill-over effects emanating from important international stock markets last year also clearly show the risk that setbacks on foreign equity markets pose for share price trends in the German market. This became evident at the beginning of April when share prices in Germany fell by more than 3 % in one day (as measured by the composite DAX share price index) in the wake of the slump in share prices in the United States.

1 The composite DAX share price index reflects the average share price movement of all ordinary and preference shares of German public limited companies listed on the Frankfurt stock exchange.

Issue activity significantly influenced by Telekom flotation

Issue activity in the German market in 1996 was primarily influenced by the flotation of Deutsche Telekom. The Telekom shares accounted for about two-thirds of the total issue volume of domestic shares, which reached a record DM 34 billion. Apart from Deutsche Telekom, domestic enterprises showed little interest in raising funds through the issue of shares. The number of enterprises that went public, 11 altogether, was actually much lower than in the previous year when 20 enterprises had been floated on the stock exchange. This figure, which is still low by international standards, may be due to the fact that in 1996 a number of potential candidates considered the conditions for going public to be rather unfavourable owing to the Telekom flotation. A comparatively large volume of foreign equities was placed in Germany in 1996 (DM 34½ billion), with portfolio investment accounting for about two-thirds of this. A total of DM 68½ billion was raised in the German equity market, which was much more than in 1995 (DM 46½ billion).

Non-residents again on the buyers' side

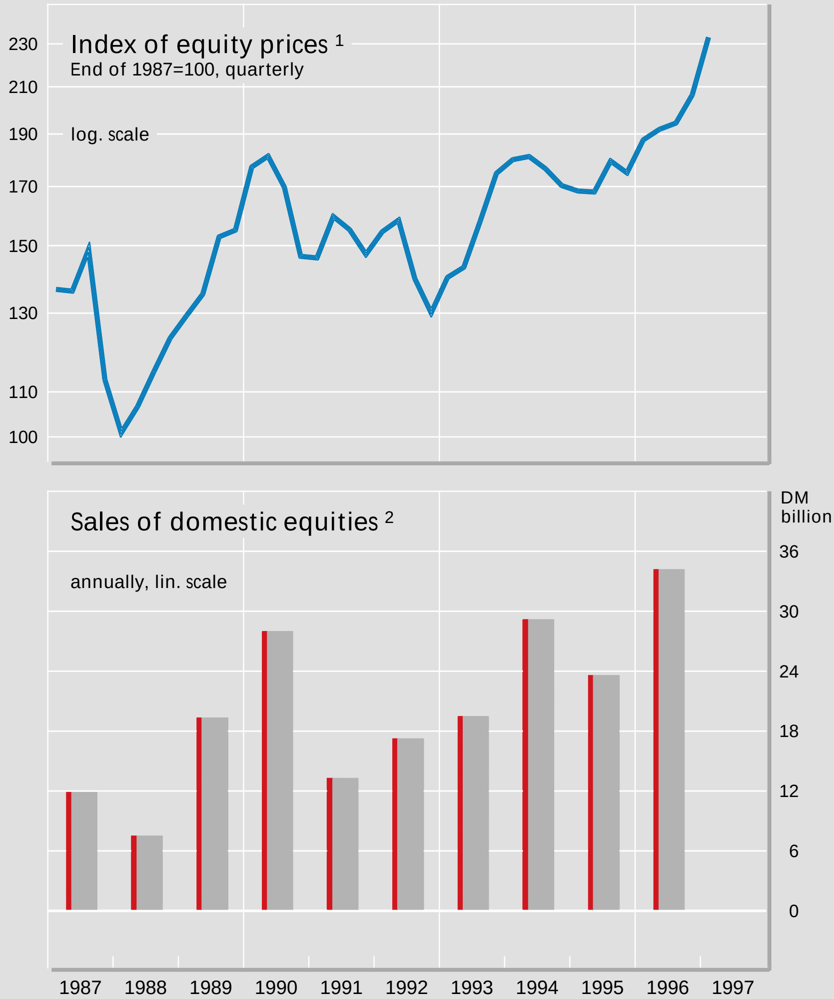
In view of the improved earnings prospects of German enterprises and the bull run on international equity markets foreign investors were strong buyers of German shares last year; they bought domestic equities worth DM 20½ billion net after being net sellers of German equities to the tune of DM 1½ billion in 1995. Most of the buying took place in May and June as well as in November when especially non-residents' purchases of Telekom shares had an effect. At DM 35½ billion, purchases by domestic non-banks reached a similar level to that in the previous year. However, the interest of non-banks focused almost exclusively on foreign shares, while their holdings of German equities rose only slightly. While households' share purchases were fairly high, accounting for about 4 % of private financial asset formation, German institutional investors sold a substantial amount of domestic shares to non-residents. The banks' equity portfolios rose by DM 12½ billion.

Prospects for promoting equity investment

The flotation of Deutsche Telekom had the effect that shares in Germany attracted an unusually high level of public interest, at least temporarily. Sustained efforts will be necessary to transform this interest in the long term into an increased use of shares as an investment and financing instrument, a development which would be desirable from a macroeconomic point of view. The establishment of the *Neuer Markt* (new market) on March 10, 1997 is intended to facilitate stock market listings by improving access to risk capital, especially for young enterprises, through, for example, special disclosure regulations. The acceptibility of shares among the general public ultimately depends on the performance of the investment in addition to the institutional improvements just

Conditions in the equity market

Chart 18



1 Composite DAX share price index of the German Stock Exchange plc; quarterly averages. — 2 At issue prices.

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mentioned. From an economic policy point of view, reforms which strengthen the enterprises' propensity to invest and their profitability therefore indirectly enhance the attractiveness of shares.

(d) Mixed development at investment funds

Sharp growth of specialised funds

The inflow of funds at domestic investment funds rose to DM 79 billion in 1996 (previous year: DM 54 billion). This is solely due to the sharp growth of specialised domestic funds where net inflows, at DM 62 ½ billion, were almost twice as high as in 1995. By investing through specialised funds, institutional investors such as insurance enterprises or pension funds are able to "decouple" securities transactions to a certain extent from their own balance sheet, which is advantageous, for example, with a view to creating valuation reserves. Not least for that reason the bulk of funds normally accrue to mixed funds (1996: DM 38 billion) which offer a broad range of investment possibilities. Of the specialised funds the bond funds and the equity funds sold certificates worth DM 19 billion and DM 6 billion, respectively, in 1996. Specialised funds in the form of money market funds have been rather insignificant hitherto, since their specific advantage – lot size transformation – is only of minor significance for institutional investors.

Stagnation at investment funds open to the general public

Business stagnated at domestic investment funds open to the general public last year; as in 1995, the amount raised was DM 16½ billion. Money market funds, which experienced inflows of DM 6 billion net in 1995, had to redeem fund certificates worth DM 4½ billion net last year. These refluxes are due to the low interest rate level in the money market as well as the growing range of deposit forms which the banks are now offering and which carry rates of interest that are comparatively closely in line with market conditions. Finally, money market fund certificates lost their tax advantages through the abolition of the wealth tax at the beginning of 1997 (investment certificates were only taxed at half the wealth tax rate). The focus of interest was on open-end real estate funds (DM 14 billion) in 1996, which is not unusual in phases of low capital market rates. Bond funds and equity funds sold certificates worth DM 6 billion and DM 1 billion net, respectively. Foreign investment fund certificates worth DM 5 billion were sold in the domestic market in 1996.

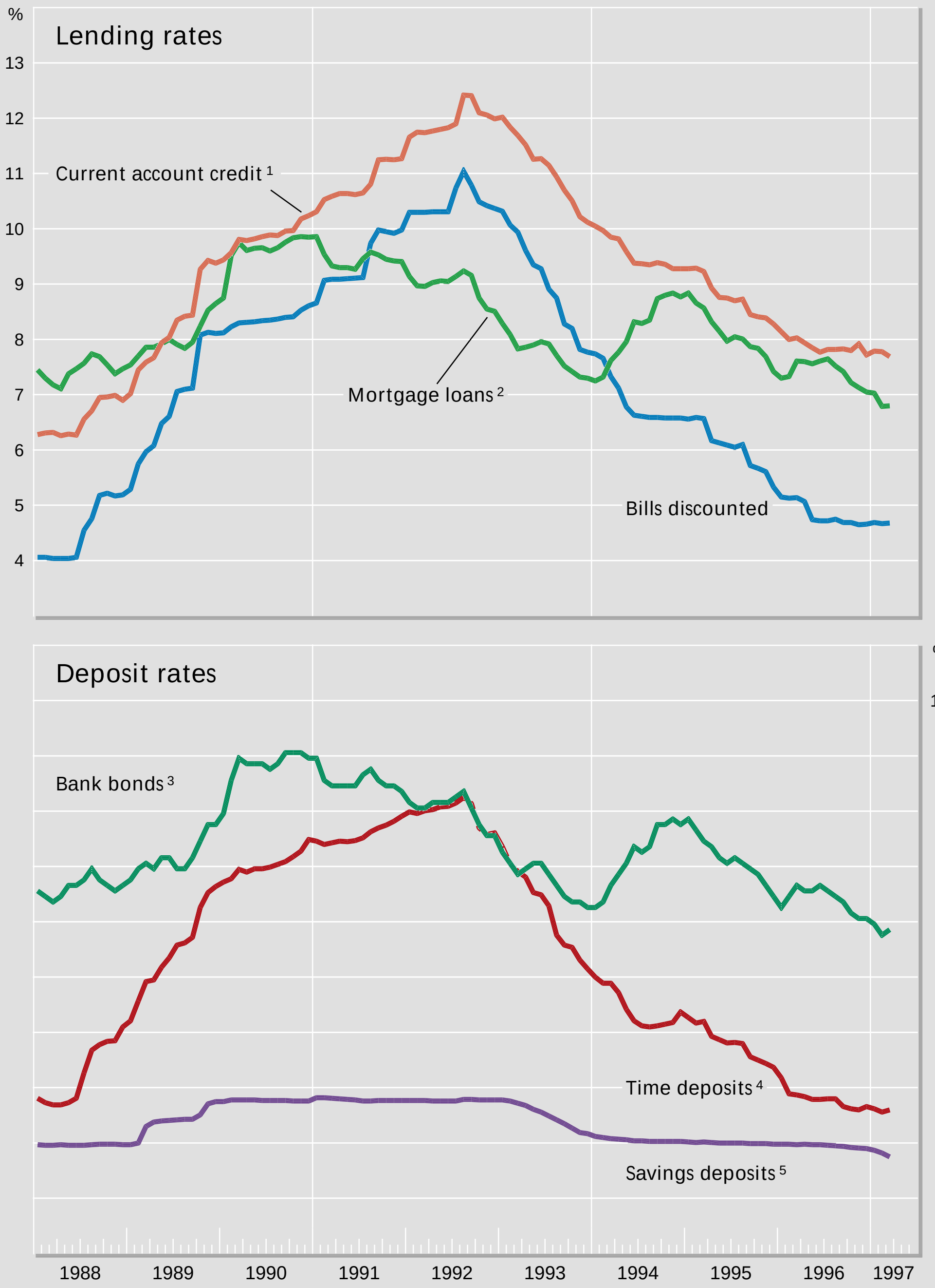
(e) Trends in the banking sector

Bank lending to domestic non-banks

Of the larger categories of banks the mortgage banks and the regional banks were able to increase their market shares in lending last year. Their lending to domestic non-banks rose by 13.8 % and 10.0 %, respectively, which was distinctly above the average rate of increase for all banks (7.6 %). The rapid growth of loans to the public sector was the decisive factor in this development. At the regional giro institutions growth of lending operations (at 7 %) was slightly below average, which was partly due to the discernible slowdown in long-term lending to public authorities. The regional institutions of the credit cooperatives, the big banks and the savings banks moved almost in line, their lending volume increasing by 6.4 %, 6.2 % and 6.0 %, respectively. The sharp rise in their medium and long-term lending to the business sector contrasted with a slower

Movements in selected bank interest rates *

Chart 19



* 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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increase in short-term lending. The credit cooperatives, however, performed less well (+ 4.4 %), since lending to the public sector declined more sharply. The market share of credit institutions with special functions also declined; at + 1.8 %, their lending business was almost stagnant.

Expected trends in earnings

According to the data so far available, the profitability of German credit institutions in the financial year 1996 was probably more or less as satisfactory as in the year before. This was due in particular to the fall in interest rates over the whole maturity range and to the rise in the bond and equity markets; by contrast, strong competitive pressures in deposit business and the high number of insolvencies acted as a squeeze on earnings. The average interest margin is likely to have been somewhat below the 1995 level. A stabilising effect probably came from long-term lending, which offered possibilities of maturity transformation in view of the steep interest rate structure, thus enhancing earnings. In view of developments in the financial markets and the high equity market turnover, the commission result is likely to have developed favourably as well.

Balance sheet structures

The balance sheet structures in the lending business of credit institutions did not change significantly in 1996. The share of interbank lending as a proportion of total business volume increased by 1 percentage point to slightly below 33 %. The share of lending to non-banks correspondingly fell by the same extent to 62 %. On the liabilities side, the share of short-term time deposits up to three months, which had peaked at just over 7 % in 1993, fell again by ¾ percentage point to about 4 %, whereas the share of special savings facilities rose further by ½ percentage point to 8.2 %. After the deregulation of the provisions governing savings at the end of 1993 the share was still as low as 5.8 %. Since that time the share of special savings facilities with a three-month period of notice has roughly doubled from 2.7 % to 5.5 % of total business volume. In the balance sheet of the savings banks and the credit cooperatives, the special savings facilities accounted for slightly more than one-fifth of the respective business volume at the end of 1996. These two banking groups represented about four-fifths of the total volume of special savings facilities at the end of 1996.

III. International monetary policy cooperation

1. Continuing but still insufficient convergence progress on the way to EMU

Further convergence progress in curbing inflation

Participation in the planned European economic and monetary union (EMU) requires a sufficient and sustained degree of common alignment in the commitment of the EU countries to a policy of monetary stability. The advances made towards that goal are measured by the Maastricht Treaty's convergence criteria, which apply to the movements of prices, budget deficits, government debt, exchange rates and long-term interest rates.[1] In 1996 the reference values, which are the gauge for assessing the success of convergence, were met in full only by Finland and Luxembourg. Further progress in curbing inflation was recorded across a broad front, however. Compared with 1992, the year in which the Maastricht Treaty was signed, the average inflation rate of the 15 EU countries had fallen by about half up to the end of 1996. The criterion for assessing whether a country has achieved sufficient price stability is that its rate of inflation must not exceed that of the – at most three – best-performing EU member states by more than 1½ percentage points. If the simple average of the rates of price increases in the three best-performing countries is taken as the reference basis, the inflation criterion was met by ten member states in 1996. In the other five EU countries the upward thrust of prices weakened perceptibly in most cases. What is more, the degree of convergence recorded is now founded on a further harmonised statistical basis. In 1995 only partly harmonised consumer price indices had been available for measuring the year-on-year trend; as a temporary expedient, those items of private consumption whose method of calculation varied most sharply from country to country were omitted from the index calculation. For 1996 a comparison of consumer prices is possible for the first time on a broader basis using largely harmonised methods of calculation. These indices, the coverage of which is to be amplified further in the coming years, permit a more reliable cross-country comparison of price trends in the EU than was the case hitherto.

1 The convergence criteria are defined in article 109j of the EC Treaty (convergence criteria; entry into stage three) in conjunction with the Protocol on the convergence criteria referred to in article 109j and in article 104c (monitoring the budgetary situation in the member states) in conjunction with the Protocol on the excessive deficit procedure.

State of public finance remains unsatisfactory

Advances in reducing excessive budget deficits were likewise made in 1996 in every country except Germany; even so, the current deficit of a majority of the countries exceeded the reference value of 3 % of GDP. The cumulative high budget deficits also led to a rise in six countries in the public debt level relative to the national product. In 1996, as a result, no fewer than 11 countries – including, for the first time, Germany – exceeded the reference value of 60 % of GDP, and in nearly all the states with a declining debt ratio overall indebtedness still exceeded the critical 60 % mark significantly or even massively. In many countries of the European Union, therefore, public finance is still a long way from achieving a sustainable position, as demanded by the Maastricht Treaty, especially as a rise in the current relatively low interest rate level would increase the cost of financing government debt and would partly jeopardise the progress made so far in lowering the level of new borrowing. A lasting consolidation of public finance is not only an essential prerequisite for the launch of EMU, however; it is also crucial for regaining greater freedom for fiscal policy action in the longer term. Irrespective of the planned creation of a single currency, a steady course of fiscal consolidation is urgently required, not least in view of the problems that are becoming increasingly evident in most European countries, owing to the demographic trend, in respect of funding their retirement pension schemes.

Entry of the Finnish markka and the lira into the exchange rate mechanism

The Maastricht Treaty's exchange rate criterion demands that any country wishing to join EMU must have participated in the exchange rate mechanism of the European Monetary System (EMS) in the two years prior to the convergence examination, and that, during this period, its currency has neither been unilaterally devalued nor has been subject to considerable depreciation pressure. Finland and Italy incorporated their currencies into the exchange rate mechanism (ERM) in autumn 1996 (in the case of the lira, this meant re-entry after four years of floating). The central rates of both were fixed close to the market level. However, this institutional consolidation of the EMS contrasted with temporary fluctuations and tensions in the exchange rate mechanism during which some currencies tended to strengthen against the Deutsche Mark. Although most partner currencies rose only a little or not at all against the Deutsche Mark, the temporary upward thrust of certain currencies led to a substantial increase in the foreign exchange reserves of the countries concerned. In addition, the Irish pound witnessed an exceptional development. After the Irish currency had already firmed appreciably from the end of 1995 against all other ERM currencies, a dramatic upward trend began in August 1996 which carried the punt way above its central rate level. This increase was due at least partly to the concur-

Progress in convergence as measured by the EMU criteria (disregarding the exchange rate criterion)

Table 9

EMU threshold value met

Country	Change in consumer prices from previous year in % – Partly harmonised index 1995	Partly harmonised index 1996	Harmonised index 1 1996	Financial balance of the public sector as % of GDP 1995	Financial balance of the public sector as % of GDP 1996
EMU threshold value 3	2.7	2.6	2.5	– 3	– 3
Austria	2.0	1.9	1.8	– 5.3	– 3.9
Belgium	1.4	2.0	1.8	– 4.1	– 3.4
Denmark	2.3	2.3	1.9	– 1.9	– 1.7
Finland	1.0	1.2	1.0	– 5.1	– 2.6
France	1.7	2.1	2.1	– 4.8	– 4.1
Germany	1.5	1.3	1.2	– 3.5	– 3.8
Greece	9.0	8.2	7.9	– 9.2	– 7.4
Ireland	2.4	2.1	2.1	– 2.0	– 0.9
Italy	5.4	3.9	4.0	– 7.1	– 6.8
Luxembourg	1.9	1.5	1.2	1.7	1.4
Netherlands	1.1	1.5	1.5	– 4.0	– 2.4
Portugal	3.8	2.9	2.9	– 6.0	– 4.1
Spain	4.7	3.5	3.6	– 6.6	– 4.4
Sweden	2.9	0.9	0.8	– 7.7	– 3.6
United Kingdom	3.1	3.0	3.0	– 5.8	– 4.8

Country	Yield on long-term public bonds in % 1995	Yield on long-term public bonds in % 1996	Gross government debt as % of GDP 2 1995	Gross government debt as % of GDP 2 1996
EMU threshold value 3	9.7	9.1	60	60
Austria	7.1	6.3	69.3	69.8
Belgium	7.5	6.5	133.5	130.0
Denmark	8.3	7.2	72.1	70.2
Finland	8.8	7.1	58.8	58.8
France	7.5	6.3	52.8	56.2
Germany	6.9	6.2	58.1	60.7
Greece	17.4	14.8	111.8	111.8
Ireland	8.3	7.3	81.5	72.8
Italy	12.2	9.4	124.4	123.6
Luxembourg	7.2	6.3	5.9	6.4
Netherlands	6.9	6.2	79.6	78.5
Portugal	11.5	8.6	66.6	65.8
Spain	11.3	8.7	65.7	70.3
Sweden	10.2	8.0	78.2	77.7
United Kingdom	8.3	7.9	54.2	56.3

Sources: European Commission, BIS, EMI, EUROSTAT and national statistics. — **1** Partly harmonised index for Ireland and the United Kingdom since harmonised inflation rates are not available for 1996. — **2** As defined in the national accounts (including social security funds). — **3** The rate of inflation must not exceed that of the – at most three – best-performing countries in terms of price stability by more than 1½ percentage points. The yield on long-term public bonds must not exceed that of the – at most three – best-performing countries in terms of price stability by more than 2 percentage points. The threshold values listed here for the inflation rate and the yield relate to the unweighted average of the three best-performing countries in terms of price stability. In this table, fulfilment of the criteria is measured in terms of these threshold values.

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rent exchange rate gains of the pound sterling, which does not belong to the exchange rate mechanism, owing to the fact that Ireland has very close economic links with the United Kingdom and that the Irish economy is growing vigourously.

Narrowing of the interest rate differential markedly reinforced by speculative bond purchases

Long-term interest rates, which, on the one hand, give an indication of how market participants assess each country's stability policy prospects and, on the other hand, partly also reflect speculation about which countries will qualify for EMU, fell further in 1996 in virtually every EU state and in the process moved very close to German interest rates, which likewise declined. According to the Maastricht Treaty, a country's interest rate level meets the convergence criterion if it does not exceed the long-term interest rates in the – at most three – Community countries with the lowest inflation rates by more than 2 percentage points. If, as in the case of the inflation criterion, all three countries with the lowest rates of price increases are taken as the basis for calculating the reference value, the interest rate criterion was met in 1996 by all countries, apart from Italy and Greece. This advance towards convergence reflects both the success in combating inflation and the renewed efforts to cut budget deficits. However, this advance was evidently also based on the expectation that EMU will start on time and with a large group of participating countries. Market participants thus invested in debt securities of EMU candidates with relatively high interest rates in order to profit from the process of interest rate convergence through rising securities prices (convergence trades). In order to pre-empt the danger, as far as possible, of major reverses in their interest rate and exchange rate trends should such expectations be disappointed, the countries in question ought to concentrate on convincingly pursuing a policy that is geared lastingly to stability. It should also be noted that the present high degree of interest rate convergence is overstated somewhat by the calculation of the reference value according to the method specified in the Maastricht Treaty, as the interest rate level in one of the three best-performing countries in terms of price stability (Sweden) is stilll fairly high.

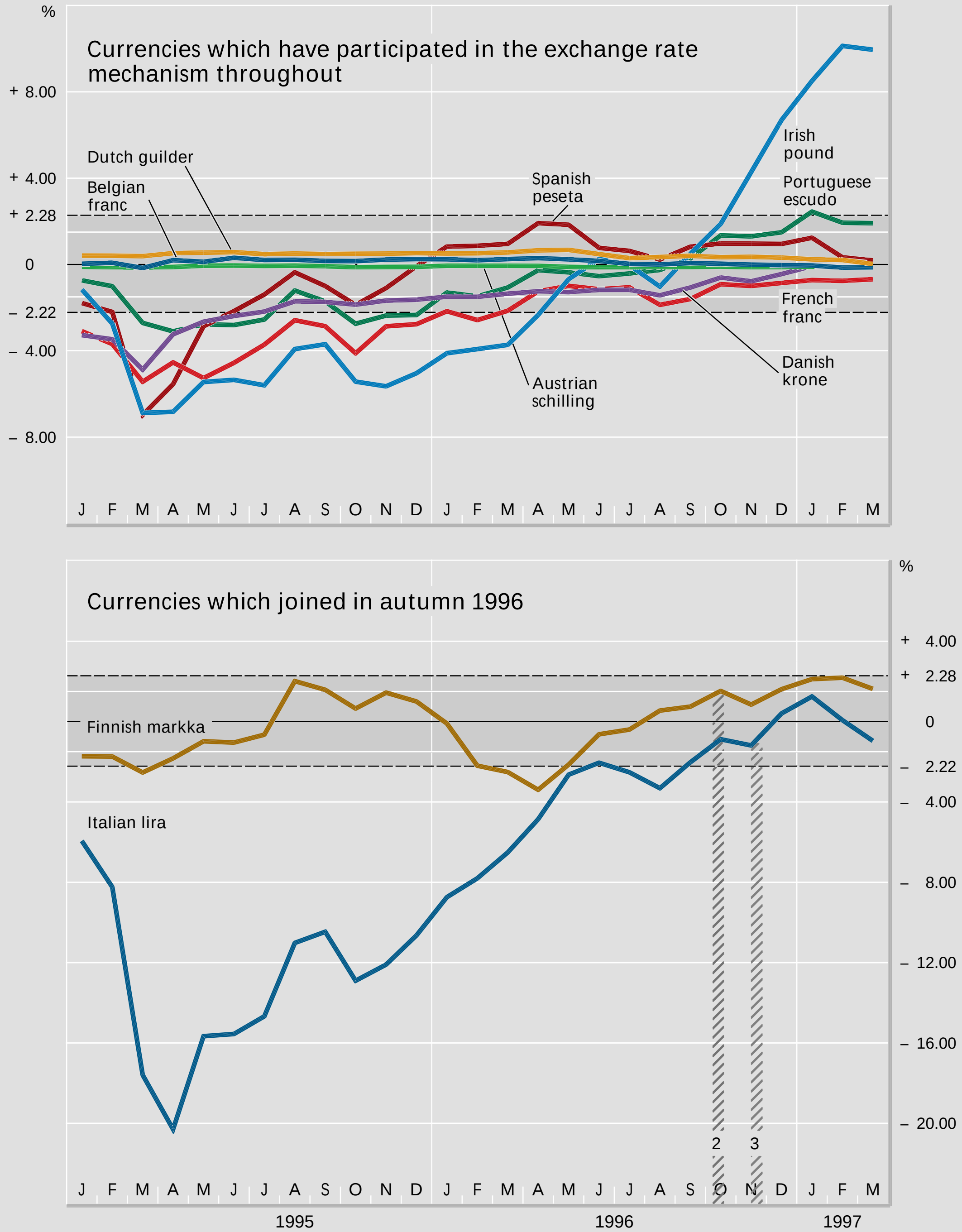
Independence of the national central banks not yet implemented comprehensively

In addition to requiring candidates for EMU to meet the convergence criteria, the Maastricht Treaty also stipulates that the country concerned must have ensured the independence of its central bank by the time the eligibility examination is made, at the latest. This independence has to be safeguarded in institutional, staffing, functional and financial respects (in this context, functional independence means, above all, that the central bank must be primarily committed

Movements of currencies participating in the EMS exchange rate mechanism against the Deutsche Mark

Chart 20

Deviations from the central rate of the Deutsche Mark in %, monthly averages 1



1 Depiction of the narrow fluctuation margin (± 2¼%) for the period subsequent to its widening to ±15% in July 1993 serves merely to facilitate assessment of exchange rate movements. — 2 Joined the exchange rate mechanism with effect from October 18, 1996. — 3 Rejoined the exchange rate mechanism with effect from November 25, 1996.

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to the objective of price stability). Despite some progress, a number of countries still have an adjustment need.

Insufficient convergence progress officially noted by the European Council

The Maastricht Treaty provided for the possible launch of EMU as early as in 1997 if a majority of the member states fulfilled the convergence criteria in time. To this end it stipulated that a convergence examination was to be carried out by the end of 1996 at the latest. In line with this, the European Council concluded in December 1996, based on the convergence reports produced by the European Monetary Institute (EMI) and by the Commission, that the prerequisites necessary for introducing a European currency had not yet been established and that, consequently, EMU is to begin only at the start of 1999. The necessary convergence examination will be conducted at the beginning of 1998 on the basis of the actual data for 1997.

Convergence criteria must be met on a lasting basis

In the interests of providing a sound basis for EMU, the stability policy efforts being made by the member states with a view to passing the forthcoming convergence examination must be oriented towards achieving lasting convergence success. This principle of sustained stability, which is enshrined in the Maastricht Treaty, has attracted increasing attention since the past year after fiscal policy tendencies towards "creative accounting" became apparent in several countries. The European Council therefore emphasised in Dublin in December 1996 that, when making its convergence examination, it will take account of the extent to which an improvement in public finance in a given country may be attributable to measures which have a merely transitory impact. The Commission, in its Annual Economic Report for 1997, has meanwhile likewise expressed this view. It stresses that in 1998, when the decision is to be made on which countries meet the convergence criteria, close scrutiny will have to be given to the extent to which one-off measures taken by individual countries have been supplemented by lasting improvements in their budgetary position.

2. Institutional preparations for EMU

Preliminary decisions on many key issues

At its meeting in Dublin in December 1996, the European Council reached conclusions concerning the legal framework for the use of the euro, the stability and growth pact and the future exchange rate mechanism which are of major importance for the timely implementation of stage three of EMU. Under the current Dutch Presidency of the EU, those conclusions are to be translated into formal legal texts before the Amsterdam summit in June 1997. At the same time, the EMI Council took some key preliminary decisions regarding the strategy and instruments of monetary policy. It also selected the designs for the future European banknotes. By contrast, little progress has been made so far towards developing the European Union further in political and institutional terms.

(a) Legal framework for the euro under Community law

Euro to be introduced in place of the national currencies but initially use not compulsory

The European Council meeting in Dublin considered two draft Council regulations of the Community covering the legal framework for the euro. The draft regulation containing the central monetary and conversion provisions for the adoption of the euro by the participating countries is based on article 109 l (4) sentence 3 of the EC Treaty. This foresees that, on the launch of monetary union, the euro is to be introduced in place of the currencies of the participating member states, i.e. in Germany in place of the Deutsche Mark. For a transitional period of three years, however, the national currency units are deemed to be subunits of the euro. For the rest, the replacement of the national currencies by the euro will have neither legal nor practical consequences during the transitional period for the continued use of the national currency units, for example, in laws and contracts. Although, during this changeover phase, anyone is free to agree on the use of the euro, no one is to be compelled against his volition to use the euro instead of the Deutsche Mark. Only at the end of the transitional period will all national currency units be replaced by the euro by force of law.

National banknotes and coins remain legal tender for the time being

For the duration of this transitional period, the national banknotes and coins will be the sole legal tender. Monetary tokens denominated in euro will not yet be available during this phase. The German view is that the introduction of European banknotes and coins should coincide as closely as possible with the abolition of the national currency units. However, no final date has yet been agreed for the introduction of euro notes and coins.

Principle of general conversion at the end of the transitional period applies to the public sector, too

The general rules according to which the national currency units basically need not be converted until the end of the transitional period apply fundamentally to the public sector as well, i.e. notably to all public authorities and government agencies. However, at variance with the principle that no one is to be compelled to use the euro instead of the national currency, participating countries are to be free to decide whether to convert their existing debt earlier. The same applies to the use of the euro in certain regulated markets, i.e. in particular for stock market quotations, and in payment systems. In these areas, too, a switch-over to the euro before the end of the transitional period would be permissible. Any other binding conversion measures before the termination of the transitional period will require corresponding agreements at Community level.

Whether public sector in Germany will permit use of the euro already during transitional period not yet clarified

One question that has not yet been clarified is the extent to which the German public sector will permit the use of the euro during the transitional period alongside the Deutsche Mark as the principal currency. Individuals and business enterprises alike can choose, by mutual consent, to conclude contracts during the transitional period in euros. Larger German enterprises especially seem interested in being able to use the euro already during the changeover phase also for administrative and regulatory aspects of their operations, for example in matters of accounting. That runs counter to the provision contained in the changeover scenario adopted by the European Council in Madrid at the end of 1995, which states that, as a general principle, the public sector is to convert to the euro only at the end of the transitional period; moreover, a confusing and cumbersome accounting duality caused by using both currency units should be avoided as far as possible.

Conversion of existing liabilities still partly unclarified

From the German point of view, the current state of preparations still leaves one key question unanswered. As things stand at the moment, the important private bond issues sector of the German capital market, especially the mortgage bonds segment, cannot be included in an early conversion together with the bond issues of public borrowers by force of law. The same applies to foreign Deutsche Mark bonds. It is to be hoped that the European Council's brief to have this issue settled by the time of the next summit in Amsterdam will be executed to the satisfaction of the German side, too.

Enactment of the central conversion regulation only possible by the EMU participants

The regulation containing the central monetary and conversion provisions will enter into force upon the launching of the monetary union. However, the prepared draft cannot be definitively enacted until it is known which member states have qualified for EMU by meeting the Maastricht Treaty's convergence criteria. Only they are entitled to vote on the formal adoption of the provisions governing the changeover of their currencies to the euro.

Some technical issues to be clarified before the start of monetary union

Besides the future monetary law of the Community, which – according to international legal interpretation – will also have effect in third countries by virtue of the euro's substitution for the abandoned national currencies, a second Council regulation prepared for Dublin is intended to clarify certain mainly technical questions which can be resolved by the Council of Ministers prior to the start of monetary union. This Council regulation, which is based on article 235 of the

EC Treaty and which will be valid throughout the Community, is to take due account of market requirements following the timely clarification of issues in the run-up to monetary union concerning the transition of the basket ECU to the euro, the continuity of contracts and the rounding of amounts translated between national currencies and the euro. In this way, too, legal certainty and transparency during transition to the euro are to be increased for the general public and, particularly, for the market participants concerned.

(b) Stability and growth pact

Budget policy discipline of particular importance for a successful anti-inflation policy

Under EMU, national budget policy will play a particularly important role. According to the EC Treaty, member states in stage three of EMU are obliged to avoid incurring excessive budget deficits.[1] Whereas responsibility for monetary policy will lie in future with the independent European Central Bank (ECB) and will be geared primarily to safeguarding price stability, national budgetary policy will remain in the hands of the EU member states. However, a stability-oriented budget policy on the part of all participants is extremely important for the success of monetary union. At its Dublin meeting in December 1996, therefore, the European Council reaffirmed the central significance of lasting fiscal discipline. It welcomed the intention of the member states to reduce their budgetary imbalances further in 1997 so as to achieve the degree of sustained convergence required for participating in the single currency.

Agreement on a stability and growth pact

The Council, meeting in the composition of the heads of state or government, emphasised that the four criteria for sustained convergence must be applied strictly and that the required independence of the national central banks also has to be ensured. The Council considered it equally important that fiscal consolidation is achieved by the public sector on a lasting basis and is not artificially embellished by measures which have merely a transitory effect. In particular, the member states are to commit themselves to aiming for balanced budgets or budget surpluses in the medium term. With a view to achieving these objectives, the European Council in Dublin – largely following an initiative of the German Federal Minister of Finance – agreed on a stability and growth pact. This agreement, on the legal details of which the finance ministers and central bank governors fundamentally reached agreement at their meeting in Noordwijk in

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1 Pursuant to article 5 of Protocol No. 11, this obligation does not apply to the United Kingdom unless that country notifies the Council of its intention to enter stage three of EMU.

April 1997, will apply to all EU countries, except for its provisions on financial sanctions to be imposed on fiscal delinquents.

Shortening of the excessive deficit procedure and restriction of the existing decision-making latitude of the Commission and the Council

The stability and growth pact envisages essentially the speeding-up and spelling-out of the procedure set out in article 104 c of the EC Treaty for monitoring the EU countries' fiscal policy, which must be geared to medium-term budgetary equilibrium. To this end excessive deficits are to be identified early on and the currently existing decision-making latitude of the Commission and the Council is to be restricted. To that extent, the agreements on the stability and growth pact have brought about important clarifications and improved the prospects of a stability-oriented budgetary policy course on the part of the EMU participants. The concept, which had been backed by Germany, in particular, of the automatic imposition of sanctions to punish infringements of the Maastricht fiscal criteria – which have an ongoing validity – was not accepted, however. The success consists mainly in the fact that the Commission and the Council have accepted not only the objective of medium-term budgetary equilibrium but also the need for a stronger commitment by each country to resolute action as part of the procedures to monitor the budgetary situation and to avoid excessive deficits. The stability and growth pact will have a threefold legal basis: a Council regulation on intensified surveillance of the budget situation and coordination of economic policy, a second Council regulation aimed at speeding up and clarifying the excessive deficit procedure, and a resolution of the European Council on the stability and growth pact.

Creation of a surveillance and early warning system

The regulation on the intensified surveillance of the budget situation and coordination of economic policy, which will develop the concept of multilateral surveillance set out in article 103 of the EC Treaty, will commit the member states participating in the euro area to submit stability programmes in which they must basically present their medium-term budget targets and, where necessary, chart a public finance adjustment path aimed at meeting the fiscal criteria. Those member states not participating in the euro have to submit convergence programmes whose contents largely resemble those of the stability programmes. The Commission and the Council of Economic and Finance Ministers will examine the stability and convergence programmes. In the event of major divergences from the medium-term budget target which could lead to an excessive budget deficit, the Council will recommend that corrective budget policy measures be taken. This early warning is an important preliminary step in initiating the excessive deficit procedure.

Restricted definition of exceptional circumstances for excessive budget deficits

The draft resolution agreed by the European Council on the stability and growth pact envisages a commitment on the part of the Commission to initiate the excessive deficit procedure and prepare a report whenever the planned or actual general government deficit of a member state exceeds the reference value of 3 % of GDP. However, the Council regulation on speeding up and clarifying the excessive deficit procedure empowers the Commission to classify an overshooting of the reference value of 3 % as a tolerable exception in its report if the country in question is suffering a severe recession with an annualised decline in real GDP of at least 2 %. Given a negative change in GDP of less than 2 %, the Council may choose not to ascertain that an excessive deficit exists if the member state in question can point to exceptional circumstances, particularly if the cyclical deterioration has occurred very suddenly or if an "accumulated loss of output relative to past trends" needs to be taken into account. However, the member countries are to pledge not to claim that their country is in severe recession unless real GDP has declined by at least 0.75 %. Extraordinary occurrences which lie outside the control of the member concerned and which have a considerable impact on its financial situation, such as natural disasters, are fundamentally to be classified as exceptional circumstances.

Council can impose sanctions on EMU participants within ten months after ascertaining that an excessive deficit exists

If the Council ascertains that an excessive deficit exists and if its recommendations to adopt suitable measures to reduce the deficit within four months are not followed, it can make those recommendations public. If a participant in the euro area is affected, that country is given notice in a subsequent step and will have sanctions imposed upon it before the end of the tenth month following notification of the existence of the excessive deficit if it persists in failing to comply with the Council's recommendations. In the case of a planned deficit which, by decision of the Council, is deemed excessive, an accelerated procedure is to be applied.

Deposits and fines as the most effective sanctions

Prior to the imposition of sanctions for the first time, a country is to be required to lodge a non-interest-bearing deposit which as a rule, if the excessive budget deficit persists, is transformed after two years into a fine. The amount of the deposit to be established in the event that an excessive deficit persists is limited to an annual maximum of 0.5 % of GDP and consists in the first year of a flat rate of 0.2 % plus a variable component of one-tenth of the amount by which the deficit exceeds the reference value of 3 % of GDP. If in the following years an excessive deficit persists because an EMU member has failed to heed the Council recommendations, the Council can increase the sanctions. However, the level of any additional deposit is limited to the variable component of the sanctions.

(c) Exchange rate cooperation between the euro area and the other EU countries

Common interest in intra-EU exchange rate cooperation

Not all EU countries will presumably be able or willing to participate in the euro area from the outset. However, close economic and monetary policy cooperation between the euro area and the other EU states is in the common interest because it can contribute to helping those countries which do not participate initially to qualify rapidly for the euro area, to avoiding exchange rate distortions and also excessive exchange rate fluctuations between the euro and the other EU currencies and hence to promoting the smooth functioning of the single market.

Consensus on the basic principles and main operational features of a new exchange rate mechanism

In support of these aims, the European Council in Dublin reached agreement on the basic principles and the main operational structures of a successor system to the current exchange rate mechanism of the EMS. On the analogy of the legal foundation of the present EMS, the new mechanism will likewise be based on an agreement between the governments of the member states in the form of a European Council resolution, a draft version of which was recently approved by the finance ministers and central bank governors and which will probably be adopted as early as June 1997. The operational details will be settled later in an agreement between the ECB and the national central banks of those countries which do not yet belong to the euro area. This agreement is being elaborated at the present time so that it can be formally concluded in the interim period between the setting-up of the ECB and the start of EMU.

The euro as an anchor with a wide standard margin

In the context of monetary policy cooperation, the euro is to take on the anchor role in future. Accordingly, the central rates of the currencies of countries not participating in the euro area will be defined under the new exchange rate mechanism vis-à-vis the euro. As in the present EMS, the maximum degree of fluctuation of these currencies around their respective central rates will be defined by a standard margin of 15 %. The existing practice of intramarginal interventions will likewise be retained, as will the principle that interventions in crisis situations are to be made only as a supporting measure. Lasting exchange rate stability requires, first and foremost, a convergence-oriented monetary and fiscal policy.

Narrower fluctuation margins for countries showing greater convergence

Ultimately, participation in the exchange rate mechanism will be voluntary. But in accordance with the Treaty principle that exchange rate policy is to be regarded as a matter of common interest, participation in the mechanism will be expected of countries displaying sufficient monetary and fiscal policy convergence. Given extensive convergence, the possibility of a more intensive degree of cooperation between the euro area and the other member states by way of closer exchange rate links is explicitly envisaged. This may take the form either of a formal agreement that is made public or of an informal, confidential compact.

Arrangements to initiate timely central rate adjustments and a possible suspension of interventions

The future exchange rate mechanism developed by the EMI and approved, in the meantime, by the European Council is designed in such a way that the primary objective of the European System of Central Banks (ESCB) of safeguarding price stability is not impeded. As the liquidity effects associated with persistent foreign exchange market intervention could jeopardise a stability-oriented monetary policy, the ECB and the other central banks of countries participating in the exchange rate mechanism are likewise to be given the right to initiate a confidential procedure for reviewing the central rates. The central banks will also be empowered to suspend intervention, if need be.

(d) Interim results of the work on preparing the monetary policy strategies and instruments

Monetary targeting and direct inflation targeting as possible strategies for the ESCB

In the field of monetary policy the EMI Council last year pressed on with the preparations for stage three of monetary union and took some key preliminary decisions. That is necessary to enable the Governing Council of the ECB, shortly after the ESCB is set up, to make the final decisions, so that a suitable basis for conducting monetary policy in the monetary union is available at the start of EMU. In January 1997 the EMI Council published a progress report on the state of the discussions and preparations.[1] The range of possible strategies for the ESCB has been narrowed down to monetary targeting and direct inflation targeting. Of these two alternatives, the Bundesbank favours the use of an intermediate monetary target because it makes it easier both to publicly present the monetary policy stance and to assess its performance and is therefore conducive to strengthening the credibility of anti-inflation policy. Monetary targeting has proved its worth in more than 20 years of use in Germany. Initial studies confirm that the long-term stability of the demand for money in the euro area – a precondition for adopting a monetary targeting strategy – appears to be given.

Combination of the two strategies also conceivable

A strategy of direct inflation targeting likewise has to fulfil a number of empirical preconditions if it is to be applied successfully. In particular, the relationships

1 See EMI, The Single Monetary Policy in Stage Three; Specification of the operational framework, January 1997.

between various indicators and the future price trend have to be stable. An alternative approach might be to rely mainly on monetary targets while making use in addition of elements of a direct inflation targeting strategy. Such a scenario must have a clear hierarchy to ensure that, in case of doubt, the trend in monetary growth is of paramount importance for monetary policy action. The final decision on which strategy the ESCB is to pursue is reserved for the Governing Council of the ECB.

EMI Council has defined the key monetary policy instruments and their main features

The EMI Council has meanwhile defined the various monetary policy instruments that are to be available to the ESCB as well as their main features. Open market operations will play a leading role. They will consist in the main of weekly refinancing operations with a maturity of two weeks. Longer-term transactions are also envisaged as a method of basic refinancing. In this way smaller credit institutions, in particular, are also to be granted direct access to comparatively continuous central bank funding. This instrument will thus take on an important function which in Germany is performed at present by the rediscount credit facility. In addition, various fine-tuning instruments are being prepared. Open market operations are to be flanked by two standing facilities – a deposit facility and a marginal lending facility. The interest rate charged for the latter will – like the lombard rate in Germany today – be the ceiling for the money market rate. By contrast, the Bundesbank has no standing facility at the moment for accepting interest-bearing deposits with the aim of providing a floor for movements in the short-term interest rate. The function of an interest rate floor is currently performed – although to a limited extent – by the discount rate or by the rate which the Bundesbank applies to its temporary sales of Treasury bills. A minimum reserve system is also being prepared by the EMI. If the ECB Governing Council makes use of it, volatilities in the money market rates would be reduced so greatly that the ESCB would not need to intervene continually in the market.

Decentralised monetary policy operations with a large range of participants

It is agreed that, as a matter of principle, the ESCB will conduct its monetary policy operations on a decentralised basis and, as a rule, with a large range of counterparties. The eligibility criteria are geared mainly towards whether the counterparties are subject to banking supervision or similar regulations. It has further been agreed that not only public paper but also private paper will be eligible as collateral in monetary policy operations, as the Bundesbank wished. The eligible assets are grouped into two tiers. One group contains marketable debt instruments that will be defined by the ECB union-wide according to uniform criteria. The second tier lists marketable and non-marketable assets which are rated as eligible by the national central banks in accordance with ECB guidelines and which are important for the financial markets and banking systems of the respective countries. Finally, collateral located in one country within the euro area will also be allowed to be used as a basis for obtaining central bank credit in partner countries.

(e) Design of the euro banknotes

Designs for the euro banknotes selected following a European competition

At the beginning of December 1996 the EMI Council, pending a final decision by the Governing Council of the ECB, selected the individual designs for the euro banknotes. The designs were presented in mid-December to the European Council and, at two press conferences in Dublin and Frankfurt am Main, to the general public. The process of selection by the EMI Council was preceded by a seven-month design competition on the themes "Ages and styles in Europe" and "Abstract/modern design" in which banknote designers nominated by the national central banks took part. The total of 44 design series submitted were examined by the respective central banks to ensure that they met the prescribed list of technical requirements and were compatible with the capabilities of printing technology; they were then forwarded to a notary, who deleted all references to the identity of the individual designers. An independent group of experts consisting of advertising specialists, graphic artists and art historians then selected five series for each theme to be presented as proposals to the EMI Council. The principal evaluation criteria were public acceptability, functionality, aesthetic merit and national balance. A Europe-wide representative public survey was then carried out on the ten series by an opinion research institute. In making its choice, the EMI Council also took account of the reports made by the group of experts and the opinion research institute. The series of designs selected is now being reworked and refined.

High security standard

The euro banknotes will have security features embedded in the paper (for example, watermark, security thread) and built into the printed design (for example, intaglio printing, effect colours) and will also contain reflecting and diffractive foils. In addition, machine-readable features will enable the authenticity of the notes to be checked reliably in central banks' money processing machines as well as in automated teller machines and vending machines. Handling of the euro banknotes by visually handicapped people will be facilitated by clearly differentiated banknote sizes and primary colours, clearly visible denomination numbers and tactile features.

(f) On the way to further political integration

Inter-governmental conference now in its final stage

The aspired EMU can only be viable in the long term if it is underpinned by an appropriate political structure for the Union. The inter-governmental conference, which opened in Turin in March 1996, has the task of further developing the elements of a political union which were envisaged in the Maastricht Treaty. The main aims in this connection are the realisation of a European citizenship (in particular, the further development of cooperation on home affairs and justice), the elaboration of a common foreign and security policy and the institutional strengthening of the Union, primarily with regard to the forthcoming enlargement of the EU. At the European Council meeting in Dublin, the Irish Presidency put forward a general framework for a draft revision of the treaties. On that basis the negotiations – now under Dutch Presidency – have entered into their final phase.

No fundamental advances so far on institutional issues

In the meantime a certain convergence of views seems to be emerging on a number of issues; in the institutional field, however, which is especially important for ensuring the Union's future ability to act, little progress is discernible. Growing importance is being attached in the consultations to the question of a "flexible approach"; thought is being given to whether a general clause should be included in the Treaty that would enable a group of member states, under certain preconditions, to deepen their cooperation within the framework of the Union. The conference is scheduled to be concluded in June 1997.

3. Recent developments at the IMF

Total credit outstanding heavily concentrated on a few countries

After drawings on the IMF had reached an unprecedented level in 1995, mainly owing to financial assistance to Mexico and Russia, their magnitude returned to normal in 1996. All in all, IMF financial assistance worth around SDR 6 billion was disbursed in 1996, compared with more than SDR 18 billion in the previous year. The high lending to individual countries continued, however. A commitment to Russia totalled SDR 6.9 billion, SDR 2.2 billion of which was disbursed in 1996. The stand-by arrangement for Mexico dating from the year 1995 (a commitment totalling SDR 12.1 billion) was extended in 1996 by six months to mid-February 1997. Owing to its favourable foreign exchange position, however, Mexico was able to forgo further drawdowns and, moreover, to make early repayments of SDR 1.8 billion by the beginning of 1997). The relatively heavy concentration of Fund resources on just a few countries, which has been evident

Disbursements, repurchases and repayments and total credit outstanding under IMF facilities

Table 10

SDR billion

Item	1992	1993	1994	1995	1996
Disbursements					
Credit tranches	3.3	1.1	1.8	14.4	2.5
Extended Fund Facility	0.9	1.9	0.9	2.0	2.6
Compensatory and Contingency Financing Facility	0.6	0.7	0.3	0.0	0.2
Structural Adjustment Facility 1	0.5	0.3	0.9	1.4	0.7
Systemic Transformation Facility 2	–	1.4	1.9	0.6	–
Total disbursements	5.3	5.3	5.9	18.4	6.0
Repurchases and repayments	4.2	3.9	4.8	7.1	5.6
Net disbursements	1.1	1.4	1.1	11.3	0.4
Total IMF credit oustanding 3	27.8	29.2	30.3	41.6	42.1
of which					
Mexico	4.3	3.5	2.6	10.6	9.2
Russia	0.7	1.8	2.9	6.5	8.7

Source: IMF. — **1** Including both the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF); both facilities are financed out of special IMF accounts and are available only to countries whose per capita income is particularly low. — **2** Temporary facility for countries in transition; purchases were possible until the end of 1995. — **3** End-of-year level.

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for some time, means that now almost SDR 24 billion, or more than half of total IMF credit outstanding, is accounted for by just four countries (Mexico, Russia, Argentina and the Ukraine). Credit outstanding totalled SDR 42.1 billion at the end of 1996; that was over 50 % more than at the end of 1992, the year of the last quota increase.

Eleventh General Review of Quotas

In order to be able to meet justified requests for financial support of its member countries, the Fund requires adequate resources of its own. The standard source of funds is the quotas subscribed by the member countries, the adequacy of which is reviewed on a regular basis. The aim of the current Eleventh General Review of Quotas is to adjust the Fund's resources to the higher level of world trade since the last increase in quotas and hence to the financing requirements of its member countries, which have likewise tended to grow. Account should be taken not only of the IMF's current liquidity position but also, in particular, of the constantly growing role of the international financial markets in financing balance of payments deficits. Irrespective of the size of any quota increase, the respective quota shares also need adjustment. The quota structure is intended to approximately reflect the relative importance of the individual member countries in the world economy. Some countries' weightings have shifted considerably in recent years. Within the framework of the current review of quotas it is therefore necessary to adjust the quota shares of the individual countries to their actual weight in the world economy by means of selective quota increases. Germany is one of the countries whose quota needs to be raised substantially.

Agreement on parallel arrangements to the GAB

In addition to its own financial resources, the Fund can draw on refinancing lines from the Group of Ten plus Saudi Arabia under the General Arrangements to Borrow (GAB) which can be activated whenever the IMF needs additional financial resources to ward off a threat to the international monetary system. Following the recommendations of the economic summit of 1995, the GAB countries, 14 other financially strong countries and the Fund itself reached agreement in January 1997, after protracted discussions, on supplementary "New Arrangements to Borrow" (NAB). By means of the NAB, the Fund's present credit lines under the GAB of SDR 17 billion will be doubled to SDR 34 billion (almost US$ 50 billion). These credit lines can be activated in the event of systemic financial crises. The IMF expects that the agreement will be ratified by the individual countries in the second half of 1997. Like the GAB, however, the NAB are no substitute for adequate quotas, nor must they be misinterpreted as signalling the international community's readiness to bail out individual member countries of the Fund on the occasion of each and every external disturbance through generous injections of liquidity. In order to avoid the associated problems of moral hazard, especially in respect of the investment behaviour of international investors, the NAB are designed to be activated only in acute emergencies. In view of the Fund's strengthened crisis prevention measures, it is to be hoped in any case that systemic financial crises can largely be avoided.

Germany's subscription to the "Special Data Dissemination Standard"

A crucial role in improving the surveillance of the economic and monetary policies of the IMF's member countries, and hence in ensuring more effective crisis prevention, is played by the timely availability of reliable economic data. According to the rules proposed by the Fund, all members are in future to meet certain minimum requirements regarding the quality and timeliness of the data they provide (General Standard). For countries that have or seek access to the international capital markets there is a stricter data standard (Special Data Dissemination Standard – SDDS). It is designed to further improve transparency for market participants. Publication deadlines for the economic data are to be announced in a calendar. The Fund will provide a description of the data, the so-called metadata, on the Internet. It is likely that the participants will also publish detailed data on the Internet. Germany joined the SDDS in December 1996, pledging to meet this standard after a transitional period (up to the end of

1998). At the beginning of 1997 a total of 42 countries, including all G-10 countries, had committed themselves to the SDDS.

Transformation of the ESAF into a permanent facility

Following a recommendation of the Interim Committee in autumn 1995, the Fund extended the commitment period for loans under the Enhanced Structural Adjustment Facility (ESAF) in December 1996 by four years to the end of 2000. By means of this longer-term facility with clear development policy features, the Fund grants structural adjustment assistance from a separate Trust Fund on particularly favourable terms to developing countries with a low per capita income. These credits were financed hitherto through direct loans from financially strong IMF members to the ESAF Trust Fund. On this basis the resources will probably suffice up to the end of the year 2000. From 2005 the facility's funding could be permanently ensured by resources from a special IMF account which will then be released. The Fund has made a positive decision of principle on converting the ESAF into a permanent facility. Despite intense discussions, however, issues concerning the financing method and, notably, how to bridge the interim period between the years 2000 and 2005 have not yet been settled definitively. One possible solution would be to extend the available resources over a longer period, while seeking at the same time to mobilise voluntary bilateral contributions.

Financing the ESAF by ordinary Fund resources or gold sales would be inappropriate

From Germany's point of view, both the proposed sale of IMF gold in order to finance the interim ESAF and suggestions that ordinary IMF resources should be used for this purpose are not acceptable. The IMF has primarily a monetary mandate which, in addition to monitoring the monetary and economic policies of its member countries, includes, *inter alia,* temporary balance of payments financing. The IMF's gold reserves are intended to ensure its financial integrity and to give it the necessary backing to be able to fulfil the tasks assigned to it even under difficult underlying conditions. Any attempt to solve the problem of financing the ESAF through recourse to ordinary Fund resources or through gold sales would inevitably weaken the Fund and damage its credibility as a monetary institution.

Agreement on the basic principles of the HIPC initiative

In the course of 1996 the plan to solve the debt problems of heavily indebted poor countries (HIPCs) took on concrete shape. The IMF and the World Bank have meanwhile developed a two-step concept for reducing the debt burden of a particular group of countries. In principle, a country will be eligible for debt relief operations by the IMF and the World Bank if its indebtedness, even upon application of all existing relief mechanisms, exceeds a sustainable level. To ensure that the prospect of debt relief does not undermine the economic policy discipline of the countries concerned, they must demonstrate that they are undertaking comprehensive reform efforts of their own over an extended period and are thus doing everything possible themselves to overcome their debt problem. If it turns out that a rescheduling of debt owed to governments and other bilateral creditors on a customary scale would not suffice to make the countries' indebtedness sustainable in the long term, additional coordinated measures may be taken by the multilateral and bilateral creditors.

Debt relief operations via Trust Funds

The HIPC concept developed by the IMF and the World Bank foresees no direct debt forgiveness by multilateral creditors, however. Instead resources are to be contributed – including through bilateral contributions from member countries – to special Trust Funds and would then be made available as grants or highly concessionary loans to help finance the debt service of heavily indebted poor countries. The amount of financial resources needed by the IMF for that purpose is currently estimated at just short of US$ 500 million (discounted present value). The amounts necessary for the World Bank are estimated to be around US$ 1 billion. To finance its share, the World Bank has already committed US$ 500 million from its profit for the year 1996 to a Trust Fund managed by the International Development Association (IDA). Under these conditions the Paris Club has announced its willingness to provide debt reduction of up to 80 % (compared with 67 % hitherto) on eligible debt on a case-by-case basis.

Maintenance of preferred creditor status

The financing of debt relief measures via Trust Fund resources obtained through bilateral contributions and, in part, also through contributions "of their own", would at least formally maintain the preferred creditor status of multilateral donors. If this status were to be diluted, the IMF, too, would have to gear its lending more than hitherto to considerations of creditworthiness, with the result that, especially in times of crisis, fewer resources would be available than in the past. For that reason alone it is important not to relax the criteria governing the selection of countries and the implementation of the HIPC initiative. From Germany's point of view, moreover, it is not the task of the IMF, which is a monetary institution, to involve itself direct in development policy matters.

Amendment of the Articles of Agreement to allow an equity allocation of SDRs is in preparation

In the context of the ongoing debate about how a number of new members which have not yet received an allocation of special drawing rights, as well as certain other countries with a comparatively low SDR allocation, could be enabled to participate adequately in the SDR system, the proposal of a one-time "equity allocation", which would be based on an amendment of the Articles of

Agreement, has now received broad support. No agreement has yet been reached, however, on the size of such a special allocation. The German side believes that it is important, above all, that such a special allocation is not grounded on a supposed long-term global need which, under the existing IMF Articles of Agreement, is the sole valid allocation criterion for general SDR allocations. Given the supply of funds in the international financial markets, such a global need could not be substantiated convincingly or justified in terms of stability policy.

4. Close cooperation between central banks within the framework of the Bank for International Settlements

Key role of BIS in cooperation between central banks

The Bank for International Settlements (BIS) – which was established in 1930 as a public limited company and has been owned and run by central banks ever since – acts as a coordinating body to facilitate cooperation between its shareholders. From the outset the fostering of international monetary cooperation was enshrined in the statutes of the oldest worldwide financial organisation as one of its foremost tasks. For many years now the regular meetings of central bank representatives organised by the BIS at its headquarters in Basle have played a central role in the international cooperation between central banks. But in addition to the representatives of the BIS shareholder banks who meet there, non-members are also frequently invited. The relatively small size of the group of participants provides excellent opportunities for in-depth discussions and consultations and thus helps to improve mutual understanding. The range of issues discussed embraces all matters of interest to central banks, but furthering the stability of the international financial system has always been a key objective.

Enlargement of membership

The global nature of the topics discussed, especially the growth and increasing worldwide integration of financial markets, has posed new challenges to the BIS in recent years. Mindful of this, the Basle-based organisation – which in the past was predominantly a grouping of central banks from industrial nations – has stepped up its contacts, in particular, with those developing countries and countries in transition which have a growing importance in ensuring the stability of the international financial system. A major step in this direction was not least the decision taken in 1996 to admit nine further central banks and comparable institutions from this group of countries – all major economies in their respective region or significant financial centres. That has raised the number of members of the BIS to 41.[1] It is planned in addition to invite representatives of other central banks to the meetings of the BIS Governors more frequently than in the past.

Cooperation between G-10 central banks remains particularly important

Notwithstanding these changes, the grouping of the Central Bank Governors of the G-10 Countries, which was set up at the BIS as a counterpart to the Group of Ten meetings, which bring together representatives from the respective governments and central banks, continues to play a pivotal role in international cooperation between central banks. In their broad-ranging activities, the G-10 Central Bank Governors are able to draw on the expertise of numerous committees and working groups; furthermore, representatives not only of non-G-10 countries but also of non-members of the BIS have been drawn increasingly into the collaboration of late. One example of the work performed at the committee level is given by the Basle Committee on Banking Supervision, a body set up in the mid-seventies, to which the supervisory authorities of the G-10 countries and Luxembourg belong. Although this body has no international prudential powers but can only issue recommendations in line with the consensus principle, its efforts have meanwhile led to a remarkable degree of international convergence in the improvement of banking supervision (for the more recent activities of this committee, see page 143 ff.).

1 A full list of the countries belonging to the BIS is contained in the Bundesbank special publication *"Weltweite Organisationen und Gremien im Bereich von Währung und Wirtschaft"* (Worldwide organisations and bodies in the monetary and economic field), which is due to appear shortly.

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 on December 31, 1996, at DM 260.4 billion, was DM 12.0 billion (or 4.8 %) higher than at the end of 1995. The value of coins in circulation, by contrast, rose by only 1.4 %. At the end of 1996, 94.4 % of all currency in circulation consisted of banknotes, and 5.6 % of coins.

Currency in circulation and its pattern

Table 11

Trends over time

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
1992	227,285	213,355	13,930
1993	238,641	224,341	14,300
1994	250,907	236,165	14,742
1995	263,510	248,363	15,147
1996	275,744	260,390	15,353

Pattern at the end of 1996

Banknotes in circulation			Coins in circulation		
Notes of DM	DM million	Percentage of total	Coins of DM	DM million	Percentage of total
1,000	86,557	33.2	10.00	2,383	15.5
500	27,772	10.7	5.00	5,668	36.9
200	10,092	3.9	2.00	2,246	14.6
100	100,115	38.4	1.00	2,294	14.9
50	21,938	8.4	0.50	1,109	7.2
20	8,476	3.3	0.10	1,023	6.7
10	5,130	2.0	0.05	317	2.1
5	310	0.1	0.02	147	1.0
			0.01	166	1.1
Total	260,390	100.0	Total	15,353	100.0

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At the end of the period under review, more than 2.6 billion notes were in circulation. Of these, 113 million were notes of the old series. In the denominations between DM 10 and DM 100 which are significant in payments, these old notes accounted for shares of between 1.6 % (DM 100) and 7.3 % (DM 10) of the respective denominations in circulation. The notes of the old series ceased to be legal tender on July 1, 1995. However, the Bank will continue to replace them at their face value.

Destruction of banknotes

The following banknotes were destroyed as they were no longer fit for circulation or had been called in:

	1992	1993	1994	1995	1996
Number (million)	1,697	914	516	739	659
Value (DM billion)	97.5	120.0	28.2	50.6	27.7

The decline in the number of banknotes destroyed is essentially due to the drop in the share of banknotes which have been called in; in particular, the reduction is attributable to the smaller amount of banknotes in denominations of DM 500 and DM 1,000 to be destroyed.

Coins

The stock of German coins held by the Bank at the end of 1996 amounted to DM 2,057 million (end-1995: DM 2,091 million). In 1996 about DM 251 million was credited to the Federal Government in respect of coins received from the mints and about DM 78 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1996 the Bank – acting on behalf of the Federal Government – received coins amounting to DM 19,463 million and redeemed coins which were no longer fit for circulation or which had been called in, equivalent to DM 2,053 million. At the end of 1996 coins totalling DM 15,353 million were in circulation, equivalent (given 81.8 million inhabitants) to DM 188 per head of the population.

Counterfeits

The number of counterfeit banknotes detained in payments and appraised by the Bank decreased, compared with the previous year; the quality of counterfeits, however, has continued to improve. The number of counterfeit coins increased.

Counterfeits detained in payments, as recorded by the Bundesbank — Table 12

	Banknotes		Coins	
Year	Number	DM thousand	Number	DM thousand
1992	14,057	2,520	21,257	103
1993	41,838	5,732	8,086	39
1994	23,028	3,317	15,561	77
1995	31,148	4,919	24,201	111
1996	25,769	3,839	35,352	169

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Forgeries of the DM 100 and DM 200 notes accounted for 85 % of the total, while forged DM 5 coins accounted for 94 % of all coin forgeries.

2. Cashless payments

Number of payments submitted nearly unchanged

In 1996 the number of credit transfer orders and collection orders channelled through the Bank remained largely unchanged compared with the previous year. In 1996, too, a total of 2.3 billion payments were submitted, resulting in a slightly higher total of DM 195,931 billion.

Retail payments

Both the credit institutions and the Bank are continuing their efforts to apply efficient and cost-effective paperless procedures. In April 1996 the "Agreement on credit transfers" entered into effect, according to which transfers still submitted in paper-based form in order to be passed between credit institutions are generally to be converted by the first-commissioned credit institutions into data records and passed on in a paperless form starting in June 1997. This conversion obligation currently applies only to credit transfers totalling DM 1,000 and more; nevertheless, many credit institutions have already started to convert transfers below this amount limit, too. As a general obligation to convert all direct debits and to collect them in a paperless form has already been in effect since November 1993, this means that from mid-1997 onwards, only cheques may be passed between credit institutions in a paper-based form. On a voluntary basis, however, credit institutions may convert and collect cheques for amounts below DM 5,000 under the paperless cheque collection procedure (BSE procedure). Moreover, under the large-value cheque collection procedure (GSE procedure), the Bank also converts cheques channelled through it amounting to DM 5,000 or more each. These cheques are processed in paperless form, yet the original cheques (which are frequently made out for very large amounts) are still transmitted and presented separately.

Transfers made increasingly in paperless form

Owing to the above-mentioned obligations and possibilities regarding conversion, some 99 % of all cheques and direct debits as well as 93 % of all credit transfers in retail payments involving the Bank were executed in paperless form last year. In the year under review, the Bank itself converted, against payment, some 92 million cheques and almost 10 million credit transfers for paper-based submission in retail payments.

The Bank's cashless payments

Table 13

Item	1995 Number (million)	1995 DM billion	1996 Number (million)	1996 Change in %	1996 DM billion	1996 Change in %
Retail payments						
MAOBE transactions 1						
Collection items	26.7	240	20.2	– 24.3	224	– 6.5
Credit transfers	88.6	27	57.7	– 34.8	16	– 39.9
Total	115.3	267	77.9	– 32.4	241	– 9.8
DTA transactions 2						
Collection items	1,499.1	3,277	1,473.3	– 1.7	3,174	– 3.2
of which: Conversions	(105.1)	(2,263)	(91.8)	(– 12.7)	(2,127)	(– 6.0)
Credit transfers	657.8	1,155	724.8	10.2	1,214	5.1
of which: Conversions	(11.5)	(19)	(9.7)	(– 15.7)	(18)	(– 4.6)
Total	2,156.9	4,433	2,198.1	1.9	4,388	– 1.0
Grand total	2,272.2	4,699	2,276.1	0.2	4,628	– 1.5
Large-value payments						
Gross settlement procedures						
EIL-ZV	5.5	27,007	7.2	31.1	28,743	6.4
Local credit transfers	8.1	5,190	3.1	– 61.4	3,870	– 25.4
Other 3	2.1	1,440	1.2	– 44.6	1,350	– 6.3
Total	15.7	33,638	11.5	– 26.8	33,964	1.0
Net settlement procedures						
Daily local clearing system						
Collection items 4 (conventional)	0.7	670	0.5	– 35.1	621	– 7.3
Local credit transfers 4 (conventional)	1.0	6,712	0.5	– 49.3	3,309	– 50.7
EAF/EAF 2	17.8	148,387	18.8	5.8	153,410	3.4
Total	19.5	155,770	19.7	1.5	157,339	1.0
Grand total	35.2	189,407	31.2	– 11.2	191,303	1.0
Cashless payments	2,307.3	194,107	2,307.3	0.0	195,931	0.9

1 Excluding payments submitted in a paper-based form which were converted and passed on in a paperless form by the Bank's units. — **2** Including payments submitted in a paper-based form which were converted and passed on in a paperless form by the Bank's units. — **3** E.g. special procedures for public authorities, conventional collections and credit transfers. — **4** Settled delivery envelopes (clearing items).

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New procedures in the large-value payment system

In order to increase the efficiency and security of large-value payments, the Bank introduced two new procedures in 1996.

EIL system

In the *Eiliger Zahlungsverkehr* (EIL-ZV) system (express electronic credit transfer system), telegraphic credit transfers and urgent credit transfers are executed. Same-day execution can only be guaranteed, however, in the case of telegraphic credit transfers at present; same-day transmission of urgent credit transfers – not supported by contingency regulations – is achieved for no less than 99 % of all orders. Both forms of credit transfers have so far been executed via the decentralised computer systems installed at the branch offices and interlinked via data telecommunication. The Bank, however, intends to execute EIL-ZV in future by means of a new EIL system which can be used as before through the giro accounts at the branch offices via two special high-availability computer centres (HVRZ). As a first step, starting on July 26, 1996 the processing of urgent credit transfers was shifted to the first HVRZ opened for operation in Düsseldorf. The second HVRZ, in Frankfurt am Main, will probably start operations as early as the first half of 1997. Owing to the increased efficiency of the new system, the previous amount limit of DM 50,000 for urgent credit transfers was abolished in September 1996. Altogether, in the year under review some 3 million urgent credit transfers (+ 66 %) as well as 4.2 million telegraphic credit transfers (+ 14 %) were executed; the latter continued to be executed via the decentralised computer systems installed at the branch offices. In EIL-ZV, too, the banking industry made increased use of the possibilities afforded by paperless submission; thus, under the electronic counter procedure (ELS), nearly three-quarters of all orders were placed by means of data telecommunication or diskette.

EAF 2

In the Frankfurt am Main banking centre, the major money market in Germany and the most important interface with other countries, the previous EAF net settlement procedure was replaced on March 8, 1996 by the new liquidity-saving, risk-reducing EAF 2 procedure. The new procedure, developed in co-operation with the banking industry, comprises two phases. In phase 1, early finality is achieved by bilaterally offsetting payments. In the subsequent phase 2, an attempt is made to multilaterally clear and settle in two stages the remaining payments which have not been offset bilaterally. In the event of uncovered debit balances, however, no unwinding (involving the exclusion of participants) will take place any longer; instead, only individual payment orders which have remained uncovered will be returned. Altogether, the risk situation for the participants has been decisively improved by the integration of important elements of a gross settlement system (such as the cover principle and the early finality of individual payments), yet the liquidity-related advantages of the former EAF have largely been kept. In the year under review, some 19 million credit transfers totalling DM 153,410 billion (an average of DM 614 billion per day) were exchanged fully automatically between the participants via EAF/EAF 2.

3. Special trends in national and cross-border payments

(a) Structure of the TARGET system

TARGET – an EMU-wide real-time gross settlement system of the central banks

In the year under review, the EU central banks, together with the European Monetary Institute (EMI), continued to work on the introduction of a European real-time gross settlement system, the so-called TARGET system (Trans-European Automated Real-Time Gross Settlement Express Transfer). TARGET[1] is intended to support the European System of Central Banks (ESCB) in its efforts to implement the single monetary policy within EMU and to make a speedy and efficient execution of cross-border payments possible.

Controversial topics for discussion

In the last quarter of 1996, particularly the issue of the participation of EU central banks outside the euro area in TARGET as well as the tasks of the European Central Bank (ECB) regarding cashless payments were discussed by the central banks and the EMI.

Participation of EU central banks outside the euro area

It is also technically possible to link euro real-time gross settlement systems of EU central banks outside the euro area to TARGET in order to execute payments in euro – in addition to the national currency – at an early stage. It is still unclear whether the ESCB will grant credits to EU central banks outside the euro area to cover euro balances during the day (and overnight, too, in exceptional cases – if at all). If these central banks had free settlement balances at their disposal, as non-EMU participants they could use these balances to create euro, even though this is the exclusive right of EU central banks in the euro area in their area of responsibility. This would also regularly involve the granting of overdrafts in euro, and thus in foreign currency, by the EU central banks outside the euro area to its credit institutions, which would be completely unusual in international banking, in the view of the Bank. Citing the principle of equality, some central banks demand the granting of intraday credit by the ESCB to EU central banks outside the euro area. They fear that without intraday credits, it might not be possible to execute TARGET payments between the EU central banks inside and outside the euro area smoothly. The Bank, though, is of the opinion that this will not be the case since the EU central banks outside the euro area can always

1 In September 1996, the Bank, in its first *Informationsbrief zur Europäischen Wirtschafts- und Währungsunion,* already presented the structure and the important functions of the TARGET system and reported on the envisaged measures for harmonising prices, operating hours and the provision of intraday liquidity to support payments.

obtain the necessary covering funds on the market and can thus participate in TARGET if they have credit balances.

"Spillover" problem

The participation of EU central banks outside the euro area in TARGET solely on a credit balance basis would, in addition, avoid the problem of the "spillover" of intraday credit into overnight credit and protect the ESCB from having to refinance possible speculative attacks against the euro. At present, several options of preventing the spillover of intraday credits – if they are granted – are under discussion. In December 1996, the EMI Council agreed to leave the final decision on this matter to the ECB Governing Council. The Bank is of the opinion that EU central banks outside the euro area should be treated like foreign banks in third countries; that means that payment orders should be executed on a credit balance basis only. Avoiding intraday credit would also preclude the danger of an unwanted overnight credit.

Competition-related problems

Intraday credits to EU central banks outside the euro area also present competition-related problems. Access to a central bank facility in euro, without having to accept the burdensome aspects of the ESCB's set of instruments (e.g. minimum reserves), would give the credit institutions in countries outside the euro area cost advantages enabling them to attract additional euro business, particularly with third countries.

Central tasks of the ECB as part of TARGET

In accordance with the Maastricht Treaty, TARGET was designed as a decentralised system. The ECB only performs a few central functions, such as matching the payment messages exchanged by the participating central banks and preparing the daily consolidated turnover and balance report of the ESCB at the end of the day. Its predecessor, the EMI, has to establish a test centre by mid-1997 in order to be able to test the ability of the TARGET system to function in association with the central banks.

ECB payment system

In the event that the ECB is granted the right to hold accounts for central banks and credit institutions outside the EU, international organisations (e.g. the United Nations) and supranational administrations (e.g. the European Commission), it will be necessary for the ECB to process payment orders by third parties appropriately, in addition to executing its own orders. Its activities would thus resemble those of a national central bank – albeit to a limited extent.

(b) Electronic money

Trend in Germany

On a national and an international scale, electronic money (e-money: prepaid cards and network money) systems are continously gaining in importance. Thus, in 1996, a pilot project involving three super-regional prepaid card systems was launched; the "GeldKarte" project of the Central Credit Committee, during the course of which some 58 million EC-cards and cards issued by banks to customers have been equipped with the functions of prepaid cards, has been gradually expanded over the whole Federal territory since the autumn of 1996.

Significance to central banks

Because digital value units are replacing cash and giro money, the increasing expansion of these electronic means of payment affects the function of central banks as issuers of banknotes, guardians of the currency, overseers of the payment system, and, as the case may be, participants in banking supervision. The great significance which the central banks give to this trend is reflected in the fact that they deal intensively with electronic money not only at the national level, but also at the international level in the European Monetary Institute (EMI) and the Bank for International Settlements (BIS) in Basle (as a forum for the G-10 central banks).

Discussion at the level of the EMI and the G-10

As early as May 1994, the EMI presented a report on prepaid cards, stating that the issuance of electronic purses should be restricted to credit institutions. Since the autumn of 1996, studies have been continued in order to prepare a follow-up report on recent trends, to further analyse payment systems, and to clarify questions of banking supervision, monetary policy and security. The responsible Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries (CPSS) has commissioned further studies on legal aspects as well as on matters of security, monetary policy and issuance; regarding the last aspect, there are conflicting political approaches. Some central banks feel that the sole right of banks to issue e-money entails restrictions on competition and innovation. However, the Bank, together with most EU central banks, holds that the consumer cannot be expected to judge the creditworthiness of issuers of e-money and that, therefore, the sole right of banks to issue is needed as a "quality assurance stamp" guaranteeing the financial integrity of the issuer.

Arrangement provided for in the Sixth Act Amending the Banking Act

In Germany, the debate on the issue of e-money has been reflected in the Sixth Act Amending the Banking Act, which envisages incorporating prepaid cards and network money transactions into the definition of banking business in section 1 of the Banking Act. However, smaller systems of multi-purpose prepaid cards may be exempted from some legal regulations laid down in the Banking Act.

c) Reduction of foreign exchange settlement risks

Strategy and measures

In March 1996, the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries (CPSS) published a report on foreign exchange settlement risks. The report introduces a three-pronged strategy to limit the danger to the financial system emanating from the currently practiced methods of executing foreign exchange transactions of the banks. Besides the measures of individual banks (such as improving their methods of measuring and dealing with risks), the strategy includes certain measures by groups belonging to the banking industry (provision of risk-limiting multi-currency settlement systems) as well as by the central banks (promotion of private-sector activities, possible improvements in domestic payment systems).

Implementation and monitoring

In order to ascertain whether the objectives listed in the report are being implemented, the G-10 central banks conduct surveys of individual banks on the measures they have either taken or planned for managing their foreign exchange settlement risks. Furthermore, they cooperate with groups of the banking industry, such as the "Group of 20", an association of large banks, leading in the foreign exchange business, which are currently discussing a settlement system for foreign exchange payments. In its discussions with the banking industry, the Bank has drawn attention to the existing settlement risks and the report's conclusions. As early as October 23, 1995, the Federal Banking Supervisory Office issued a statement on minimum requirements regarding the conduct of trade business by credit institutions, which also dealt with the problem of settlement risks. Furthermore, in the next two years the G-10 central banks will monitor the progress made by the private sector in the field of risk reduction in order to ascertain whether there is a need for further action on their part.

II. The Bank's international transactions

Foreign exchange spot deals

The Bank's turnover in foreign exchange spot deals (foreign currency against Deutsche Mark) increased in the year under review by more than half. The key factor in this was another sharp increase in customer business. Sales and purchases were as follows:

	1996 DM billion	1995 DM billion
Sales	22.2	14.0
Purchases	33.0	20.4
Turnover	55.2	34.4

Other foreign exchange deals

The volume of cross deals (foreign currency against another foreign currency) was DM 3.0 billion, compared with DM 3.1 billion a year before. In addition, US dollar inter-centre switch transactions totalling US$ 85 million were entered into (against US$ 111 million in 1995).

For managing the domestic money market, liquidity-providing swap deals to the tune of DM 7.4 billion were concluded in the year under review.

Foreign bill of exchange and cheque deals

In the context of refinancing operations, the Bank bought foreign bills of exchange worth over DM 44 billion (see page 134) in 1996. Moreover, it sold 29,872 foreign cheques payable to order amounting to DM 101 million (compared with 31,745 cheques totalling DM 116 million in the previous year). Another 39,750 cheques, to the value of DM 61 million, were presented in 1996 under the simplified collection procedure for foreign cheques; in 1995, 36,323 cheques worth DM 51 million had been so presented. For the rest, the Bank accepted 11,258 items bought on a commission basis (mainly bills and cheques) for realisation in foreign commission business; a year earlier, 12,627 such items had been bought. Transactions in foreign notes and coins hardly changed at all compared with the previous year.

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

Discount credit

In 1996, too, the Bank granted credit institutions basic refinancing by supplying central bank money through the discount credit facility.[1] At December 31, 1996

1 The monetary policy regulations currently in force are being published by the Bank in a brochure that is appearing simultaneously with the 1996 Annual Report: Deutsche Bundesbank, Monetary policy regulations, Banking regulations 3, April 1997. This publication is available to interested parties, upon written request, from the Press and Public Relations Division.

the volume of rediscount quotas fixed amounted to DM 65.9 billion (in 1995: DM 65.6 billion). As usual, the quotas were recalculated on November 4, 1996 to take account of the increase in the liable capital which had occurred in the meantime and of the changes in the business structure and bill operations of the individual credit institutions. The special rediscount facility for the financing of export orders, the so-called ceiling B of the *AKA Ausfuhrkredit-Gesellschaft mbH,* had already been lowered from DM 2,250 million to DM 1,250 million in 1995 as part of the final structural adjustment to the refinancing facilities and was eliminated entirely at midnight on May 31, 1996. Funding commitments made up to that date will be gradually phased out.

Purchases of domestic bills of exchange

The utilisation of the rediscount quotas ran at a high level throughout most of 1996. Overall, 1.2 million domestic bills totalling DM 278 billion were purchased under the rediscount quotas or the special rediscount facility (ceiling B) granted to the *AKA Ausfuhrkredit-Gesellschaft mbH* (in 1995: 1.3 million such domestic bills had been purchased, amounting to DM 280 billion). In the absence of payment, 6,883 bills totalling DM 237 million were returned and charged to the parties presenting them for discount (in 1995: 6,686 bills amounting to DM 193 million).

Purchases of foreign bills of exchange

Purchases of foreign bills of exchange, which are counted towards the rediscount quotas, numbered 74,821 in 1996, and totalled DM 44 billion (in 1995: 79,828 bills totalling DM 44 billion). As in the previous year, the share of foreign bills denominated in foreign currencies came to 1.7 %.

Securities repurchase agreements

The weekly open market transactions under repurchase agreements in securities (“securities repurchase agreements”), which are part of money market management, continued to be the most important means of regularly providing funds. In all, 52 such transactions were concluded, four of which were in the form of variable-rate tenders. All fixed-rate tenders were announced in advance. The standard maturity of the transactions was two weeks. The volume of securities repurchase agreements outstanding at the end of 1996 was DM 161.6 billion.

Operational safe custody accounts

All debt securities eligible as collateral for lombard loans that are officially listed or traded in the Regulated Market (Treasury discount paper is included even if unlisted) may be purchased. At the end of 1996, securities amounting to DM 485 billion (in 1995: DM 471 billion) were lodged by credit institutions in operational safe custody accounts at Land Central Banks for securities repurchase agreements (and therefore for lombard purposes, too). In addition, securities totalling DM 4 billion were pledged in such safe custody accounts, exclusively for lombard purposes.

Fine-tuning operations with ...

In 1996, too, fine-tuning operations as part of ongoing money market management were an exception. Such measures were used only four times to supplement the regular provision of funds through securities repurchase agreements. Not least, this indicates that the stabilisation and buffer function of the minimum reserve requirements is a major prerequisite of the comparative rarity of central bank interventions.

... quick tenders, ...

At the beginning of the year, the Bank provided short-term liquidity in the form of a quick tender. Quick tenders are securities repurchase agreements which are effected within about one hour and, for that reason, are restricted to a fairly small number of banks operating in the money market. The contract amount of the five-day fixed-rate tender came to DM 3 billion.

... foreign exchange dealings and ...

In view of the surprisingly high outflows of funds, the Bundesbank temporarily concluded liquidity-forming foreign exchange swap transactions at the end of May and in early December to stabilise the money market.

... short-term Treasury bill sales

Given the marked relaxation on the money market, the Bank sold liquidity Treasury bills (pursuant to section 42 of the Bundesbank Act) with a regular maturity of three days at the end of April.

Lombard loans

Throughout the year, recourse to lombard loans was available to banks to meet their short-term liquidity needs. On a daily average, utilisation of the lombard loan facility decreased from DM 0.7 billion in 1995 to DM 0.4 billion in 1996. This was due, among other things, to the fact that money market rates became more stable as a result of the liquidity provided by fixed-rate tenders and to banks' more sophisticated liquidity management operations. At DM 7.1 billion, the highest recourse to lombard loans was reached on September 30, 1996.

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

Issuers

In 1996 the Bank was involved solely in the issuing of Federal securities and of a security issued by the Land of Lower Saxony. The Federal special funds (Redemp-

Bonds issued by the Federal Government in 1996 Table 14

Issue	Amount issued or increased (DM billion)				Terms				
	Total	Syndicate amount	Amount allotted by auction	Market management amount	Nominal interest rate (% p.a.)	Maturity (years/months)	Issue price or average allotment rate (%)	Yield on issue price or allotment rate (% p.a.)	Date of issue
Federal Government (WKN 113 499)	15.0	5.0	5.0	5.0	6.00	10/0	101.00/ 100.19	5.87/ 5.97	Jan. 3/ Jan. 4
Increase	10.0	–	6.2	3.8	6.00	9/11	–/ 101.60	–/ 5.78	Jan. 24
Total volume	25.0								
Federal Government (WKN 113 500)	12.0	4.0	4.4	3.6	6.00	10/0	100.20/ 99.19	5.97/ 6.11	Feb. 13/ Feb. 14
Federal Government (WKN 113 501)	10.0	3.0	3.5	3.5	6.25	10/0	100.20/ 99.51	6.22/ 6.32	Apr. 23/ Apr. 24
1st increase	2.0	–	–	2.0	6.25	9/10	–	–	June 21
2nd increase	1.0	–	–	1.0	6.25	9/9	–	–	July 23
3rd increase	1.0	–	–	1.0	6.25	9/8	–	–	Aug. 27
Total volume	14.0								

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tion Fund for Inherited Liabilities, "German Unity" Fund, Federal Railways Fund and ERP Special Fund) raised funds only through borrowers' note loans. In 1996, the Indemnification Fund started to allocate debt securities under the Indemnification and Compensation Act; by the end of the year, DM 10.3 million of such debt securities were outstanding.

Issues of bonds

In 1996 the Bank participated in the floating of three Federal bonds with a total volume of DM 51.0 billion. The volume of one bond was increased once, and that of another bond three times, benefiting the liquidity of those issues. The tendency to reduce the number of securities and increase the volume of bonds outstanding thus continued. In the preceding year, bonds were issued with a total volume of DM 47.0 billion.

Issuing procedures

The bonds were again launched by a combined syndicate and auction procedure, with certain amounts being earmarked for sale on the stock exchanges for market-management purposes. Credit institutions participating in the

Issues of five-year special Federal bonds in 1996

Table 15

Issue	Amount issued (DM million)				Terms				Start of sales on market terms/ date of stock exchange listing
					Sales on market terms		Auction procedure		
	Total	Sales on market terms	Amount allotted by auction	Market management amount	Issue price (%)	Yield (% p.a.)	Average allotment rate (%)	Average yield (% p.a.)	
5.125 % series 117 of 1995 (2000)	1 11,366	546	4,235	6,585	100.55 – 102.65	4.50 – 5.00	99.92	5.13	Jan. 2/ Feb. 27
5.25 % series 118 of 1996 (2001)	10,000	1,635	3,040	5,325	99.90 – 101.30	4.93 – 5.27	100.38	5.15	Feb. 21/ May 28
5 % series 119 of 1996 (2001)	8,000	2,362	3,162	2,476	97.80 – 100.10	4.98 – 5.52	99.12	5.20	May 21/ Aug. 26
5 % series 120 of 1996 (2001)	9,000	1,542	4,752	2,706	99.50 – 101.75	4.58 – 5.12	101.58	4.61	Aug. 20/ Dec. 2
4.75 % series 121 of 1996 (2001)	2 827	827	2 ...	2 ...	100.75 – 101.30	4.45 – 4.58	2 ...	2 ...	2 Nov. 26/ ...

1 Sales of this series began on November 21, 1995; total amount sold on market terms: DM 1,180 million; total amount issued: DM 12,000 million. — **2** Sales were not completed at the end of the year.

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Issues of Treasury notes by the Federal Government in 1996

Table 16

Issue	Amount issued (DM million)			Terms				
	Total	Amount allotted by auction	Market management amount	Nominal interest rate (% p.a.)	Maturity (years/ months)	Average allotment rate (%)	Average yield (% p.a.)	Date of issue
Federal Government (WKN 113 675)	10,000	7,988	2,012	3.50	2/0	99.92	3.54	Sep. 18
Federal Government (WKN 113 676)	10,000	7,507	2,493	3.50	2/0	99.92	3.54	Dec. 18

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Issues of Treasury discount paper by the Federal Government ("Bubills") in 1996

Table 17

Issue	Amount issued (DM million)	Date of issue	Terms		
			Maturity (months)	Average allotment rate (%)	Average yield (% p.a.)
July 1996/6 (WKN 111 419)	10,962	July 17	6	98.416	3.18
October 1996/6 (WKN 111 420)	8,568	Oct. 16	6	98.528	2.96

Memorandum item: DM 19,530 million outstanding at December 31.

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Federal Bond Consortium underwrote bonds totalling DM 12.0 billion. A further DM 19.1 billion was allotted to syndicate banks under the auction procedure. DM 19.9 billion was held back for gradual sale on the stock exchanges for the purpose of market management.

In February 1996 the quotas in the Federal Bond Consortium were again recalculated. At the end of the year, the Consortium hence consisted of 87 (formerly 95) credit institutions, including 42 institutions wholly owned or majority-owned by non-residents.

Five-year special Federal bonds

In 1996, too, following the conclusion of sales on market terms of five-year special Federal bonds issued on tap every three months (February, May, August, November), another tranche of each given series was offered by auction to the credit institutions. The Bank reserves the right to close a series outside that set pattern of times with a subsequent auction. In 1996 five series of five-year special Federal bonds were offered for sale. Moreover, the amount set aside for market management operations of series 116 issued last year was increased by a total of DM 6.0 billion. Of the total issue volume amounting to DM 45.2 billion (in 1995: DM 33.7 billion), sales on market terms accounted for DM 6.9 billion and allocations by auction for DM 15.2 billion. DM 23.1 billion were earmarked for market management operations. The issuing of five-year special Federal bonds also by auction, which was begun in 1995, represented an increase in the volume of the securities available in the Bobl future.

Federal savings bonds and Treasury financing paper

In the year under review, the Bank, acting for the account of the Federal Government, was also 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 of DM 25.3 billion (in 1995: DM 30.0 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, again played a considerable part in budget financing in 1996. Treasury financing paper sold in the form of discount paper with maturities of one year and two years were issued to a total volume of DM 5.8 billion (in 1995: also DM 5.8 billion).

Treasury notes

Following the discontinuation of sales of four-year Federal Treasury notes in 1995, two-year Federal Treasury notes *("Schätze")* have been sold by auction every three months (March, June, September, December) since mid-1996. Two issues of these notes yielded DM 20.0 billion, DM 15.5 billion of which was allocated by auction and DM 4.5 billion being set aside for market management operations.

Issues of Federal savings bonds in 1996 — Table 18

Issue	Sales period 1996	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
1995 / 17 + 18	1 Jan. 2 – Jan. 19	3,105	2,695	410	3.75 – 7.25	5.54	5.88
1996 / 1 + 2	Jan. 19 – Mar. 15	4,424	4,116	308	3.50 – 7.00	5.10	5.46
1996 / 3 + 4	Mar. 15 – May 13	5,427	5,043	384	3.50 – 7.50	5.74	6.10
1996 / 5 + 6	May 13 – June 18	1,885	1,729	156	3.25 – 7.50	5.50	5.88
1996 / 7 + 8	June 18 – Aug. 8	3,470	3,078	392	3.25 – 7.75	5.81	6.20
1996 / 9 + 10	Aug. 8 – Sep. 16	2,250	2,051	199	3.25 – 7.50	5.50	5.88
1996 / 11 + 12	Sep. 16 – Oct. 1	803	733	70	3.00 – 7.50	5.33	5.74
1996 / 13 + 14	2 Oct. 1 – Dec. 31	3,933	3,480	453	3.00 – 7.25	5.13	5.52

1 Sales began on November 28, 1995; total sales issue 1995/17: DM 3,985 million, issue 1995/18: DM 531 million. — **2** Sales were not completed at the end of the year.

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"Bubills"

The Bank offered Federal securities running for less than one year by auction for the first time in July 1996. The issue volume of such discount paper, which is issued in the form of Federal discount paper ("Bubills") every quarter (July, October, January, April), was DM 19.5 billion (gross). The maximum amount outstanding was limited to DM 20.0 billion in 1996 and 1997.

Market management operations

Of the amounts set aside for market management operations when listed Federal securities (bonds, five-year special Federal bonds and Treasury notes) are issued, the Bank gradually sold DM 47.3 billion on the stock exchanges on behalf of and for the account of the Federal Government and the Federal Railways Fund in 1996 (in 1995: DM 53.7 billion).

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 and the former Treuhand agency, as well as for securities issued by the Reconstruction Loan Corporation and the German Equalisation Bank. The Bank also conducts price management operations with respect to the bonds issued by the Land of Lower Saxony, as listed on the stock exchanges in Frankfurt and Hanover.

Issue calendar extended

In 1996 the Federal Government's issue calendar, which is regularly published for the following quarter, again attracted a great deal of attention. It was extended to include Treasury discount paper running for less than one year ("Bubills"), which was issued for the first time ever, as well as two-year Treasury notes *("Schätze").* In addition to the Federal bonds issued at irregular intervals, the calendar thus includes three types of securities which are issued by the Federal Government every three months.

Stripping

With due regard to the competitiveness of the German financial market, the Federal Government decided in December 1996 to allow the stripping – probably from July 1997 – of newly-issued 10-year and 30-year bonds with a coupon date of January 4 and July 4. Stripping will also be possible for the 30-year 6.25 % bond of 1994 (2024) issued in early 1994 and the 10-year 6 % New Year bond of 1997 (2007). It is envisaged that another strippable 30-year bond with a coupon date of July 4 will be issued in mid-1997 and subsequently increased in volume.

V. Statistics

Reliable statistics as a basis for successful monetary policy

For a successful monetary policy, the European Central Bank requires reliable statistical data on monetary and real economic trends in the euro area, and it obtains them – with the assistance of national central banks – from statistical offices or economic agents direct. For all monetary statistics, the ECB itself prescribes the data to be included. To ensure that the statistical data are available in time for the start of monetary union, the reporting requirements must be defined at an early stage, so as to give the institutions required to report enough time to make the necessary changes to their bookkeeping programs.

"Implementation package" for the statistical reporting requirements of EMU

The Working Group on Statistics at the European Monetary Institute (EMI) has devised a strategy for harmonised monetary statistics in the past few years, which was approved by the Council of the EMI on July 2, 1996. It was presented to the general public under the name of "implementation package" and distributed to all credit institutions in Germany as advance information, in the form of an explanatory booklet summarising the principal data requirements. The requirements focus on the core areas of banking statistics and balance of payments statistics.[1]

Inclusion of "European" reporting requirements in German report forms ...

Immediately following the presentation of the "implementation package", preparations were started to adjust the statistics in Germany to the new requirements. It was the banking statistics that were primarily affected. New report forms were devised in the Bundesbank, in particular for the credit institutions' monthly balance sheet statistics reports and their monthly external position reports. A major aim was to keep the institutions' workload as small as possible in the forthcoming changeover. It was therefore planned not to introduce a completely new reporting system, but rather to modify the existing reporting framework for the banking statistics accordingly. It had to be borne in mind, however, that – besides the "European" data requirements – there will in future also be a national need for information on monetary and economic developments in Germany which will derive not least from the banking industry itself (for example, for the purpose of structural analyses of the German banking system). Moreover, the dual function performed by reports for the banking statistics (which are used for both statistical and supervisory purposes), which has proved its worth for many decades in Germany, and has spared credit institutions a good deal of extra work, is to be retained. Finally, care had to be taken to ensure that – as advocated by the Council of the EMI as early as December 1995 – the data included in the reports for the monthly balance sheet statistics can also be used to calculate required reserves if the ECB Governing Council decides to adopt a minimum reserve system in the third stage of EMU.

... as a basis for credit institutions' preparations

The central associations of the banking industry were involved in the planning at an early stage. Already in August 1996 they were invited to an initial exchange of views and information. In October the revised draft forms were discussed in detail. Overall, the associations agreed to the Bundesbank's approach. They welcomed the fact that the new reporting requirements for EMU were to be integrated into the existing reporting framework for the banking statistics, and that the deletion of some items no longer regarded as essential at the same time made it possible to simplify the reports in some respects. The specimen new report forms also show, however, that some changes to the credit institutions' EDP programs, operating procedures and to the coding of accounts and data will be unavoidable. To enable the new reporting requirements to be met

1 See also Deutsche Bundesbank, *Informationsbrief zur Europäischen Wirtschafts- und Währungsunion,* No. 2, October 1996, page 11 ff.

in full, and on time, at the start of the third stage of EMU, work which is especially time-consuming must be embarked on right away.

Central Bank Council decision

This was endorsed by the Central Bank Council in its decision of January 23, 1997. In this decision the Bank requested all German credit institutions which are defined as "Monetary Financial Institutions (MFIs)"[1] to make the necessary arrangements to enable them to use the newly designed report forms for the monthly balance sheet statistics, the monthly external position report, the quarterly borrowers' statistics and the statistics on investment companies as the basis for their future reporting to the banking statistics, to be decreed by the European Central Bank once it has been set up. In the same decision the Bank also stipulated, pursuant to section 18 of the Bundesbank Act, that, from the start of the third stage of EMU, several report forms (as part of the monthly balance sheet statistics and the regional statistics), the bank-weekly statistics "short external position report" and the monthly lending commitments statistics will no longer be collected. At the beginning of February 1997 the German MFIs required to report were informed by the Land Central Banks, with the aid of specimen forms, about the new reporting requirements and the associated changes compared with the current reporting arrangements.

"Implementation package" in the field of the balance of payments statistics ...

In the field of balance of payments statistics, the requirements of the "implementation package" essentially comprise the provision of monthly figures on some key items of the balance of payments for the EMU area and the quarterly compilation of an EMU balance of payments classified in accordance with the IMF standard components. Initially, the data required are to be collected with the aid of the proven national reporting systems.

... initially involves no additional reporting requirements

At present, the data collected as part of the German balance of payments statistics suffice virtually to meet the definitional and conceptual requirements of the EMU balance of payments statistics. The provisions of the IMF Balance of Payments Manual, which were used as a guideline for harmonising the concepts and definitions in the EU countries, have been implemented in Germany over the past two years with the aid of internal measures which did not impose any burdens on those required to report.

1 These are all institutions which receive deposits, or close substitutes for deposits, from the public (e.g. by issuing securities), and grant credits (also in the form of investments in securities) for their own account. In Germany, MFIs currently mainly comprise the credit institutions that have hitherto been subject to reporting requirements.

Over the longer term, however, it is especially in the areas of foreign travel and securities transactions that collection procedures will have to be altered. Once euro notes are issued, it will no longer be possible to cover foreign travel on the basis of purchases and sales of foreign notes and coins. Where securities transactions are concerned, changes in investment behaviour due to the introduction of the euro may entail an adjustment of data collection techniques. Finally, changes to the German reporting system may also be necessitated by the long-run harmonisation of European reporting systems.

Figures for the EMU balance of payments statistics from the beginning of the third stage

From the beginning of the third stage of EMU, monthly figures on the key items and more detailed quarterly data on balance of payments statistics will be available on a harmonised basis. Even so, for the time being the compilation of a German balance of payments cannot be dispensed with. For one thing, its figures are required for the national accounts; for another, they are needed for the ongoing analysis of German trade and financial flows within EMU.

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

1. International harmonisation of banking supervision

In the year under review the Bank was involved at an international level in several bodies engaged in projects concerning the further harmonisation of banking supervision.

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

Capital requirements for market risks

As already described in last year's Annual Report, in January 1996 the Basle Committee proposed amending the Capital Accord of 1988 to incorporate market risks, after the central bank governors of the G-10 countries had approved such an amendment. Under the new arrangements, which must be implemented by the G-10 countries not later than the end of 1997, capital charges must be applied to risks pertaining to interest-rate-related instruments and equities in the trading book of internationally operating banks, and to foreign exchange risk and commodities risk throughout the bank. The capital requirements for the items mentioned may in future also be met by short-term subordinated liabilities. For the calculation of capital requirements for market risks, banks may use – subject to the approval of the banking supervisory authorities – internal risk management models as an alternative to the prescribed standardised measurement methods.

Multilateral netting

In April 1996 the Basle Committee issued a document presenting its interpretation of the Capital Accord under the heading: "Multilateral netting of forward value foreign exchange transactions" in connection with counterparty default. This form of netting covers not only contracts between two counterparties, as in the case of bilateral netting, but also contracts among a number of counterparties. Multilateral netting is achieved by netting, through a central clearing house, all transactions that originate bilaterally between the participating counterparties. Because of the novelty of multilateral netting systems and the lack of experience, it was decided not to amend the Capital Accord formally at this stage. The said document proposes some reduction in capital requirements for forward value foreign exchange contracts included in a recognised netting system, provided that a number of conditions are met.

Interest rate risk

The Committee also resumed its work on interest rate risk in the year under review. As early as April 1993 it had issued a paper on the "Measurement of banks' exposure to interest rate risk" and presented this paper, along with papers on market risk and netting, to the interested public for comment. The paper proposed a method of measuring interest rate risk over the whole bank for the purpose of identifying outliers. In view of the comments on these papers received from all over the world, the Committee first of all devoted itself to revising the market risk paper. After the completion and approval of the latter by the central bank governors, the work on interest rate risk was resumed. It culminated in the presentation of a new consultative proposal in January 1997. This new paper sets forth principles for the management of interest rate risk by credit institutions. The Committee has thus relinquished its original intention of designing a single measuring system. Given the variety of the methods used by banks to control and manage interest rate risk, it seemed difficult to achieve the requisite standardisation of measuring methods at this stage. Credit institutions are now expected to have in place a risk management system which ensures the efficient monitoring, measurement and control of the interest rate risk incurred. In addition, the supervisors are to obtain sufficient information on the interest-sensitive positions of a credit institution, which enables them to carry out a quantitative analysis of individual banks' exposures to interest rate risk. Twelve principles are laid down for the following areas: the role and responsibilities of the board and senior management, risk policies and procedures, measurement and monitoring, and internal controls and reviews. The last principle relates to the supervisory authorities obtaining information on, and analysing, the interest rate risk. The basic features of the requirements for the design of the risk management system are comparable to the "Risk management guidelines for derivatives" issued by the Committee in July 1994 and implemented by the Federal Banking Supervisory Office as part of the "Minimum requirements for the trading activities of credit institutions" in October 1995.

Worldwide reinforcement of banking supervision

In 1996 the Basle Committee continued its work in the area of the prudential supervision of cross-border banking business, and published a document containing 29 recommendations. These recommendations are designed to help remove obstacles impeding the introduction of effective consolidated supervision. The paper was approved by the representatives of the supervisory authorities of 140 countries at the international conference of banking supervisors in Stockholm in June 1996. In November 1996 the Basle Committee held a meeting with representatives of the supervisory authorities of 15 countries which are not members of the G-10. The participants agreed to the proposal to draw up draft guidelines on efficient banking supervision in time for the spring meeting of the IMF and World Bank and the G-7 Summit Conference in Denver in June 1997. This document is currently being drafted by a joint working group of the Basle Committee and the banking supervisors of non-G-10 countries.

Transparency of derivatives activities

The Basle Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) last year again surveyed annual report disclosures about the trading and derivatives activities of internationally active banks and securities firms. The findings were published in a joint report of the two committees in November 1996. It was found that the banks and securities firms analysed further improved their disclosures about trading and derivatives activities in their 1995 annual reports, compared with 1994.

In particular, there was a marked rise in the number of institutions which disclosed the risk coefficients (value-at-risk figures) computed by means of their internal risk management models. This also applies to German credit institutions. In this respect, the institutions which are members of the Federal Association of German Banks have followed their association's recommendation dated January 1996. The recommendation lists, in addition to the market risk coefficient, some further particulars which should be considered for public disclosure already at this stage, such as figures on trends in value-at-risk and a comparison with the actual changes in the value of the trading book.

Even though significant progress has been made in international public disclosure practices, the scale and type of the information disclosed continue to diverge. The Basle Committee and the Technical Committee of IOSCO therefore encourage, in particular, those institutions which have hitherto provided little information on their trading and derivatives activities to disclose additional data. In this context they refer to the supervisory recommendations set out in their joint report of November 1995. This likewise goes for German credit institutions. Despite the progress that has been made so far, their annual report disclosures do not yet fully conform to the recommended level of information.

Financial conglomerates

The "Tripartite Group", an informal grouping of representatives of banking, securities and insurance supervisors, concluded its work already in April 1995 by presenting a report entitled "The Supervision of Financial Conglomerates". It was succeeded by the "Joint Forum", an official group meeting under the auspices of the Basle Committee, IOSCO, and the International Association of Insurance Supervisors (IAIS). The mandate of the "Joint Forum" includes fostering the exchange of information between supervisory authorities, identifying any obstacles that might impede the exchange of information, and identifying the criteria for designating a "lead regulator" or "prime convenor" in the event of a financial conglomerate being faced with a crisis. The German authorities are represented in the "Joint Forum" by the Federal Banking Supervisory Office and the Federal Supervisory Offices for Insurance Enterprises and for Securities Trading. The constitutive meeting was held in January 1996. Early results are not to be expected, however, because of the complexity of the subject matter.

(b) Harmonisation in the European Union

EC Netting Directive

The so-called "EC Netting Directive", which was issued by the European Parliament and the Council of the European Union in March 1996, amended the EC Solvency Ratio Directive of 1989. By this amendment, the range of bilateral netting agreements which may be recognised by banking supervisors when calculating the counterparty risk involved in over-the-counter derivative instruments, and which will therefore reduce the capital requirements, has been extended, subject to certain conditions. While contractual netting in the form of what are known as contracts for novation ("novation netting") has hitherto been recognised, other netting agreements, such as close-out agreements (close-out netting), have now also been included in the range of recognisable netting agreements. The condition under which supervisory authorities may recognise the netting agreements mentioned is that the competent authorities of all the countries concerned must be satisfied, on the basis of legal opinions to be submitted by the banks, that in the event of bankruptcy the contractual netting agreements are legally valid.

In April 1996 the European Commission adopted a proposal for another EC Directive, which proposes *inter alia* some amendments to the EC Solvency Ratio Directive and thus further amends the EC netting provisions. It provides for the possibility of taking into account the risk-reducing effects of recognised contractual close-out netting agreements when calculating the capital requirements for potential future credit risks inherent in over-the-counter derivative instruments. This ensures that the provisions are largely consistent with the corresponding provisions of the Basle Capital Accord

EC Capital Adequacy Directive

In the spring of 1996 the European Commission presented an initial working paper proposing an amendment of the EC Capital Adequacy Directive ("CAD II"). This amendment is designed to bring that Directive more closely into line with the Basle market risk provisions. Moreover, it is intended to authorise the internal risk management models for calculating capital requirements at the EU level as well. These changes are to take effect by the end of 1997, simultaneously with the entry into force of the Basle market risk provisions.

Branches of German credit institutions abroad

In the year under review the Federal Banking Supervisory Office, in conjunction with the Land Central Bank responsible for the German "parent institution" and the Central Office of the Bank participating, started paying information visits to foreign branches of German banks within and outside the EU. Such visits take account, firstly, of the home country control principle introduced in the EU under the Second Banking Coordination Directive, which provides that the supervision of the branches of a credit institution operating in another EU member state is largely the responsibility of the supervisory authorities of the country in which the credit institution has its registered office. Secondly, the business of the foreign branches is of increasing importance for the business of the entire institution concerned, and therefore requires direct supervision by the home country authorities.

The foreign supervisory authorities welcome these visits (which also provide an opportunity for an informal exchange of views and information between the supervisory authorities) as a token of a practical approach to banking supervision. In the EU states, in particular, the host country supervisory authorities have little knowledge of the business of a branch from another member state. At the same time, the exchange of information enhances German supervisors' knowledge of the financial centre concerned.

Working group on accounting and disclosure of financial instruments

A joint working group of the Banking Advisory Committee and the Contact Committee for the interpretation of accounting directives was set up at the European Commission. It will address the issue of accounting and the disclosure of financial instruments. Since the EC Bank Accounts Directive of 1986 does not contain adequate provisions on the accounting and valuation of derivative financial instruments, the Commission had been asked by the European Parliament to elaborate some pertinent proposals. The working group convened twice in the year under review. The focus of its proposals is expected to be on the accounting of credit institutions' trading activities at market values, which is a topical international issue.

2. Amendments of national banking supervision legislation

Sixth Act Amending the Banking Act

With the adoption of the draft Sixth Amendment of the Banking Act in December 1996, the Federal Cabinet initiated the legislative process. That amendment translates three EC Directives into German law. In accordance with the provisions of the EC Investment Services Directive, investment firms will in future be subject to solvency supervision by the Federal Banking Supervisory Office, comparable to the supervision of credit institutions; such firms are already mostly subject to market supervision by the Federal Supervisory Office for Securities Trading. Under the EC Capital Adequacy Directive, the market risks arising from the trading book business and derivatives transactions of credit institutions and securities firms must be backed by own funds. Moreover, capital adequacy provisions which differ from those of the EC Large Exposures Directive apply to large exposures in respect of these transactions. The BCCI Directive, which is likewise implemented by this amendment, closes the supervisory loopholes which emerged when the Bank of Credit and Commerce International (BCCI) collapsed. For example, it will no longer be permissible for a credit institution to have its registered office and its head office in different states. It is expected that the bill will be passed speedily, and that at least some parts of the Sixth Act Amending the Banking Act will come into force before the end of 1997.

Large Exposures Regulation

The Large Exposures Regulation was amended in the year under review in accordance with the provisions of the EC Netting Directive. Following this amendment, contractual netting agreements concluded by credit institutions will be recognised as risk-reducing for prudential purposes, provided that certain requirements are met.

Principles Concerning the Capital and Liquidity of Credit Institutions

Three points of Principle I, relating to the weighting of risk assets, were changed with effect from May 1, 1996: in keeping with an amendment of the EC Solvency Ratio Directive, the technical definition of "Zone A" was modified so as to exclude OECD countries that have rescheduled their external debt in the past five years from any privileged weighting of risk assets. Moreover, advantage has now been taken of some options in favour of credit institutions provided for in the EC Solvency Ratio Directive. Hence a zero weighting is, firstly, to apply to risk asset items constituting claims carrying the explicit guarantee of the European Communities. Secondly, a 20 % weighting only is now to be applied to asset items constituting claims on, or carrying the explicit guarantee of, specified foreign "Zone A" authorities, provided that the national banking supervisory authorities put them on an equal footing with central or regional governments or local authorities.

In addition, the EC Netting Directive (see Section 1.b above) was implemented from October 30, 1996 by means of another amendment of Principle I.

A revision of Principles I and Ia is also necessary in the wake of the Sixth Act Amending the Banking Act. The preparatory work was concluded for the time being in the year under review; a preliminary draft amendment of Principle I was discussed with the banking associations as early as June 1996. According to this draft, market price risks pertaining to interest-rate-related instruments and equities in the trading book and to foreign exchange risk and commodities risk throughout the bank will be included in Principle I in future. Capital charges will thus be applied to these risk positions, as hitherto has been the case with the counterparty risk involved in on-balance-sheet and off-balance-sheet transactions. Furthermore, it is planned to cancel the limit currently applied to market price risk positions under Principle Ia and to introduce a reporting requirement for derivatives positions only for those institutions which come within the summary ceiling for trading book positions.

Following the amendment of the EC Capital Adequacy Directive, the use of the banks' internal risk management models for the calculation of capital require-

Internal risk management models

ments in connection with market risk is permitted, as a more precise alternative to the relatively simple standardised measurement methods. By using proprietary risk management models for prudential purposes, the banks avoid the duplication of calculations, but they must obtain the prior approval of the Federal Banking Supervisory Office. In order to ensure a minimum of uniformity in the capital requirements, the banks must meet some qualitative and quantitative requirements. Compliance with these requirements will be checked – also as part of on-site examinations – by authorisation teams consisting of representatives of the Federal Banking Supervisory Office, the Central Office of the Bank and the Land Central Banks. To alleviate the problems of transition, it is planned also to accept the use of models for individual risk areas and for organisational units within an institution (partial use). Both for the banks and for the banking supervisors, the authorisation of the use of internal risk management models for prudential purposes is a new challenge requiring thorough discussion.

In the year under review preliminary work was started on a revision of the liquidity principles on the basis of residual maturities.

3. Ongoing banking supervision operations

Decline in the number of credit institutions covered

At the end of 1996 3,725 credit institutions were covered by banking supervision; specifically, 3,447 institutions in the old Länder and 278 in the new ones. That was 101 institutions fewer than in the preceding year. Once again, in the year under review most of the fall – which was slightly steeper than in the previous year – was due to mergers. For example, there were 84 mergers in the co-operative bank sector (including 7 in the new Länder) and 17 in the savings bank sector (including 11 in the new Länder). Altogether, a decline of 128 was accompanied by an increase of 27, recorded above all among regional banks and other commercial banks (11) and the branches of foreign banks (11).

Land Central Banks' participation

The Land Central Banks are responsible for the major part of the direct practical supervision of credit institutions. The details of the work performed by them in 1996 are shown in the table on the facing page.

Causes of major changes

As far as the reports on loans of DM 3 million or more are concerned, it should be borne in mind that the Fifth Act Amending the Banking Act, which came into force on December 31, 1995, changed the concepts of both capital and loan; this resulted in contrary trends, the extent of which cannot be quantified,

Ongoing banking supervision operations

Table 19

Number of operations conducted

Item	1993	1994	1995	1996
Individual reports pursuant to section 13 of the Banking Act	68,542	65,908	66,714	71,744
Borrowers included in the lists submitted pursuant to section 13 of the Banking Act	75,996	76,987	77,317	59,463
Reports on loans of DM 3 million or more pursuant to section 14 of the Banking Act	2,001,923	1,109,990	1,184,719	1,373,698
Reports pursuant to section 16 of the Banking Act	14,376	14,887	13,795	26,567
Reports pursuant to section 24 of the Banking Act	19,828	49,312	51,245	40,305
Monthly returns pursuant to section 25 of the Banking Act	49,514	48,914	46,900	45,897
Reports on the volume of external lending	998	407	302	299
Annual accounts of credit instititutions	4,338	4,147	4,008	4,050
Auditor's reports on annual accounts	2,294	2,450	2,429	2,643
Reports on the auditing of safe custody accounts	407	534	412	499
Routine, special and deposit guarantee fund auditor's reports	463	647	683	812
Audits commissioned by the Federal Banking Supervisory Office pursuant to				
section 44 (1) of the Banking Act	33	32	34	29
section 44 (2) of the Banking Act	122	141	103	33
Reports under the Capital Accord of the Basle Committee on Banking Supervision	102	96	97	97

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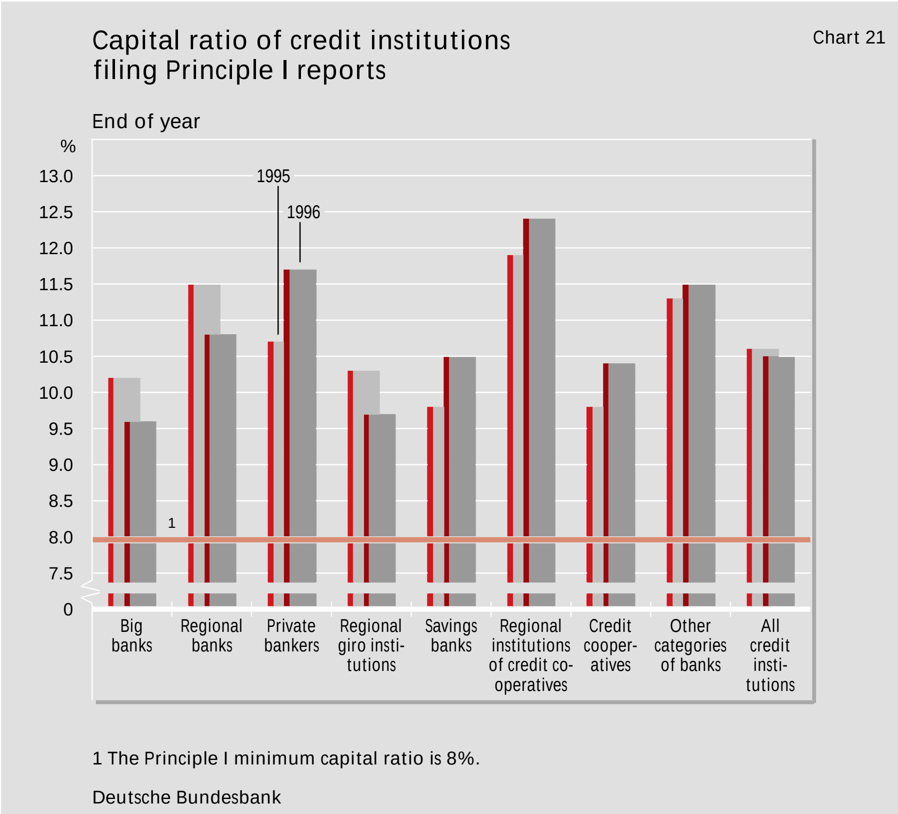
in the number of individual reports and the lists. Many of the initial reports – in the form of lists – required as a result of the changeover and relating to the reporting date June 30, 1996 were received late by the Land Central Banks. They could not all be processed in the year under review, so that an overhang was carried forward to 1997. Because of the amended Reports Regulation, credit institutions had to submit summary reports on their loans to managers, etc. pursuant to section 16 of the Banking Act (which are due every five years) for the first time in the year under review. This explains why the number of reports almost doubled. The fall in the processed number of reports pursuant to section 24 of the Banking Act is attributable both to developments at individual banks and to the fact that some of the reports cannot be finally processed until the current year.

Principle I

Principle I provides that a minimum 8 % capital charge is to be applied to the weighted risk assets both of an individual credit institution and of a group of credit institutions or financial holding group. The average capital ratio for all individual credit institutions was 10.5 % at December 31, 1996, and had thus decreased marginally compared with the level at the end of 1995 (10.6 %). On a consolidated basis, the capital base of German banks at the end of December 1996 came to no more than 9.7 % (previous year: 9.8 %). The chart overleaf shows the average capital ratio of the various sectors of the banking industry.



Principle Ia

Principle Ia limits a credit institution's market price risks arising from positions in foreign currency or precious metals to 21%, those arising from interest-rate-related derivatives to 14 %, and those arising from derivatives positions involving other price risks to 7 %, of the liable capital. At the end of December 1996 the average ratios of all credit institutions were 3.5 %, 2.5 % and 0.8 %, respectively, and thus well below the prescribed ceilings.

Principles II and III

1996 saw no changes in the liquidity principles. As at December 31, 1996 the average ratios were 88.6 % for Principle II and 68.1% for Principle III.

Credit register for "Millionenkredite"

The number of loans of DM 3 million or more to be reported quarterly under section 14 of the Banking Act increased by about one-third to around 410,000 within the year from the reporting dates September 30, 1995 to September 30, 1996 (see the table opposite). The total volume of loans of DM 3 million or more reported went up from about DM 2,800 billion to DM 7,200 billion during that period, and thus more than doubled. This considerable increase in the credit volume reported was caused by the changes to the Banking Act (Fifth Act Amending the Banking Act), which came into force in 1996 and which had to be taken into account in the reports on loans of DM 3 million or more for the first time for the reporting date September 30, 1996. The reporting requirements now also cover interbank loans with a maturity of up to 90 days (which were previously excluded), loans to public credit institutions, debt securities and derivative financial instruments. Moreover, the range of lenders required to report was considerably enlarged, notably by the inclusion of financial institutions. As at the reporting date September 30, 1996, 3,667 credit institutions, 551 insurance enterprises and, for the first time, 874 financial institutions submitted reports on loans of DM 3 million or more.

On the basis of the reports submitted, the credit register ascertains the borrowers' overall debt and discloses it to the lending institutions in its notifications. There was a year-on-year increase of about 36,000 (to around 269,000 borrowers now) in the number of borrowers notified to lenders at the reporting date September 30, 1996. Almost two-thirds of the borrowers were amalgamated into 56,500 single borrowers as defined in section 19 (2) of the Banking Act. At the end of September 1996, 85 single borrowers had debts exceeding DM 2 billion; the total indebtedness of those borrowers amounted to DM 435 billion, thus accounting for 6 % of the total volume of lending reported. Lending to domestic borrowers, at DM 4,600 billion, made up almost 64 % of the total volume of lending reported. The table below shows the changes since 1992.

Insolvencies

In 1996 the credit register recorded a total of 1,299 insolvencies of enterprises and individuals, who, at the date when the insolvency became known, had loans of DM 3 million or more outstanding. That was 186 more insolvencies than a year before (+ 16.7 %). The volume of loans of DM 3 million or more reported for insolvent borrowers amounted to around DM 14 billion or about DM 4 billion more than in the previous year (+ 42 %).

Credit register for "Millionenkredite"

Table 20

3rd 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 (%)	credit institutions	insurance enterprises	financial institutions
1992	2,593	+ 7.4	547,486	+ 10.6	3,608	518	–
1993 1	2,444	– 5.8	275,691	– 49.6	2,403	403	–
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	7,237	+ 159.3	410,500	+ 33.5	3,667	551	874

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

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International cooperation between European credit registers

Cooperation between the European credit registers continued in 1996. In Austria and Portugal the legal framework for participation in the international cooperation between credit registers operating in Europe was put in place in 1996. Seven countries (Austria, Belgium, France, Germany, Italy, Portugal and Spain) are now taking part in the agreed exchange of information on the indebtedness of borrowers, which to date can be used for banking supervisory purposes only. The efforts being made as part of the cooperation now focus on creating, in the individual countries, the legal basis which will allow them to make the information received from foreign credit registers available to credit institutions, too, in order to enhance debt transparency.

Minimum requirements for the trading activities of credit institutions

In 1996 credit institutions made great efforts to implement, by December 31, 1996, the "Minimum requirements for the trading activities of credit institutions" issued by the Federal Banking Supervisory Office. That statement also supersedes the old minimum requirements for foreign exchange transactions and securities trading, and contains provisions on the organisational structures and processes involved in trading activities – in particular, on efficient risk management and risk controlling. The Bank provided advisory services to facilitate the necessary restructuring measures.

In the light of the increasing significance of trading activities for credit institutions and the resultant risks, the Central Bank Council complied with the Federal Banking Supervisory Office's request and decided on May 30, 1996 to extend the foreign exchange audits carried out by the Bank on behalf of the Federal Banking Supervisory Office, pursuant to section 44 of the Banking Act, to include the overall trading activities of credit institutions. These audits are to be carried out by the Bank alternately with external auditors. They are intended to ensure compliance with the minimum requirements for trading activities.

VII. Authorisations under monetary law

Value guarantee clauses

Decisions on the authorisation of value guarantee clauses are taken by the Bank in accordance with its "Principles Governing Decisions on Applications for

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

Table 21

Year	Applications	Authorisations	Certificate of non-applicability of authorisation requirement	Applications rejected
1986	40,064	30,998	7,367	1,699
1987	37,083	28,069	7,523	1,491
1988	37,812	29,899	6,313	1,600
1989	38,633	30,349	6,448	1,836
1990	42,552	33,232	7,123	2,197
1991	48,806	37,837	8,197	2,772
1992	54,129	41,689	8,840	3,600
1993	57,155	44,949	8,231	3,975
1994	68,698	54,490	9,886	4,322
1995	71,881	57,643	9,767	4,471
1996	63,176	50,084	8,902	4,190

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Authorisations Pursuant to Section 3 of the Currency Act (No. 2 (c) of the Currency Regulation for Berlin)".[1]

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

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

VIII. UN embargo measures: recent developments in the field of financial sanctions

1996 saw the lifting of the Yugoslavia sanctions and, for the first time, some relaxation of the Iraq sanctions.

1 Deutsche Bundesbank Notice No. 1015/78 of June 9, 1978. For the Bank's policy in granting such authorisations, see also Deutsche Bundesbank, Value guarantee clauses – synopsis of the Bundesbank's policy in granting permits, Monthly Report, April 1971, page 25 ff. Regarding the incurrence of liabilities denominated in the European Currency Unit (ECU) or the special drawing right of the International Monetary Fund (SDR), see Deutsche Bundesbank Notice No. 1002/90 of January 5, 1990, published in Federal Gazette No. 3 of January 5, 1990, page 54.

2 Deutsche Bundesbank Notice No. 1006/90 of June 13, 1990, published in Federal Gazette No. 114 of June 23, 1990, page 3,215.

Serbia/ Montenegro and Bosnia-Herzegovina (where controlled by Serbs)

After the Yugoslavia sanctions had been suspended in November 1995 because of the Dayton Agreement, they were finally terminated in October 1996 by the "Termination Resolution" No. 1074/96 of the UN Security Council dated October 1, 1996. In the wake of the UN Resolution, the EC likewise terminated its Yugoslavia sanctions (EC Regulation No. 2382/96 of December 9, 1996, Official Journal L 328/1 of December 18, 1996). The German provision, section 69 k of the Foreign Trade and Payments Regulation, will soon be formally cancelled by the 39th Regulation Amending the Foreign Trade and Payments Regulation.

Freedom of payments and financial transactions with Serbia/Montenegro and Bosnia-Herzegovina has thus been restored.

On the other hand, the UN Security Council abides by its warning that every care should be taken, where withdrawals of the assets of old Yugoslavia are concerned, as long as no agreement has been reached among the successor states.

Iraq

The relaxations of the Iraq sanctions were the outcome of lengthy negotiations between the UN and Iraq. In its Resolution 986, the UN offered Iraq, as early as April 1995, the sale of oil to the value of US$ 2 billion within 180 days. Most of the proceeds are to be used for humanitarian purposes, but in large part also for the payment of reparations and to meet the costs incurred by the UN. However, this resolution was not implemented until one year later, in May 1996, by a "Memorandum of understanding" under which Iraq accepted the main conditions set by the UN. In August the Sanction Committee adopted the procedural rules necessary for implementing UN Resolution 986; these were published in the form of a UN document (S/1996/636 of August 12, 1996). The UN Secretary General put the "oil-for-food" programme into operation on December 10, 1996 (UN Doc. S/1996/1015 of December 9, 1996).

When implementing UN Resolution 986, the EC took the opportunity to summarise its current sanctions while at the same time issuing the necessary authorisations for the "oil-for-food" programme, including those in the field of payments (EC Regulation 2465/96 of December 17, 1996 (Official Journal L 337/1 of December 27, 1996).

A leaflet outlining the procedures to be observed when importing oil, delivering humanitarian goods or making payments, which was prepared by the Federal Foreign Office and the Federal Ministry of Economics, with the Bundesbank also being involved, is available from the Land Central Banks – Main Offices of the Deutsche Bundesbank.

Apart from this "oil-for-food" programme, the UN financial sanctions imposed on Iraq in 1990 continue to apply.

Libya

The UN financial sanctions imposed on Libya likewise continue to apply.

Overview

The following provisions implementing UN financial sanctions applied at the end of 1996:

Iraq: sections 52 and 69 e of the Foreign Trade and Payments Regulation (sections 52 and 69 e will be changed to sections 69 b and c by the 39th Regulation Amending the Foreign Trade and Payments Regulation).

Libya: section 69 n of the Foreign Trade and Payments Regulation.

IX. Technical central bank cooperation by the Bank

Further rise in demand for technical cooperation

As in previous years, the Bank provided training and advisory services for a large number of central banks in countries in transition and developing nations in 1996. The aim of such assistance is to promote the construction and development of central banking systems which are geared to the free market, to foster the process of monetary reform, and to enhance economic stability in the countries concerned. Cooperation is very largely bilateral; sometimes the Bank, together with other G-10 central banks, also takes part in cooperation on a multilateral basis, for example under the auspices of the International Monetary Fund or the European Community. Once again, the number of requests for cooperation the Bank received and the number of its activities increased markedly compared with the previous year. This reflects not only the continued great demand for technical cooperation, but also confidence in the Bank as a partner in cooperation.

Cooperation offering customised solutions

As a matter of principle, the Bank provides assistance to central banks in countries in transition and developing nations. In each case, the form which the cooperation takes is individually tailored to the specific needs and wishes of the recipient central bank. On the basis of cooperation in a spirit of partnership, customised solutions are sought for each individual case and brought into line with the Bank's staffing resources. The training and advisory services are provided by the Bank's own experts.

Variety of forms of cooperation

As mentioned, the focus of technical central bank cooperation is, firstly, on training activities and, secondly, on project consultancy. As part of the training assistance, executive personnel of foreign central banks are invited individually or in small groups to pay information visits to the Bank in order to discuss specific issues with the Bank's appropriate experts. Specialist seminars are organised for the systematic dissemination and acquisition of knowledge about general subjects. Seminars for small groups of participants mostly take place in Germany, while, as a matter of principle, those for large groups are held in the countries of the central banks being advised. This arrangement ensures the highest possible degree of efficiency while at the same time minimising the costs involved. Bundesbank experts are seconded to foreign partner central banks for project consultancy; there they engage in the on-site solution of problems.

To supplement the demand-oriented technical assistance provided to foreign central banks for specific subjects, the Bank organises what are known as standardised seminars for junior executive staff in Frankfurt. In these seminars, both general and basic issues of modern central banking are addressed, such as questions of monetary and exchange rate policy, with particular emphasis on the presentation of the theoretical background. The standardised seminars are intended for a broad range of interested central banks in countries in transition and developing nations. At the same time they provide a forum where young central bankers from different countries can meet.

Shift in the regional and technical foci persists

The geographical shift towards the east in the Bank's central bank cooperation, which was already evident in 1995, continued during the year under review. Whereas central banking has developed quite positively in the majority of the transition nations in central Europe, and the need for cooperation is therefore tending to decrease there, the demand from eastern Europe remains unchanged. Besides this, new requests for cooperation are being received from the Transcaucasian countries and from central and east Asia. In 1996, 60 % of all training activities in the context of the Bank's technical central bank cooperation were accounted for by eight partner countries (Russia, Ukraine, the Czech Republic, Poland, Vietnam, China, Uzbekistan, the Slovak Republic); in terms of the number of participants, this represents a share of no less than 70 %.

In 1996 the Bank worked together with about 40 foreign central banks, all told, in the context of technical central bank cooperation; the key subjects involved were monetary policy, banking supervision, internal audits, internal security and payments.

First European seminar successful

There was a striking increase in the interest shown by central and south European, as well as Baltic, countries in transition – all of which have EU associate status – in issues that are relevant to central banking in connection with preparation for possible EU membership. At the invitation of the Bank, a first "European seminar" dealing with these issues was held for executives from the central banks of this group of countries in October 1996. Since the economies and institutions of most of these countries still lag some way behind those in the European Union, the main point of this seminar was to explain to interested central banks what still has to be accomplished in economic and technical terms in order to catch up.

Continued growth of activities

As mentioned above, the Bank's cooperation activities continued to increase rapidly in 1996. For example, the number of information visits to Germany went up by about 25 % (from 90 to 113), and the on-site advisory services also increased. There was a steep rise in the number of seminars held abroad and in Germany last year. Altogether, the training and advisory activities provided in the context of technical central bank cooperation increased by almost one-quarter (to 216) in 1996 from the previous year's level. The number of foreign central bank staff who participated in the 173 information visits and seminars in 1996 went up by about 40 % to around 1,700. On average, just under ten foreign central bank staff members participated in each training scheme.

Close cooperation between the Central Office, the Land Central Bank areas and the Bank's Training College

The technical support offered to foreign central banks is organised and coordinated by the "Technical Central Bank Cooperation" Division at the Central Office and carried out by the entire Bank; that is to say, the Land Central Banks and the Bank's Training College also take part. For example, in 1996 the Bank's training activities separately or jointly involved the Central Office in 128 cases, the Land Central Banks in about 100 cases and the Training College in some 20 cases. Staff members of the Bank's Central Office spent a total of about 130 working days, and those of the Land Central Bank areas a total of about 180 days, on short and medium-term on-site project consultancies. In addition, three staff members of the Bank are currently on medium-term secondments abroad as advisors to the governors of one east European and two African central banks.

Evaluation of success difficult

It often proves difficult to evaluate the success of the technical central bank co-operation provided by the Bank and other central banks – particularly in specific cases. Nevertheless, it can be said that a number of countries in transition have not only made considerable progress in setting up an up-to-date central banking system but have also been conspicuously successful in combating inflation and putting their banking systems on a more stable footing. The consultancy and technical assistance measures provided by the Bank and other central banks have been instrumental in these developments, although they cannot be classified or quantified in terms of their individual impact. The Bank's technical central bank cooperation is an integral part of the intensive international efforts to foster the free market forces of reform in the countries in transition and in other parts of the world.

The Bundesbank will continue to do everything in its power to meet these challenges, and to engage in active cooperation with those central banks which seek its assistance in building up an efficient, up-to-date central banking system.

X. Organisation and staff

Further streamlining of branch office network

The process of rationalisation and concentration which continued unabated among private banks and the associated changes resulted in a further decline in the demand for central banking services from the Bank's nationwide branch network. As a consequence, the Bank continued to streamline its branch office network in 1996, reducing the number of its branches by ten to 167.

Since the Central Bank Council's decision of 1993 on the branch office network, the number of branches has therefore been reduced by 21, or 11%. The staff members affected have been offered further employment within the Bank – mostly at neighbouring branch offices.

Staff levels again reduced

The decline in the volume of business caused a further cutback in staff levels at the branch offices. Altogether, the number of persons employed decreased by 321, or 3.7 %, which was a crucial factor in the reduction of the overall staff level by 359 employees. The peak employment level of 18,237 reached in 1992

Trends in staff levels

Table 22

Beginning of 1997

Employed persons	Central Office of the Bank	Land Central Banks	Total 1	Male	Female
Civil servants	1,030	5,717	6,747	5,791	956
Other salaried staff	1,366	6,964	8,330	3,807	4,523
Wage earners	180	757	937	208	729
Total	2,576	13,438	16,014	9,806	6,208

Beginning of 1996

Employed persons	Central Office of the Bank	Land Central Banks	Total 1	Male	Female
Civil servants	1,022	5,776	6,798	5,865	933
Other salaried staff	1,402	7,178	8,580	3,911	4,669
Wage earners	191	804	995	212	783
Total	2,615	13,758	16,373	9,988	6,385

1 of whom

	Beginning of 1997	Beginning of 1996
Trainee civil servants, civil servants undergoing training programmes and other trainees	384	405
Part-time employees:		
Civil servants and other salaried staff	1,230	1,146
Wage earners	612	649
The following are not included in the staff figures:		
persons seconded to work for 12 months or more for other public employers, international organisations or otherwise abroad	79	75
members of the Bank's staff released without pay	691	694

Deutsche Bundesbank

as a result of German unification has since been reduced by a total of 2,223 (or 12.2 %) to 16,014 employees.

The major part of the decrease in the year under review was accounted for by the Bank's Intermediate Service. By contrast, there was a slight increase in staff levels in the Upper Intermediate and Higher Services at the Main Offices of the Land Central Banks and at the Bank's Central Office. This increase was mainly due to new tasks in banking supervision and to the diverse and intensive preparations for the planned European monetary union.

Promotion of part-time employment

With overall staff levels declining, the number of persons working part-time increased by 47 in 1996, to 1,842. In the past four years, the number of persons working part-time has gone up by 134, thus raising the ratio of part-time employees at the Bank from 9.5 % to 11.5 % during that period.

In 1996 training and further training schemes were again marked by topicality and flexibility, particularly in order to enhance staff members' knowledge of fi-

Purposeful deployment of training and further training measures

nancial innovations and international relations at an early date. For the sake of a rapid and nationwide dissemination of knowledge, the participants in training courses acted as multipliers, so to speak. Management training was likewise stepped up. The growing need to have a working command of English was met *inter alia* by enabling staff members to hone their language skills in close connection with their regular duties. In addition, as part of the individual training courses, a start was made on holding lessons in English. By increasing the admission of the staff of European central banks and other institutions to Bundesbank training courses, the Bank contributed significantly towards strengthening cooperation at the European level.

Annual accounts of the Deutsche Bundesbank for 1996

I. Balance sheet of the Deutsche Bundesbank as at December 31, 1996

Assets

				DM	31.12.1995 DM million
1	Gold			13,687,518,821.70	13,688
2	Reserve position in the International Monetary Fund and special drawing rights				
	2.1 Drawing rights within the reserve tranche		8,485,151,159.20		(7,469)
	2.2 Loans under special borrowing arrangements		—		(—)
	2.3 Special drawing rights		2,959,442,661.80		(2,868)
				11,444,593,821.00	10,337
3	Claims on the European Monetary Institute				
	3.1 ECU balances	33,213,557,481.15			
	less: Difference between the ECU value and the book value of the gold and dollar reserves contributed	11,166,041,315.26			
			22,047,516,165.89		(28,798)
	3.2 Other claims		—		(—)
				22,047,516,165.89	28,798
4	Balances with foreign banks and money market investments abroad			72,332,818,017.70	68,464
5	Foreign notes and coins			31,573,593.05	20
6	External loans and other external assets				
	6.1 Loans in connection with EC medium-term balance of payments assistance		—		(—)
	6.2 Other loans to foreign monetary authorities		—		(—)
	6.3 Loans to the World Bank		1,250,000,000.00		(1,750)
	6.4 Other external assets		190,680,000.00		(204)
				1,440,680,000.00	1,954
7	Lending to domestic credit institutions				
	7.1 Securities bought in open market transactions under repurchase agreements		161,614,847,500.00		(145,754)
	7.2 Domestic bills of exchange		52,285,560,170.56		(52,210)
	7.3 Foreign bills of exchange		8,968,439,604.44		(9,635)
	7.4 Lombard loans		3,282,528,300.00		(5,533)
				226,151,375,575.00	213,132
8	Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			8,683,585,988.93	8,684
9	Securities			—	884
10	German coins			2,056,651,716.90	2,090
11	Land and buildings			3,700,983,287.16	3,559
12	Furniture and equipment			216,817,569.00	203
13	Items in course of settlement			1,845,664,248.68	—
14	Other assets			2,701,150,271.30	2,572
15	Prepayments			62,711,791.21	62
				366,403,640,867.52	354,447

Liabilities

				31. 12. 1995
			DM	DM million
1	Banknotes in circulation		260,390,460,565.00	248,364
2	Deposits of credit institutions			
	2.1 Deposits on giro accounts	51,910,402,732.83		(49,669)
	2.2 Other	17,213,726.21		(18)
			51,927,616,459.04	49,687
3	Deposits of public authorities			
	3.1 Federal Government	117,091,962.91		(40)
	3.2 Federal special funds	14,271,621.51		(7)
	3.3 Länder Governments	239,489,920.99		(79)
	3.4 Other public depositors	111,652,204.21		(38)
			482,505,709.62	164
4	Deposits of other domestic depositors		1,165,493,794.15	707
5	Liabilities arising from liquidity paper sold		2,570,700,000.00	1,584
6	Liabilities arising from external transactions			
	6.1 Deposits of foreign depositors	13,021,878,663.39		(14,799)
	6.2 Other	11,176,042.23		(7)
			13,033,054,705.62	14,806
7	Counterpart of special drawing rights allocated		2,701,750,402.00	2,580
8	Provisions			
	8.1 for pensions	3,360,000,000.00		(3,093)
	8.2 for other purposes	7,629,175,694.53		(6,992)
			10,989,175,694.53	10,085
9	Items in course of settlement		—	2,253
10	Other liabilities		356,715,182.70	508
11	Accruals		361,104,530.35	393
12	Capital		290,000,000.00	290
13	Reserves			
	13.1 Statutory reserves	12,418,200,000.00		(11,808)
	13.2 Other reserves	290,000,000.00		(290)
			12,708,200,000.00	12,098
14	Unappropriated profit		9,426,863,824.51	10,928
			366,403,640,867.52	354,447

II. Profit and loss account of the Deutsche Bundesbank for 1996

Expenditure

			DM	1995 DM million
1	Interest expenditure		558,125,041.96	797
2	Staff costs			
	2.1 Wages and salaries	1,069,704,011.21		(1,074)
	2.2 Social security contributions, spending on retirement pensions and on maintenance payments	639,217,745.95		(706)
			1,708,921,757.16	1,780
3	Other operating expenditure		371,837,432.55	368
4	Banknote printing		169,768,810.23	163
5	Depreciation			
	5.1 of land and buildings	272,061,900.46		(234)
	5.2 of furniture and equipment and of other assets	106,957,785.92		(127)
			379,019,686.38	361
6	Write-downs of monetary reserves and other foreign currency positions		636,026,617.21	1,149
7	Other expenditure		59,405,018.33	57
8	Profit for the year (= unappropriated profit)		9,426,863,824.51	10,928
			13,309,968,188.33	15,603

Receipts

		DM	1995 DM million
1	Interest	12,932,957,948.78	15,084
2	Fees	111,828,889.31	110
3	Other receipts	265,181,350.24	409
		13,309,968,188.33	15,603

Frankfurt am Main, February 11, 1997

Deutsche Bundesbank
The Directorate

Prof. Dr Dr h.c. Tietmeyer Gaddum
Haferkamp Hartmann Prof. Dr Dr h.c. Issing Meister Schieber Schmidhuber

According to the audit we have carried out in line with our mandate, the bookkeeping and annual accounts comply with German law. The annual accounts conform to generally accepted accounting principles 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 21, 1997

C & L Deutsche Revision
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Windmöller
Certified Auditor

Langen
Certified Auditor

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Brackert
Certified Auditor

Rönnberg
Certified Auditor

III. Notes on the annual accounts for 1996

1. Legal basis and classification

Legal basis

Notwithstanding its public-law status, the Deutsche Bundesbank is a trader within the meaning of section 1 (2) 4 of the German Commercial Code *(Handelsgesetzbuch – HGB)* because it conducts banking operations. Hence it is also subject to generally accepted accounting principles. In particular, the legal basis for its accounts is provided by sections 26 and 27 of the Bundesbank Act *(Gesetz über die Deutsche Bundesbank – BBankG)*. In accordance with those provisions, the layout of, and the notes on, the annual accounts must pay due regard to the Bank's duties. Regarding valuation, the provisions of the Commercial Code relating to incorporated enterprises are to be applied as appropriate.

Specifically, the current assets (which include, first and foremost, the monetary reserves) are to be shown in the balance sheet strictly in accordance with the principle of the lower of cost or market (section 253 (3) of the Commercial Code). Furthermore, write-downs may be effected in order to obviate the need to change the valuation in the very near future on account of fluctuations in value. Pursuant to section 26 (2) of the Bundesbank Act, the Bank may retain such a lower valuation in the following years, too. Moreover, in the context of determining the profit or loss, liability items may be created in respect of general hazards encountered in domestic and international operations.

In accordance with section 27 of the Bundesbank Act, 20 % of the net profit or DM 20 million, whichever is the higher, is to be transferred to the statutory reserves until they reach 5 % of the total amount of banknotes in circulation. Up to 10 % of the remaining net profit may be used to form other reserves, which in the aggregate may not exceed the amount of the Bank's capital. The balance is to be paid over to the Federal Government. The final transfer to the Fund for the Purchase of Equalisation Claims was effected out of the net profit for 1994, since the fund was wound up in December 1995.

Classification

The balance sheet no longer contains the item "Balances on postal giro accounts", as the Bank's last postal giro accounts were closed in spring 1995 in the course of the dismantling of the special regulations for the Postbank.

Auditing and approval of the annual accounts

The annual accounts of the Bank for 1996 were audited by *C&L Deutsche Revision AG Wirtschaftsprüfungsgesellschaft* of Frankfurt am Main and *KPMG Deutsche Treuhand-Gesellschaft AG Wirtschaftsprüfungsgesellschaft* of Frankfurt am Main, whom the Central Bank Council had appointed to be auditors in accordance with section 26 (3) of the Bundesbank Act. In their certificate of audit, the auditors confirmed without qualification that the Bank's annual accounts for 1996 and bookkeeping comply with German law and present a true picture of the Bank's assets and liabilities, financial position and profitability. The Central Bank Council approved the annual accounts for 1996, together with the profit distribution, on April 17, 1997.

Harmonisation of accounting on transition to stage three of EMU

The ESCB/ECB Statute contains regulations concerning the publication of the ESCB's financial data. Accordingly, the figures for the ECB and the individual national central banks must be ascertained on a harmonised basis. In 1996 the EMI Council approved accounting principles for the Weekly Return and the consolidated balance sheet of the ESCB.

The accounting principles for the ESCB, which will have to be definitely decided by the ECB Governing Council, are to be applied to all items which are of significance for the ESCB's monetary policy operations. In addition, national central banks will be free, even after the start of stage three of EMU, to draw up and publish their financial statements according to their own accounting principles.

2. Assets

Gold

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

Reserve position in the International Monetary Fund and special drawing rights

This item contains the claims on the IMF financed and held by the Bank resulting from the Federal Republic of Germany's membership of the IMF. The drawing rights within the reserve tranche correspond to the amounts actually paid to the IMF in gold, special drawing rights and Deutsche Mark under the German quota. At December 31, 1996 their level amounted to DM 8,485 million (= SDR 3,803 million), compared with DM 7,469 million (= SDR 3,505 million) at the end of 1995. They represent the difference between the German quota of SDR 8,242 million and the Deutsche Mark balances totalling DM 9,905 million (= SDR 4,439 million) at the disposal of the IMF at the end of the year. Mainly owing to Deutsche Mark drawings and Deutsche Mark repayments by other member countries, the holding of drawing rights increased by SDR 298 million on balance in 1996.

During the year under review, the Bank did not grant the IMF any new loans under special borrowing arrangements. At the end of 1996, a credit line in favour of the IMF amounting to SDR 2.4 billion remained outstanding under the GAB, but the IMF can utilise it only subject to certain conditions.

Special drawing rights, by means of which convertible currencies can be obtained at any time, were originally allocated free of charge to the extent of SDR 1,211 million. The counterpart thereof is shown on the liabilities side. The level of special drawing rights held at the end of 1996 amounted to DM 2,959 million (= SDR 1,326 million). Increases totalling SDR 132 million owing to interest receipts were accompanied by decreases amounting to SDR 152 million on account of freely agreed sales.

Claims on the European Monetary Institute

This item comprises the Bank's ECU balances and the claims denominated in ECUs which arise when other central banks avail themselves of the very short-term financing mechanism. The ECU balances amounting to DM 33,214 million derive from the 20 % of the Bank's gold and US dollar reserves which it has transferred temporarily to the EMI. At the end of the year, the Bank held no balances of reserve ECUs (1995: DM 9,221 million) transferred to it by other central banks participating in the EMS. The gold and US dollar reserves temporarily contributed to the EMI under the terms of the EMS against the crediting of ECUs were transferred at market prices, and therefore at values higher than those shown in the balance sheet. The resulting difference of DM 11,166 million is deducted from the ECU balances. No other claims denominated in ECUs arising from lending under the very short-term intervention-financing mechanism were outstanding at the end of 1996.

Balances with foreign banks and money market investments abroad

The balances with foreign banks and money market investments abroad, the greater part of which are denominated in US dollars and bear interest, amounted to DM 72,333 million at the end of 1996, against DM 68,464 million at December 31, 1995 (not counting the US dollar reserves temporarily contributed to the EMI). The assets and liabilities expressed in US dollars were valued at the balance sheet rate of US$ 1 = DM 1.3620, which represented (as at the balance sheet date) the all-time low of the dollar (recorded on April 19, 1995).

External loans and other external assets

The main constituents of this item are loans to the World Bank which were granted against borrowers' notes denominated in Deutsche Mark. No loans under the EC medium-term balance-of-payments assistance arrangement or other loans to foreign monetary authorities were outstanding at December 31, 1996. The other external assets represent limited investments with foreign institutions. Because of their lesser liquidity, external loans and other external assets are not counted among the monetary reserves.

Lending to domestic credit institutions

This item reflects the volume and pattern of domestic credit institutions' refinancing. Most of it is made up of the securities repurchase operations used as part of the Bank's flexible money market management. In that context, the Bank buys securities eligible as collateral for lombard loans on condition that the sellers repurchase them forward. At the end of the year, the claims deriving from such transactions amounted to DM 161,615 million (in 1995: DM 145,754 million). The portfolio of domestic and foreign bills of exchange which the Bank purchases at the discount rate under the rediscount quotas decreased by DM 591 million compared with December 31, 1995. Lombard loans, by means of which the Bank supplies central bank money against the collateral of certain securities and Debt Register claims, serve to meet temporary short-term liquidity needs on the part of credit institutions. On the balance sheet date the lombard loans outstanding amounted to DM 3,282 million.

Equalisation claims

Equalisation claims on the Federal Government and the non-interest-bearing debt certificate in respect of Berlin both date back to the currency reform of 1948. They form the balance sheet counterpart of the amounts paid out at that time in cash per head 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 laid down that equalisation claims are to be redeemed in ten annual instalments, starting in the year 2024.

Securities

During the year under review the Bank's portfolio of securities (in 1995: DM 884 million) was run down completely.

German coins

The Bank's portfolio of coins is held as a reserve for use in payments. The Bank, acting for the account of the Federal Government (which holds the coinage prerogative), receives new coins from the state mints at face value. At the end of 1996 the amount of coins in the Bank's portfolio was equivalent to 13.4 % of the volume of coins outstanding. Under the supplementary provisions of Article 104 of the Maastricht Treaty, the Bank's coin portfolio must be kept below 10 % of the volume of coins in circulation; as an interim measure, however, a ceiling of 15 % applied until December 31, 1996 (as in the Coinage Act).

Land and buildings

In 1996 the balance sheet value of the Bank's land, offices and residential buildings increased on balance by DM 142 million. Net additions of DM 414 million were accompanied by depreciation amounting to DM 272 million.

Furniture and equipment

In the year under review the value of the Bank's furniture and equipment rose by DM 14 million, after net additions of DM 111 million and depreciation totalling DM 97 million.

Items in course of settlement

"Items in course of settlement" primarily comprise the cheques and direct debits (asset items) and transfers (liability item) circulating within the Bank, which are set off against each other at the end of the day. Since the introduction of the large-value cheque collection procedure in 1994, liability items have always outweighed asset items. On account of the limited working hours of the various categories of banks on the last day of the year, however, the positive float stemming from the collection items submitted at December 30 was only partly offset by the rather small number of transfers submitted at the end of the year. This resulted in a credit balance of DM 1,846 million at December 31, 1996, in contrast to a debit balance of DM 2,253 million at the end of 1995.

Other assets

"Other assets" mainly constitute interest income from external assets and securities repurchase transactions which is not due until 1997 but is assignable to the profit and loss account for 1996. This item also includes participating interests in the European Monetary Institute, Frankfurt am Main, the Bank for International Settlements, Basle, the cooperative society S.W.I.F.T., La Hulpe (Belgium), and *Liquiditäts-Konsortialbank GmbH*, Frankfurt am Main. The capital share in the European Monetary Institute amounts to DM 255 million (= ECU 139 million), or 22.55 % of the EMI's aggregate capital. The 30 % interest in *Liquiditäts-Konsortialbank* entails for the Bank an unchanged maximum additional commitment of DM 558 million.

Prepayments

Prepayments consist mainly of payments booked in the year under review, but relating to 1997, for salaries and pensions, and for interest expenditure on liquidity paper sold.

3. Liabilities

Banknotes in circulation

Compared with the end of 1995, the volume of banknotes in circulation rose by DM 12,027 million to DM 260,390 million, representing an increase of 4.8 %. In the preceding year the increase had amounted to 5.2 %.

Compared with the previous year, the total amount of currency in circulation went up by DM 12,234 million to DM 275,744 million; DM 15,353 million of this sum was accounted for by coins.

Deposits of credit institutions

Credit institutions' deposits on giro accounts, totalling DM 51,911 million (in 1995: DM 49,669 million), are mainly minimum reserves to be held at the Bank. The sub-item "Other" (DM 17 million) contains the deposits of domestic credit institutions and of the branches of foreign banks on US dollar accounts.

Deposits of public authorities

This item encompasses the balances of the Federal Government, its special funds, the Länder Governments and other public depositors. The special funds comprise, above all, the Equalisation of Burdens Fund, the ERP Special Fund, the Redemption Fund for Inherited Liabilities and the "German Unity" Fund. The deposits of other public depositors constitute the balances of social security funds and local authorities. At December 31, 1996 such deposits amounted to DM 483 million in all (in 1995: DM 164 million).

Deposits of other domestic depositors

This balance sheet item contains the deposits of enterprises and individuals. At the end of 1996 such deposits totalled DM 1,165 million, against DM 707 million in the previous year.

Liabilities arising from liquidity paper sold

"Liabilities arising from liquidity paper sold" amounted to DM 2,571 million at the end of 1996 (in 1995: DM 1,584 million). In the year under review Federal Treasury bills were sold to foreign monetary authorities and other institutions; the latter use these instruments *inter alia* for investing, at interest, balances not required for payment purposes. Moreover, Treasury bills were sold to credit institutions to mop up short-term liquidity in the context of money market management.

Liabilities arising from external transactions

This balance sheet item, totalling DM 13,033 million (in 1995: DM 14,806 million), consists primarily of the Deutsche Mark deposits of foreign monetary authorities. Specifically, DM 12,911 million (in 1995: DM 14,694 million) was accounted for by the balances of foreign banks and DM 122 million by other deposits.

Counterpart of special drawing rights allocated

The counterpart of the special drawing rights (SDRs) allocated by the IMF free of charge, and shown in item 2 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.

Provisions for pensions

After an increase of DM 267 million, the provisions for pensions amount to DM 3,360 million; they match the actuarially computed requirements.

Provisions for other purposes

The provisions for other purposes, which serve principally to cover general risks inherent in domestic and international operations and doubtful liabilities, were increased by DM 637 million net as at December 31, 1996. They now amount to DM 7,629 million (see also the notes below on the item "Write-downs of monetary reserves and other foreign currency positions").

Items in course of settlement

At the end of 1996 the "Items in course of settlement" showed a credit balance, which is recorded in asset item 13.

Other liabilities

The other liabilities, amounting to DM 357 million (in 1995: DM 508 million), constitute amounts not yet passed on and interest expenditure falling due in 1997 but relating to 1996.

Accruals

Accruals totalled DM 361 million at December 31, 1996 (in 1995: DM 393 million). This item comprises the interest received during the year under review, but relating to the following year, on domestic and foreign bills of exchange and US Treasury bills.

Reserves

In accordance with the decision taken by the Central Bank Council on April 18, 1996, the statutory reserves were increased by DM 610 million out of the unappropriated profit for 1995. Thereafter, the statutory reserves totalled DM 12,418 million; they thus reached the maximum level permissible by law of 5 % of the amount of banknotes in circulation, which came to DM 248,364 million at the end of 1995. The other reserves had reached the statutory ceiling of DM 290 million as long ago as the end of 1980.

Unappropriated profit

See the notes on "6. Profit for the year" below.

4. Expenditure

Interest expenditure

Interest expenditure fell by DM 238 million in the year under review. Interest expenditure on both international and domestic operations decreased.

Staff costs

Staff costs declined by DM 71 million in 1996 to a total of DM 1,709 million. Excluding the transfer to provisions, which was lower than a year before, staff costs went up slightly (by 0.5 %) in the year under review. This increase was due mainly to the general pay rise which came into effect on May 1, 1995 and which affected the full year in 1996. These additional costs were partly offset by the fact that the average number of persons employed at the Bank fell by 3.1% in 1996, compared with the preceding year.

DM 479 million (in 1995: DM 548 million) of the staff costs was accounted for by retirement pensions. This sum includes the increase of DM 267 million in provisions for pensions, as well as the payments made to staff members of the former *Deutsche Reichsbank* and to other persons to whom the Act concerning Article 131 of the Basic Law applies, for whom the Bank is required to provide in accordance with section 41 of the Bundesbank Act.

Payments to serving members of the Directorate of the Bundesbank and the Executive Boards of the Land Central Banks amounted to DM 10,333,855.92 in the year under review. Former members of the Directorate of the Bundesbank, the Board of Directors and Board of Managers of the *Bank deutscher Länder*, and of the Executive Boards of Land Central Banks, including their surviving dependants, received payments totalling DM 14,422,676.59.

Other operating expenditure

The other (non-staff) operating expenditure of the Bank remained virtually unchanged against 1995.

Banknote printing

In the year under review expenditure on banknote printing went up slightly (by DM 7 million) to DM 170 million.

Depreciation of fixed assets

The amount of the depreciation of land and buildings and of furniture and equipment is stated under the respective balance sheet items. Further depreciation relates to computer software, which is included on the assets side under "Other assets".

Write-downs of monetary reserves and other foreign currency positions

This item comprises the outcome of the valuation of the monetary reserves and other foreign currency positions; it also includes the profits and losses resulting from purchases and sales of foreign currencies and the changes in the provisions likewise affecting the external position. Altogether, losses of DM 636 million were incurred, mainly owing to write-downs of the US dollar reserves.

5. Receipts

Interest

In the year under review the interest received, at DM 12,933 million, was DM 2,151 million lower than in 1995. The crucial factor here was the interest received from lending to domestic credit institutions; it declined by DM 2,164 million owing to further cuts in central bank rates. Interest income from international operations, by contrast, rose by DM 193 million against the previous year to a total of DM 6,631 million; in particular, the interest received from US dollar investments increased on account of higher average holdings and exchange rates.

Fees

Receipts from fees, which accrue primarily in connection with the handling of payments, went up by DM 2 million to DM 112 million.

6. Profit for the year

The profit and loss account for 1996 records a profit for the year of DM 9,426,863,824.51, which is shown in the balance sheet as unappropriated profit (net profit). In accordance with section 27 of the Bundesbank Act, DM 601,300,000.00 of this sum will be transferred to the statutory reserves. The balance, amounting to DM 8,825,563,824.51, will be paid over to the Federal Government. After this appropriation, the statutory reserves will total DM 13,019,500,000.00; they will therefore come up to the statutory ceiling of 5 % of the amount of banknotes in circulation.