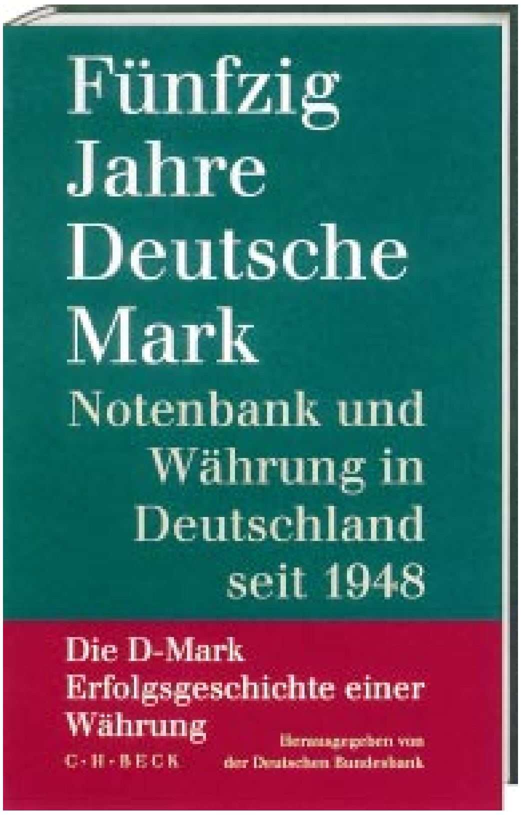
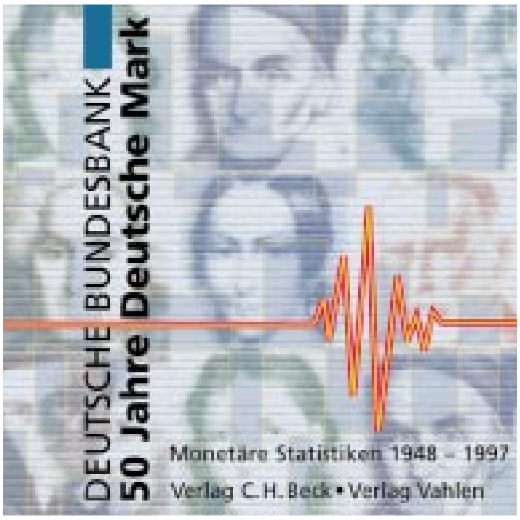
Deutsche Bundesbank
Annual Report 1997



Fünfzig Jahre Deutsche Mark

Central bank and currency in Germany since 1948

On the occasion of the 50th anniversary of the creation of the Deutsche Mark on June 20, 1998, the Deutsche Bundesbank will publish the most extensive account possible of half a century of German domestic and external monetary policy. In doing so, it hopes to give those responsible for the future monetary system in Europe the advantage of its wide experience of pursuing a successful monetary policy as well as of its knowledge of the limits and risks associated with monetary policy. The Bank asked independent scholars for their expert opinions. The contributors to the resultant book are: Ernst Baltensperger, Peter Bernholz, Christoph Buchheim, Günter Franke, Jakob A. Frenkel, Morris Goldstein, Jürgen von Hagen, Carl-Ludwig Holtfrerich, Harold James, Wolfgang Kitterer, Manfred J.M. Neumann, Jochen Plassmann, Rudolf Richter, Klaus Stern, Manfred E. Streit and H. Jörg Thieme. The authors, who had access to the Bank's records, including the most recent ones, were themselves responsible for the content of the chapters they contributed. The book presents articles which reflect a wide variety of opinions. These not only record an appreciation of what has generally been a successful monetary policy but also provide critical analyses.



Monetary statistics from 1948 to 1997 on CD ROM

For the first time the Deutsche Bundesbank is publishing, as a supplement to the written word, a CD ROM with long time series taken from the Bank's monetary statistics. The new medium provides users from the worlds of science, politics and journalism not only with comprehensive information in the form of almost 1,400 tables on trends in the monetary and banking systems, the capital markets and external relations; it also makes it possible for individuals to process this material further on their own. The CD ROM contains both the read-only tables and, in a separate database, all of the time series appearing in the tables and numbering approximately 25,000. These series can be further processed in readily available software programs (e.g. EXCEL).

The original German-language edition of the book (ISBN 3-406-43659-5) and the CD ROM (ISBN 3-8006-2240-8) will be available from booksellers from June 20, 1998 at DM 88 and DM 49, respectively. An English-language edition of the book will appear at the end of 1998.

Deutsche Bundesbank
Annual Report 1997

We mourn the death in 1997 of

Werner Lucht

former Member of the Directorate and the Central Bank Council

– died 28. 2. 1997 –

and the following members of our staff:

Detlef Krause	6. 1. 1997
Sigrid Mocker	17. 1. 1997
Marlis Kellerhaus-Basczok	4. 3. 1997
Götz Hagen Fröhlich	5. 3. 1997
Erhard Arnold	7. 3. 1997
Edgar Müller	23. 3. 1997
Barbara Momberger	17. 5. 1997
Joachim Georgi	17. 5. 1997
Franz Lack	25. 5. 1997
Frank Barz	26. 5. 1997
Johannes Wilhelm Vogt	3. 6. 1997
Eberhard Kraus	8. 6. 1997
Dieter Haase	10. 7. 1997
Dieter Sottorf	17. 7. 1997
Manfred Fuß	1. 8. 1997
Torsten Liebscher	2. 8. 1997
Wilfried Rottmann	8. 8. 1997
Peter Görtzen	13. 8. 1997
Friedhelm Jedamczik	14. 8. 1997
Reinhold Kirchhof	19. 9. 1997
Beate Lichtenthäler	14. 10. 1997
Karl Hudelmaier	24. 10. 1997
Franz Metzner	25. 10. 1997
Reinhold Heil	10. 12. 1997

We also keep in remembrance the retired staff members of the Bank and the former Deutsche Reichsbank who died in 1997.

We will honour their memory.

DEUTSCHE BUNDESBANK

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on May 1, 1998

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Chairman of the Central Bank Council

Johann Wilhelm Gaddum
Deputy Chairman of the Central Bank Council

Dieter Haferkamp

Wendelin Hartmann

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Ernst Welteke

Dr Franz-Christoph Zeitler

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to May 1, 1998

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of the Deutsche Bundesbank

Johann Wilhelm Gaddum
Vice-President
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Records of policy measures

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Note

The current monetary policy regulations are included in the following special publication, which is, on written request, available to interested parties free of charge:
Deutsche Bundesbank, Monetary policy regulations,
Banking regulations 3,
Frankfurt am Main, May 1998;
The Principles will be published in the near future in:
Deutsche Bundesbank, Principles Concerning the Capital and Liquidity of Credit Institutions,
Banking regulations 2a,
Frankfurt am Main.

Abbreviations and symbols

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

Discrepancies in the totals are due to rounding.

Foreword by the President of the Deutsche Bundesbank

Foreword

1997 was a year of many facets – in national and international terms alike. And this time, to a greater extent than in previous years, any look back is almost inevitably associated with a look forward, too. That applies particularly to the European economic and monetary union (EMU), whose outlines are meanwhile coming into sharper focus, now that the participating countries have been selected. Following the publication of the Convergence Reports of the EU Commission and the European Monetary Institute (EMI), the European Council, meeting in the composition of the Heads of State or Government and acting on the recommendation of the Commission and the Council of Ministers of Economics and Finance, and after having consulted the European Parliament, decided on May 2 to start Stage Three of EMU with eleven countries on January 1, 1999. It was then agreed, with the approval of the central bank governors, to base the conversion of national currencies into euros on the current bilateral central rates in the European Monetary System. This advance announcement is intended to stabilise expectations in the markets, so as to ensure as smooth a transition as possible. The appointment of the ECB President, Vice-President and other members of the Executive Board has now been initiated. This means that the European Central Bank (ECB) and the European System of Central Banks (ESCB) can be set up in time, so that the decisions necessary for the immediate functionality of the ESCB and for the assumption of the responsibility for monetary policy in the euro monetary area (which is due from the start of Stage Three of EMU at the beginning of next year) can be taken forthwith.

The preparations for EMU are now moving into their decisive phase. The ECB can draw in this connection on a mass of preliminary work, which was pressed on with last year; major agreements concern both technical aspects of the currency conversion and domestic and external monetary policy issues. The Stability and Growth Pact concluded by the national governments underlines the joint responsibility of fiscal policy for anti-inflation policy in EMU.

In 1997 developments in the international financial markets were overshadowed by the crises in eastern Asia, which highlighted once again how important dependable underlying conditions are for the prosperity of the world economy. The dislocations undoubtedly owed something to weak banking and financial systems, a one-sided orientation of monetary policy towards nominal exchange rate stability, the unclear debt situation of some countries and generous lending by some foreign investors. The international community provided exceptionally massive financial aid, with the intention of preventing the crisis from spreading to the global financial system.

Although rescue operations of this kind may afford relief in the short run, for the future they involve the risk of a recurrence of unwelcome behaviour on the part of market players: relying on intervention by official bodies or international organisations, they may enter into positions the prospective returns on which are in no reasonable relation to the risks involved. A major role is played in such operations by the "pursuit of returns", as a result of the short-term measurement of profits which is common among investors. At times of moderate inflation rates, the low level of nominal interest rates in industrial countries apparently obscures the view of the real rate of interest on capital, which is ultimately what matters.

Given that the real economic adjustment burdens are associated with sharp fluctuations in cross-border capital flows and severe exchange rate upheavals, the question of a suitable regulatory framework for international capital movements is constantly being raised anew. The liberalisation of capital movements yields significant economic benefits in the shape of enhanced financing facilities and more favourable financing terms – particularly for the emerging economies. On the other hand, these benefits may be accompanied by a country becoming more dependent on external influences. To be able to cope more effectively with disruptions of the international environment, the national financial system must display a high degree of flexibility and resilience. Hence the answer to the crises in eastern Asia cannot be a return to a system of regulated capital movements; nor would that be possible, indeed, in an era of global capital markets. Instead, what is needed in the individual countries is a strengthening of the financial and supervisory systems, calculable underlying macroeconomic conditions, a stability-oriented economic policy and a more transparent economic situation, to enable market players to take rational decisions based on comprehensive data.

The promotion of such prophylactic measures is a prime task of the international financial organisations. The improvement of "surveillance" by the International Monetary Fund (IMF) and the formulation and dissemination of standards for the publication of up-to-date and reliable business statistics both aim in that direction. In the event of a crisis, the IMF should mostly be content with the role of an intermediary, especially in the case of debt problems rooted in the private sector. In specific instances, that by no means rules out limited, conditional balance of payments assistance as part of adjustment programmes. Such programmes may actually play, as they have done in the past, a kind of catalyst role in the conclusion of rescheduling agreements. Doing more than that, on the other hand, would inevitably foster "moral hazard" problems in the longer run. To avert that risk, creditors and debtors alike are to be made increasingly accountable in future. They, too, must do their bit towards overcoming crises – for instance, by means of voluntary rescheduling agreements.

The crises in eastern Asia, viewed in isolation, have certainly curbed the growth prospects of the world economy. In Germany, however, the damage has so far been relatively limited, with the result that the generally stronger expansionary forces have ultimately made themselves felt. Driven by a buoyant demand for exports, the upswing gathered pace during 1997 as a whole. However, last year's greater economic momentum was not strong enough to afford the labour market relief. On the contrary, unemployment again increased distinctly in Germany, even if part of the rise is attributable to reduced deployment of labour market policy measures. Unfortunately, the catching-up process in the new Länder likewise came to a halt in 1997; for the first time since German reunification, the economic growth rate in eastern Germany was below that in the west. That was indicative of how difficult the road to be traversed in eastern Germany still is.

In terms of monetary policy, it must be rated a success that the average pace of inflation in Germany – despite temporary clouding owing to import prise rises and administrative price increases – remained below 2 % in 1997; by the beginning of the present year, virtual price stability had been reached, at even lower rates. The lengthening of the time-horizon of monetary targeting to two years at the end of 1996 – in the run-up to EMU – was thus a success; the target for the expansion of the money stock in 1997 was met.

The present Annual Report analyses the monetary policy of the Bundesbank last year. It also takes account of current economic developments in Germany and of the international environment. At the same time, the Bundesbank presents its annual accounts for 1997, which have been audited (and certified) by two firms of auditors, and which were approved by the Central Bank Council on May 14, 1998.

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 members of the Bank's staff for the great commitment with which they performed their duties in 1997. I also wish to express my gratitude to the staff representative bodies for their cooperation in a spirit of mutual trust.

Frankfurt am Main, May 1998

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

The currency and the economy

I. International economic fundamentals

Robust growth of the world economy

In the past year the world economy once again grew robustly. At just over 4 %, world output grew as sharply in 1997 as in the previous year, and thus distinctly more vigorously than on average during the eighties and nineties. At the same time the regional variation in growth in the world economy narrowed. In continental Europe, in particular, the economic recovery grew stronger and broader in the course of last year, whereas the East Asian economies, whose development had been especially dynamic until then, experienced sharp reductions in growth in connection with the burgeoning currency and financial crises in the area (see also page 109 ff. of this Report). In some central European countries in transition as well, which had made good progress in the transformation process, the hitherto above-average economic growth increasingly encountered constraints, particularly in foreign trade. By contrast, the buoyant growth in the Latin American countries had a clearly expansionary impact on the world economy.

Setback in Japan

Of the major industrial states, Japan suffered most from the turbulence in the Far Eastern financial markets owing to its own weak economic development and its close real economic and financial links with the East Asian emerging markets. The already lacklustre state of the domestic economy in the summer half of 1997 was compounded by an initial weakening of export demand in the autumn; with a rate of growth of real GDP of just under 1%, Japan consequently trailed behind the other industrial countries. The structural problems of the Japanese financial system that have existed for quite some time likewise proved a heavy burden, to which the Japanese government responded by means of extensive debt assumptions and promises of financial assistance. By contrast, the monetary policy stance – which has been very expansionary for a number of years already – turned out not to have an impact in stimulating the desired economic growth. In these circumstances the Japanese government evidently thought that its announcement of comprehensive additional public spending in the first few months of 1998 was the only way to put the economy back on the path of growth, although – given the already high level of government indebtedness – this may give rise to new problems in respect of the room for manoeuvre in economic and fiscal policy in future.

Solid economic growth in North America

As opposed to Japan, the other industrial countries were at first directly affected far less by the crises in East Asia. The same applies, with certain qualifications, even to North America, which along with Japan is one of the most important

Macroeconomic benchmark figures of selected industrial countries *

Table 1

Countries	Real GDP 1996	Real GDP 1997 p	Consumer prices 1 1996	Consumer prices 1 1997 p	Public sector fiscal balance 2 1996	Public sector fiscal balance 2 1997 p	Unemployment rate 3 1996	Unemployment rate 3 1997 p
	Change from previous year in %				as % of GDP		in %	
Industrial countries	2.4	2.5	2.6	2.0	– 2.8	– 1.5	7.6	7.3
of which								
European Union	1.7	2.6	2.5	2.0	– 4.2	– 2.4	10.9	10.6
of which								
France	1.6	2.3	2.1	1.1	– 4.1	– 3.0	12.4	12.4
Germany	1.4	2.2	1.5	1.8	– 3.4	– 2.7	8.9	9.7
Italy	0.7	1.5	3.9	1.7	– 6.7	– 2.7	12.0	12.1
United Kingdom	2.2	3.3	3.0	2.8	– 4.8	– 1.9	8.2	7.1
United States	2.8	3.8	3.0	2.3	– 1.1	0.0	5.4	4.9
Japan	3.9	0.9	0.1	1.8	– 4.3	– 3.5	3.4	3.4
Canada	1.2	3.8	1.6	1.6	– 1.8	+ 0.5	9.7	9.2

Sources: IMF, OECD, EU Commission and national statistics. — * EU countries plus the United States, Japan, Canada, Switzerland, Norway, Iceland, Australia and New Zealand. — **1** Consumer price index. — **2** As defined in the national accounts (EU countries in accordance with the Maastricht Treaty). — **3** Standardised unemployment rate based on OECD and Eurostat calculations excluding Iceland.

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trading partners of the countries in the crisis region. It was only at the start of the current year that US exports to the East Asian emerging economies fell more strongly. The US economy developed extremely favourably in the past year apart from a slight dampening of demand which, given the sustained buoyancy of business activity, was seen as no bad thing. Real GDP in the United States grew by 3.8 %, which, along with Canada's, was the highest rate of growth among the major industrial states. The further sharp rise in output is all the more remarkable as inflation declined perceptibly in 1997 despite the high and increasing level of capacity utilisation. Key prerequisites for these achievements were the extensive flexibility of the US labour market, the strength of the US dollar and the declining trend in world raw material prices. For that reason, the US Federal Reserve Bank has maintained its monetary policy course up to the present following a slight tightening of interest rates in the spring of 1997. Finally, the positive overall picture of the US economy is rounded off by the fact that the US government budget was balanced last year. Welcome progress in the consolidation of public finance was also made by Canada, where the public sector generated a fiscal surplus for the first time since the early seventies. The growth rate of the Canadian economy more than doubled in 1997 to 3.8 %. At the same time inflation remained low, with central bank interest rates being raised slightly.

Accelerated growth in western Europe

In western Europe (especially continental Europe) the economic climate at last began to brighten in 1997. GDP growth in the European Union (EU) accelerated from 1.7 % in 1996 to 2.6 % last year. Owing to the European economies' relatively limited direct links with the Asian countries concerned, the turbulence in that area has so far apparently had hardly any dampening influences which would have weakened the internal forces of growth. One particularly positive development for the prospects of economic growth in Europe is that in two large EU countries, Germany and France, economic momentum has now also accelerated; last year, growth in those two countries increased almost identically by nearly 1 percentage point to around 2 ¼ %. Above-average increases in output were recorded by the United Kingdom and various smaller EU countries which have made further progress in economic growth. The United Kingdom, where the upturn persisted for the fifth year in succession in 1997, raised real output further by just over 1 percentage point to 3 ¼ %. It was not until the turn of 1997-8 that growth decelerated perceptibly. This was due in part to the strong appreciation of the pound sterling, which slowed British export growth, and in part to the far-sighted interest rate policy of the Bank of England, which was meant to counter the danger of an overheated economy. Higher-than-average growth rates were also achieved, *inter alia,* by Spain, the Netherlands, Finland and Norway. At 1½ %, Italy's rate of growth in 1997 was distinctly below that of the other EU countries, although the expansionary forces strengthened appreciably in the course of the year.

Declining deficits

The largely favourable cyclical trend helped most European countries to make considerable progress in consolidating their public finances. In Europe, three member countries of the European Union generated a budget surplus in 1997. Eleven member states ran a current government deficit of no more than 3 % of GDP, although in most cases they barely undershot that ceiling (for the progress made towards convergence see page 99 ff. of this Report). The aggregate public sector deficit of all EU countries was reduced on average from 4.2 % in 1996 to 2.4 % last year. At the same time government indebtedness, measured as a percentage of GDP, declined slightly (from 73.0 % to 72.1%); yet it was still far higher than at the beginning of the nineties (1991: 56.0 %).

The need for fiscal consolidation therefore remains as pressing as ever. It is all the more necessary as the reduction in the deficits of a number of member

Reduction of government ratio is a key task

states was achieved by measures that will only have a temporary effect, such as postponing expenditure until the future or levying special taxes. In addition, the budgetary consolidation was helped along by falling interest rates. In member states with a high government debt level, in particular, this alone led to substantial cost relief. Moreover, many European countries face unresolved problems in connection with financing their social security systems. The need to reduce the high government ratio, which narrows the scope for private economic activity, therefore remains a key task. It is important not least in view of the unresolved employment problems in the European Union.

Unresolved employment problems

Despite the higher growth, unemployment remained high, especially in most countries of continental Europe. Although the average unemployment rate in the EU countries decreased slightly (by ⅓ percentage point), its level in 1997, at 10.6 %, was still only marginally lower than the peak reached in 1994 (11.1%). Without radical reforms aimed at making the labour markets more flexible and improving the incentives to work by reducing the burden of taxes and social security contributions on labour costs and labour income and by undertaking comprehensive deregulation of the goods markets, no lasting progress will be made on this issue, which is the most urgent economic policy problem.

First growth of the countries in transition

In 1997, the countries in transition – whose importance for the German economy has increased sharply during the nineties – achieved a growth rate for the first time in eight years when considered as a group, too, of almost 2 %. The main reason for this was that the reforms initiated in Russia began to show the first fruits of success and the drastic decline in production over the past few years was halted. In the Ukraine, too, the process of contraction appears to have stopped. However, the central European states, which have played a pioneering role in the policy of reform and which had previously been accustomed to unbroken success, saw growth weaken last year to an average of 3 %. The deceleration of output growth in the Czech Republic from 4 % to 1% was particularly striking. This was caused by mounting external trade deficits and political problems which culminated in a currency crisis in the spring of 1997 and necessitated a noticeable tightening of the monetary and fiscal policy course. By contrast, the immediate effects of the crises in East Asia on the group of reform states remained within narrow bounds.

Latin America's improved resilience

The dangers emanating from the financial market turbulence in East Asia were more acute in the case of the Latin American countries, although the countries concerned successfully countered the threat by tightening their monetary and fiscal policies. One factor which had a positive impact is that the structure of the external debt of the Latin American countries is more favourable, and the banking system in a better state, than in the East Asian crisis countries. On balance, the region developed last year to become a new "pole of growth" within the world economy. The economic growth of 5 % was the highest achieved by Latin America since the seventies.

Combating inflation remains a key task in developing and transitional countries

As the experience of some South American countries in the past year showed, convincing stability policy efforts helped not least to lessen their vulnerability to speculative attacks. In most developing and transitional countries, however, inflation still stood at substantial double-digit rates, even though they have continued to tend to decline. The risks and serious potential dangers which insufficient stability policy resoluteness poses for future economic growth is something which even individual "pioneers" among the reforming countries of central Europe experienced last year in the form of serious balance of payments crises. A major reason for that was persistent cost and price pressure which diminished the previous competitive advantages of these young market economies. In order to safeguard the process of economic reconstruction and integration and to finally reap the full fruits of their reform policy, the economies in question must pursue their stability policy efforts unrelentingly.

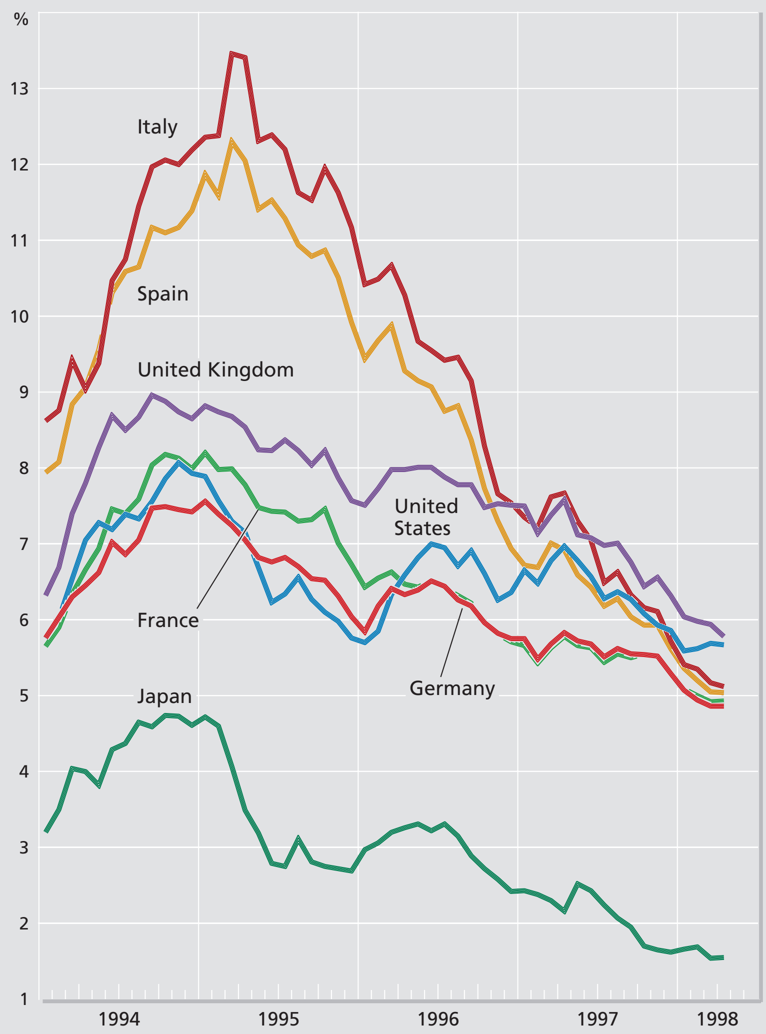
High degree of price stability maintained in the industrial countries

Against this background, it is particularly gratifying that, at least in the industrial countries, the progress made in combating inflation has been sustained despite the more vigorous global growth. The rate of inflation in the industrial countries fell further by around ½ percentage point to 2 %. The temporary danger of overheating in the Anglo-Saxon countries was initially countered by a tightening of the monetary policy reins. Later on in the year, as mentioned, the dampening effects emanating from the crises in the East Asian countries provided a counterweight to the latent inflation risks, especially in the United States.

Further fall in capital market rates

In the international financial markets, the vigilant monetary policy course pursued by the industrial countries, by means of which the anti-inflationary successes achieved in recent years were safeguarded against incipient inflationary dangers – particularly in countries which have reached an advanced stage in the business cycle – was reflected in persistently low capital market rates. In most industrial countries they fell to their lowest level since the seventies. At the same time share prices climbed to new record heights. The financial markets received stimuli, especially in the second half of the year, from the sharply rising inflow of funds resulting from relocations of assets by investors out of the East Asian crisis

Capital market rates of selected industrial countries * Chart 1



* Government bonds with a maturity of approximately ten years.

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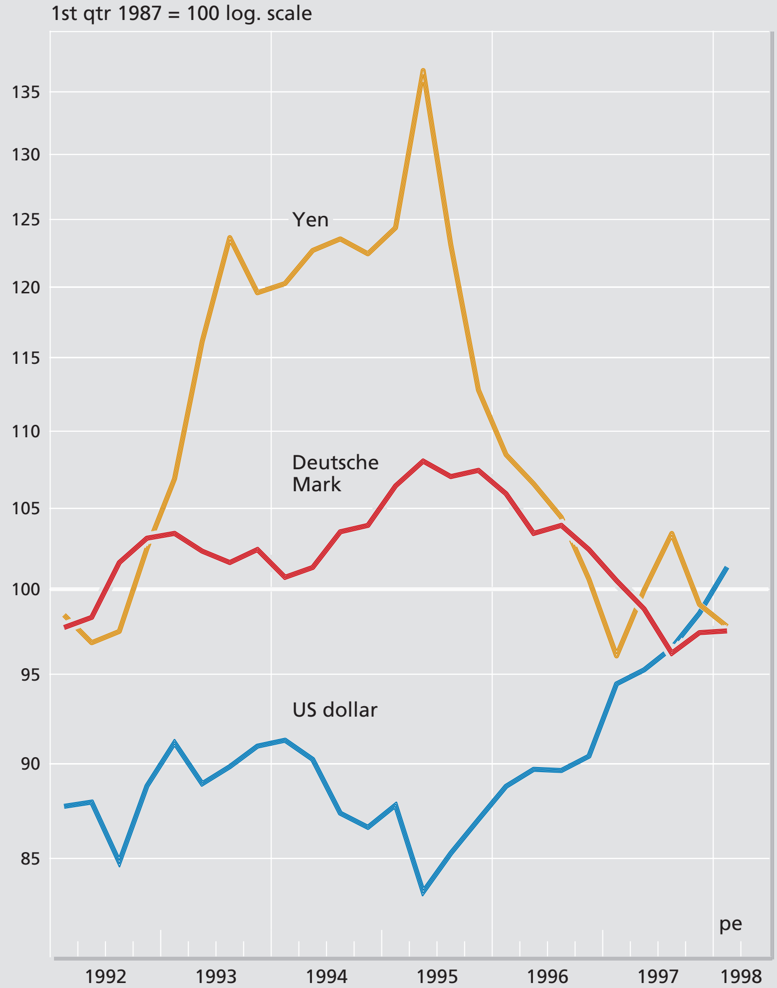
regions into "safe havens" with low credit, liquidity and exchange rate risks. Finally, in Europe the capital markets of the Mediterranean states also benefited from the interest rate convergence in anticipation of the conditions in the future European monetary union (EMU). The widest gap between the capital market rates in the countries seeking accession to EMU and Deutsche Mark interest rates (measured in terms of government bonds with a maturity of approximately ten years) of late was only around ¼ percentage point, compared with almost 2 percentage points at the end of 1996.

Real external value of selected currencies *

Chart 2



* Weighted nominal external value against the currencies of the respective main trading partners, adjusted for the different overall price trend, measured by total sales prices (Deutsche Mark) and consumer prices (US dollar, yen). — Source for US dollar and yen: IMF.

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Shifts in international currency parities

In the past year, largely no doubt as a reflection of the even more pronounced cyclical differential between the industrial states on either side of the Atlantic at the beginning of 1997, further shifts occurred in the foreign exchange markets between the world's major currencies in favour of the US dollar. The exchange rate relationships between the dollar and the continental European currencies only stabilised with the growing convergence of growth prospects in the second half of the year. At the same time the Japanese yen depreciated significantly under the influence of the spreading currency turbulence and financial market crises in its East Asian neighbouring countries over the last few months of 1997. In particular, when some Japanese financial institutions collapsed towards the end of the year, the Japanese currency sustained substantial exchange rate losses, although these were later reversed to some extent when it became apparent that the state would intervene in support of the currency with substantial financial resources. On balance, the real weighted external value of the yen was of late slightly above its value in the spring of 1997, whereas the US dollar – measured in real terms and on a weighted average – had increased in value by 7 ½ %.

Drastic fall in value of East Asian currencies

Particularly stark changes in exchange rate parities were sustained, however, by the currencies at the centre of the East Asian financial crises. Thus, Thailand, Malaysia, South Korea and the Philippines saw their currencies depreciate in the past year by between 35 % and 50 %. At its nadir, the Indonesian currency had lost as much as around 80 % of its value. After reforms had been initiated in many states at the beginning of 1998, the currencies of these countries stabilised and regained some of their value. Nevertheless, the exchange rate losses in 1997 were so severe that the real external values of the currencies concerned were distinctly lower of late than before the outbreak of the crises. It is unclear at the moment to what extent this can be equated with a corresponding improvement in price competitiveness in the individual states leading to an enduring shift in competitive conditions in favour of those countries and to the detriment of the highly industrialised economies. The dramatic rise in the cost of imports to the crisis countries brought about by exchange rate movements, at any rate, also means a considerable surge in inflationary pressure which will erode some of the competitive gains resulting from devaluation. It is all the more important to curb those inflationary dangers by taking resolute stabilisation and structural measures.

II. Economic development in Germany and central bank policy

1. Higher growth in a mixed overall situation

Brighter overall situation ...

Surrounded by a favourable international environment, the German economy once again returned somewhat to its medium-term path of growth last year. It continued to be able to rely on a series of positive fundamentals. Some of the positive factors were that the upswing took place without external tension and that the easy price climate remained basically unharmed despite some disruptive influences. The terms of financing also had a positive impact. Given a buoyant and solid state of financial markets and largely stable prices, the terms under which enterprises, private building owners and the public sector were able to obtain shorter-term or longer-term funds were more favourable than they had rarely before been. Improvement in the locational conditions continued to make progress, though it tended to be sluggish and was not without some setbacks. Management and labour made efforts to take account of the lack of real leeway for income distribution and to take the need for flexibility into greater consideration with regard to working hours and payment; there was visible progress in 1997. That meant an important precondition had been created for enterprises to take full advantage of their improved competitiveness on international markets and to use it to regain market share.

... yet dampening moments

However, these favourable fundamentals contrasted with some dampening moments. In 1997 fiscal policy was focused on reducing the public sector deficit. It was possible to influence longer-term expectations positively only to a limited extent. In particular, it was not possible to enact the planned tax reform. Besides limits on government investment in the infrastructural area, the fact that the typical cyclical pattern was partly deformed owing to various economic promotional measures in the past, especially affecting the construction sector, likewise acted as an obstacle. Enterprises' willingness to invest in fixed capital in Germany rose somewhat in 1997; this has not been accompanied by a broadly based growth of investment up to now. Under the impression of the mixed overall situation, despite a gradual consolidation of the upswing, the turnaround in the labour market which had been hoped for did not materialise, despite a gradual firming of the upswing; stabilisation tendencies in western Germany contrasted with a serious setback in the eastern part of the country.

Increased expansion, with great disparities

Seen in an overall context, German economic growth accelerated in 1997. According to calculations by the Federal Statistical Office, economic output rose by 2 ¼ % over the preceding year, in which the growth of real GDP had only been 1½ %. The increase was largely in line with the economy's medium-term scope for expansion; the production capacities existing under the conditions of largely tension-free growth were used only a little more than in the preceding year. It is true that in important subsectors of the economy, such as industry, capacity utilisation increased sharply; by contrast, though, other sectors, such as the construction sector and the wholesale and retail trade sector, remained well behind their capacities.

West/East divide in growth rates

From a geographic perspective, too, the cyclical setting was not particularly balanced. For the first time since 1991, the growth rate in the new Länder, at 1½ %, was lower than in the old Länder. That is, the catching-up process in eastern Germany did not continue in 1997; up to now, despite advancing modernisation and successes in adjustment in certain sectors, there has not yet been a self-sustaining upswing. This, too, is a reason why domestic demand in Germany as a whole remained muted in 1997.

Flourishing foreign business

Once again exports provided the key stimuli. Foreign demand for products by German industry, the sector with the greatest foreign trade links, rose in 1997 by no less than 13 ¼ %, calculated in constant prices, and thus more than twice as sharply as in the preceding year. Intermediate and investment goods were particularly in demand. The exceptionally sharp increase in orders by international customers does not merely reflect the favourable cyclical trends in a number of important buyer countries which had in part been clouded by the turbulence in East Asia as late as the end of last year. Moreover, German exporters' distinctly improved competitiveness had an impact; major rationalisation efforts, an adjustment of the product range, and continuing domestic cost containment formed a good foundation. Exchange rate trends also contributed to German sellers being able to assume favourable positions on their most important foreign markets in terms of prices.

Industrial output on the upswing

In the wake of the lively demand, output by manufacturing, which had largely stagnated in 1996, rose visibly once again. Growth of nearly 4 ½ % had last been seen in 1994. Enterprises in the new Länder played a major role in this development, with deliveries abroad providing important stimuli. The expansion of export business by nearly one-third indicates a considerable improvement in the competitiveness of east German manufacturing and increasing integration into the international division of labour. However, even as of late, the export share did not even reach half that for western Germany, where around one-third of turnover is with foreign customers. East German industry's share of the corresponding foreign turnover for all of Germany did not exceed 3 %. It must be borne in mind, though, that some east German export deliveries – the exact number is unknown, but possibly a considerable share – are reported for statistical purposes by west German headquarters of enterprises and are therefore included in west German exports.

Rising degree of utilisation

The noticeable expansion of industrial output led to a jump in the utilisation of the existing production facilities. According to the surveys by the Ifo Institute, utilisation in western Germany exceeded the range of the medium-term average use by nearly 4 percentage points at the end of 1997, seasonally adjusted; the level attained was not much lower than during the economic boom at the beginning of the nineties. In terms of the last cyclical trough in the summer of 1993, the margin at year's end was more than 8 percentage points. In the new Länder, too, the utilisation of the technical facilities rose noticeably, reaching a new all-time high there.

Subdued investment by enterprises

Investment made by trade and industry showed a somewhat sharper rise for the first time since 1991, going up by just over 2 % in real terms. Producing enterprises invested particularly in machinery and equipment (+ 4½ %); this more than compensated for the renewed cutback in construction investment (– 2 %). All the same, the propensity to invest remained clearly behind what was to be observed in earlier upswings. The export boom which had been continuing as of late has not been reflected accordingly in domestic investment projects yet. This indicates that the correlation between utilisation and investment has continued to become weaker.

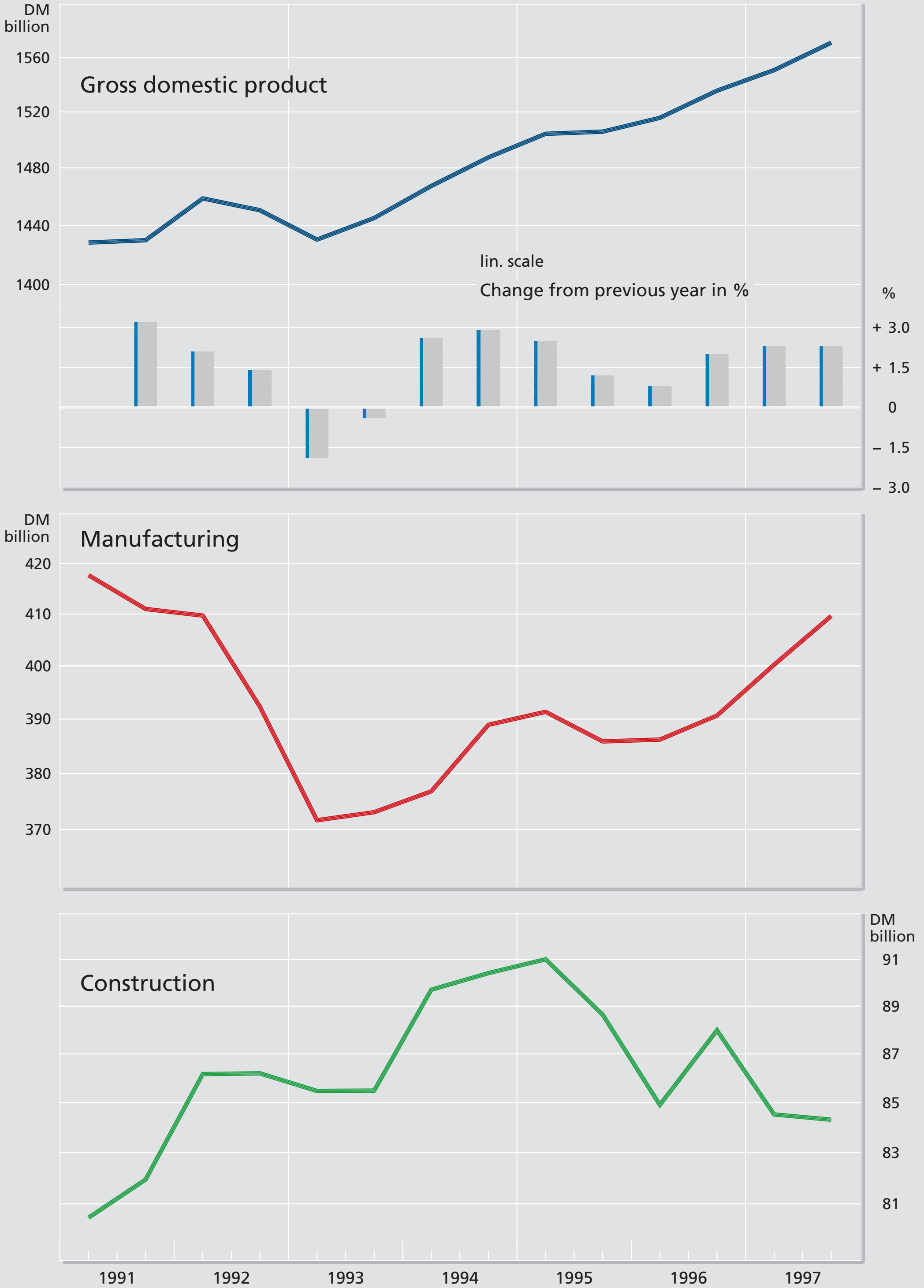
Determinants of industrial investment

Numerous factors probably play an important role. For example, for a long time already, it has been possible to see a divergence in trends between machinery and equipment, on the one hand, and buildings in the entrepreneurial sector, on the other. Construction measures have lost importance, i.e. economic growth is much less construction-intensive than it used to be. In addition, the traditional distinction between replacement and expansion projects is likely to become even more blurred in practice; as a result of the high rate of technical innovations and shortened product cycles, reinvestment also generates significant capacity effects. A consequence thereof is that a statistically clean distinction between pure price changes and quality improvements, precisely in machin-

Chart 3

Gross domestic product and
value added in selected sectors of the economy

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



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ery and equipment, poses particular problems. A trend towards underestimating the quality component would be reflected in a reduced growth in statistically recorded real investment.

In addition, there are indications that it was possible to considerably enhance the efficiency of the capital stock by generally increasing the implementation of modern computer technology. The increased use of expanded flexibility leeway in labour input is likely to be having a similar effect. Moreover, the fact that recourse could be taken in many cases to still existing capacity reserves at other production sites as part of enterprise-wide and conglomerate-wide planning strategies has surely likewise played a role. Such opportunities were available both in eastern Germany and in the numerous east European countries in transition and not least in the southern EU member states.

High demands on rates of return

This also expresses the fact that with increasing mobility of international capital flows, the continuing trend towards the diversification of production sites and an ever-increasing variety of investment forms, investment in domestic fixed capital must more and more hold its own against such investment abroad or in international financial assets. The return on fixed capital here is in competition with the enterprises' profit outlook and risk considerations of entrepreneurial activities in cross-border economic areas which, with increasing integration, are more and more assuming the character of single markets. Consequently, the current investment behaviour of German enterprises might not least be a result of increasingly intensified competition among industrial locations. With such structural changes, comparisons with earlier cyclical phases are only valid to a limited extent. The propensity to invest at home cannot be used to derive without reservations the general propensity to invest of German enterprises. Only sufficient rates of return can spark off long-term investment projects.

Sharply diverging profits

Additionally, the profit situation has by no means improved across the board. Rather, the current situation is typified by sharply differing profits between sectors, for which the increased risk of insolvency and the high number of business failures in western and eastern Germany (just over 27,000 cases) is also a sign. The impression prevailing among many in the general public that there is a high degree of profitability in business is considerably influenced by the annual accounts of conglomerates listed in the stock market and subject to disclosure requirements, which have a large and booming business abroad; this impression cannot be generalised. Furthermore, improved profits – and this is also true of domestically oriented enterprises – have been accompanied by numerous out-

Key economic variables in Germany

Table 2

Item	1994	1995	1996	1997
	Change from previous year in %			
Growth (real) [1]				
Private consumption	+ 1.2	+ 1.8	+ 1.4	+ 0.2
Government consumption	+ 2.1	+ 2.0	+ 2.6	– 0.4
Expenditure on machinery and equipment	– 1.0	+ 1.6	+ 1.9	+ 3.9
Buildings	+ 6.5	+ 0.3	– 3.1	– 2.2
Stockbuilding				
Change (in DM billion)	(+ 23.2)	(+ 12.8)	(– 8.2)	(+ 33.0)
Domestic demand	+ 2.7	+ 2.0	+ 0.8	+ 1.2
Net exports [2]				
Change (in DM billion)	(– 0.0)	(– 6.3)	(+ 17.8)	(+ 30.9)
Exports	+ 7.9	+ 6.6	+ 5.1	+ 10.7
Imports	+ 7.7	+ 7.3	+ 2.8	+ 7.0
Gross domestic product	+ 2.7	+ 1.8	+ 1.4	+ 2.2
Western Germany	+ 2.1	+ 1.5	+ 1.3	+ 2.2
Eastern Germany	+ 9.6	+ 5.2	+ 1.9	+ 1.6
Contribution to GDP growth in %				
Domestic demand (excluding stocks)	+ 1.9	+ 1.6	+ 1.0	+ 0.1
Stockbuilding	+ 0.8	+ 0.4	– 0.3	+ 1.1
Net exports	+ 0.0	– 0.2	+ 0.6	+ 1.0
Employment				
Employed [3]	– 0.7	– 0.4	– 1.3	– 1.4
Average working time per employed person	– 0.4	– 1.4	– 0.3	– 0.2
Total number of hours worked	– 1.1	– 1.7	– 1.5	– 1.6
Unemployed (in thousands)	3,698	3,612	3,965	4,385
Western Germany	2,556	2,565	2,796	3,021
Eastern Germany	1,142	1,047	1,169	1,363
do. as % of the total labour force	9.6	9.4	10.4	11.4
Western Germany	8.2	8.3	9.1	9.8
Eastern Germany	15.2	14.0	15.7	18.1
Prices				
Consumer price index	+ 2.7	+ 1.8	+ 1.5	+ 1.8
Western Germany	+ 2.7	+ 1.7	+ 1.4	+ 1.8
Eastern Germany	+ 3.7	+ 2.1	+ 2.2	+ 2.1
Producer prices of industrial products [4]	+ 0.6	+ 1.8	– 0.5	+ 1.2
Overall construction price level	+ 2.0	+ 2.1	– 0.1	– 0.5
Import prices	+ 0.8	+ 0.4	+ 0.5	+ 3.2
Export prices	+ 0.9	+ 1.7	+ 0.2	+ 1.5
Terms of trade	+ 0.1	+ 1.2	– 0.4	– 1.6
GDP deflator	+ 2.4	+ 2.1	+ 1.0	+ 0.6
Value added and labour costs				
GDP per hour worked by employed persons [1]	+ 3.9	+ 3.6	+ 2.9	+ 3.8
Gross compensation per hour worked by employees [3]	+ 4.0	+ 5.4	+ 2.9	+ 2.1
Labour costs per unit of value added in the economy as a whole [5]	+ 0.2	+ 1.8	– 0.1	– 1.7

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 compensation generated in Germany per hour worked by employees divided by real GDP per hour worked by employed persons. — The data from the national accounts and the figures on employed persons from 1995 on are provisional.

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sourcings of divisions, a strong urge to enter into mergers and a considerable amount of downsizing. For the rest, profits not immediately flowing into fixed assets are not unproductive, seen either from a microeconomic or a macroeconomic perspective. They often serve to strengthen financial stability and to fund the stock of fixed assets, to establish research and development activities, or to engage in the strategic acquisition of participating interests; all this also means protecting existing jobs and high productivity.

Declining construction investment

A sizeable amount of unlet properties, particularly office and administrative buildings, may have been partly responsible for construction investment in the enterprise sector once again falling by 2 %; in 1996 the decline had already been 7 %. This applies especially to the new Länder, where construction activity had been stimulated by a large number of improved depreciation facilities. The structural decline in the significance of expenditure on construction within the context of overall investment was additionally aggravated by the decreasing need for space caused by increasingly prevalent computerisation of operations and a falling trend in stockkeeping.

Sharp downturn in housing construction

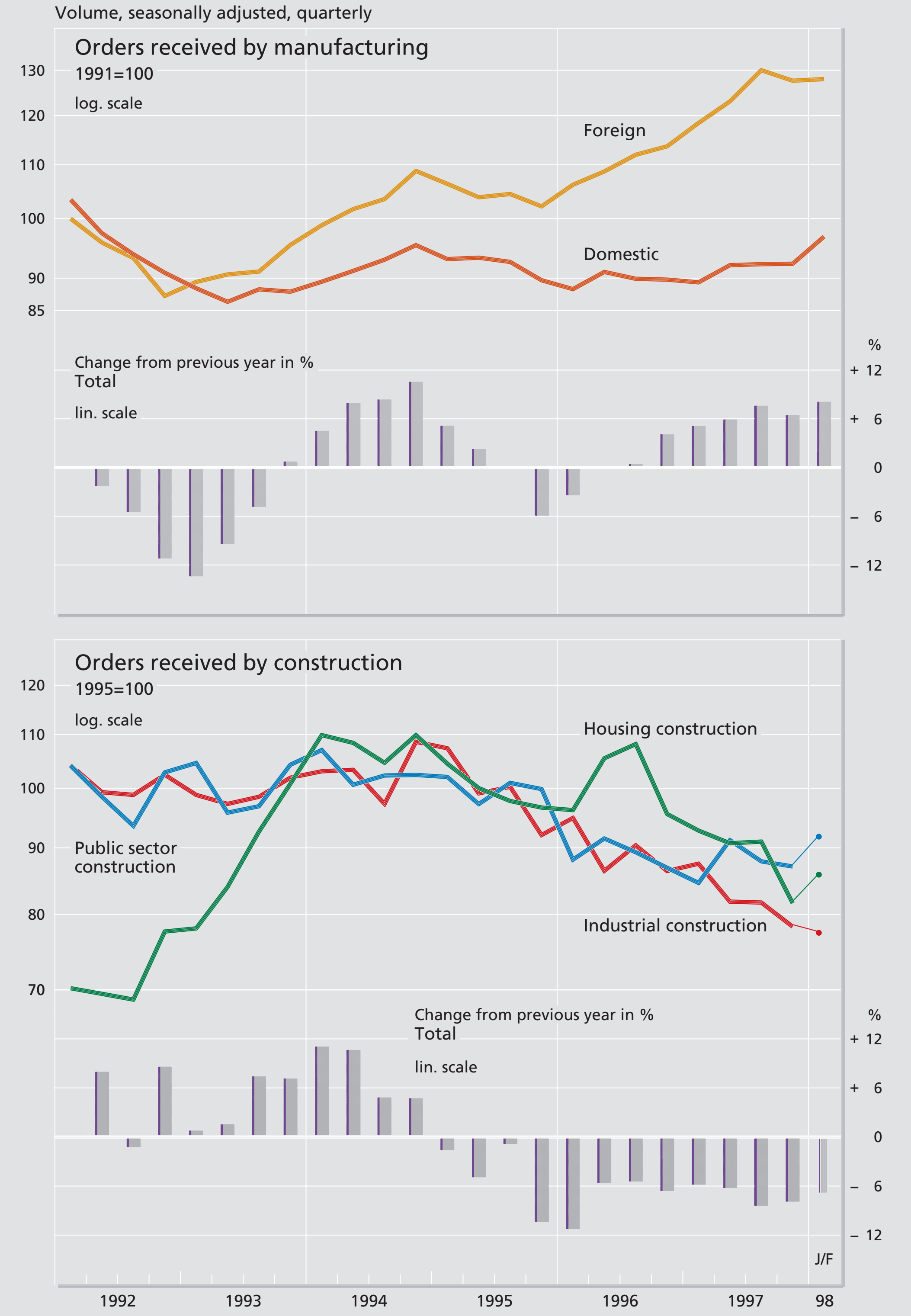
In the housing construction sector, which accounts for more than half of all investment in construction, visible signs of saturation could also be recognised in 1997; despite favourable terms of financing, demand took a steep plunge. In terms of real orders received in the construction sector, there was a decline of 12 ½ % in Germany as a whole, and in the new Länder alone it was even 19 %. The number of construction permits for housing has gone down perceptibly, too; by 4 % to 374,000 units in western Germany, and by 16 % to 156,000 in eastern Germany. In particular, this affected rental housing, whereas the construction of owner-occupied housing had more of a stabilising effect. All the same, in 1997 the number of finished dwellings – due to the long planning and production times typical of this sector – was, at 570,000, once again slightly above the preceding year's result. The visible downturn in the old Länder contrasted with a renewed surge in the eastern section of Germany. The supply of housing, which was already more favourable in purely quantitative terms than in the old Länder in 1995, is thus likely to have continued its improvement, despite continued differences in quality.

Weak construction sector in eastern Germany

The noticeable decline in construction investment, which was exacerbated by public sector clients owing to scarce funds and to the fact that infrastructure in eastern Germany has since also attained a high level, had far-reaching consequences for overall economic development, particularly in the new Länder. The

Trends in demand

Chart 4



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noticeable improvement in the industry was by no means able to compensate for the shortfall in the construction industry, with the result that growth in the domestic product, as previously mentioned, for the first time did not outpace growth in western Germany. This was all the more true as expansion in the services sector likewise clearly lost its dynamism.

Disappointing labour market

Hopes for a change for the better on the labour market remained unfulfilled in 1997, too. Instead, unemployment rose once again perceptibly, and employment was once again visibly reduced. With the elimination of an annual average of 490,000 jobs, and an increase in unemployment by 420,000, the labour market continued its slide. It is true that a significant role was played in part by restrictions in labour market policy measures taken owing to the need to consolidate public budgets, yet even if such retrenchment efforts are cancelled out, the picture is not fundamentally altered.

Downsizing particularly in eastern Germany

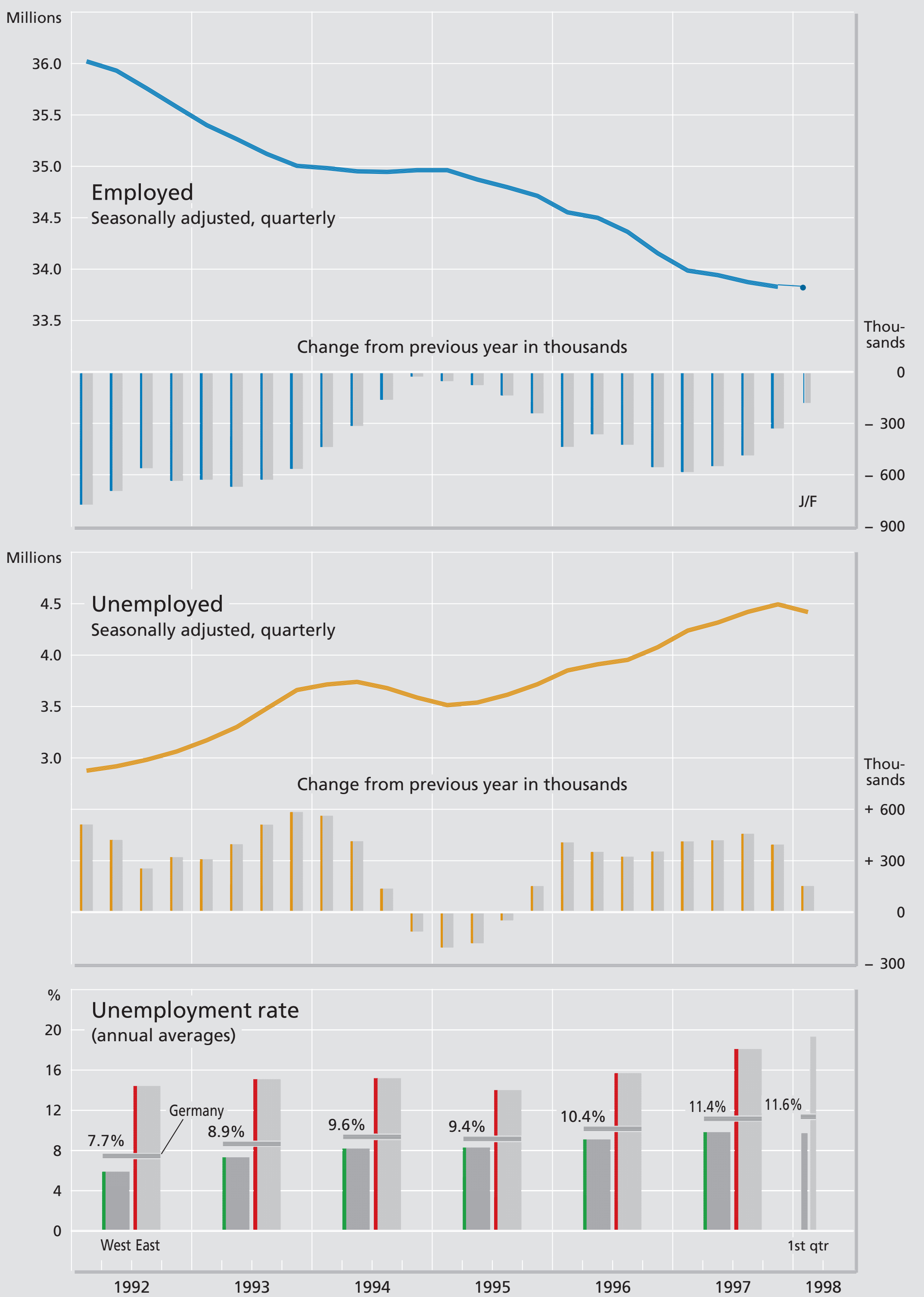
Whereas downsizing probably came to a standstill over the course of the year in western Germany, in eastern Germany the unfavourable employment trend continued, even if the pace has been gradually slackening. Especially the construction industry continued to downsize, which had a particularly powerful impact in view of the relatively high intensity of employment, and which affected many other sectors. But in the services sector, too, which had created additional jobs in the past few years, employment declined in 1997. In addition, public administrations, wholesale and retail trade, and transport continued to downsize under pressure from high labour costs. Not least the reduction in active labour market policy measures had a particularly strong impact. In western Germany, jobs disappeared primarily in industry and construction.

Structure of unemployment

Of the total of 4.4 million persons unemployed in Germany in 1997, 3.02 million were in western Germany and 1.36 million in eastern Germany. That meant that the risk of becoming unemployed – defined as the number of unemployed persons as a percentage of the labour force – was, at 18.1% in the new Länder, nearly twice as high as in the old Länder (9.8 %). In all of Germany, 11.4 % of the labour force was unemployed, compared with 10.4 % the previous year. Older workers and persons not having comprehensive vocational training continued to be particularly affected by unemployment. Whereas women have been less at risk of unemployment than men in western Germany, women made up 56 % of all unemployed persons in eastern Germany. This is especially linked to the fact that in general, women account for a rather large share of the

Labour market

Chart 5



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labour force, but the fact that expansion did not continue in the services sectors in which many women usually find employment may have also had an impact.

Unemployment more deep-seated

The long and increasing duration of unemployment is a particular sign of the increasingly deep-seated nature of the unemployment. According to information provided by the Federal Labour Office, in 1997 34 % of persons unemployed in western Germany were without work for one year or longer; that is 2 percentage points higher than in 1996. The average duration of unemployment likewise rose in both the old and the new Länder, from just under 30 weeks to 32 weeks. The picture given by these figures is too rosy insofar as those involved in labour market policy measures are no longer considered unemployed; if they do not find work after such measures have ended, according to official statistics they are regarded as persons once again unemployed. This is probably the case in eastern Germany in particular, where according to official statistics "only" 28 % of those affected are considered to be long-term unemployed.

Progress in pay policy

Against the background of worsening labour market disequilibria and increasing international competition among industrial locations, the wage bargainers strove last year to improve the conditions for economic growth and employment. The agreements reached resulted in an increase in necessary differentiation and flexibility and contributed greatly towards easing domestic cost pressures. The pay settlements, calculated on a monthly basis, were at an average of 1½ % in 1997. This was once again rather moderate, although the unions were able to preserve for the most part the continued payment of salaries during illness, which they considered to be a central provision, in exchange for concessions in the final rate or other wage and salary components. The general wage restraint did not exert maximal impact on labour costs, though, owing to higher contribution rates for social insurance. With growth at a nominal rate of 1¾ %, gross compensation per employee remained nearly constant in real terms. With the inclusion of the high rise in productivity, in which a strong shedding effect is also reflected, nominal unit labour costs declined considerably. This is particularly valid for eastern Germany; here, manufacturing, following a hard "kill-or-cure" remedy, has pretty much "shrunk back to health", and in this sector – which only makes up around one-fifth of gross value added – the gap between it and western Germany in terms of labour costs and productivity was nearly closed (see table on page 35).

Labour market policy measures

Table 3

in thousands

Time	Un-employed	Short-time workers	Employees involved in job-creation schemes	Partici-pants in further training or retraining schemes	Beneficiar-ies under section 105 of the Work Promotion Act 1, 3	Recipients of retire-ment pension due to unemploy-ment 2, 3	Recipients of tran-sitional old-age benefits or early retire-ment pensions
	Germany						
1995	3,612	199	384	560	244	538	343
1996	3,965	277	354	546	267	662	187
1997	4,384	183	302	431	318	749	60
1st qtr	4,548	303	313	495	304	717	103
2nd qtr	4,317	197	313	458	306	741	73
3rd qtr	4,331	111	298	392	319	761	44
4th qtr	4,342	121	286	379	343	777	19
	Western Germany						
1995	2,565	128	72	306	205	335	2
1996	2,797	206	76	308	200	391	2
1997	3,022	133	68	248	197	446	1
	Eastern Germany						
1995	1,047	71	312	254	39	203	341
1996	1,169	71	278	238	67	271	186
1997	1,363	49	235	184	121	303	59

1 Persons receiving benefits under section 105 a, b, and c of the Work Promotion Act. — **2** Recipients of pensions 60 years of age and older yet under 65. — **3** Data provided by the German Council of Economic Experts.

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Problematic alternatives

It is occasionally asserted that the real available scope for purposes of income distribution should be oriented solely to the measured growth in productivity in the current economic situation, too. Accordingly, a sharper rise in labour productivity would justify a correspondingly higher real wage level. Such a view implies either that the productivity path is exogenously predefined and not also the result of certain wage policy behaviour, or it is assumed that the employment risks connected to a rise in real wages would be relatively low, meaning that on the whole the "mass income", and not least private consumption, would profit. Experience has shown that a wage policy along these lines would, under the present circumstances, achieve the exact opposite and would endanger jobs.

Labour productivity not exogenous

The statistically calculated growth in labour productivity is only a rather incomplete measure of the greater productiveness of labour as a factor of production. As far as the question of employment is concerned, this yardstick is even misleading if, as a consequence of excessive labour costs, staff is released in increasing numbers. A factor price which is initially not in line with the market can find the matching labour productivity via this path, which the mechanical ex post review shows to be remuneration which is in line with productivity. For example, in 1997, too, the high gains in productivity were to a large degree only a reflection of the exit of enterprises which were no longer competitive, which, together with a strong pressure to rationalise, meant the loss of many jobs. The exit of suppliers no longer competitive and the shedding of labour, on the whole, are an indication of structural labour market problems, as in the past.

The path that promises more success

Such labour market disequilibria tend to be an argument in favour of carefully assessing the part of the increase in productivity intended for primary distribution in principle and not exhausting it entirely. Enshrined in a longer-term, credible strategy of wage policy moderation and flexibility, and flanked by a cost-level-oriented social policy, with burdens of levies declining overall, more output could be profitable, and at the same time the employment intensity of economic growth could be increased. This path is in line with the guiding principle of "economic policy appropriateness and sustainability", including in employment policy, instead of betting on risky strategies of increasing real wages or on the useless interventionist approach of manipulating the employment threshold by artificially putting the brakes on technical progress which promotes prosperity.

Sluggish level of consumption

Households' consumer expenditure rose in value by 2¼% in 1997; in real terms, it hardly exceeded its previous year's level, which particularly hit retail trade. The key factor behind the sluggish consumer demand was, from the income side, the severe decline in employment; but the larger burden of levies had a dampening impact, too. Moderate wage settlements, a slower momentum of interest-dependent income from property and cutbacks in social security transfers had a similar impact. A stabilising factor from a cyclical point of view was private saving, which even declined in absolute numbers. The private households' saving ratio, at 12% of disposable income, remained once again below its long-term average.

Moderate price increases

In the efforts at securing price stability, the year of 1997 was, to be sure, at times not free of burdens; however, the calm price climate remained unharmed at the end of the year. As an annual average, the consumer price index, which continues to be considered a measure of the current rate of inflation, rose by 1.8%, following 1.5% the previous year. There were two key factors behind this somewhat higher rate of inflation; one was administered price increases, and the other was unfavourable external influences. These contrasted with lower unit labour costs and a domestic demand which, on the whole, tended to be weak. On balance, the high degree of monetary stability achieved over the

Pay and unit labour costs in eastern Germany — Table 4

Sector of the economy	Gross compensation per employee [1]	Real value added [2] per employed person	Labour cost [3] per unit of real value added	Labour cost [3] per unit of nominal value added	Labour cost per unit of nominal value added in 1997 as % of the west German figure
	Change between 1991 and 1997 in %				%
Producing sector (excluding construction)	130.6	222.1	– 28.4	– 33.0	104.3
Construction	54.2	28.0	20.4	– 15.3	102.3
Wholesale and retail trade and transport	95.4	72.7	13.1	– 7.9	122.7
Services [4]	64.8	13.6	45.1	7.5	135.1
Public sector, households, etc.	92.5	10.5	74.2	– 1.4	101.2
Total economy	92.1	70.4	12.7	– 22.5	123.1

Source: Federal Statistical Office. — **1** Work-place concept. — **2** At 1991 prices. All figures for individual sectors before deduction of imputed remuneration for bank services. — **3** Gross compensation generated in Germany per employee divided by real or nominal value added per employed person. — **4** Services excluding letting of dwellings.

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past two years was able to be preserved, which is also likely to have had a positive impact on further price expectations.

Administered price increases

From the administrative side, immediately at the beginning of the year the radio and television licence fees were hiked by nearly one-fifth. Moreover, in the new Länder the last stage of the rent adjustments envisaged in the Rent Transference Act of 1995 went into effect, affecting major municipalities in conurbations. In the spring and at the middle of the year, furthermore, considerably higher contribution payments to prescription medicines were levied. Finally, the motor vehicle tax and the postal fees underwent upward price adjustments. Overall, these measures caused an increase in consumer prices of well over ½ percentage point.

External inflationary stimuli

After a long phase of falling or stable import prices, considerable inflationary stimuli came in from the outside in 1997. A similar effect was exerted by both the international raw material prices, which were rising at times, and by a marked appreciation of the US dollar, which in many transactions on the world market takes on the role of a "numéraire". Approaching mid-1997, the increase in import prices reached a year-on-year level of as much as 5.4 %; in the wake of the recovery of the Deutsche Mark, as well as a favourable price climate in important buying countries, price-dampening factors then gained the upper hand. As an annual average for 1997, Deutsche Mark import prices rose by 3.2 % following an increase in the previous year of only 0.5 %.

Domestic producer prices

Domestic price trends did not remain unaffected by these influences. Domestic producer prices of industrial goods rose at an accelerated pace in the first half of the year; the margin to the preceding year, having been 0.7 % at the beginning of 1997, widened to 1.5 % in August. Although there was a calming down over the further course of 1997, the annual average increase was 1.2 %. In the preceding year a slight decline of 0.5 % had even been measured; however, the abolition of the "Kohlepfennig" had a perceptibly price-dampening effect.

Continued favourable price climate

Following the turn of the year 1997-8, the favourable price trend of the past few months continued across the board. International quotations for raw materials declined distinctly under the impression of a severe drop in crude oil prices. In March, imported goods were even slightly cheaper than in the previous year. At the domestic producer and consumer level, prices remained virtually stable after seasonal adjustment. Besides cheaper energy, a calmer trend in rents and services also played a role. In the first four months, the consumer price index exceeded its year-on-year value by only 1.2 % (a statistical baseline effect also played a role). The good starting position, continuing restraint in domestic spending and the high intensity of competition on many sales markets are creating favourable conditions so that the degree of price stability achieved so far can be preserved in the current year despite additional value-added tax burdens.

Economic outlook for 1998

After the upward trend lost steam in the final quarter of 1997, the economy got off to a good start in the new year, which may have been assisted by the mild winter weather. Important conditions for a more robust expansion of business activity continue to be fulfilled. It is true that the crises in East Asia must be taken into account as an internationally significant burdening factor which will slow down economic growth, yet the associated cyclical risks seem by all accounts to have remained within bounds, viewed from a global perspective; price-dampening market reactions and lower real interest rates in the industrial countries, in addition to the aid programmes and adjustment measures in the affected regions which are already under way, are serving as stabilising counterweights (see also page 112 ff. of this Report). Even if third-market effects are taken into account, export business will therefore remain an important pillar of the German economy. This, as well as the relaxed domestic cost situation and

Prices

Chart 6

Change from previous year in %, quarterly

1 Domestic sales. — **2** Calculated by the Bundesbank.

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an improved profit situation, is likely to contribute to a consolidation of the propensity to invest in the enterprise sector. The dampening moments on the part of the construction sector, however, will only gradually become somewhat weaker. Under these conditions, the labour market situation in Germany as a whole will only take a turn for the better in the further course of this year. Owing to a slight increase in employment, accompanied by relatively stable consumer prices and a declining burden of direct levies on households, private consumption may potentially be revived. However, the economic momentum will probably not be strong enough for the unemployment rate to decline in terms of annual average. However, a certain improvement can likewise be expected here over the course of the year. Even so, this means unemployment will remain the most pressing problem occupying the German economy.

2. Fiscal policy against a background of difficult adjustment measures

(a) Trends in 1997

Large tax shortfalls persist

Trends in the central, regional and local authorities' budgets were overshadowed by persistent tax weakness last year. For the third consecutive year, tax revenue remained far below expectations. Compared with the official forecast in the autumn of 1996 on which their financial planning had been based, the Federal and the Länder Governments as well as the local authorities had to bear shortfalls of DM 33 billion in tax revenue; thus the shortfalls were even slightly above those of a year earlier. Only a fairly small proportion of the tax shortfalls was attributable to the fact that nominal economic growth was 1 percentage point lower than had been assumed in the autumn of 1996 and that the number of persons employed continued to decrease markedly, also contrary to expectations. The impact of these cyclical factors was felt particularly in the revenue from wage and turnover taxes; the fact that economic growth was supported principally by exports, which are tax-free, had an additional retarding effect on turnover tax receipts.

Structural factors in the case of assessed taxes, however, were of greater importance regarding the fall in receipts. This was due not only to the intensified international competition in tax levels but, apparently, also in the main to the fact that, given the high general tax rates, legal opportunities for tax-saving transactions, which had increased considerably in the wake of unification, were made use of to a large extent. Additional shortfalls, particularly in the Länder

Public sector finance *

Table 5

Item	1995 p	1996 pe	1997 pe	1995 p	1996 pe	1997 pe
	DM billion			Change from previous year in %		
Central, regional and local authorities						
Expenditure						
Expenditure on personnel	370.3	372	372.5	+ 3.2	+ 0.5	+ 0
Other operating expenditure	158.4	160	159	– 0.5	+ 1	– 0.5
Transfers 1	360.7	353.5	347.5	8 + 3.7	– 2	– 1.5
Interest paid	129.1	130	132.5	+ 13.1	+ 1	+ 2
Fixed capital expenditure	96.9	92	89	– 2.8	– 5	– 3.5
Financial aid 2	82.0	75.5	73	– 0.3	– 8	– 3.5
Total expenditure 3	1,201.1	1,186	1,174,5	+ 3.3	– 1	– 1
of which						
Federal Government 4	489.5	489.5	479	+ 2.3	– 0	– 2
West German Länder Governments 5	389.8	399	397.5	+ 3.8	+ 2.5	– 0.5
East German Länder Governments	104.9	107.5	107	+ 5.9	+ 2.5	– 1
West German local authorities	270.6	266.5	262.5	+ 1.5	– 1.5	– 1.5
East German local authorities	70.4	68	64	8 + 1.4	– 3.5	– 6.5
EU 6	40.2	39.5	42	– 2.0	– 1.5	+ 6.5
Receipts						
Tax revenue	814.4	799.5	797	+ 3.7	– 2	– 0.5
Other receipts	280.3	271.5	289	+ 1.4	– 3	+ 6.5
Total receipts 3	1,090.8	1,066	1,078.5	+ 3.2	– 2.5	+ 1
of which						
Federal Government 4, 7	439.3	411	415.5	+ 0.1	– 6.5	+ 1
West German Länder Governments 5	357.8	364	368.5	+ 2.9	+ 2	+ 1
East German Länder Governments	91.8	96.5	97.5	+ 11.4	+ 5.5	+ 0.5
West German local authorities	258.3	262	257.5	– 1.0	+ 1.5	– 1.5
East German local authorities	68.5	66	62.5	8 + 6.3	– 4	– 5
EU	40.2	39.5	42	– 2.0	– 1.5	+ 6.5
Deficit (–)	– 110.3	– 120.5	– 96	.	.	.
of which						
Federal Government	– 50.5	– 78.5	– 63.5	.	.	.
West German Länder Governments 5	– 32.0	– 35	– 29.5	.	.	.
East German Länder Governments	– 13.1	– 11	– 9.5	.	.	.
West German local authorities	– 12.4	– 5	– 5	.	.	.
East German local authorities	– 1.9	– 2.5	– 1.5	.	.	.
"German Unity" Fund	+ 2.3	+ 2.5	+ 3.5	.	.	.
Redemption Fund for Inherited Liabilities	+ 7.3	+ 9.5	+ 8	.	.	.
ERP Special Fund	– 2.5	+ 1	+ 1	.	.	.
Federal Railways Fund	– 7.0	+ 0	+ 0.5	.	.	.
Social security funds						
Expenditure	753.3	797	807.5	+ 6.8	+ 6	+ 1.5
Receipts	744.4	786.5	812.5	+ 5.4	+ 5.5	+ 3.5
Surplus (+) or deficit (–)	– 8.9	– 10.5	– 5.5	.	.	.
Public sector, total						
Expenditure	1,860.4	1,878	1,874	+ 4.8	+ 1	– 0
Receipts	1,741.2	1,747	1,783	+ 4.3	+ 0.5	+ 2
Deficit (–)	– 119.2	– 131	– 91	.	.	.

* 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 and the share of mineral oil tax are included here on a gross basis. — **5** Including Berlin. — **6** EU expenditure financed out of EU revenue in Germany. — **7** The figure for the Bundesbank's profit transfer 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.

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budgets, were also due to the fact that, contrary to original expectations, the abolition of wealth tax had still not been offset fiscally by corresponding increases in receipts from the inheritance tax reform and from the rise in the tax on the acquisition of land and buildings.

Tax ratio declines further

Given a nominal economic growth of 2.8 %, tax revenue decreased by 0.4 % against 1996, especially for the reasons given above. As a result, the overall tax ratio – the relationship between tax receipts and nominal GDP – fell further, i. e. by 0.7 percentage point to 21.9 %; thus the declining trend in this ratio that had set in in 1993 continued. If the abolition of wealth tax is disregarded, however, this further decline does not reflect an improvement in general tax conditions. On the contrary, the low yield from the taxation system in fiscal terms exposes the system's structural deficiencies, which are reflected in an increasing erosion of the tax assessment base while general tax rates continue to be high.

Higher burden of social security contributions

The burden of social security contributions increased further last year. This was attributable especially to the sharp rise (from 19.2 % to 20.3 %) in the contribution rate to the pension insurance scheme at the beginning of the year, which was undertaken to stock up the reserve to the statutorily required minimum level of one month's expenditure. Besides that, the contribution rates to the health and nursing care insurance schemes increased on an annual average. If all social security sectors are taken together, contributions amounted to just over 42 % of eligible income at the end of 1997; thus they had increased by 6 ½ percentage points since the beginning of this decade. There has been a "vicious circle" here for quite some time now: rises in contributions lead to higher costs of labour, thereby impairing employment conditions and increasing unemployment, and this, given the existing legislation on benefits, results in further rises in contributions. In spite of the higher burden of social security contributions, however, last year's overall revenue ratio was somewhat below that of 1996, owing to the lower tax ratio; as defined in the national accounts, it was 42.7 % in relation to GDP, compared with 43.0 % in the year before.

Strict retrenchment at all levels

The central, regional and local authorities' budgetary policy was characterised by efforts to cushion the tax shortfalls as far as possible through further expenditure restraints and increased sales of assets. A strict retrenchment course was pursued at all levels of government; the central, regional and local authorities' expenditure was 1% lower than in 1996. This was facilitated by the fact that expenditure on staff, which alone accounted for approximately one-third of the total volume of expenditure, hardly increased any further, reflecting the moderate pay settlement in the public sector and a restrictive recruitment policy. Owing to the sustained low level of capital market interest rates, the increase in interest expenditure was significantly restricted despite the previous substantial public sector borrowing, as the expiring debt could be refinanced on more favourable terms.

Transfer payments decreased by 1½%, especially as the increase in benefits from the statutory nursing insurance scheme had led to lower spending on social assistance. Fixed capital expenditure declined even more sharply, i.e. by 3½%, for the fifth year in succession; this was due to the persistent pressure exerted by the decrease in receipts. In addition, measures with a temporary effect were taken on both the expenditure and receipts sides, and some of these led to the shifting of burdens within the public sector. One example is the cutback in the Federal Government's contributions towards the Redemption Fund for Inherited Liabilities.

Moderate increase in expenditure in social security funds

Expenditure in the social security sector rose by just under 1½% on balance, compared with an increase of 6% in 1996; this was due not least to legislative cutbacks in benefits. The nursing care insurance scheme, where the additional cost incurred by the extension of benefits to cover in-patient nursing care showed its effect, recorded particularly sharp increases. The expenditure of the pension insurance scheme grew by 2¾%, although this increase in expenditure was counteracted by cutbacks in benefits in the rehabilitation sector. The Federal Labour Office recorded a considerable increase in unemployment payments, which was accompanied by reductions in the field of "active labour market policy"; the Federal Labour Office's expenditure decreased by 2¾% overall. The statutory health insurance scheme, too, recorded a reduction in expenditure of 2%. This was made possible by the very low sickness ratio and the measures taken to contain the rise in costs in the health care sector.

Distinct reduction in government ratio

All in all, public sector expenditure remained virtually unchanged last year, thus enabling a distinct reduction to be achieved in the government ratio. As defined in the national accounts, this fell to 48.8% from 50.0% in 1996, which meant that for the first time since 1992 government expenditure made up less than one-half of total output. Hence, fiscal policy makers came one step closer to their objective of reducing the government ratio to its pre-reunification level (of just under 46%).

Deficit and debt ratios

As defined in the financial statistics, the central, regional and local authorities' budget deficits, which amounted to DM 96 billion, were substantially lower than in 1996 (when they had reached a total of over DM 120 billion). The social security funds recorded a positive swing from a large deficit (DM 10½ billion) to a surplus of slightly less than DM 5½ billion in 1997, although this was achieved mainly by the increase in the contribution rate to the pension insurance scheme. The overall public sector deficit reached DM 91 billion in 1997, compared with approximately DM 131 billion the year before. As defined in the national accounts, which, according to the Maastricht Treaty, is decisive, and based on the provisional result available (which still contains some estimated elements), the public sector deficit, at 2.7 % of GDP, was somewhat below the 3 % reference value required by the Treaty. This compares with a ratio of 3.4 % in 1996. At 61.3 %, however, the public debt-to-GDP ratio actually exceeded the reference value laid down in the Maastricht Treaty to a somewhat greater extent than before.

(b) Outlook and fiscal requirements

Expenditure constraints and substantial sales of participating interests

In order to continue to reduce deficits despite the persistent sluggishness in tax revenue, the Federal and the Länder Governments as well as the local authorities intend to pursue their present retrenchment policy. According to the budget plans, the central, regional and local authorities' total expenditure will be increased by 2 %, which is about half the rate of expected nominal economic growth. The envisaged containment of the increase in expenditure will be facilitated by the low level of interest rates and the moderate pay settlement in the public sector. Furthermore, owing to the budgetary situation, which remains tight, investment expenditure and other operational expenditure is unlikely to go up much this year, in spite of the price rises following the increase of value-added tax on April 1. In addition, all levels of government, and especially the Federal Government, hope that substantial sales of government assets will make a considerable contribution towards reducing the deficits. The transfer of Bundesbank profits, which are substantial, especially as a consequence of the revaluation of the Bank's foreign exchange reserves, will be particularly important for the trend in the debt level.

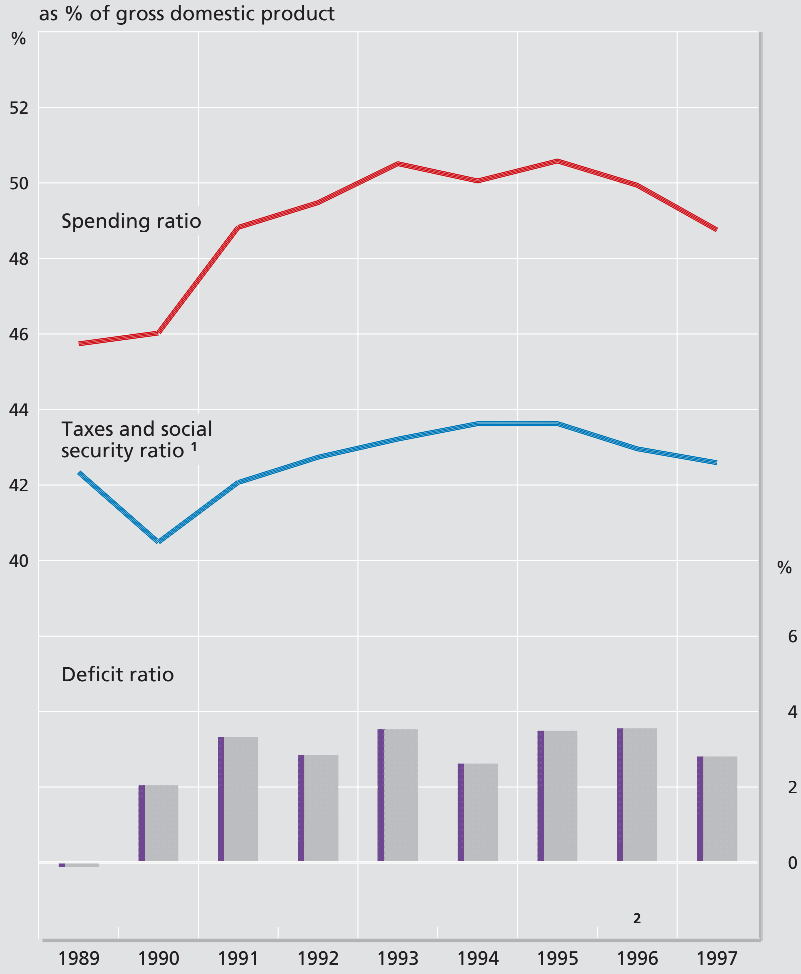
Tax revenue expected to remain subdued

The necessary reduction in budget deficits envisaged in the budget plans for this year will be impeded by the fact that tax revenue is not expected to keep pace with nominal economic growth again in 1998. In the official tax estimate of November 1997 an increase in tax revenue of no more than just under 2½ % was

Ratios of public sector budgets *

Chart 7

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 (1997: 3.4% of GDP) is not included here. — **2** The spending ratio and the taxes and social security ratio have been reduced by approximately ½ percentage point since 1996 owing to the net recording of child benefit.

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forecast for 1998 while nominal economic growth was put at around 4½%. Although – with the expected additional receipts from the rise in turnover tax – tax revenue should now increase by around 3½%, this improvement in revenue prospects will be accompanied by corresponding additional expenditure in the form of a larger Federal grant to the pension insurance scheme.

However, it now appears that the rate of economic growth will be somewhat weaker than expected last autumn. The overall tax ratio is forecast to decrease further in 1998, although the tax relief that was introduced at the beginning of this year will make less of an impact than the additional tax burdens. Thus, the tax relief provided by the reduction in the solidarity surcharge and by the higher basic allowance in the case of income tax is still somewhat less than the effect this year of the increase in value-added tax (although the full effects of this increase will not be felt until 1999). The abolition of trading capital tax is being financed through reduced deduction possibilities for enterprises.

Growing surplus in the social security sector

The social security funds are expected to record an even more favourable result this year than in 1997. The decisive factor for this is that the pension insurance scheme is expected to run a higher surplus and therefore to reach the statutorily required fluctuation reserve of one month's expenditure (after missing this target in 1997). It was possible to avoid the (otherwise) necessary increase in the contribution rate through the restructured financing which was approved in connection with the pension reform – even though the pension reform will not come into force until next year. The topping-up of the Federal grant financed through taxes will temporarily stop the upward trend in statutory non-wage labour costs; however, this restructuring will do nothing to change the total burden of taxes and social security contributions in Germany, which is rather high by international standards.

Deficit declines

This year's budget plans indicate a sizeable decline in the overall deficit as defined in the financial statistics. As defined by the national accounts, however, this improvement will be far more modest as the proceeds from privatisation do not affect the deficit. In its Annual Economic Report presented in March, the Federal Government said it expected the deficit ratio to decline, in terms of the definition in the Maastricht Treaty, to 2 ½ % in 1998. The present rate of growth in the debt ratio is expected to come to a halt this year. Furthermore, another distinct decrease in the government spending ratio seems likely in 1998. Although this will be accompanied by a reduction in the burden of taxes and social security contributions, this downward trend is primarily attributable to the inefficiency of the current tax system.

Continuation of consolidation process necessary

As the efforts made so far to reduce new public sector borrowing have relied to some extent on temporary measures, priority must be given in future years to sustaining the process of consolidation. Given a planned deficit ratio of 2 ½ % this year, Germany's fiscal position is still far from meeting the requirements of the Stability and Growth Pact, which was implemented especially on Germany's initiative and which demands a fiscal position that is close to balance or in surplus in normal economic situations. Consequently, fiscal policy makers continue to face difficult challenges. For example, the rise in consumption expenditure, in

Indebtedness of the central, regional and local authorities Table 6

DM billion

Item	1996	1997 pe	1996	1997 pe
	Level at end of year		Change from previous year	
Borrowers' note loans	879.7	914.5	+ 70.6	+ 35
Securities	1,149.5	1,215.5	+ 65.2	+ 66
Other debt	100.0	91	– 2.5	– 9
Total indebtedness	[2] 2,129.3	[2] 2,221	[3] + 133.4	[3] + 91.5
Federal Government	839.9	905.5	+ 83.0	+ 66
West German Länder Governments	477.4	505.5	+ 34.8	+ 28
East German Länder Governments	81.0	90	+ 11.8	+ 9
West German local authorities [1]	161.4	162.5	+ 1.8	+ 1
East German local authorities [1]	39.2	41.5	+ 2.2	+ 2
"German Unity" Fund	83.5	79.5	– 3.6	– 4
ERP Special Fund	34.1	33.5	– 0.1	– 0.5
Federal Railways Fund	77.8	77.5	– 0.6	– 0.5
Redemption Fund for Inherited Liabilities	331.9	322	+ 3.0	– 10
Equalisation Fund for Safeguarding the Use of Coal	3.1	3	+ 0.9	+ 0
Indemnification Fund	0.0	0	+ 0.0	+ 0

1 Including municipal special-purpose associations. — **2** In the definition relevant for compliance with the EMU convergence criterion, the indebtedness comes to DM 2,141 billion in 1996 and DM 2,232 billion in 1997. — **3** The change in the debt level deviates from net borrowing, since it includes the assumption of old debt and extractions from the public sector budgets.

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particular, must be contained in the longer term, so that the ratio of government spending can be reduced further on a sustainable basis. This will probably entail further substantial revisions of existing public benefit programmes.

Underlying need for tax system reform

However, a consistent retrenchment course on the expenditure side is unlikely to be sufficient to reduce the deficits unless the structural deficiencies of the tax system are eliminated, too. These deficiencies are leading to a less than proportional growth in tax revenue, in spite of high tax rates. A radical structural reform of taxation with far lower general tax rates and fewer exemptions than now is therefore needed in order to render the tax system more efficient and fiscally remunerative again. The resulting favourable effects on overall economic growth and on employment would lay the foundation for a sustainable trend in public finance that would not overtax economic capacities, which is one of the basic requirements of the forthcoming EMU.

Consequences of EMU for federal system

EMU and especially the regulatory framework of the Stability and Growth Pact likewise show how necessary it is that budgetary discipline within federal systems is effectively implemented at all levels of government. However, the Federal and Länder Governments have still not reached a joint agreement on a "national stability pact" which would take account of the implications for Germany of complying with the deficit criterion and of sharing, within the public sector, any financial burdens arising from sanction payments. In general, there are many arguments in favour of a review of the public finance system which would allow for a higher degree of responsibility at the individual levels of government. The most important requirement here would appear to be the drawing of a more distinct delineation of legislative powers, which could be tied to a relaxation of the existing revenue-sharing scheme between the Federal and the Länder Governments and a greater autonomy for the latter in tax matters. The aim of a reform of the public finance system ought to be to re-emphasise the link between public benefits and the burden of taxes and social security contributions and, consequently, to create on a permanent basis effective incentives for an economical use of public funds.

3. Further growth in foreign trade and payments

Favourable external environment

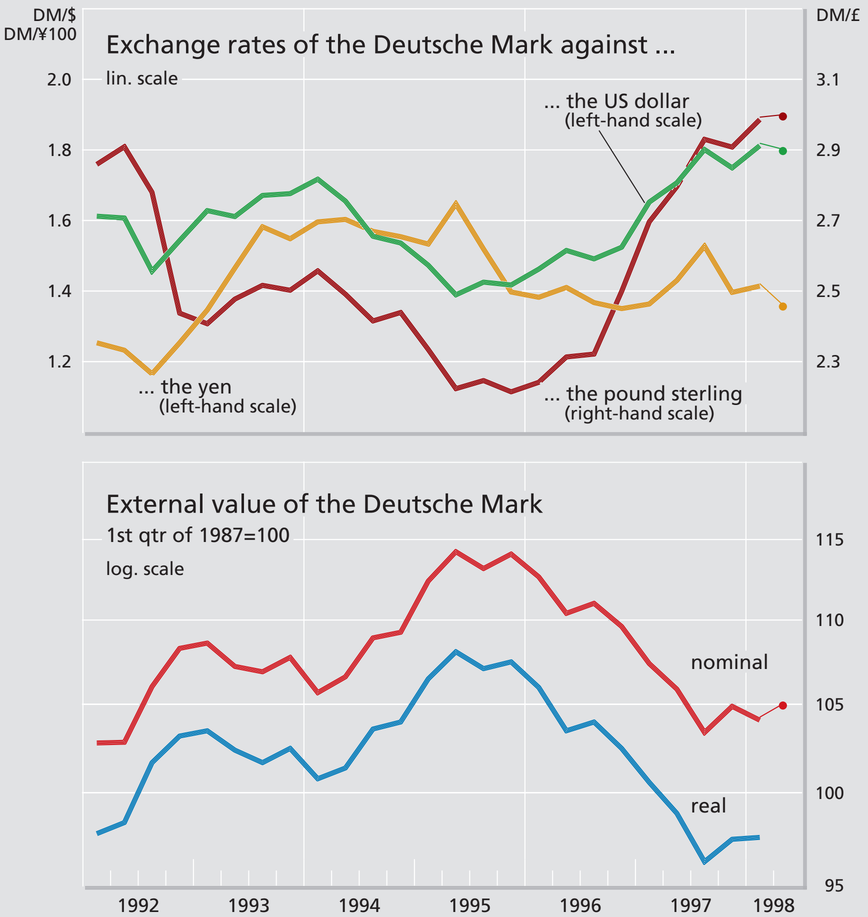
The external economic environment provided excellent conditions for a strong cyclical revival in Germany in 1997. It was not only the sustained recovery in many partner countries that made this possible. Exchange rate trends also helped. Over the year as a whole, these were characterised by progressive relaxation and normalisation in relation to the US dollar while the European foreign exchange markets were marked by increasing convergence and stability. In the second half of the year, however, the currency crises in the Far East resulted in uncertainty and disruption. Yet, in terms of the importance of the region for German foreign trade, these disturbances, which in some cases were dramatic, had little effect on the favourable and advantageous underlying trend arising from the improvement in the relationship to the US currency.

Sharp appreciation of the dollar

The appreciation of the dollar against the Deutsche Mark reached a peak – at DM 1.89 – in August 1997. The US currency then entered a period of weakness after the growth prospects for Germany and for Europe as a whole had significantly improved while a less favourable forecast had been made on the future trend in the US economy. From the end of November, however, when apparently large amounts of capital from South-East Asian countries were looking for "safe havens", the US currency began to make a good recovery. This trend continued into the new year. When this Report went to press, however, the dollar, at DM 1.78, was again slightly weaker.

Exchange rates of selected currencies and the external value of the Deutsche Mark *

Chart 8



* Exchange rates are calculated on the basis of the official spot middle rates. External value against the currencies of 18 industrial countries. The real external value is the 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 May 14, 1998.

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Yen influenced by the crises in east Asia

The yen also gained ground against the Deutsche Mark at first last year. It rose from DM 1.33 at the beginning of the year to DM 1.60 in August, thereby reaching its highest level since mid-1995. Later in the autumn, however, the Japanese currency, unlike the dollar, increasingly became embroiled in the east Asian currency turbulence. The extensive investment by Japanese business, especially by the banks, in this region again revealed the structural weaknesses of the Japanese financial sector and, consequently, brought the yen under pressure, which did not ease discernibly until the Japanese government announced remedial measures towards the end of the year. Recently, however, the Japanese currency was again hovering at DM 1.32 against the Deutsche Mark.

Upward pressure on pound sterling

Of the EU currencies, it was mainly the pound sterling that, largely in line with the US dollar, recorded substantial exchange rate gains. Underpinned by the robust economic growth in the United Kingdom and by the raising of interest rates on several occasions, the pound crossed the DM 3 mark in the summer of last year. The possibility that uncertainty on the part of investors in the run-up to EMU also fostered this development cannot be ruled out. As in the case of the dollar, this was followed by a period in which there was a correction downwards; the pound firmed again later in the year, however, and even during the first few months of 1998 it was still being distinguished by its strength against the Deutsche Mark. Indeed, for a time, the British currency, at approximately DM 3.10, had never been more expensive during the nineties so far, but at the time this Report went to press, it was again somewhat weaker at DM 2.88.

Steady exchange rate trend in EMS

By contrast, the exchange rate trends of most other EU currencies against the Deutsche Mark were fairly steady. This applies in particular to the currencies participating in the exchange rate mechanism of the European Monetary System (EMS). These currencies came close to their respective central rate against the Deutsche Mark, especially in the second half of 1997. The expectation which had been widely held by market players for some time, namely that the bilateral exchange rates of the currencies of countries participating in monetary union would be the same as the respective central rates in the exchange rate mechanism of the EMS on January 1, 1999, played a major role in this. Only the course of the Irish pound was significantly different. This was substantially marked right into the autumn by the appreciably stronger growth of the Irish economy and its close integration with that of the UK. The Irish currency has been extricating itself discernibly from its resultant parallel course with the pound sterling since the middle of October and, in expectation of Ireland's participation in monetary union, has been approaching its central rates in the EMS. Nevertheless, the Irish pound was still clearly above its official central rates within the exchange rate mechanism of the EMS. Consequently, the central rates of the Irish pound were revised upwards by 3 % in March 1998. Since then, the currency has been trading more or less at the new parities.

External value of the Deutsche Mark declines further

In terms of the weighted average of the currencies of the group of 18 industrial countries, the (nominal) external value of the Deutsche Mark declined by 3 % from the first quarter of 1997 until the first quarter of the current year, especially as a result of the appreciable strengthening of the US dollar. Even if the difference in the rates of inflation between Germany and the rest of the world is taken into account, the picture remains the same. As a general measure of Ger-

Balance of payments

Table 7

DM billion

Item	1994 1	1995 1	1996 1	1997 1
I. Current account	– 32.9	– 32.4	– 20.7	– 1.7
1. Goods	+ 82.5	+ 93.2	+ 107.3	+ 130.0
Exports (f.o.b.) 2	696.4	749.9	786.5	885.2
Imports (f.o.b.) 2	613.9	656.7	679.2	755.2
2. Services	– 64.0	– 65.1	– 65.5	– 71.2
of which				
Foreign travel	– 49.3	– 49.1	– 50.3	– 51.5
3. Factor income	+ 11.4	– 1.8	– 7.7	– 4.2
of which				
Investment income	+ 11.0	– 0.4	– 5.9	– 2.4
4. Current transfers	– 62.8	– 58.7	– 54.8	– 56.4
of which				
Net contributions to the EC budget 3	– 31.0	– 29.3	– 27.2	– 28.1
Other official current transfers to non-residents (net)	– 15.3	– 12.8	– 10.2	– 10.8
II. Capital transfers	+ 0.3	– 0.9	– 0.0	+ 3.6
III. Financial account (capital exports: –)	+ 66.4	+ 72.3	+ 28.1	– 12.6
1. Direct investment	– 25.0	– 36.3	– 48.6	– 57.8
2. Portfolio investment 4	– 39.3	+ 52.0	+ 86.7	– 10.6
Equities	– 10.7	+ 0.0	+ 1.1	– 25.2
Investment fund certificates	– 17.0	– 2.2	– 5.5	– 18.5
Bonds and notes	– 4.7	+ 61.9	+ 80.6	+ 44.9
German investment abroad (increase: –)	– 27.3	– 24.1	– 21.9	– 77.0
Foreign investment in Germany (increase: +)	+ 22.6	+ 86.0	+ 102.4	+ 121.8
Other portfolio investment 5	– 6.9	– 7.7	+ 10.6	– 11.8
3. Credit transactions 4	+ 132.2	+ 61.7	– 6.1	+ 60.2
Credit institutions	+ 141.7	+ 42.4	– 5.0	+ 63.4
Long-term	+ 15.9	+ 38.9	+ 23.1	– 4.4
Short-term	+ 125.8	+ 3.6	– 28.2	+ 67.8
Enterprises and individuals	– 16.4	+ 23.5	– 5.9	+ 13.5
Public authorities	+ 6.9	– 4.2	+ 4.9	– 16.7
4. Other investment	– 1.5	– 5.1	– 4.0	– 4.3
IV. Balance of unclassifiable transactions	– 21.6	– 21.3	– 8.9	+ 2.3
V. Change in the Bundesbank's net external assets at transaction values (increase: +) 6, 7	+ 12.2	+ 17.8	– 1.6	– 8.5
Memo item				
Change in the Bundesbank's net external assets at balance sheet rates (increase: +) 7, 8	+ 8.6	+ 15.1	– 1.5	– 5.5

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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man competitiveness, the weighted real external value of the Deutsche Mark in 1997, calculated on the basis of the price index of total sales, was more or less in line with its long-term average.

High rate of export growth

In the light of this scenario German exporters have been able to look back on an extraordinarily successful year. In 1997 the value of exports increased by 12½%. That was the strongest growth in German sales abroad since reunification. Some of this increase is due to higher prices, but even after eliminating relevant price increases, there was still an 11% rise in exports in real terms. The main driving force behind this development was the unusually rapid expansion of real world trade. This grew at a rate of approximately 9½%, which was significantly faster than in the previous year (6½%). German business benefited from this increase to an above-average degree and for the first time in a number of years again gained market shares.

Strong growth in export markets outside western Europe

German exporters recorded particularly strong sales growth in the dynamically expanding markets outside western Europe. In the lead were the countries in transition in central and eastern Europe, which absorbed almost one-third more (29%) than they had done in 1996. As a result, this region's share of total German exports rose to just over one-tenth. Exports to the developing countries increased almost as sharply; the Latin American countries, some of whose markets are again showing rapid growth rates following the efforts to achieve stability over the past few years, showed the fastest growth (28½%). However, the significance of this region for German exporters is still fairly slight (its share of total German exports being just over 2½%). Much the same is true of exports to the OPEC countries, which have likewise increased at an above-average rate (20%). Owing to the steep rise in the price of oil until the early summer of last year, the income of these countries was evidently substantial. At 9%, by contrast, German exports to the crisis region in South-East Asia grew considerably more sluggishly. However, exports to these states represent only a relatively small share (5½%) of total German exports.

Export success in the US market

Of the industrial countries, the United States was the market where German exporters had their greatest success; exports to the United States in 1997 were 27½% up on the previous year's level – not least because the strength of the dollar improved the price competitiveness of German exporters. By contrast, the rate of growth in exports to other EU countries, which are by far the most important markets for German goods, was below average (8½%). The level of orders from these countries was fairly low during the first few months of last year, but demand subsequently picked up discernibly and, owing to the far-reaching impact of these markets, compensated to a certain extent for the more sluggish market growth in Asia.

Imports also rise sharply

In terms of value, imports last year rose only slightly more slowly than exports although the rise of 11% (on an f.o.b. basis[1]) was greater on the export side owing to price increases. Import prices rose by just over 3 % compared with 1996, particularly as a result of the appreciation of the US dollar and sharp increases in the prices of raw materials and oil in the first half of 1997. The volume of imported goods increased by approximately 7 ½ %, which was remarkably high given the moderate increase in real domestic demand. The fact that the sharp rise in exports led to considerable imports of semi-finished and intermediate goods – owing to growing vertical integration – evidently played a role here. Accordingly, the rise in imports was primarily due to the supply of these types of product from abroad whereas the rise in demand for finished goods was less brisk.

Regional breakdown distorted by price and exchange rate differences

There were particularly high growth rates in the case of German imports from the central and east European countries in transition. Although part of this nominal increase was due to the rise in oil prices, which lasted until well into the spring of 1997, trade between German firms and those in central and eastern Europe intensified in both directions outside the energy field. Germany has become one of the most important trading partners for this group of countries not only as a supplier of high-quality machinery and equipment but also as a customer. Substantial rises in turnover were also recorded in the case of imports from some non-European industrial countries. This is particularly true of the United States; however, the import figures in Deutsche Mark terms rose sharply mainly as a result of the exchange rate because presumably most of the imports from the United States are invoiced in dollars. Goods imported from within the European Union, which account for just over one-half of total German imports, rose less steeply in nominal terms because such price and exchange-rate-related distortions in trade with other EU countries were insignificant last year; in real terms, however, such imports likewise rose sharply.

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1 In line with international practice, the freight and insurance costs incurred in the case of imports are allocated to services in this calculation. This breakdown of the import data is not possible in the regular monthly reports; imports are therefore shown on a c.i.f. basis, i.e. including freight and insurance costs.

Current account more or less in balance

Despite the substantial increase in the value of German imports, trade in goods showed a considerably larger surplus of DM 130 billion (on an f.o.b./f.o.b. basis) as a result of the sharp growth in exports mentioned above and thereby returned to the record levels reached at the end of the eighties. In contrast to the case at that time, however, significantly larger deficits on invisibles were recorded in 1997 with the result that the current account closed more or less in balance rather than with a surplus. Even so, 1997 was therefore the first year since reunification that Germany's external position was no longer marked by fairly substantial deficits.

Deficit on invisibles virtually unchanged

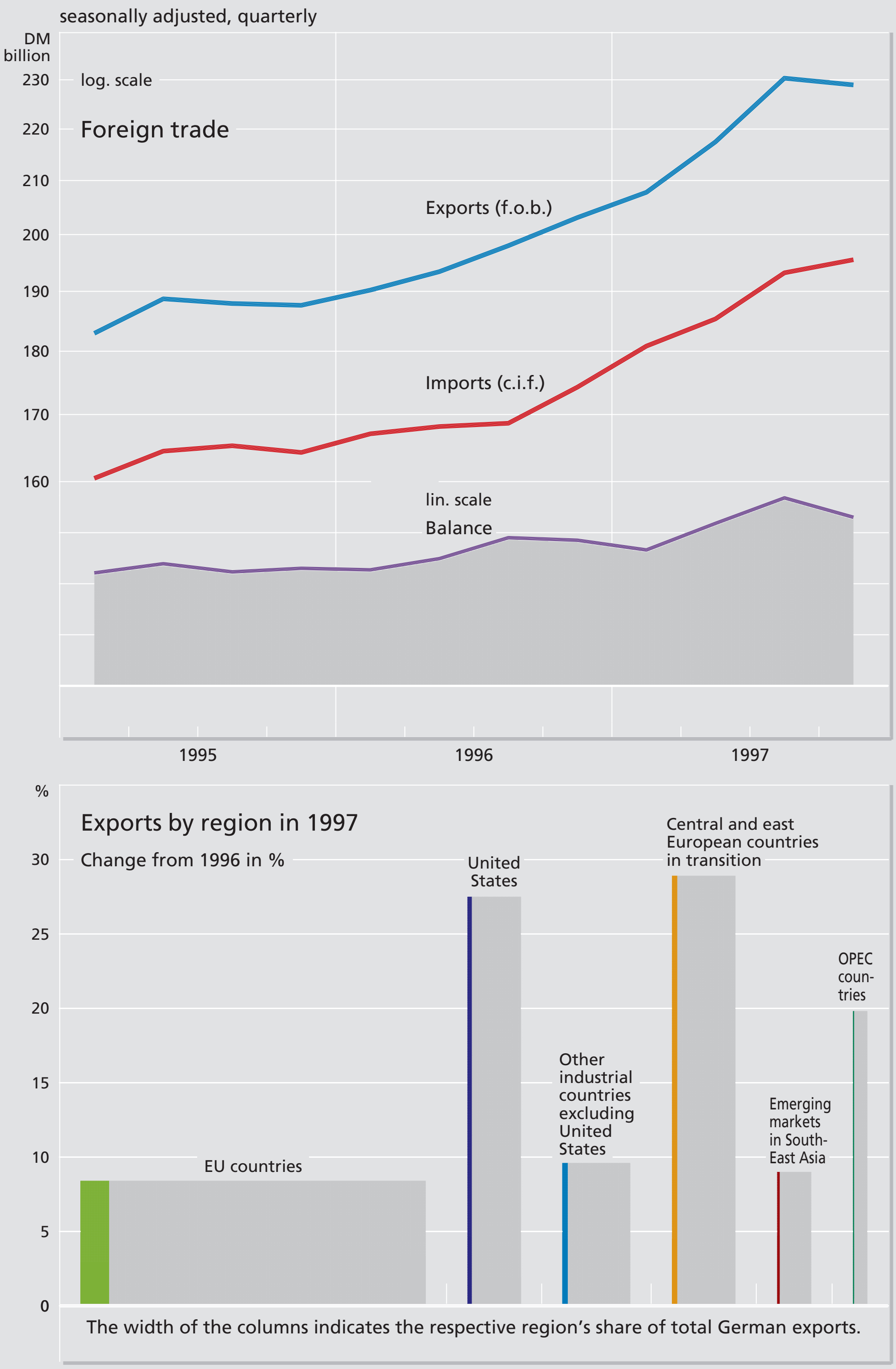
This trend was fostered by a certain degree of stability in invisible transactions, the deficit on which, at DM 132 billion net, was similar to that of the previous year. Until 1996 the deficit recorded here had been increasing year after year. For one thing, there were sharply rising deficits in the case of expenditure by German tourists for trips abroad after reunification. For another thing, declining net investment income had increased the deficits on invisibles – after the fall in net German external assets between the beginning of the nineties and the time this Report went to press to no more than just over one-quarter of its former record level. Recently, however, this unfavourable trend has not continued in its previous form either. The third segment, and in terms of the net amount the most important one, with respect to the large deficit on invisibles is Germany's current transfers to non-residents. These amounted to DM 56½ billion last year. Germany's net contributions to the EU alone came to DM 28 billion.

Large direct investment by Germany abroad

The increasing international integration of German business was apparent last year not only in the expanding cross-border exchange of goods but also in the sharp growth in the acquisition of participating interests abroad. Spurred by the rapid growth of German export markets and improved profitability of German enterprises, German direct investment abroad increased markedly again in 1997 and, at DM 57½ billion, broke the previous record set in 1995. The rapidly expanding US market in particular attracted German equity capital. As a result, the United States' share of German outward investment rose to about one-quarter. However, German firms also increased their investment in Mexico and in a few South American countries. By contrast, the rise in German direct investment in other EU countries was generally modest while for the first time since the beginning of the process of reform in the central and east European countries in transition there was a slight decline in new investment there in 1997 – after substantial investment in the previous few years.

Trend of foreign trade

Chart 9



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No change in foreign direct investment in Germany

Despite the improved competitiveness and more favourable growth prospects in Germany, foreign investment here, as shown in the balance of payments, continued to be rather disappointing.[1] As in 1996, foreign enterprises, in fact, slightly reduced their participating interests in Germany in 1997 (minus DM ½ billion). Relatively large dividends paid to foreign shareholders exceeded the inflows of funds which were somewhat greater than in 1996 and which had arisen from the acquisition of equity capital and the granting of long-term loans to German affiliated enterprises. There was therefore a deficit of DM 58 billion on direct investment, compared with one of DM 48 ½ billion in 1996.

Deficit in portfolio transactions

Portfolio transactions, too, resulted in net outflows (of DM 10 ½ billion) in 1997 (compared with net inflows of DM 86 ½ billion in 1996). German residents' purchases of foreign securities, in particular, rose sharply in 1997 and reached a record level even though in the final quarter – probably partly as a result of greater risk awareness following the outbreak of the crises in east Asia – a certain reluctance to invest abroad was discernible for a time.

Record investment in foreign equities and bonds

All in all, German investors acquired foreign securities worth DM 161½ billion in 1997; this was almost exactly three times as much as in 1996. A wide range of foreign securities was in demand, but the emphasis was on paper denominated in foreign currency. Thus, in the case of foreign bonds and notes (DM 77 billion compared with DM 22 billion in 1996) it was the purchases of foreign currency bonds that increased most noticeably (DM 64 ½ billion compared with DM 14 ½ billion in 1996). Much of this is a reflection of the lively "convergence trading" that occurred, particularly in the first half of the year, in the hope of making capital gains in the run-up to EMU. The comparatively low German interest rates together with the strong dollar presumably also supported the trend towards an international diversification of German investors' portfolios. Foreign equities, which accounted for as much as DM 52 ½ billion of total German capital exports in the year under review (1996: DM 21½ billion), ultimately also benefited from this. There was also an increase in demand for investment fund certificates (DM 14 ½ billion) and for money market paper (DM 6 ½ billion).

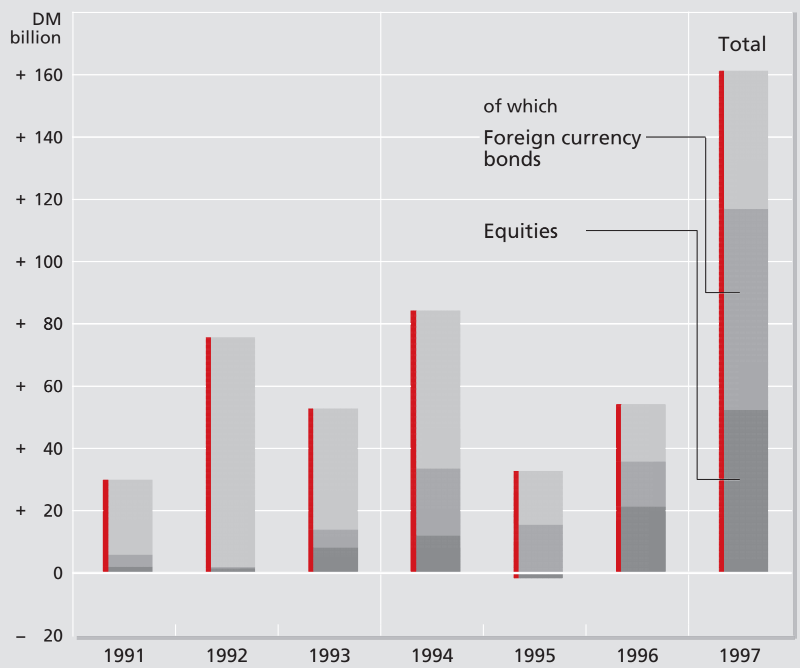
Foreigners' purchases of German securities also rise

Judging by the consistently substantial purchases of securities by non-residents, however, the financial transactions in the opposite direction did not suggest that non-residents were departing from the German market either. In the year

1 The low level of participating interests acquired by non-residents in Germany, a development which has been observed for some years, is probably also related to problems in statistical definitions and recording methods.

German securities investment abroad

Chart 10



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under review non-residents invested DM 150½ billion in German paper compared with DM 141 billion in 1996. As usual, they were primarily interested in German bonds and notes (DM 122 billion). In contrast to 1996, foreign investors clearly preferred public bonds (DM 78 billion) to bank bonds once again. Most bank bonds have recently been issued in the form of foreign currency paper. In the process, there was a slight shift in favour of Deutsche Mark paper, which was therefore quite able to hold its own against international competition. The heavy investment by non-residents in the German equity market likewise points in this direction. With net purchases of DM 27 billion, the previous year's outturn, which was already considerable, was again exceeded. The inflows of capital were concentrated on June and July when the German share indices – under the impact of the strong foreign presence on the buyers' side – reached new record levels but tended to tail off again somewhat during the rest of the year.

Diverging trends in credit transactions

The net capital exports through portfolio transactions and, more importantly, through direct investment were largely offset by inflows of funds through credit transactions. However, the trends in the various areas of cross-border credit transactions by banks and non-banks varied widely. Comparatively large outflows of funds in the case of public authorities (DM 16½ billion) – primarily as a result of redemption payments on loans previously raised abroad – were accompanied by largely short-term net capital imports by enterprises and individuals (DM 13½ billion). These reflect, for example, a further reduction in Euro-deposits and an increase in the net borrowing of foreign banks. There were modest outflows of funds (minus DM 4½ billion) through the long-term credit transactions of the banks in 1997 whereas in 1996 there had been net capital imports of DM 23 billion in this area. This reversal was primarily due to a discernible increase in the lending of German institutions to non-residents.

Fall in banks' short-term external position

The short-term credit transactions of the banks constitute the most important counterpart to the aforementioned deficits on current transactions and in the other segments of the financial account. There were imports of funds amounting to DM 68 billion in this area – largely as a result of cross-border interbank operations.

Transaction-related decline in the Bank's net external assets

A second – albeit a much smaller – counterpart to the aforementioned deficits in the balance of payments is to be found in the net external position of the Bank. At transaction values (the definition which is important for analysing the balance of payments), this declined by DM 8½ billion in 1997. It is principally the decline in the external assets that is important here as far as the value of the external position is concerned because the Bank returned to the market part of the foreign exchange assets which it had previously acquired through interest income and the exchange of dollars from US troops stationed in Germany. By contrast, the external liabilities rose slightly.

Revaluation of the monetary reserves

With respect to the balance sheet values, however, the revaluation of the monetary reserves which was carried out when the annual accounts at the end of 1997 were approved was of greater importance than the transaction-related changes in the external position. The valuation of the dollar assets was raised from DM 1.3620 per dollar to DM 1.5396 per dollar; this alone resulted in an increase of DM 11 billion in the monetary reserves shown in the balance sheet. When valuing the dollar reserves at a rate that was closer to the market rate, the Bank took advantage of the leeway provided by the valid accounting regulations while observing the strict principle of the lower of cost or market. The balance sheet rate chosen was derived from the average purchase costs of the dollar assets. In line with the guidelines of the International Monetary Fund, special drawing rights were also converted at a somewhat higher rate (DM 2.42043 per SDR) than before (DM 2.23145 per SDR).

Holdings at the end of 1997

After taking account of all transaction and revaluation-related changes, the holdings of monetary reserves (including other external assets) amounted to just under DM 128 billion at the end of 1997. The dollar assets, which are now valued at a higher rate, accounted for approximately 60 % of these and were worth DM 76 ½ billion. The claims on the European Monetary Institute (EMI) amounted to DM 22 ½ billion after deducting the difference between the ECU value and the book value of the gold and dollar reserves contributed; owing to the revaluation, this was likewise somewhat higher than at the end of 1996. By contrast, the monetary gold held by the Bank and shown in its balance sheet remained unchanged at DM 13 ½ billion. The reserve position in the IMF (including the special drawing rights), which at the end of 1997 was just under DM 14 billion, was somewhat greater. This reflected not only the higher valuation of the SDRs already mentioned but also the aid provided by the IMF to the Asian countries in crisis. After deducting the external liabilities of DM 17 billion, there were therefore net external assets worth DM 111 billion at the end of 1997 compared with DM 105 ½ billion at the end of 1996.

4. German monetary reserves

Change in the significance of monetary reserves

Germany has notably large monetary reserve holdings by international standards. As pointed out above, they are recorded at DM 128 billion in the Bank's balance sheet as of the end of 1997. These reserves form part of German external assets. Upon entry into the third stage of EMU on January 1, 1999, the Deutsche Mark will be replaced by the euro and the Bank will become an integral part of the European System of Central Banks (ESCB) and, in exchange, receive a euro credit balance. Under the Maastricht Treaty, the Bank – like the other participating central banks of the ESCB – will transfer part of its foreign reserves to the European Central Bank (ECB). The remaining monetary reserves will continue to be held by national central banks; the availability of the monetary reserves will be subject to the restrictions imposed by the ECB on monetary policy grounds.

Difficult early years

When the Deutsche Mark was introduced in 1948, Germany had no significant holdings of freely disposable monetary reserves. In 1950, balance of payments problems stemming from the Korean crisis even led to the Federal Republic of Germany becoming the first problem case of the then newly established European Payments Union (EPU).

Accumulation of monetary reserves in the Bretton Woods system

The German monetary reserves were initially accumulated in the following years under the conditions of the post-war monetary system. Under the Bretton Woods system the scope for monetary policy action was restricted by a regime of fixed exchange rates supported by the central banks' intervention obligations. Rapidly and constantly growing surpluses on Germany's current account therefore caused monetary reserves to rise to DM 20 billion by the end of 1958. After the Deutsche Mark had been made convertible and initial measures had been taken to liberalise financial transactions, the significance of cross-border capital flows increased and the link between movements on current account and reserve movements began to loosen.

Problems and collapse of the fixed-rate system

At the same time, increasing tensions arose between the requirements of exchange rate policy within the fixed-rate system and the Bank's mandate of safeguarding monetary stability. Speculative capital inflows pushed monetary reserves up to a level of over DM 40 billion for a time in the late sixties. Such inflows ultimately necessitated the Deutsche Mark revaluations of March 1961 and October 1969. It became increasingly obvious that, above all, the diverging thrust of monetary and fiscal policies in Germany and the United States and the associated inflation expectations would be incompatible in the long run with a system of fixed exchange rates. During the final phase of the Bretton Woods system the Bank was compelled to intervene in the foreign exchange market on an unprecedented scale. As a result, in autumn 1973 German monetary reserves had risen to almost DM 100 billion within only three years.

Further increase in monetary reserves even with floating exchange rates ...

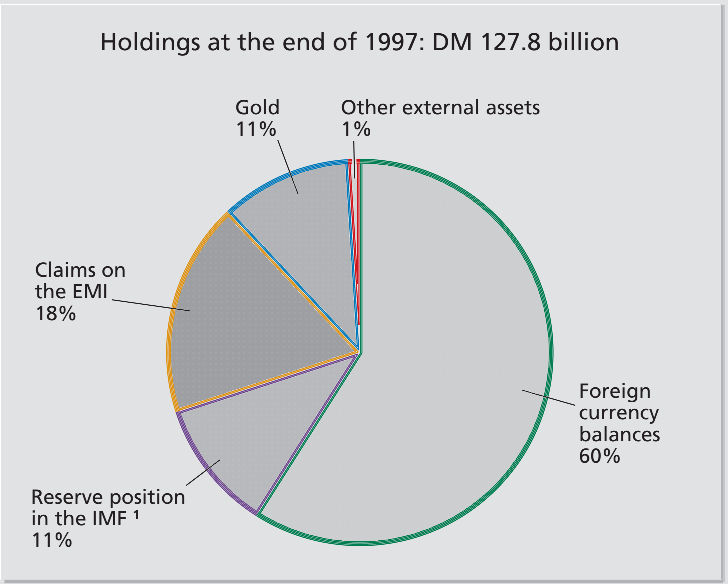
When the exchange rates between the major international currencies were finally floated, the principal reason for the sharp increase in Germany's monetary reserves in the sixties and early seventies ceased to obtain. Even so, the Bank – sometimes in consultation with other central banks – continued to intervene in the foreign exchange market on various occasions in the period which followed. The aim in such instances was to contribute to orderly market conditions without counteracting market fundamentals. At the same time, the Bank was also acting in accordance with international agreements to promote greater stability of exchange rate relationships between the industrialised countries.

... under the impact of US dollar exchange rate fluctuations

As a result, the first time that somewhat more sizeable inflows of dollars were recorded again was in 1977-8 and thereafter in 1986-7, each time in connection with the international efforts to stabilise the US currency which had a tendency to weakness during those periods. Between those dates the dollar had been very strong – a period which coincided with inflation and fiscal problems in Ger-

Structure of monetary reserves *

Chart 11



* Including other external assets; valued at balance sheet rates. — **1** Including special drawing rights.

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many. The Bank responded to the domestic risks to stability with a marked tightening of its interest rate policy and by simultaneously selling dollars to support this measure. Between the beginning of 1990 and the end of 1996 the dollar reserves, while subject to fluctuations, rose again, however. Although these developments were again accompanied by intermittent weakness of the US currency, the inflows of dollars were caused less by interventions in the foreign exchange market than by interest income from dollar assets and purchases of dollars from US troops stationed in Germany which were not fully recycled to the exchange market during that period.

Impact of the EMS

The setting up of the European Monetary System (EMS) on March 13, 1979 marked a major turning point in Germany's monetary relationships. The agreement provided for the temporary transfer of 20 % each of the national gold and dollar reserves to the European Monetary Cooperation Fund (FECOM); since then, these have been shown separately in the Bank's balance sheet as claims on the FECOM or, since 1994, on the EMI.

A factor which was of greater importance for the growth of the Bank's monetary reserves in the period thereafter, however, were the intervention obligations

Temporary large inflows of foreign exchange...

under the new exchange rate regime in Europe. Even though the EMS is not designed as an entirely fixed-rate system, but from the outset provided for realignments to be used as an instrument of adjustment in the event of fundamental exchange rate differences, the Bank repeatedly registered considerable short-term inflows to its reserve holdings resulting from support operations; at their peak German monetary reserves reached a level of almost DM 200 billion in autumn 1992.

... but no lasting impact on reserve position

Viewed over a longer period, however, interventions in the exchange rate mechanism of the EMS had scarcely any impact on the Bank's external position, as the foreign exchange holdings previously absorbed in the market generally flowed out again following the realignments, or were offset by the other central banks – to the extent that they resulted from recourse to financial assistance from partner countries through the FECOM or the EMI. On balance, the EMS therefore had no lasting impact on foreign reserve holdings.

Structure of foreign reserves

The terms of the prevailing exchange rate arrangements had a lasting impact not only on the growth of German monetary reserves, but also on their structure. German gold reserves, for example, were built up mainly in the fifties as part of the settlement of payments in the EPU and thereafter in connection with the work of the "gold pool"; until 1968 the participating central banks bought and sold gold to stabilise the gold market. The dollar assets, on the other hand, increased sharply, above all, during the periods of serious exchange rate turbulence described above, and the claims on the EMI stem from the transfer of gold and dollar reserves; in the case of the latter, financial assistance from other central banks intermittently played a significant role, too, on repeated occasions. The reserve position in the IMF (including special drawing rights allocated) likewise originates from an international monetary agreement. The drawing rights in the reserve tranche shown in the balance sheet as monetary reserves are based on German financial assistance provided to the IMF.

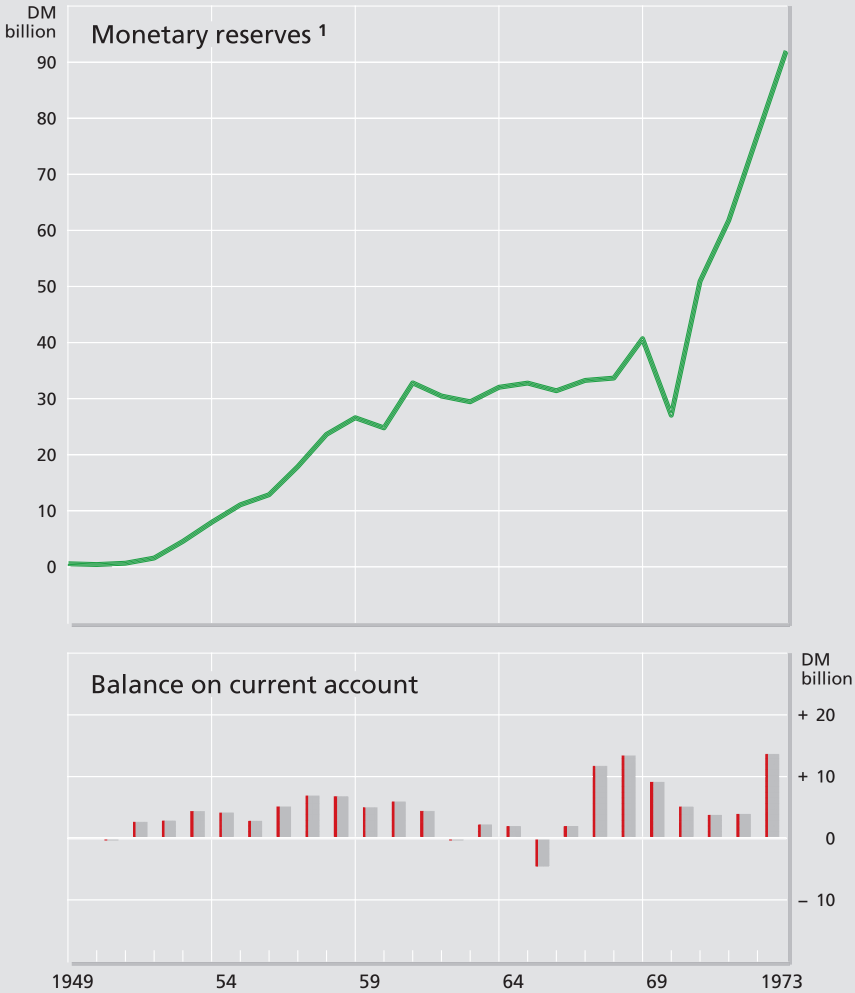
Valuation of monetary reserves

For a long time, the international monetary system also had implications for the valuation of monetary reserves. Under the Bretton Woods system the valuation of the gold and dollar reserves was based on the official parities (initially DM 4.20 per dollar and dollar 35 per ounce of fine gold).[1] In particular, the revaluations of the Deutsche Mark against the US currency were reflected thereafter in lower balance sheet rates applied to the dollar reserves. With the float-

1 The initial exchange rate of the Deutsche Mark set by the military authorities was DM 3.33 per dollar, and applied until September 1949.

Monetary reserves and current account
1949 to 1973

Chart 12



1 Including other external assets, valued at balance sheet rates. End-of-year levels.

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ing of the exchange rates, the valuation basis of the dollar was gradually lowered further – in line with current market conditions and on the strict principle of the lower of cost or market – to DM 1.3620 per dollar in the 1995 and 1996 balance sheets.

Changes brought about by EMU

The disclosure and valuation of German monetary reserves will change again with the establishment of the ESCB. The assets transferred to the EMI will reappear in the Bank's balance sheet as gold and dollar holdings, respectively. The accounting rules of the ESCB, which the Bank will likewise adopt, also provide

Record of domestic and external monetary policy measures

January 10, 1997
The European Monetary Institute (EMI) publishes a report on "The single monetary policy in Stage Three. Specification of the operational framework" of the future European System of Central Banks (ESCB). It describes the state of preparation regarding the monetary policy instruments and the discussion on the monetary policy strategy in Stage Three of EMU.

February 27, 1997
The EMI publishes a report on "The single monetary policy in Stage Three. Elements of the monetary policy strategy of the ESCB". Inter alia, it comes to the conclusion that, of the various possible monetary policy strategies, the options that are suitable for the ESCB narrow down to only two: the strategy of monetary targeting and the strategy of direct inflation targeting.

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

June 16–17, 1997
The European Council, meeting in Amsterdam, approves the Stability and Growth Pact on monetary union; in addition, it adopts the Resolution on the introduction of the exchange rate mechanism that is to supersede the EMS from the beginning of Stage Three of EMU. The euro will be at the centre of the new exchange rate mechanism.

June 19, 1997
The Federal Minister of Finance and the President of the Deutsche Bundesbank declare that agreement has been reached between the Federal Cabinet and the Bundesbank on the changes which need to be made to the Bundesbank's balance sheet structure and accounting rules upon the transition to Stage Three of EMU. These changes provide for the Bundesbank's capital structure being put on a new statutory basis, and for the statutory provisions governing the Bundesbank's accounting system being amended on the transition to Stage Three, so that the Bundesbank can bring its accounting system into line with that of the ECB. In addition, the Bundesbank intends to exploit, as early as the balance sheet for the 1997 financial year, the valuation leeway afforded by the current accounting rules, which permits a valuation of the foreign exchange reserves that is more consistent with market conditions, while retaining the principle of the lower of cost or market.

July 24, 1997
The Central Bank Council reviews the monetary target and abides by the orientation approved in December 1996, which provides for an expansion of the money stock M3 by about 5 % per annum in the course of 1997 and 1998 alike. It likewise abides by the target corridor of between 3½ % and 6½ % which it had laid down in addition for 1997. At the same time the Bundesbank states that, after the slowdown in monetary growth in the spring, it regards a further moderation of monetary expansion as necessary for the sake of anti-inflation policy.

September 23, 1997
Supplementing its report on the operational framework for the monetary policy of the ESCB, the EMI publishes a report entitled "The single monetary policy in Stage Three: General documentation on ESCB monetary policy instruments and procedures", in which it informs the general public and particularly the ESCB's counterparties about the technical details of the monetary policy instruments and procedures in Stage Three of EMU.

October 9, 1997
The Central Bank Council decides to raise the fixed rate of interest for its next two securities repurchase transactions from 3.00 % to 3.30 %. This move is prompted mainly by the changed monetary policy environment. This slight tightening of monetary policy is intended to slow down monetary growth further.

December 4, 1997
The Federal Ministry of Finance and the Bundesbank agree no longer to issue Federal bonds through the Federal Bond Consortium in future. The Consortium is disbanded because its significance has progressively decreased. Their favourable experience of setting terms under competitive conditions by means of tenders has prompted the Federal Government and the Bundesbank to make this approach general practice in future in the context of the "Bund Issues Auction Group".

December 12–13, 1997
The European Council adopts guiding principles governing further economic policy coordination in Stage Three of EMU, exchange rate policy, external monetary policy representation and the future exchange of information between the Council and the ECB.

December 18, 1997
The Central Bank Council adopts the monetary target for 1998. The Bundesbank will continue to conduct its monetary policy in such a way that price stability is safeguarded and, at the same time, the monetary conditions for sustained economic growth remain in place. To this end, the Bank deems it appropriate to abide by the two-year orientation adopted in December 1996. To give the markets a guideline for the rate of monetary expansion that is considered acceptable in the period ahead, the Central Bank Council lays down an additional target corridor of between 3 % and 6 % for 1998 – as measured from the fourth quarter of 1997 to the fourth quarter of 1998. This target corridor is set somewhat lower than that for 1997. The Bundesbank thus takes due account of the provision of the economy with liquidity, which continues to be ample. The Bank also makes clear that it is determined to prevent any monetary inflation potential from building up in the run-up to Stage Three of EMU. At the same time, its decision creates conditions enabling the European Central Bank to effect a seamless transition from the Bundesbank's monetary targeting policy.

December 30, 1997
The Sixth Act Amending the Bundesbank Act is promulgated. That Act brings German central banking legislation into line with the requirements of Community law for German participation in Stage Three of EMU.

February 6, 1998
The Board of Governors of the International Monetary Fund approves a 45 % increase in members' quotas, from a total of currently SDR 146 billion to around SDR 212 billion.

March 16, 1998
The Irish pound is upvalued in the EMS by 3 %. At the same time, Greece joins the exchange rate mechanism of the EMS with fluctuation margins of ± 15 %.

March 25, 1998
The EMI and the EU Commission publish their Convergence Reports pursuant to Article 109j of the EC Treaty. The Commission recommends that, of the EU member states, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain should start Stage Three of EMU in 1999. (Greece and Sweden have failed to meet the preconditions for the adoption of the single currency; Denmark and the United Kingdom have "opted out" of joining in 1999.) In its report, the EMI draws attention to marked improvements in convergence, but expresses its ongoing concern with regard to the general government debt levels of Belgium and Italy, and urges the responsible authorities to continue to give top priority to the solution of this problem.

March 27, 1998
The Central Bank Council publishes its Opinion concerning convergence in the EU. Against the back-

Record of domestic and external monetary policy measures
(continued)

ground of the progress towards convergence which has been achieved in many member states, and after giving due consideration to the remaining problems and risks, the Central Bank Council concludes that entry into monetary union from 1999 appears justifiable in anti-inflation policy terms. With respect to the requirement of a sustainable public sector financial position, however, serious concern is warranted in the case of Belgium and Italy. It can be dispelled only if additional firm substantive commitments are entered into. The selection of the participants ultimately remains a political decision, however.

May 2–3, 1998
The European Council, after taking due account of the Convergence Reports of the EU Commission and the EMI, and after having consulted the European Parliament, decides that Stage Three of EMU is to start on January 1, 1999 with the member states Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. At the same time, the Council submits its proposal on filling the vacancies on the ECB Executive Board. Furthermore, it determines that the bilateral central rates of the participating countries in the EMS are to be applied as the basis for the conversion rates into euros.

May 14, 1998
The Central Bank Council approves the annual accounts for the financial year 1997. The Bundesbank has taken due account of the changed external risk position following the decision on the participants in Stage Three of EMU, has valued its foreign exchange reserves – in keeping with the current accounting rules – more in conformity with market conditions, and has disclosed hidden reserves in the profit and loss account. DM 24.21 billion of the net profit is paid over to the Federal Government.

Record of general economic and fiscal policy measures

January 1, 1997

Major amendments of fiscal policy provisions come into effect: the 1997 Annual Tax Act (in particular, inheritance tax reform and raising of the real property transfer tax rate from 2 % to 3 ½ % in order to counterfinance net worth tax, which is no longer being levied); some elements of the 1996 Annual Tax Act (further increase in child benefit and in the tax allowance for children, reduction in special depreciation allowances for investment in the new Länder); increase in the contribution rate to the statutory pension insurance scheme from 19.2 % to 20.3 %.

January 23, 1997

The parliamentary groups of the governing coalition approve the proposals of a commission set up by the Federal Cabinet to elaborate a root-and-branch reform of income taxation. They provide, on the one hand, for a substantial reduction in income tax rates (to between 15 % and 39 %, or to 35 % for commercial earnings) and in corporation tax rates (to 35 %, or 25 % for distributed profits), and, on the other, for a broadening of the basis of assessment by the abolition of various tax concessions. The relief afforded to taxpayers, inclusive of the increase in indirect taxes, is expected to amount to as much as DM 30 billion net.

January 27, 1997

The commission set up by the Federal Cabinet on the "Further development of the pension insurance scheme" submits its proposals for reform. Its principal recommendation is to supplement the pension adjustment formula by adding a demographic factor which distributes the burdens resulting from higher life expectancy half each between contribution payers and pensioners. This measure is expected gradually to reduce the "basic pension" to about 64 % of the average net earnings of employed persons by the year 2030. In addition, the scope for drawing a pension in the event of reduced working capacity is to be lessened, and an additional tax-financed Federal grant, which would lower the contribution rate by 1 percentage point, is to be introduced.

January 29, 1997

In its Annual Economic Report, the Federal Cabinet expects that, despite the favourable underlying economic conditions (low nominal interest rates, moderate wage rises, stable prices, buoyant foreign demand and a further improvement in corporate earnings), the momentum of the upswing will be sluggish in 1997. Real economic growth in the whole of Germany is forecast to reach an annual average of around 2 ½ %. Since a faster rise in labour productivity of around 3 % is expected at the same time, that would result in the number of employed persons declining further by up to 200,000. An equally sharp increase in unemployment might cause the jobless rate to go up to just under 11 %.

March 18, 1997

The Federal Cabinet adopts the 1998 Tax Reform Bill, which in an initial step is intended to implement the proposals submitted for 1998 by the tax reform commission (reduction of the tax rates in the enterprise sector with counterfinancing in a way

Record of general economic and fiscal policy measures
(continued)

that does not affect tax revenue, lowering of the solidarity surcharge by 2 percentage points to 5 ½ %).

April 22, 1997
By adopting the 1999 Tax Reform Bill, the Federal Cabinet also approves the second part of the reform strategy, which is geared broadly to the proposals of the tax reform commission.

June 17, 1997
At a summit meeting in Amsterdam, the European Council approves the Stability and Growth Pact, which is designed to ensure that all member states meet the criteria guaranteeing the sustainability of the government financial position within monetary union. Apart from the medium-term objective of having a budget position that is close to balance or in surplus, the agreement contains specific provisions on the amount of the fines to be imposed in the event of excessive budget deficits, and on the procedures to be followed.

June 18, 1997
The Federal Cabinet adopts the 1999 Pension Reform Bill, which largely endorses the proposals made by the pension reform commission, and also provides for improvements in the inclusion of child-rearing performance which go beyond the pertinent requirements of the Federal Constitutional Court.

June 26, 1997
The Bundestag passes the Act Prolonging Economic Promotional Measures in the New Länder, which provides for the follow-up promotion of investment in eastern Germany being continued until 2004 and, simultaneously, for the range of promotional instruments being streamlined and simplified. For instance, from 1999 tax concessions for investment assistance will be effected solely by way of investment grants (which will be considerably higher than under the present legislation, and which will supersede the existing special depreciation allowances).

July 11, 1997
The Federal Cabinet adopts the draft supplementary budget for 1997 and the draft Federal budget for 1998. The supplementary budget, which takes due account of the shortfalls in tax revenue and the labour-market-induced rise in expenditure, involves an increase of about DM 18 billion in net borrowing in 1997 to a total of DM 71.2 billion. The 1998 Federal budget – with an expenditure volume of DM 461 billion, which is only 0.5 % above the volume of 1997 – envisages a reduction in net borrowing to DM 57.8 billion. The medium-term financial plan, which is submitted at the same time, provides for the annual growth rate of expenditure to be limited to an average of just over 1%, and for the deficit to be reduced to DM 47 billion by 2001.

September 5, 1997
After approval by the Bundestag, the Bundesrat, too, agrees to the suggestion of the inter-House mediation committee, according to which trade tax on capital is to be abolished with effect from January 1, 1998, and that tax is not to be levied in the new Länder in 1997 either. To offset the consequent shortfalls in receipts, local

authorities will receive a 2.2 % share in the revenue from turnover tax from 1998 onwards. In addition, counter-financing measures aimed at lessening enterprises' scope for tax-deductible provisions are approved.

September 26, 1997
After two inter-House mediation sessions, the 1998 and 1999 Tax Reform Bills founder.

October 9, 1997
The Bundestag decides to lower the solidarity surcharge by 2 percentage points to 5 ½ % from the beginning of 1998. The associated additional shortfalls in tax revenue, amounting to around DM 6 ½ billion relative to the existing draft budget for 1998, are to be offset by cuts in the Federal transfers to the Redemption Fund for Inherited Liabilities and by the assignment of Federal claims arising from the sale of land.

November 28, 1997
The Bundestag approves the Federal budget for 1998, with an expenditure volume of DM 456.8 billion. At DM 56.4 billion, the deficit is actually DM 1.4 billion below the figure of the draft, although, in comparison with the draft budget, additional burdens amounting to over DM 20 billion have to be coped with. The additional budget gap is closed mainly by stepping up the sales of participating interests, which were deferred to 1998, as well as by further cuts in the transfers to the Redemption Fund for Inherited Liabilities.

December 11, 1997
The Bundestag adopts the 1999 Pension Reform Act, rejecting the Bundesrat's objection by means of the "chancellor's majority".

December 19, 1997
The Bundesrat approves the suggestion of the inter-House mediation committee on the amended financing of the statutory pension insurance scheme. The additional Federal grant included in the scheme is to be financed by raising the standard turnover tax rate by 1 percentage point, to 16 %, from April 1, 1998.

January 1, 1998
A number of major fiscal policy measures come into effect: the abolition of trade tax on capital, the lowering of the solidarity surcharge, the raising of the basic income tax allowance.

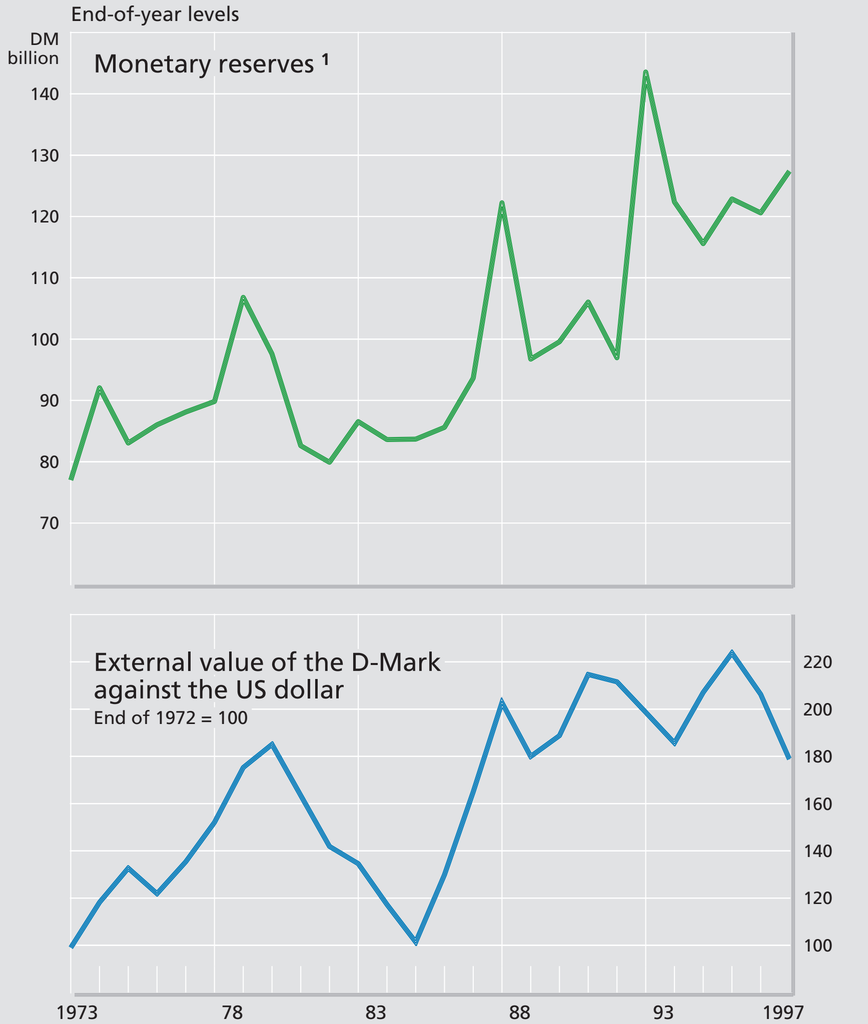
January 13, 1998
According to preliminary budget figures, the deficit in the Federal budget for 1997 amounts to DM 63.4 billion, and is thus DM 7.6 billion below the sum envisaged in the supplementary budget; DM 3 billion of this improvement is accounted for by spending cuts and DM 4 ½ billion by additional – mainly non-tax – receipts.

March 11, 1998
According to the Federal Government's Annual Economic Report, economic growth in 1998 is likely to be somewhat higher than in the previous year, and might reach 2 ½ % to 3 % – as measured by the real gross domestic product. Major stimuli are again to be expected from foreign trade, although the turmoil in the emerging markets of south-east Asia will not fail to leave its mark. Domestic demand will pick up. In view of the slackening growth of productivity, the employment situation may be expected to improve again in the further course of the year. Taking the average of the year, however, the number of persons in employment will not exceed last year's figure. The annual unemployment rate is expected to stand at 11½ %, and would thus be about as high as in 1997.

April 1, 1998
The increase of 1 percentage point in the standard rate of turnover tax, to 16 %, comes into effect.

Monetary reserves and exchange rate
1973 to 1997

Chart 13



1 Including other external assets, valued at balance sheet rates.

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that foreign reserves are valued at market-related rates and any valuation gains included in a balancing item. This, too, will have major implications for the balance sheet accounting of German monetary reserves. As an interim step, the dollar valuation was, as mentioned, brought more closely into line with market rates in the annual accounts for 1997; the balance sheet rate was raised from DM 1.3620 per dollar to DM 1.5396 per dollar (see also page 174 of this report). Finally, the ECB is to be provided with foreign reserves (initially to an amount not exceeding euro 50 billion) by the national central banks at the start of the third stage of EMU, in exchange for which the national central banks will receive a claim on the ECB.

National foreign reserves in EMU

As not all of the EU member countries will be entering the third stage of EMU immediately, the maximum amount stated in the Maastricht Treaty will not be attained initially. Nor have the precise terms of the transfer been settled yet. At all events, however, German monetary reserves are considerably larger than Germany's share. This holds true even allowing for the fact that some of the monetary reserves (around DM 14 billion) are tied up by international agreements in the form of its reserve position in the IMF (including special drawing rights allocated). The Bank will therefore also have "proprietary" monetary reserves at its disposal under monetary union; their role, however, will be different from that which obtains under the conditions of national monetary sovereignty.

5. Monetary policy aimed at safeguarding stability success on an enduring basis

(a) Monetary policy stance tightened slightly in the autumn

Steady approach to interest rate policy up to the summer

Last year the Bank kept its interest rates unchanged until the autumn. It left the discount rate at 2.5 %, the lombard rate at 4.5 %, and the repurchase rate at 3.0 %. In addition, the Bank gave guidance to the market by offering all securities repurchase agreements in the form of fixed-rate tenders and – well into the summer – by always announcing the terms of the forthcoming transactions in advance following the meetings of the Central Bank Council. The central bank interest rates therefore remained at the low levels to which they had fallen as a result of the interest rate cuts in April and August 1996. The slope of the yield curve flattened. Yields in the capital market dropped to historic lows.

Until about mid-year the steady approach to interest rate policy was consistent with monetary and macroeconomic conditions. Monetary growth did exceed the target corridor of 3½ % to 6½ % in the first few months of 1997, but this overshooting had occurred before the turn of the year and shortly thereafter. Then the pace of monetary expansion slackened, and in spring the money stock M3 entered the target corridor. The price climate remained favourable. This was mainly due to the fact that neither domestic demand nor costs generated any particular discernible inflationary pressures. The overall output gap narrowed only gradually; wage settlements were again very moderate. The low inflation and risk premiums included in capital market rates signalled that capital market players, too, were gearing themselves to sustained monetary stability.

The price outlook became more gloomy in the summer months. The external value of the D-Mark declined more sharply than was warranted by the economic fundamentals. The cost of German imports rose markedly. In addition, a number of administered prices was raised so that consumer price inflation increased to over 2 %. In order not to jeopardise the stability success previously achieved, monetary policy had to prevent such exogenous price factors from acquiring a momentum of their own and leading to a general deterioration of the price outlook. Even though there was no cause to dramatise price developments, it was important to watch all indicators of any emerging inflationary pressures especially carefully.

Change in the procedure for announcing securities repurchase agreements

It seemed appropriate to enlarge the short-term room for manoeuvre in interest rate policy in order to be able to make a rapid response to any change in underlying conditions. The Bank therefore changed its procedure for announcing securities repurchase agreements. In the summer months it switched from announcing the form and terms of the weekly securities repurchase transactions in advance following the Central Bank Council meetings to doing so only on the day of the invitation to bid. During this period the Bank retained the fixed-rate tender and kept the repurchase rate at 3.0 %. Nevertheless, interest rate uncertainty increased, and market players' expectations became more and more geared to rising central bank rates. Quotations in the money market and at the shorter end of the capital market increased appreciably.

Raising of the repurchase rate in October

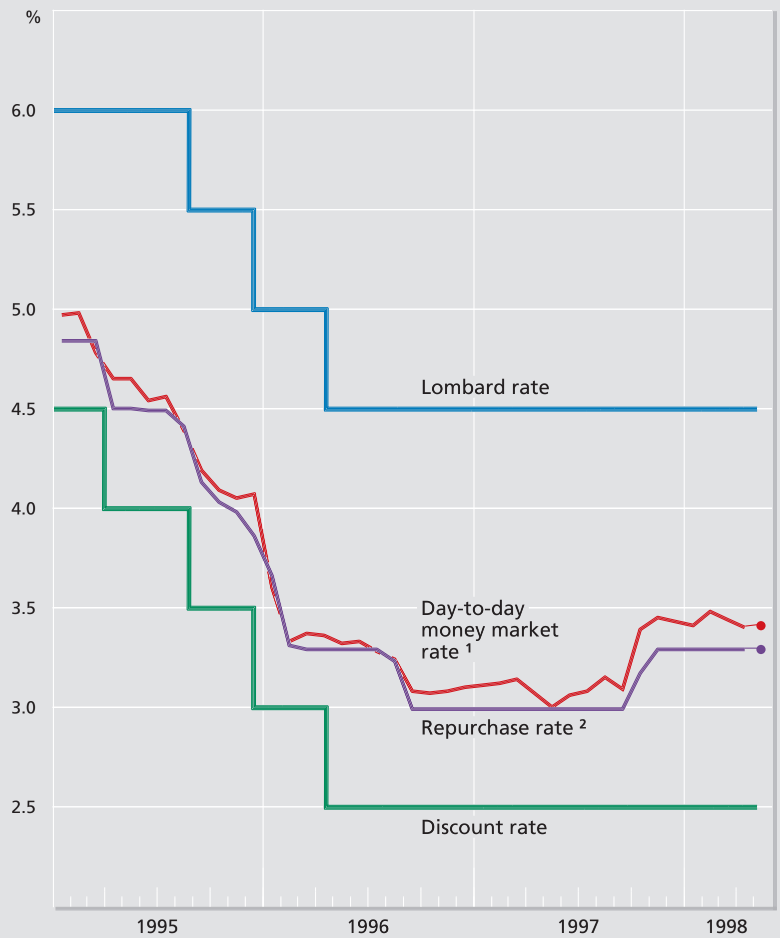
In mid-October the Bundesbank then tightened its interest rate policy slightly. It raised the securities repurchase rate from 3.0 % to 3.3 %, while keeping the discount rate at 2.5 % and the lombard rate at 4.5 %. The main aim of this interest rate policy measure was to bring about a further reduction in monetary growth in order to prevent a build-up of monetary inflation potential in the run-up to EMU. Although the money stock M3 had entered the target corridor in spring, the Bank had already made it clear when the monetary target for 1997 was reviewed in July that it considered a further slowdown in monetary expansion necessary for stability reasons.

"Steady-as-she-goes" interest rate policy resumed since then

After raising the repurchase rate in October, the Bank continued its "steady-as-she-goes" policy. It stabilised market expectations by again regularly announcing the terms of the forthcoming tender operations in advance following Central Bank Council meetings and by retaining the fixed-rate tender with an unchanged rate of interest. This "steady-as-she-goes" approach to interest rate policy was facilitated by a slight brightening of the monetary outlook at the turn

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

Chart 14



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: May 14, 1998.

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of the year. Inflationary pressures eased in connection with the declining commodity prices. At the beginning of 1998 consumer price rises slowed down markedly. Prices are undergoing a process of decelerating inflation rather than a deflation, i.e. a sustained fall in the overall price level. This also applies if account is taken of the statistical uncertainties in inflation measurement.

Term structure of interest rates in the money market and international interest rates

The interest rate level in the money market rose slightly following the raising of the tender rate. At the same time, the yield curve flattened further. There was scarcely any change in the position of the Deutsche Mark money market rates in the international term structure of interest rates; they remain in the lower section. The Bank's interest rate policy decision last October was accompanied by similar moves on the part of several other central banks in the European core countries. In countries with a comparatively high interest rate level, on the other hand, central bank rates – except in the United Kingdom – were lowered; the interest rate range in the money market section in Europe has therefore narrowed.

Exemption of repurchase transactions from minimum reserve requirements

The institutional and technical underlying conditions for the Bank's ongoing money market management were kept virtually unchanged last year. With effect from January 1, 1997, liabilities from "genuine" repurchase transactions (repos) with maturities of up to one year in marketable securities were exempted from minimum reserves. This move enhanced the efficiency and competitiveness of the German financial market without adversely affecting the functioning of the minimum reserve instrument. The impact on the level of credit institutions' required reserves was small, which meant that the stability of the demand for central bank money and the buffer function of the minimum reserves in the money market were retained. Exempted liabilities in respect of repo transactions have grown strongly (from DM 14.4 billion in December 1996 to about DM 66 billion in March 1998), but this increase is likely to reflect mainly new repo business with non-residents. There were therefore no discernible major effects on required reserves resulting from formerly minimum reserve-carrying deposits being shifted to reserve-free repo liabilities.

Float reduction

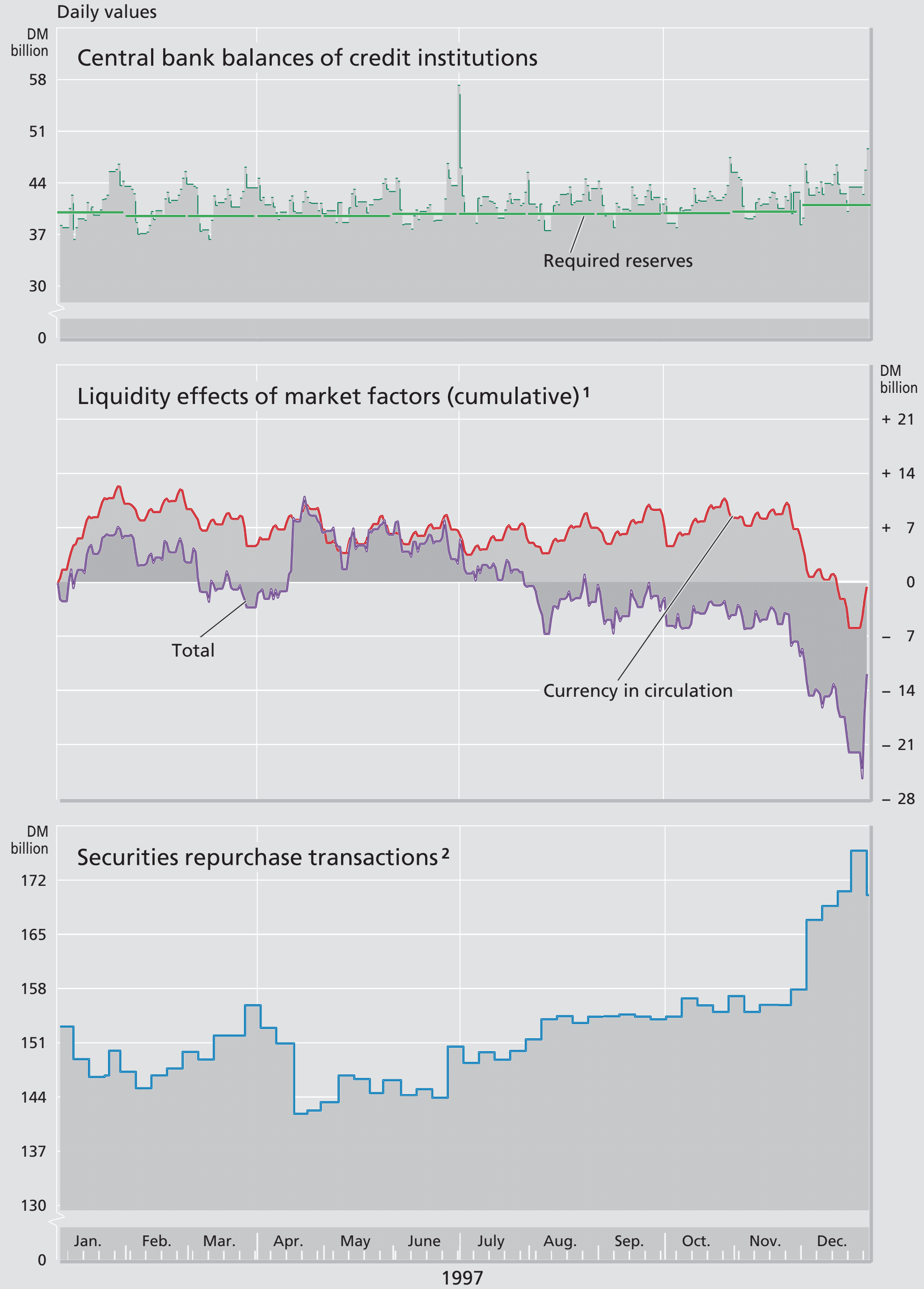
At the end of November 1997 the Bank – with a view to expanding the float-free processing of its payments transactions – changed over to booking all of its supra-regional direct debit and cheque collections, too, on a same-day basis. Previously, float-free processing in this section of payments was subject to a minimum amount. As a result, the fluctuation margin of the processing-period-based float, in particular, was reduced further; the credit institutions' central bank balances since then have thus been tending to show a smoother monthly profile.

Liquidity management through securities repurchase agreements

Throughout the period under review, provision of funds by the Bank was aimed at keeping the money market in equilibrium. It sought to impose a strict limit on the daily fluctuations of the banks' central bank balances at around the level of required reserves and to enable the banking system to meet its minimum reserve requirements as evenly as possible without releasing credit institutions from their responsibility for reserve management and the risk associated with it. In managing the money market the Bank relied almost exclusively on the usual weekly

Liquidity management by the Bundesbank

Chart 15



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 24 to 28, 1997.

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conclusion of securities repurchase agreements. The associated low intervention frequency was generally sufficient to stabilise the day-to-day money market. Liquidity shocks were absorbed smoothly in most cases by the buffer function of the minimum reserves. Such shocks included day-to-day fluctuations in the float in the Bundesbank system which are often hard to predict, major changes in the Bank's net external position, and sharp fluctuations in currency in circulation due to working-day variations. In addition, the Bank had to take into account the transfer on April 17 of that part (DM 8.8 billion) of the Bundesbank profit for the financial year 1996 which is due to the Federal Government. The increase in liquidity resulting directly from the profit transfer was offset without friction by a same-day matching reduction in the outstanding volume of securities repurchase agreements.

Quick tender in January 1997

The Bank had occasion to use very short-term assistance measures only once in 1997. After announcing the actual, unexpectedly high minimum reserve requirements for January 1997, it responded to credit institutions' inadequate reserve holdings and the tensions emerging in the day-to-day money market towards the end of that month by concluding a quick tender with a five-day maturity.

Refinancing operations of the banks

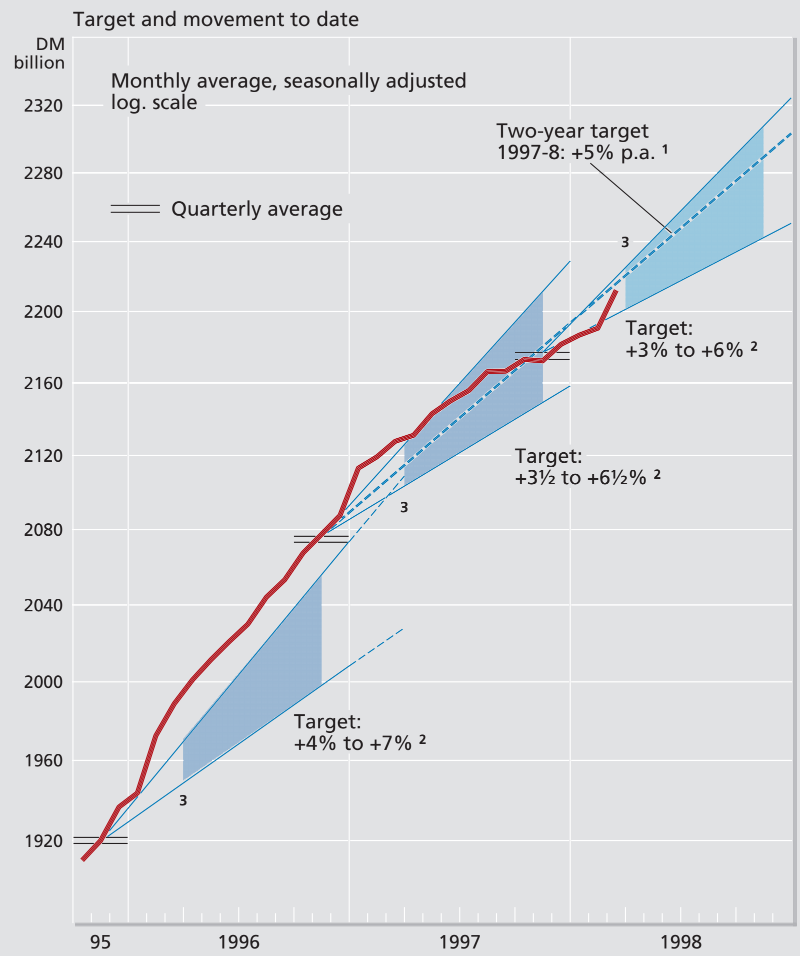
There was virtually no change in the rediscounting of bills of exchange by credit institutions in 1997. Only at the end of the year did utilisation of rediscount quotas slacken markedly for a time. Lombard borrowing was very slack; the amount outstanding was very often below DM 50 million. In isolated cases, the banks – contrary to the usual practice – had to take up hardly any lombard loans even at the end of the month as part of their final minimum reserve management operations. As an annual average, lombard borrowing, at DM 0.3 billion, dropped to its lowest level since 1987; this amount accounted for 0.1% of the total funding of credit institutions.

Borrowing requirements increased

In 1997 credit institutions' borrowing requirements rose at a similar rate to that in 1996 (see table on page 77). However, owing to the lower demand for currency last year (see chart "Growth of currency in circulation"), the increase in central bank money only played a minor part in this. Current entries to the Bank's profit and loss account and the decline in its external position had a major contractionary impact. These reflect transactions by the Bank whereby foreign exchange which previously accrued to the Bank (in particular, purchases of dollars from US military agencies and interest income from external assets) were rechannelled to the market. Moreover, there was a rise in credit institu-

Growth of the money stock M3 *

Chart 16



* 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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tions' reserves required on external liabilities. Another factor was the successive expiry of outstanding amounts drawn under the special rediscount line available to the AKA Ausfuhrkreditgesellschaft mbH (ceiling B), which was abolished with effect from the end of May 1996. These liquidity-reducing effects were accompanied by a greater utilisation of the rediscount facilities (which had remained virtually unchanged) and, above all, the distribution of the Bundesbank profit in April 1997. On balance, the short-term liquidity gap of the banking system expanded – as in 1996 – by DM 16.6. billion. The additional needs of funds were met by an increase in regular securities repurchase transactions, the share of which in total refinancing rose further to an annual average of around 70 %.

Bundesbank profit for 1997 at a record level

On May 14, 1998 the Bank transferred to the Federal Government the latter's share in the Bundesbank profit for the year 1997 to the amount of DM 24.2 billion. This record amount resulted, firstly, from the usual interest income on the Bank's domestic and external assets. Secondly, the Bank – as announced in May and June 1997 – took account of the change in the external risk position and utilised the scope available to it under existing accounting provisions in valuing its foreign exchange holdings. In particular, it no longer applied the historically lowest rates to its US dollar holdings but, in accordance with the strict lower of cost or market principle, used a more market-related valuation, thereby releasing undisclosed reserves; this was reflected in the profit-and-loss account. It based its valuation on the average buying rates, a practice which it also applies to its gold holdings (see page 167). In view of the large volume of outstanding securities repurchase transactions (of over DM 160 billion) and the weekly new transactions, the Bank encountered no problems in distributing the large profit in a single amount and in directly offsetting the liquidity effect of the profit transfer by a correspondingly large cut in the repo volume. As a result, the allocation volumes of the securities repurchase transactions were very different in size. To restore a more balanced allocation profile, the Bank announced one tranche with the – usual – two-week maturity and another with a three-week maturity for the following "large" individual transaction, keeping the terms and conditions otherwise unchanged.

(b) 1997 monetary target achieved

Monetary target 1997-8 and 1997 target corridor

At the end of 1996 the Bank increased the time horizon for its monetary target to two years. The money stock M3 is to grow by about 5 % during both 1997 and 1998. By extending the time horizon the Central Bank Council made allowance for the special underlying conditions in the run-up to the third stage of EMU. The main aim of formulating a clear monetary policy course was to build up confidence at an early stage in the continuation of a non-inflationary policy up to the beginning of monetary union. For 1997 the Bank additionally set a target corridor of 3½ % to 6½ %, thus indicating the range of monetary growth that is appropriate in the short run.

After difficult start ...

Entry to the year 1997 was difficult in monetary policy terms. The money stock M3 grew vigorously at the beginning of the year primarily because of a large statistical overhang at the end of 1996. Borrowing by the private sector had increased sharply at that time in anticipation of the changes in the tax treatment of property acquisitions, especially in eastern Germany, effective as from 1997.

Monetary developments

Table 8

Changes during year

Item	1994	1995	1996	1997
	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: –)	– 15.0	– 9.8	– 14.3	– 2,4
Changes in the Bundesbank's external position (excluding foreign exchange swaps)	+ 6.3	+ 9.0	+ 0.0	– 10,7
Changes in domestic non-banks' net balances with the Bundesbank (including shifts of Federal balances under section 17 of the Bundesbank Act [3])	+ 6.4	+ 0.1	– 0.1	+ 0,1
Other factors	– 28.8	– 26.9	– 11.4	– 12,1
Total 1.	– 31.1	– 27.6	– 25.7	– 25,2
2. Lasting provision (+) or absorption (–) of funds:				
Change in minimum reserve ratios [4]	+ 29.5	+ 19.6	– 0.4	– 0,8
Change in refinancing facilities	– 0.1	+ 0.0	+ 0.1	– 0,4
Recourse to unused refinancing facilities (reduction: +)	+ 2.7	+ 0.3	+ 0.4	+ 1,0
Open market operations in liquidity paper and in the bond market	+ 11.9	+ 9.5	– 1.3	–
Transfer of the Bundesbank's profit to the Federal Government	+ 18.3	+ 10.2	+ 10.3	+ 8,8
Total 2.	+ 62.2	+ 39.7	+ 9.1	+ 8,7
3. Change in the banks' short-term liquidity gap (total 1 plus total 2, increase: –)	+ 31.1	+ 12.1	– 16.6	– 16,6
4. Meeting of remaining deficit (+) or absorption of surplus (–) by:				
Securities repurchase transactions	– 27.2	– 12.6	+ 16.6	+ 17,4
Very short-term assistance measures by the Bundesbank [5]	– 3.2	± 0.0	+ 0.2	– 0,2
Changes in lombard loans (increase: +)	– 0.7	+ 0.5	– 0.3	– 0,6
	%			
II. Key monetary indicators [6]				
Money stock M3 [7]	+ 3.9	+ 3.4	+ 7.8	+ 4,5
Money stock M3 extended [8]	+ 4.2	+ 3.2	+ 6.0	+ 3,7
Credit volume [9, 10]	+ 8.3	+ 7.5	+ 7.6	+ 6,0
	DM billion			
III. The money stock and its counterparts [9]				
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 31.9	+ 86.1	+ 174.0	+ 73,3
Counterparts in the balance sheet:				
1. Credit volume [10]	+ 318.9	+ 310.5	+ 335.4	+ 285,2
of which				
Lending by credit institutions to domestic non-banks	+ 320.5	+ 312.8	+ 336.3	+ 285,2
to enterprises and individuals [11]	+ 256.1	+ 223.0	+ 254.1	+ 225,8
to public authorities	+ 64.4	+ 89.8	+ 82.2	+ 59,4
2. Net external assets [12]	– 141.2	– 31.7	– 19.1	– 67,7
3. Monetary capital formation	+ 166.8	+ 181.7	+ 120.9	+ 116,1
of which				
Savings deposits at over three months' notice and bank savings bonds	+ 1.5	+ 15.4	– 19.1	– 11,7
Time deposits for four years and more	+ 62.1	+ 69.1	+ 69.1	+ 45,3
Bank bonds outstanding [13]	+ 73.5	+ 74.8	+ 45.4	+ 45,7
4. Federal Government deposits in the banking system	– 10.0	– 0.8	+ 4.5	– 6,5
5. Other factors	– 11.1	+ 11.9	+ 16.9	+ 34,6

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 bonds 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 bonds 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.

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This did not cause the Bank to alter its stance, however. Following this, the pace of monetary expansion did slow down perceptibly; this was a result of heavy outflows of funds generated by domestic non-banks' external payments and a normalisation of lending to enterprises and individuals. In the spring the money stock M3 entered the target corridor. In the following months it initially remained in the upper half of the corridor. When reviewing last year's monetary target in July 1997, the Central Bank Council considered a further slackening of monetary growth to be necessary on stability policy grounds. This occurred when monetary growth decelerated in the further course of the year.

... 1997 monetary target achieved

In the fourth quarter of 1997 the money stock M3 exceeded its average level in the fourth quarter of 1996 by 4.7 %. Following the undershooting in 1995 and the overshooting in 1996, not only was last year's monetary target corridor entered but the four-quarter growth rate of 5 % was in effect also achieved which is consistent with production potential and on which the two-year 1997-8 monetary target is based. Despite the fact that its growth rate during the year was consistent with the target, however, the money stock M3 increased by an average annual rate of over 6 % owing to the steep rise at the beginning of the year.

Growth of the money stock components

Growth of the individual (seasonally adjusted) money stock components was disparate last year. Savings deposits at three months' notice grew fairly vigorously again, with higher-yielding special savings facilities accounting for all of the increase. Even so, the rate of expansion of savings deposits returned to a more normal path following record growth rates in the preceding years. It appears that there has been a decline in the importance of portfolio adjustments made by savers in response to the many different product innovations offered by credit institutions after the provisions governing savings were deregulated in 1993. Sight deposits also rose less in 1997 – with sharp fluctuations from month to month – than in 1996. Currency in circulation virtually stagnated after having increased by around 5 % in both 1995 and 1996 (see also the adjacent chart "Growth of currency in circulation"). Shorter-term time deposits held by domestic non-banks were reduced further and are now back at the end-1990 level. The fall was much smaller than in the preceding years, however.

As part of its monetary analysis the Bank monitors not only the aggregate M3, but also other monetary aggregates. A special role in this connection is played

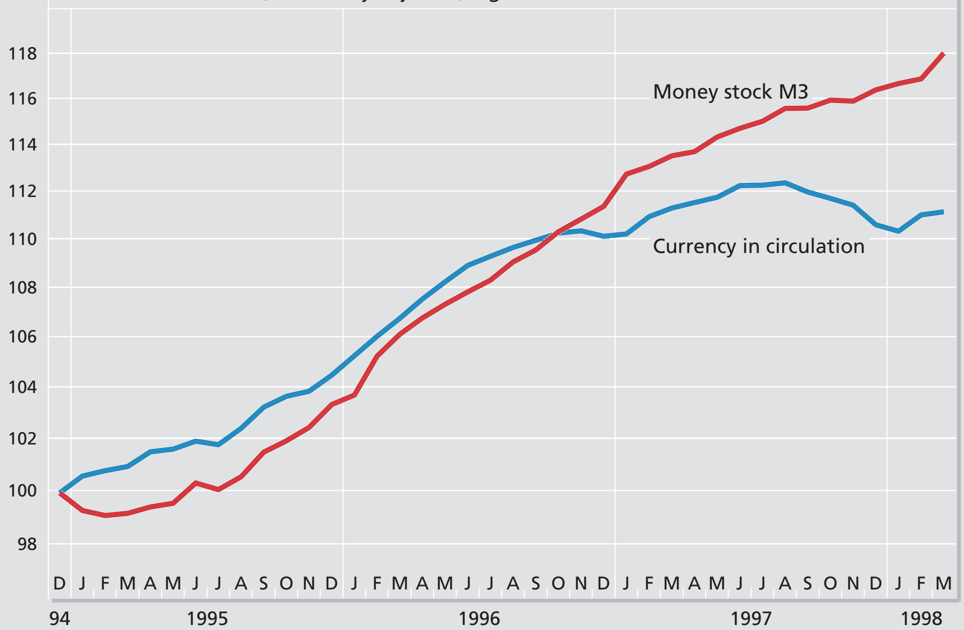
Growth of currency in circulation

Chart 17

The growth of currency in circulation did not conform to the usual pattern in 1997. In the first six months it was still in line with the longer-term trend, but declined sharply in the second half of the year; over the year as a whole, it remained virtually unchanged (see chart). The only time that annual growth had been similarly subdued previously was in 1981. Growth of both large and smaller denominations - such as the DM 50 and DM 100 notes, which are mainly used to finance everyday private consumption transactions - was slack. Households' continued restrained purchasing as well as the increased use of cashless payment media, especially of debit cards in retail transactions, may have played a part in this. Another likely cause was a more efficient use of currency in circulation and an associated higher velocity of circulation. Increasing progress in bringing down inflation in the east and south-east European countries in transition may also have curbed foreign demand for Deutsche Mark notes for transaction and hoarding purposes. Uncertainty in the run-up to European monetary union may likewise have fostered this trend. However, it is questionable whether the above-mentioned factors can satisfactorily explain the sharp fall in currency demand in the second half of the year, not least because the sharp fall was obviously reversed after the turn of the year. At all events, currency in circulation rose again in February and March of this year.

Currency in circulation and money stock M3 *

December 1994=100, seasonally adjusted, log. scale



* Currency in circulation: average of daily figures; excluding domestic credit institutions' cash holdings. Money stock M3: average of five bank-week return days; end-of-month levels included with a weight of 50%.

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Moderate growth of the money stock M3 extended

by the money stock M3 extended[1], which also comprises the liquidity in the economy not included in M3. At just over 3½%, this broadly defined money stock variable grew slightly more slowly in 1997 than traditional M3 (4½%). One factor in this was the further reduction of Euro-deposits which, however, was smaller than in the two preceding years and was concentrated on the end of the year. Moreover, domestic non-banks once again ran down their holdings of money market fund certificates (– DM 7.7 billion). On the other hand, they stepped up their purchases of short-term bank bonds.

Confirmation of the two-year target 1997-8

The Bank is continuing its policy of monetary targeting in the last year of the "remaining life of the Deutsche Mark". In December 1997 the Central Bank Council confirmed the two-year target for 1997-8 of about 5% per annum which had been adopted a year before. There had been scarcely any change in the benchmark variables on which the derivation of the target at the end of 1996 was based. At 2%, rather than just over 2%, on the average of the years 1997 and 1998, growth of real production potential had to be put at a slightly lower figure at the end of 1997 than a year earlier. The revision, however, was within the usual margin of error and was not a sufficient reason for lowering the potential-oriented four-quarter rate. The Central Bank Council maintained the medium-term price assumption which had been lowered a year before to between 1½% and 2% in anticipation of a continued moderate upward trend in prices. The price outlook is again bright for the current year. The raising of the regular rate of value-added-tax from 15% to 16% as from April 1, taken as an isolated factor, is likely to raise the consumer price level (as an annual average) by around one-third of 1 percentage point. This effect will be partly offset, however, by the price dampening effects of the hitherto favourable trend in commodity prices and unit labour costs. Finally, the increment for the trend decline in the velocity of circulation of money of 1 percentage point per year was confirmed by updated trend calculations.

1998 monetary target

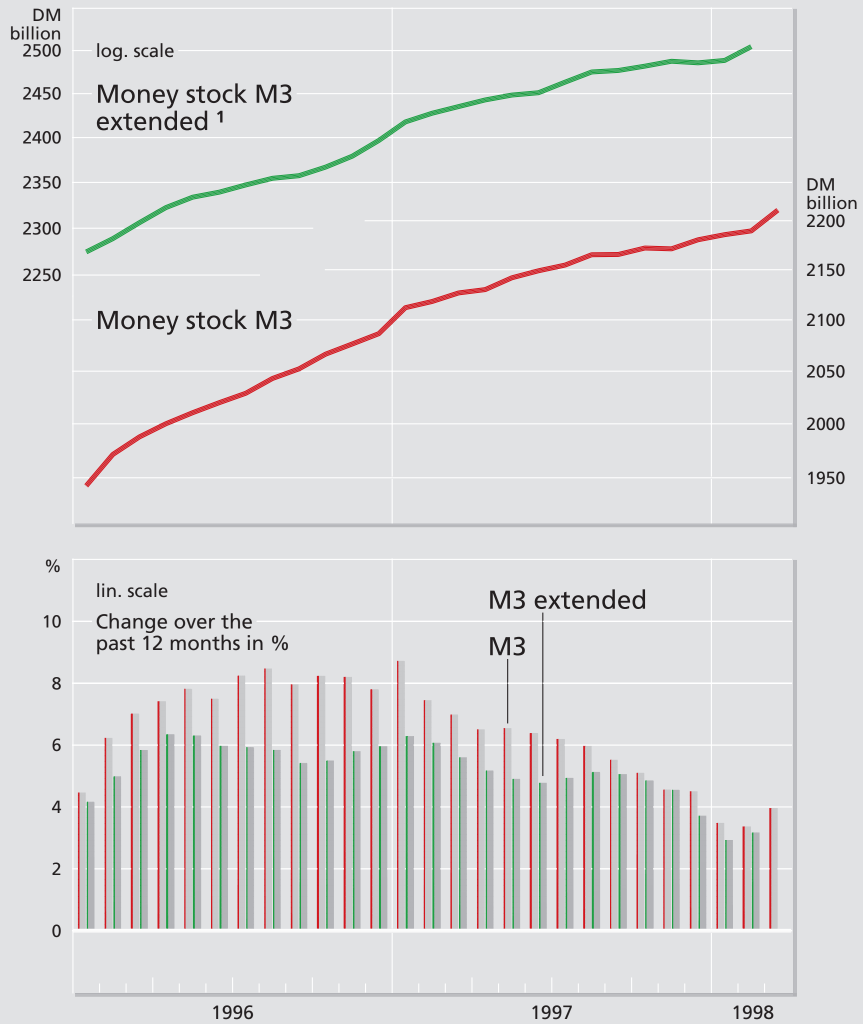
At the end of last year the Central Bank Council also specified the 1998 monetary target. It provides that the money stock M3 is to grow by 3% to 6% between the fourth quarter of 1997 and the fourth quarter of 1998. The lowering of the target range by ½ percentage point compared with the preceding year gives a clear stability signal. For one thing, it allows for the generous rate of

1 Money stock M3, domestic non-banks' deposits with the foreign subsidiaries and foreign branches of German banks and the short-term bank bonds and certificates of domestic and foreign money market fund in the hands of domestic non-banks, less the bank deposits and short-term bank bonds of domestic money market funds, calculated as the average of two end-of-month levels.

Growth of the monetary aggregates

Chart 18

Seasonally adjusted



1 Derived from two end-of-month levels.

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monetary growth of 5 % per annum for the two-year target. For another, the Bank thereby provided a response to the still fairly abundant supply of liquidity to the economy. The breadth of the corridor of 3 percentage points used since the adoption of the 1996 monetary target was retained in view of the continuing rather high volatility in shorter-term monetary growth.

In contrast to the previous year, entry to the new target period was fairly unproblematical this time. Lending to domestic non-banks expanded more rapidly again. At the same time, however, domestic non-banks' external payments generated sizeable outflows of funds. Average growth of the money stock M3 was moderate in January and February, but vigorous in March. In that month, it exceeded its level in the fourth quarter of 1997 by an annual rate of 5.1 %. Since the fourth quarter of 1996 it has risen at an annual rate of 4.8 %.

Continuity of monetary policy

With the 1998 monetary target the Bank set a monetary target for the twenty-fourth time in succession. The continuity of the strategy of monetary targeting was made possible because the empirical preconditions for monetary targeting – the stability of the demand for money, the lead which the money stock has over price movements, and the controllability of monetary growth by the central bank – were sufficiently met in Germany.

For the ECB, monetary targeting ...

Since these conditions, according to the majority of studies available so far, are also met in the larger European currency area, there are good reasons, in the Bank's view, for the European Central Bank likewise adopting a strategy of monetary targeting. The concept of monetary targeting has advantages over direct inflation targeting – the other "candidate" for the monetary policy strategy under EMU. These result not least from the fact that the money stock is an observable statistical variable while inflation forecasts, which form the centrepiece of inflation targeting, cannot in effect be assessed by the public at large. Monetary targets therefore enhance the transparency of monetary policy and make it easier to stabilise expectations and anchor inflation expectations at the level envisaged by the central bank. Moreover, they provide a suitable basis for the central bank's accountability and offer the ECB the opportunity of acquiring the reputation of a stability-oriented central bank more rapidly.

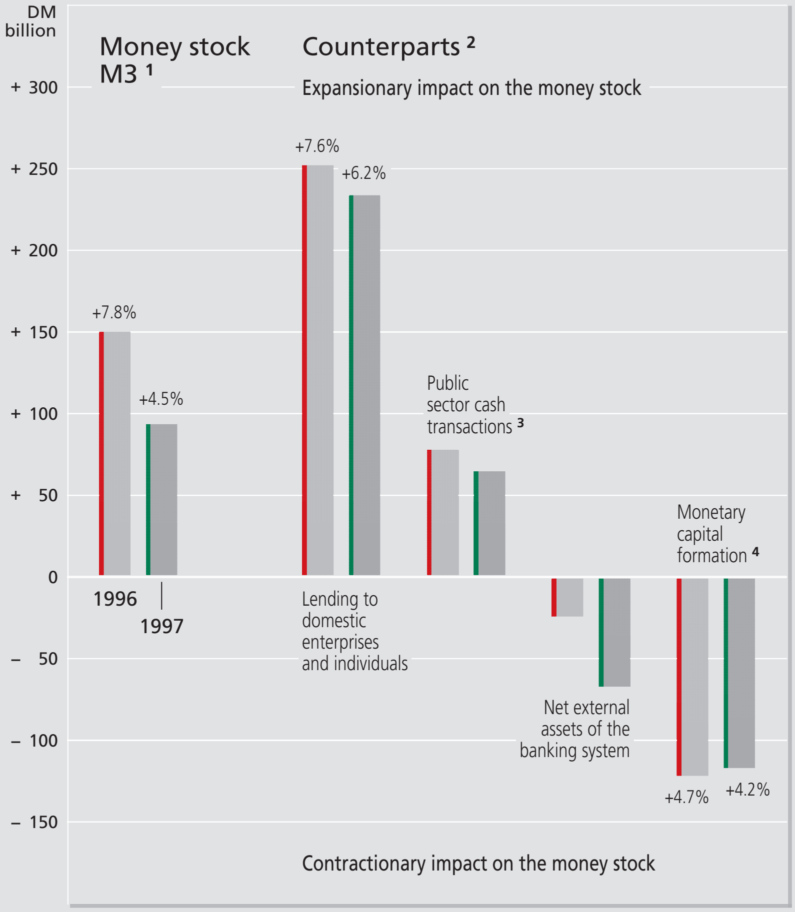
... supplemented by selected elements of direct inflation targeting advisable

However, major fluctuations in monetary growth cannot be ruled out, especially in the initial period of monetary union. The adoption of a single monetary policy represents a change of monetary policy regime to which enterprises and individuals may respond by modifying their money demand behaviour. In addition, financial structures in the member states differ quite considerably in some cases. For that reason, it might well be prudent to supplement the strategy of monetary targeting by adding elements of direct inflation targeting. A comprehensive inflation forecast would be helpful, especially if monetary growth were distorted by special factors and therefore temporarily not a reliable indicator of future price movements. Such an approach would be a further development of the medium-term strategy of monetary targeting pursued by the Bank, which has always monitored a wide range of financial and real variables besides the target aggregate. But, even if monetary targeting were to be supplemented by inflation forecasts, the monetary target should remain the primary reference point

The money stock
and its principal counterparts

Chart 19

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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of monetary policy. Only then will it be possible to realise the above-mentioned advantages of the monetary targeting strategy.

Monetary policy in the interim period

The selection of the countries which will participate in the third stage of monetary union from January 1, 1999 marked the beginning of the "interim period" which will cover the period up to the end of this year. In the coming months, cooperation between the European central banks will deepen further, but monetary responsibility during the interim period will remain with the national central banks. This cooperation, like the action of each individual central bank, will have to be strictly geared to preventing the build-up of a monetary inflation potential in order to facilitate a smooth transition from the second to the third stage. A homogeneous approach by central banks uniformly oriented towards the objective of price stability will, at the same time, strengthen confidence in the future single monetary policy and prevent the emergence of turbulence in the financial and foreign exchange markets.

With its 1998 monetary target the Bank has reaffirmed its intention of retaining its stability orientation and its strategy up to the start of monetary union. In the months ahead it will, in its analysis, take greater account of the monetary policy situation in the future EMU. As in the past, it will not gear its action mechanistically to monetary growth but review the signals given by the money stock M3 against the backdrop of a broadly-based study of all data relevant to inflationary trends. These also include all important monetary policy information in the European context.

Convergence of central bank interest rates

By the start of monetary union at the beginning of 1999 the central bank interest rates of all participating countries must have converged to a single level. For many of the countries concerned this has virtually been the case for some time. Central bank interest rates in Italy, Ireland, Spain and Portugal, by contrast, are still well above the level in, say, France or Germany. Further convergence in this respect must take place over the next few months. The appropriate level of central bank interest rates at the beginning of 1999 will depend crucially on the inflation outlook in the future currency area. Besides monetary growth, the position in the cycle of the individual countries, in particular, will be a factor in this connection.

(c) Determinants of monetary growth

Slowdown of credit expansion ...

As mentioned above, the slowdown in monetary growth during 1997 was attributable not least to a slackening of bank lending to the private sector. Bank lending to domestic enterprises and individuals increased by DM 226 billion, or just over 6 %, compared with 7 ½ %, or DM 254 billion, in 1996. For the first time in the nineties, such lending therefore grew more slowly than on the longer-term average. One contributory factor here was that, at the end of 1996, borrowing had been brought forward in connection with changes in the tax treatment of property purchases, notably in eastern Germany.

Bank borrowing by all major borrower groups slowed down last year. Housing loans, which once again accounted for over one-half of all direct lending, grew

... for all major groups of borrowers

by 7½%, compared with just under 10% in 1996. Besides the anticipatory effects already mentioned, the overhang of rented housing, in particular, had a dampening effect. Corporate loans increased by almost 5% compared with about 6½% in 1996. The main reason for this was a normalisation of the services sector's (including the professions') demand for credit following the record growth in the previous year. Manufacturing kept its bank debt virtually unchanged; this was attributable not least to subdued investment demand. At 3%, statistically recorded consumer credit expansion was fairly weak last year. Households' low propensity to incur debt may have been primarily due to the low level of employment and the uncertain income prospects.

Short-term credit declined fairly sharply

Growth of short-term credit declined much more sharply than that of longer-term loans in 1997. A part in this may have been played by the fact that borrowers further consolidated their short-term debt in order to lock in at long term at the historically low interest rates. Moreover, the favourable trend in cash flow in some segments of the corporate sector may have curbed demand for short-term credit.

Moderate public sector demand for bank credit

Public sector credit demand likewise declined last year. At DM 59½ billion, or not quite 5½%, public sector debt grew by just over one-quarter less than in 1996. This reflects the progress made in the consolidation process. Overall, one-fifth of total lending by credit institutions was accounted for by the public sector in 1997; by far the greater part consisted of direct lending.

Monetary capital formation remains slack

Domestic non-banks' propensity to acquire longer-term financial assets at banks was once again moderate in 1997. Monetary capital formation was exceptionally weak, especially at the beginning of the year and in August, when uncertainty in the bond market increased for a time. In 1997 as a whole, monetary capital at banks increased by over 4%, or DM 116 billion, and thus even slightly less than in 1996 (over 4½%, or DM 121 billion). The main reason for domestic non-banks' restrained longer-term placement of funds with banks was probably the further fall in long-term interest rates. Specifically, credit institutions received DM 45½ billion from sales of bank bonds to domestic non-banks. Long-term time deposits increased by the same amount, which was much less than in the three preceding years. Their attractiveness to institutional investors, which account for most of the demand for these deposits, has obviously decreased because of the low interest rates. Bank savings bonds enjoyed a certain popularity again with purchases of DM 9 billion net, compared with only a negligible amount that had been bought a year earlier. Savings deposits at over three months' notice, on the other hand, were reduced further (– DM 21 billion).

Heavy outflows of funds generated by domestic non-banks' external payments

Domestic non-banks' external payments generated sizeable outflows of funds last year. The net external assets of the banking system, a fall in which reflects these outflows, declined by DM 67½ billion, compared with a fall of DM 19 billion in 1996. The higher outflows of funds were primarily due to the fact that domestic non-banks invested an exceptionally large amount in foreign securities in 1997; they purchased DM 130 billion net of foreign equities, bonds and investment fund certificates, as against DM 35½ billion in 1996. Domestic investors' keen interest in foreign securities is likely to owe something to the temporary weakening of the external value of the Deutsche Mark, the price rises on many foreign stock exchanges, the mostly higher rates of interest abroad and expectations regarding EMU. The resultant outflows of funds represent a shift of asset acquisition abroad. To that extent, the balance sheet counterpart of the weak domestic capital formation is not so much a rise in monetary growth but a fall in the banking system's net external position.

6. Financial markets buffeted by global and European developments

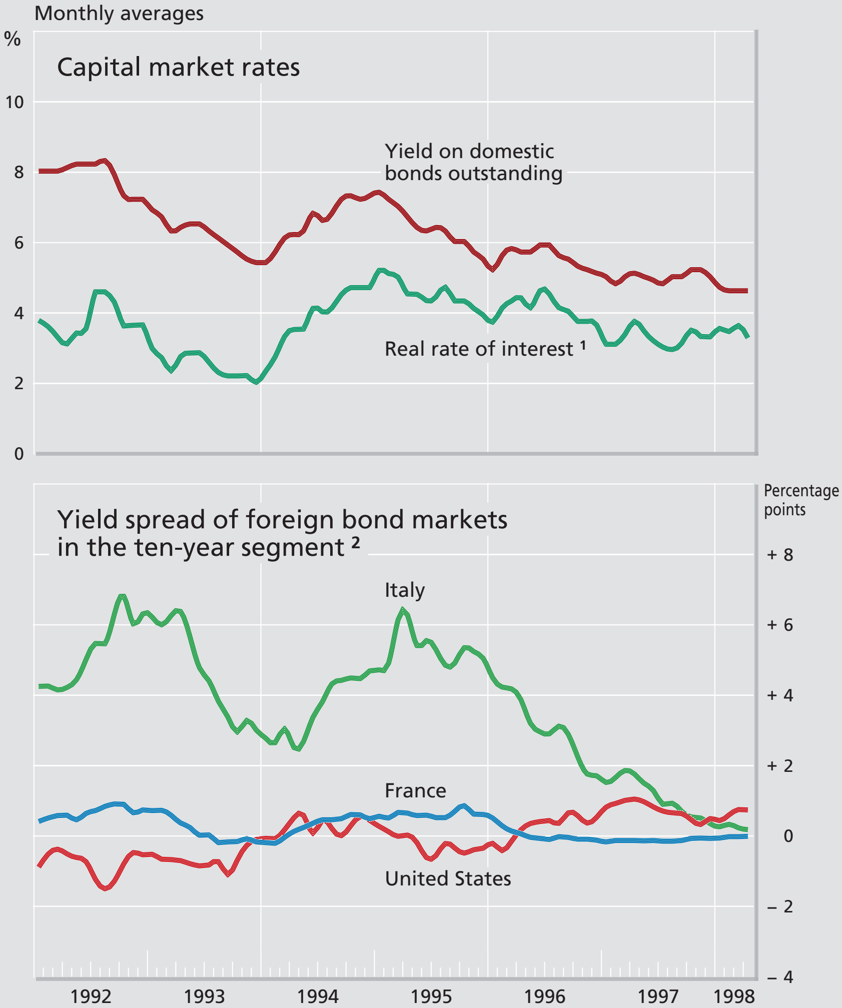
a) Capital market rates at an all-time low

Low capital market yields continue

German capital market rates fell to a new post-war low in 1997. At just over 5 %, the average yield on German bonds outstanding last year was ½ percentage point below the 1996 level. In the course of the year it fluctuated within a very tight margin of between 4¾ % and just under 5½ %. The capital market rates declined further at the beginning of 1998; they hit a new all-time low in February and March 1998 at less than 4¾ %. In the middle of May the yield on German bonds outstanding was just over 4¾ %. The German capital market's position in the international interest rate environment changed relatively little in 1997. The yield spread of the US bond market over the German market initially expanded to around 1 percentage point in the spring, but by the end of the year it had again shrunk to around ½ percentage point owing to declining fears of inflation in the United States and a substantial inflow of funds from East Asia into the US capital market. Thereafter, it again increased somewhat. The process of convergence of interest rates continued on European capital markets. The interest rate differential of the Italian and Spanish markets, which for a long time had much higher interest rates than Germany, shrank to around ¼ percent-

Interest rate movements in the bond market

Chart 20



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.

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age point. Thus, the single European capital market which is to be created by monetary union has already been largely anticipated.

Yield curve has flattened

The initially rather steep yield curve flattened distinctly in the second half of 1997. The accelerated rise in prices and the rapid appreciation of the US dollar clouded the shorter-term price prospects in the summer months and initially resulted in a rise in yields, especially at the short end of the capital market. The worsening of the crises in East Asia in October then triggered a broadly based fall in yields which was particularly pronounced in the longer-term maturity categories. Fears of inflation waned in view of the dampening effects on growth emanating from the turbulence in East Asia, and the shift of investment capital into "safe havens" provided an additional impetus to the fall in yields. This led to a further flattening of the yield curve in the German capital market at a low level. Real German capital market rates, too, are comparatively low. In 1997 on average, these rates – calculated as the yield on bonds outstanding adjusted for the current rate of consumer price increases – were just over 3 ¼ %; this is around 1 percentage point less than the average of the past 20 years.

Good anti-inflationary environment

The persistently low capital market rates and the flattening of the yield curve primarily reflect the market's optimistic assessment of stability prospects. They indicate that the success achieved in fighting inflation in the past few years is not regarded as being only temporary. Not only the intensification of international competition on product and factor markets, which has limited the scope for raising prices, but also the explicit commitment of a growing number of central banks to the target of price stability have improved the underlying conditions for that success. However, a forward-looking, stability-oriented monetary policy is also necessary in such an environment. It is the precondition for checking expectations about inflation, keeping risk premiums in capital market rates low and supporting growth by favourable long-term financing conditions.

b) Bond market in the run-up to EMU

Issuing sets new record

With gross sales of DM 844 ½ billion, issuing in the German bond market reached a new record level in 1997; this is equivalent to a rise of more than 15 % compared with the preceding year's figure of DM 729 billion. Net sales of German bonds likewise grew further. After deducting redemptions and taking account of changes in the issuers' holdings of their own bonds, net sales stood at DM 250 ½ billion, compared with DM 233 ½ billion in 1996. The bond market largely defended its position as a source of finance for German credit institutions and the public sector. Net sales of foreign bonds in Germany more than trebled, reaching DM 77 billion last year. A fairly substantial proportion of those transactions must be seen against the background of the forthcoming start of stage three of EMU. In view of the fact that the southern European countries' yield spreads, especially Italy's, were still rather large at first made investing in the capital markets there look attractive; net sales of lira-denominated bonds alone in Germany totalled DM 26 ½ billion in 1997. Not only this "convergence trading", which was boosted by expectations of a large number of countries participating in EMU, but also foreign exchange trends had an impact on investment operations. Demand for paper denominated in US dollars was particularly strong

Sales and purchases of bonds

Table 9

DM billion

Period	Sales				
		Domestic bonds 1			
			of which		
	Total	Total	Bank bonds	Public bonds	Foreign bonds 2
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	227.1	203.0	162.5	40.8	24.1
1996	255.4	233.5	191.3	41.5	21.9
1997	327.7	250.7	184.9	64.2	77.0
1997 1st qtr	115.4	102.8	76.3	26.4	12.7
2nd qtr	96.5	69.4	38.4	29.9	27.1
3rd qtr	75.4	45.9	51.3	– 5.3	29.4
4th qtr	40.3	32.6	19.0	13.2	7.7
	Purchases				
			Domestic non-banks 4		
	Total	Domestic banks (including the Bundesbank) 3	Total	of which 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	227.1	46.9	94.4	89.4	85.8
1996	255.4	116.5	32.5	34.9	106.4
1997	327.7	144.2	55.6	18.0	127.9
1997 1st qtr	115.4	80.5	– 7.0	– 8.0	41.8
2nd qtr	96.5	35.1	41.6	24.4	19.9
3rd qtr	75.4	38.4	2.5	– 14.1	34.5
4th qtr	40.3	– 9.8	18.5	15.7	31.7

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.

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and, at DM 26 billion, practically matched the volume of lira-denominated bond purchases. Overall, foreign currency bonds worth DM 64½ billion and foreign Deutsche Mark bonds worth DM 12½ billion were sold in the German bond market.

Vigorous growth of bank bonds continues

The amount of bonds sold by the banks in 1997 (DM 185 billion net) was similar to the figure in the previous year (DM 191½ billion). The focus was again on public mortgage bonds, whose amount outstanding rose by DM 114 billion. Issuing institutions tried as much as ever to improve the liquidity of the mortgage bond market and thereby strengthen their competitiveness in the Euro capital market. In addition to mentioning "jumbo" mortgage bonds (large-volume issues amounting to at least DM 1 billion), whose amount outstanding rose by around 75 % to DM 258 billion in 1997, it is also worth mentioning the introduction of an index on "jumbo" mortgage bonds (JEX) in this context. Net sales of other bank bonds likewise continued at a high level (DM 42½ billion). The value of mortgage bonds outstanding increased by DM 17 billion. Bonds issued by specialised credit institutions were sold for DM 11½ billion net.

Public sector issues more vigorous

The public sector raised DM 64 billion net in the bond market last year, which was roughly 50 % more than in 1996. This was mainly due to the vigorous issuing by the Federal Government, whose bond market indebtedness rose by DM 78½ billion, compared with DM 60½ billion in 1996. The volume of Länder Government bonds outstanding declined by DM 5½ billion, however. In addition, there were large-scale redemptions of paper issued by Federal special funds, which no longer act as issuers. For example, the volume of bonds outstanding of the former German Federal Post Office and the Federal Railways fell by DM 9½ billion and DM 5 billion, respectively.

Innovations in the Federal Government's issuing policy

In 1997, the Federal Government took further steps to revise its issuing policy. It implemented the plan it had announced in the summer of 1996 to issue in the 30-year maturity segment, which had hitherto been underrepresented; in the course of the year it issued 30-year paper worth DM 22 billion in the market. Moreover, the separate trading of registered interest and principal of securities (stripping) has been possible for newly issued ten and 30-year Federal Government bonds since the middle of 1997. Investors have so far taken advantage of this possibility on a large scale, especially in the case of very long-term bonds. Finally, the Federal Ministry of Finance and the Bank agreed in the autumn to modify the issue procedure for Federal securities. Since January 1998 Federal bonds are no longer issued via the Federal Bond Consortium but uniformly, like Federal Treasury notes, five-year special Federal bonds and Treasury discount paper *(Bubills)*, by tender procedure via the Bund Issues Auction Group. Resident credit institutions and the German branches of foreign institutions may take part in this auction group if they think they are able to bid on average for at least 0.05 % of the total issue volume allotted. The positive experience made in setting the pricing within a competitive environment has persuaded the Federal Government and the Bank to do without the Federal Bond Consortium and to use the tender procedure generally.

Sharp growth in foreign Deutsche Mark bonds

The spate of issues in the market for foreign Deutsche Mark bonds continued unabated last year. Overall, non-residents issued bonds denominated in Deutsche Mark with a nominal value of DM 115 billion (compared with DM 112½ billion in 1996). Issuers already well established in the international capital market – such as public authorities of the OECD countries (DM 17 billion) or supranational organisations (DM 8 billion) – were joined by issuers from some emerging countries and countries in transition which issued Deutsche Mark bonds for the first time in 1997. The very low capital market rates worldwide obviously encouraged investors to search even more for higher-yielding investments and thus also enabled borrowers with a lower credit rating to finance themselves on the international capital market. The result was that the credit rating range of foreign Deutsche Mark bonds was extended in 1997. Net sales of foreign Deutsche Mark bonds fell from DM 70 billion in 1996 to DM 63 billion. More of this paper – DM 12½ billion worth – was sold in the domestic market than in the preceding year.

Non-banks show little interest in bonds

Demand for bonds in 1997 was significantly influenced by persistently low interest rates and the increasing international integration of the capital markets. This is reflected, in particular, in non-banks' investment operations. Overall, non-banks invested more heavily in bonds in 1997 than in 1996; however, the increase in net purchases from DM 32½ billion to DM 55½ billion was solely due to substantial purchases of foreign bonds (DM 37½ billion), with foreign currency bonds accounting for most of this (DM 32½ billion). The main reasons behind this development might have been the higher level of interest rates in most foreign countries and the temporary fall in the external value of the Deutsche Mark, especially against the US dollar. Additionally, many investors engaged in a kind of "convergence trading", in anticipation of EMU starting with a large number of participants.

Non-banks' interest in German bonds diminished further in 1997. Compared with 1996, net purchases virtually halved, at DM 18 billion. Apparently, non-banks still consider the current interest rate level to be exceptionally low, with the result that investment is not very attractive. There was little demand for public sector bonds in particular; non-banks' holdings of such paper actually declined by DM 19½ billion. However, non-banks spent about the same amount on bank bonds – DM 36 billion – as in 1997. A contributory factor might have been that part of this paper is denominated in foreign currency.

Large purchases by banks and brisk foreign buying

In view of the lack of interest shown by German non-banks in German bonds, the banks undertook a large-scale maturity transformation via the bond market. They increased their bond holdings by DM 144 billion net, with German paper accounting for the vast majority of this, at DM 105 billion. Credit institutions bought foreign bonds worth DM 39½ billion, DM 32 billion worth of which being foreign currency bonds. The international integration of the German bond market increased further in 1997, also as a result of substantial purchases by non-residents. They invested DM 128 billion net in bonds issued by German borrowers; this was roughly as much as in 1992 when there had been a massive inflow of funds into the German bond market during the tensions in the EMS. Almost two-thirds of net purchases were accounted for by public sector bonds. Foreign investment soared towards the end of the year when the crises in East Asia escalated and large amounts of capital were channelled into "safe havens". In November and December 1997 alone, foreign investors bought public sector bonds worth DM 28 billion net.

c) Stock market rallies

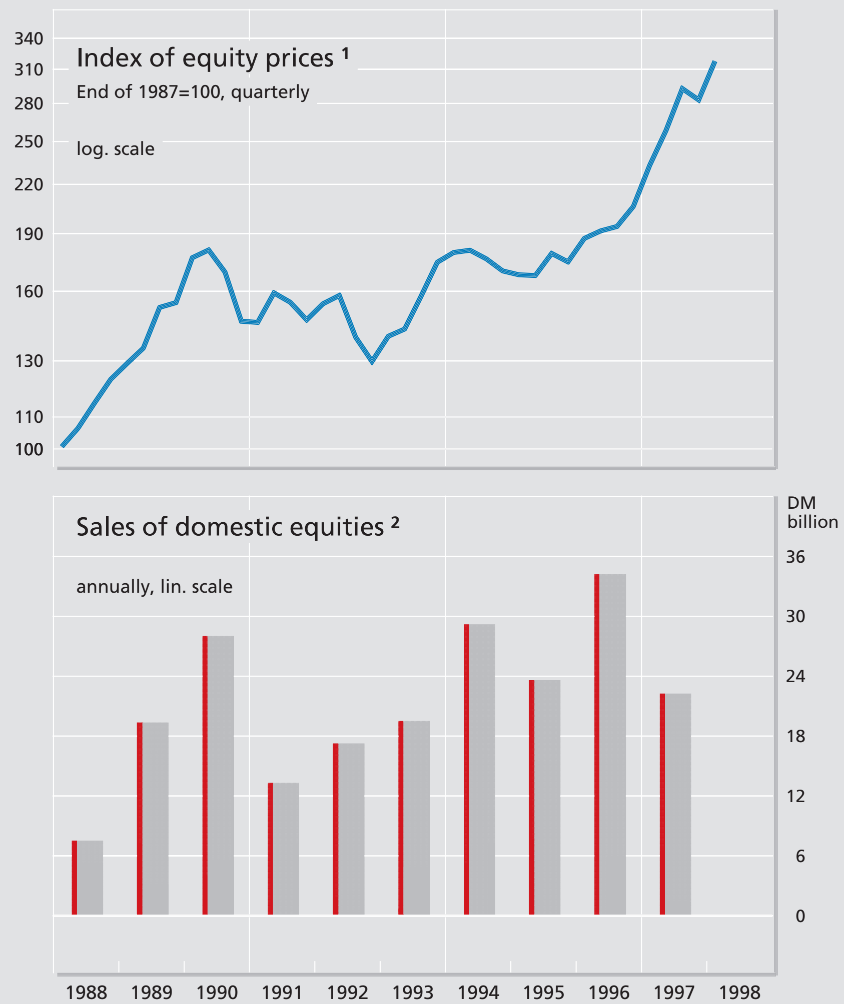
Sharp rise in share prices despite setbacks

In 1997 the German equity market recorded its third-largest rise in share prices in post-war history; on average, prices – as measured by the broadly based CDAX share price index – rose by almost 39 % last year. The DAX, which reflects the performance of a portfolio of 30 blue chips, rose even much more strongly, at 47 %. However, there were pronounced setbacks in the second half of the year. The trend in share prices was steeply upward until the end of July, with the rally developing a growing momentum of its own, especially in July; between the beginning of the year and the end of July, the CDAX rose by 46 %. The rise in prices in the first half of the year took place against the background of very low money and capital market rates and the bull run in international equity markets. At the same time, the favourable trend in profits in the case of many enterprises fuelled the rise in share prices. The share prices of credit institutions rose especially strongly in view of the mergers in the banking sector and the resultant "takeover speculation"; they had advanced by 66 % by the end of July and thus considerably outperformed the market as a whole.

From August, German equities were dragged down by the turbulences on international equity markets, emanating initially from the United States; at the same time, uncertainty in the stock market increased noticeably. The escalation of the crises in East Asia triggered another sharp fall in share prices at the end of October. As the effects of these crises gradually tapered off, the stock market was

Conditions in the equity market

Chart 21



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

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able from the end of 1997 to resume the bull run witnessed in the first half of the year. By February 1998, prices had regained their July 1997 peak, and have continued to rise sharply since then; in the middle of May the CDAX and the DAX were 24 % and 26 % higher, respectively, than at the beginning of the year.

Huge interest in going public

At DM 22 billion in 1997, the issue volume in the German equity market was much lower than in the previous year when a record DM 34 billion worth of new shares had been issued. However, some two-thirds of these were due to the flotation of Deutsche Telekom. Moreover, German enterprises' general interest in raising funds through the issue of shares rose in 1997. This is also reflected in the number of German enterprises that are going public (including shares traded off the floor). At 33, the number of these was two and a half times greater than in the previous year when 14 enterprises were launched on the stock exchange. Another contributory factor to this tendency was the "new market" created in March 1997. Only a year after its introduction the shares of as many as 17 enterprises were listed in this segment of the stock market, whose principal aim is to improve access to risk capital for recently established and innovative enterprises. A greater number of new enterprises is likely to be added soon. In addition to the creation of the new market further steps were taken to improve the underlying technical and legal conditions on German securities markets. With the Xetra computer trading system, electronic floor trading was put on a new footing towards the end of last year. The aim of the Third Financial Market Promotion Act, which came into force on April 1, 1998, is to make securities markets more attractive, particularly by simplifying access to the stock market and by increasing business opportunities for investment funds.

International integration of the equity market also increases

A marked trend towards cross-border investment could also be observed in the equity market in 1997. Foreign shares worth almost DM 82 billion were sold in the German market, with two-thirds of these being bought for portfolio purposes. This paper was acquired almost exclusively by German non-banks (DM 78½ billion) which sold German equities on a minor scale at the same time. The huge interest in an international diversification of equity portfolios must partly be seen against the background of sharply rising share prices on foreign bourses. Another factor was the chance to diversify into currencies and economic sectors that are scarcely represented in the German market, if at all. Just as in the case of residents' purchases of foreign shares, non-residents' purchases in the German stock market also increased further in 1997; altogether, foreign investors bought German shares worth DM 22 billion. The banks' equity holdings rose by DM 8½ billion; part of that reflects transactions in connection with the restructuring in the financial sector.

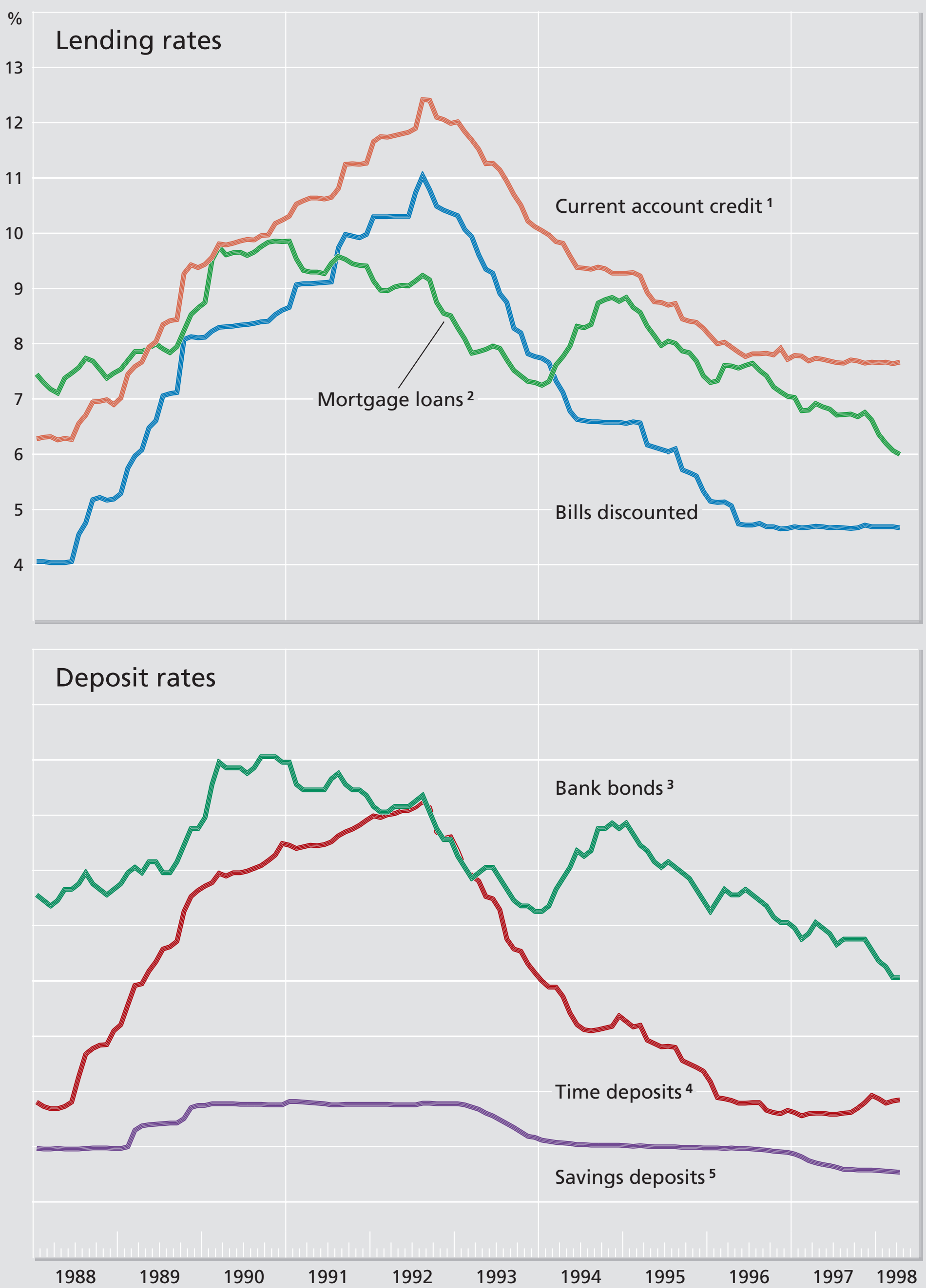
d) Diversified trend in the case of investment funds

Sharp growth in specialised funds

German investment funds saw a sharp rise in the inflow of funds in 1997. At DM 139 billion, net inflows were almost twice as high as in the previous year (DM 79 billion). The main beneficiaries were again the specialised funds managed for institutional investors (DM 107½ billion). The specialised funds managed for credit institutions – notably in the associations of the savings banks and credit cooperatives – expanded particularly strongly. They had receipts of

Movements in selected bank interest rates *

Chart 22



* 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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DM 33 billion; their number rose by around 250 to almost 1,000. Mixed funds, which provide a broad range of investment possibilities, accounted for more than half (DM 67½ billion) of the inflows to the specialised funds. Bond and equity funds saw inflows of DM 22½ billion and DM 16½ billion, respectively. Open-end real estate funds and money market funds still play an insignificant role among the specialised funds. Lot size transformation, which is the major advantage of those types of funds, is only of minor importance for institutional investors at best.

Recovery at investment funds open to the general public

Business recovered distinctly at German investment funds open to the general public in 1997, starting from the relatively low level reached in the previous year. At DM 31½ billion, the inflows of funds were almost twice as high as in 1996 when investment funds open to the general public sold certificates worth DM 16½ billion. Equity funds, which recorded the bulk – DM 21½ billion – of inflows, experienced a boom. It was particularly funds with an international investment focus that were in demand. In the case of bond funds, inflows (DM 6½ billion) were roughly the same as in 1996. Mixed funds picked up somewhat (DM 2 billion). Open-end real estate funds had clearly become less attractive to customers, with net receipts of only DM 6½ billion (1996: DM 14 billion). As in the previous year, money market funds suffered further outflows of capital (minus DM 5 billion).

e) Trends in the banking sector

Bank lending to domestic non-banks

Of the larger categories of banks it was the mortgage banks and the regional institutions of credit cooperatives that were able to increase considerably their market shares in lending to domestic non-banks last year; their lending expanded by 13½% and 11%, respectively, and thus twice as strongly as the average of all banks (6%). In the case of mortgage banks, the decisive factor was the large book credits granted to the public sector while in the case of the regional institutions of credit cooperatives it was their lending to the private sector. With a 6½% rise in lending volume, the big banks slightly exceeded the overall average. This was due in particular to substantial purchases of government bonds. The regional giro institutions, the savings banks and the credit institutions with special functions registered growth rates in lending business of around 5% each. The expansion of lending was distinctly weaker at the regional and other commercial banks (just under 3%) and at the credit cooperatives (2½%). Both categories of banks suffered a fall in short-term lending to industry and in loans to the public sector.

Expected trend in profits

According to the data so far available, the profitability of German credit institutions in the financial year 1997 was satisfactory. This was due in particular to the rise in prices on the capital market, a development which resulted in higher profits from own account trading and commission business. The interest surplus, which remains the banks' most important source of profits, is likely to have grown as well, albeit less strongly than the business volume. As a result, the interest margin has probably contracted again. This is indicated by the continued sharp rise in lower-margin, long-term lending and in interbank lending as well as by the continued strong competitive pressure in deposit business. Profitability was affected by risk provisioning in lending business. Both the persistently high number of German corporate insolvencies and the crises in East Asia have probably required larger value adjustments. Write-downs on the market prices of shares and bonds would hardly have been necessary, however.

Restructuring in the banking sector continues

Restructuring in the German banking sector continued recently owing to the progress made in information technology and the increasing interpenetration of financial markets. This resulted in a series of adjustments such as "one-stop" financing strategies, mergers, streamlining of branch networks, specialisation and the increased expansion of investment banking. In addition, electronic banking services expanded further. The banking industry is increasingly offering access to bank accounts through home banking by PC, telephone and fax, a service which seems to be increasingly demanded by bank customers. The number of direct banks as well as specialised banks and universal banks with direct banking services has risen perceptibly in recent years. As part of their marketing strategies – which are geared to a greater diversification of marketing channels – individual banks now offer their products via what are known as banking shops in retail centres. In card-based payment transactions, the use of debit cards – equipped with an electronic chip – has risen especially strongly. In Germany, these are widely spread in the form of ec cards. They are apparently used as a substitute for payment by guaranteed eurocheque and for cash payments. However, electronic money on stored-value cards or prepaid cards has not become very significant so far.

III. International monetary policy cooperation

1. European monetary integration

(a) Decisions concerning the start of EMU

EMU to begin with eleven countries

On May 2, 1998, the Council, meeting in the composition of the Heads of State or Government, taking the Convergence Reports by the EU Commission and the EMI into consideration, and also after a hearing with the European Parliament, in line with the recommendations made by the Commission and the Council of Ministers, decided that eleven member states can take part in the third stage of EMU. Those countries are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Before that, the Council of Ministers had annulled its previous decisions regarding the existence of excessive deficits in Austria, Belgium, Germany, France, Italy, Portugal, Spain, Sweden and the United Kingdom. Of the four member states not participating, Denmark had already notified the Council as early as December 1992, followed by Great Britain and Sweden in October 1997, that they did not wish to join EMU on January 1, 1999. Whereas Great Britain and Denmark had reserved the right not to participate by way of an abrogation in the Maastricht Treaty, Sweden achieved the same result by not participating in the exchange rate mechanism of the EMS as required. Greece met none of the convergence criteria.

Fixing of the euro conversion rates based on the bilateral central rates

Following the selection of countries to take part, the ministers and central bank governors of the future EMU members, the Commission and the EMI announced in a joint communiqué the procedure according to which the euro conversion rates for the national currencies taking part will be irrevocably fixed upon the start of EMU. The conversion rates into euro will accordingly be fixed using the existing bilateral EMS central rates.[1] Because of this announcement, it should be expected that in the run-up to EMU the market rates between the currencies of the participating countries will come into line with the central rates, all the more so since the central banks had already declared their willingness, if necessary, to ensure, using suitable market techniques, that the foreign

1 Under the Treaty, the value of the euro must correspond to the ECU's previous closing rates at the beginning of EMU. Since the EMU also includes currencies not yet participating in EMU, the euro conversion rates will only be able to be ascertained using the market rates of the non-participating currencies fixed at the end of 1998.

exchange rates between the participating currencies agree with their bilateral central rates on the last day of the second stage.

Proposal by the Council of Ministers for filling the posts of the ECB's Executive Board

Likewise at the beginning of May 1998, the Council of Ministers put forward its proposal for filling the posts of the ECB Executive Board. The European Parliament and the Council of the EMI have since been heard, in accordance with the Treaty. Immediately after the appointment of the President, the Vice-President and the other four members of the Executive Board by the governments of the EMU member countries, the ECB and the ESCB will be established. The ESCB will immediately take the necessary preparatory measures so that after the remaining short interim period it can assume the whole of its powers once EMU begins.

(b) State of convergence progress in the EU

High degree of sustainable convergence as a criterion for selection

Participation in EMU presupposes, besides the requirements under the Treaty regarding national legislation for the national central banks, a high degree of sustainable economic convergence.[1] That means each EMU member's inflation rate must show a large measure of convergence with the best-performing countries in terms of price stability as well as a sustainable government financial position; in addition, each EMU member country is required to have taken part in the exchange rate mechanism of the EMS for at least the last two years before the examination without severe tensions, and the result of all that has to be a considerable convergence of long-term interest rates toward those of the best-performing EU countries in terms of price stability. The narrow, strict interpretation of each of these four criteria, stressing the aspect of sustainability, has repeatedly been highlighted as indispensable for the success of monetary union, such as in 1992 by the Bundestag and Bundesrat (in resolutions taken on the occasion of the ratification of the Maastricht Treaty) and similarly at the end of 1996 by the European Council. Upon the request of the Federal Chancellor, the Bundesbank comprehensively assessed the state of convergence in the EU with regard to Stage Three of EMU. In its assessment, the Bundesbank summed up by stating the following: "Bearing in mind the progress in convergence which has been achieved in many member states, and after giving due consideration to the remaining problems and risks, entry into monetary union from 1999 appears justifiable in stability policy terms. With regard to the requirement of a sustainable financial position, however, serious concern exists in the case of Bel-

1 The previously mentioned Convergence Reports of the Commission and the EMI were each submitted and published on March 25, 1998.

gium and Italy. This could be eliminated if additional firm substantive commitments are undertaken."

Broad convergence of price and interest rate trends at a low level

The reference values for the rise in consumer prices and the long-term interest rates set in the Maastricht Treaty were not a particular hurdle for any of the EU countries, with the exception of Greece. In those countries, the average rates of inflation were closely in line during the twelve-month period until January 1998 which was relevant to the convergence examination. This favourable trend has continued thereafter. According to the consumer price data for February 1998, nearly half of all EU member states showed a gratifyingly low annual inflation rate of not more than 1.1%. The inflation rate was well above 2% in Greece only (4.1%). In addition to improved fundamentals, however, increasing market expectations of early EMU participation are also likely to have played a role in the convergence of interest rates, which accelerated sharply in some EU member states over the past few years.

Calm situation in the EMS

Thanks to the calm situation in the EMS, increasing convergence has also been achieved in exchange rate trends to the extent that the market rates of almost all the currencies participating in the exchange rate mechanism of the EMS were moving largely close to the central rates. However, Finland and Italy have only been taking part in the exchange rate mechanism since the autumn of 1996 (after the lira had left the mechanism in 1992); thus, in view of the reference period from March 1996 to February 1998, neither country has completely fulfilled the requirement of membership for at least two years. Greece only joined the ERM with effect from March 16, 1998. With this step, which included a devaluation of the drachma – measured in terms of the central rate – of over 12% from the previous ECU market rate, and was accompanied by the announcement of stability and structural policy measures, Greece has underscored its intention to join EMU at the beginning of 2001. Of the 15 EU member states, that means only the United Kingdom and Sweden are not members of the exchange rate mechanism right now. With effect from March 16, 1998, in addition, the bilateral central rates of the Irish pound were increased vis-à-vis the other participants in the exchange rate system by 3%. It was mainly owing to a rather powerful surge in the economy that the Irish pound was the only EMS currency to be quoted distinctly higher than its central rates for quite some time. With the revaluation, which also raised the conversion rate of the Irish pound for entry into EMU, Ireland has created, from a stability policy point of view, a welcome counterweight to the risks for price stability resulting from its

Performance as measured by the EMU criteria (disregarding the exchange rate criterion)

Table 10

EMU reference value met

Country	Change in consumer prices (HICP) from previous year in % – Twelve-month period up to January 1997	Change in consumer prices (HICP) from previous year in % – Twelve-month period up to January 1998	Overall fiscal balance of the public sector as % of GDP 1 – 1996	Overall fiscal balance of the public sector as % of GDP 1 – 1997
EMU threshold value 2	2.5	2.7	– 3	– 3
Austria	1.7	1.1	– 4.0	– 2.5
Belgium	1.8	1.4	– 3.2	– 2.1
Denmark	2.2	1.9	– 0.7	0.7
Finland	1.1	1.3	– 3.3	– 0.9
France	2.1	1.2	– 4.1	– 3.0
Germany	1.3	1.4	– 3.4	– 2.7
Greece	7.8	5.2	– 7.5	– 4.0
Ireland	2.1	1.2	– 0.4	0.9
Italy	3.7	1.8	– 6.7	– 2.7
Luxembourg	1.2	1.4	2.5	1.7
Netherlands	1.5	1.8	– 2.3	– 1.4
Portugal	3.0	1.8	– 3.2	– 2.5
Spain	3.5	1.8	– 4.6	– 2.6
Sweden	0.8	1.9	– 3.5	– 0.8
United Kingdom	2.4	1.8	– 4.8	– 1.9

Country	Yield on long-term public bonds in % – Twelve-month period up to January 1997	Yield on long-term public bonds in % – Twelve-month period up to January 1998	Gross government debt as % of GDP 1 – 1996	Gross government debt as % of GDP 1 – 1997
EMU threshold value 2	9.1	7.8	60	60
Austria	6.3	5.6	69.5	66.1
Belgium	6.4	5.7	126.9	122.2
Denmark	7.1	6.2	70.6	65.1
Finland	7.0	5.9	57.6	55.8
France	6.2	5.5	55.7	58.0
Germany	6.2	5.6	60.4	61.3
Greece 3	14.2	9.8	111.6	108.7
Ireland	7.2	6.2	72.7	66.3
Italy	9.1	6.7	124.0	121.6
Luxembourg	6.3	5.6	6.6	6.7
Netherlands	6.1	5.5	77.2	72.1
Portugal	8.3	6.2	65.0	62.0
Spain	8.5	6.3	70.1	68.8
Sweden	7.9	6.5	76.7	76.6
United Kingdom	7.9	7.0	54.7	53.4

Source: EMI. — **1** As defined in the national accounts and the Maastricht Treaty (including social security funds). — **2** 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. — **3** Harmonised data on long-term interest rates are available only from mid-1997; proxies are used for earlier periods.

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economic boom and from convergence of its interest rates towards the lower rates of the EMU partners.

Government deficits clearly lowered

Public sector consolidation continued to make progress in all EU member states in 1997. The EU's overall deficit, measured as a percentage of gross domestic product, declined in 1997 by 1.8 percentage points over the previous year to 2.4 %. Whereas there were still eleven EU member states which had exceeded the reference value of 3 % of gross domestic product in 1996, this only held for Greece in 1997. However, a rather mixed picture appears regarding the criterion of a sustainable government financial position in the member states, and the required sustainability of the process of consolidation in many countries does not yet seem sufficiently secure. The reduction of the deficit-to-GDP ratio was facilitated by the general drop in the interest rate level, with some countries – as previously mentioned – additionally profiting from the fact that markets were already counting on EMU membership. In addition, deficit reduction was also often based on measures with only temporary effects or on a dampening of investment not sustainable over the long run.

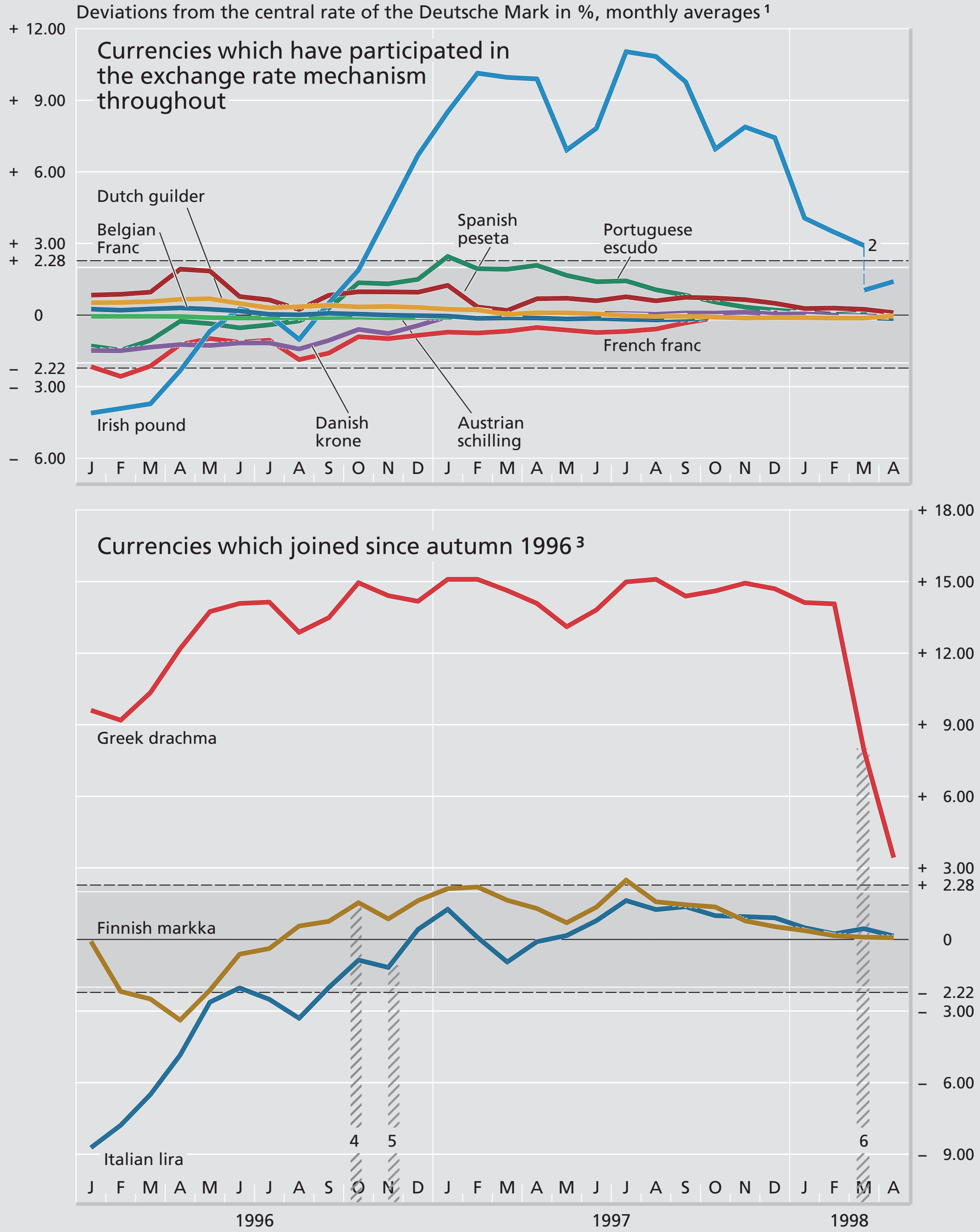
Only slight progress in reducing high level of government debt

Further considerable consolidation efforts are necessary particularly because of the fact that government debt is very high just about everywhere. In 1997, the average government debt as a percentage of gross domestic product was 72 % EU-wide, following 56 % in 1991 (when the convergence criteria were formulated). Although this ratio sank slightly in 1997 for the first time in a long time, the reference value of 60 % was exceeded in 1997, too, by as many as eleven countries. Only in Finland, France, Luxembourg and the United Kingdom was the debt-to-GDP ratio below this threshold value, although the trend was clearly pointing upwards in France, and the ratio was as of late just slightly below the reference value of 60 %. With a debt outstanding of over 120 % of gross domestic product in each case, Italy and Belgium exceeded this criterion the most egregiously, followed by Greece (109 %). If the reference value is exceeded, the Maastricht Treaty demands, as a sign of sustainable consolidation of public finances, that the ratio of government debt to gross domestic product be sufficiently diminishing and approaching the reference value at a satisfactory pace. In Germany, the debt-to-GDP ratio in 1997 was not only somewhat above the 60 % level, but also rose slightly over the preceding years' levels. One had to take account of the fact, though, that this ratio jumped considerably owing especially to reunification. In the other EU countries, excessively high debt ratios were reduced across the board. However, particularly the EMI and the Bundesbank expressed concerns and doubts as to whether Italy and Belgium have al-

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

Chart 23

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** Raising of the bilateral central rates of the Irish pound by 3% with effect from March 16, 1998. — **3** The deviations refer to the subsequent central rate before joining the exchange rate mechanism, too. — **4** Joined the exchange rate mechanism with effect from October 14, 1996. — **5** Rejoined the exchange rate mechanism with effect from November 25, 1996. — **6** Joined the exchange rate mechanism with effect from March 16, 1998.

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ready achieved a sustainable financial position. Another point which makes Italy's situation more difficult is that a very large percentage of the exceptionally high government debt has been financed on a short-term basis or at variable interest rates; therefore, a tight-money policy might dramatically exacerbate fiscal problems of this country in particular. Therefore, in respect of the commitments under the Stability and Growth Pact, too, Italy and Belgium, more than most of the other EMU participating countries, will need decisive and sustainable corrections in the government budget over the next few years, with emphasis being required on reducing current expenditure. Both countries have entered into expressly binding commitments during the procedure to allow them to enter EMU. The Resolution adopted with the recommendation of the Council of Ministers on countries participating in EMU envisages the implementation of the Council Regulation on the "strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies" as early as July 1998, and that countries having relatively high levels of government debt should be encouraged to make all the more vigorous consolidation efforts.

(c) Further institutional preparations for EMU

Council Regulations create legal clarity and transparency in changeover to the euro

Two Council Regulations form the binding legal framework for the changeover to the euro. The first one already entered into force in June 1997 and contains, in particular, provisions on the continuity of contracts and technical aspects of conversion between the euro and the national currencies. The second Regulation governs the central monetary policy and changeover issues; it will only enter into force when monetary union begins.

Modalities of the changeover in public administration

In Germany, final decisions on the modalities of the changeover in public administration are still pending. Up to now, the Federal Government's conversion plans for public administration envisage introduction of the euro only on January 1, 2002. Up to then, the use of the Deutsche Mark is to remain obligatory in the public sector, in principle. However, the Federal Government will begin issuing its bonds in euro at the beginning of January 1999. The issue of converting old debt of the Federal Government, which is also important for financial markets, was resolved by having the Federal Government convert its listed old debt as early as January 1, 1999 into euro. The legal prerequisites for this are currently under preparation.

Modified arrangement involving a reference date for the introduction of euro cash

As a complement to the "euro regulations", the Council of Ministers passed the Council Regulation on denominations and technical specifications of euro coins in 1997. Starting on January 1, 2002, banknotes and coins denominated in euro will probably be the sole legal tender in Germany. In order to secure as smooth a changeover as possible, a modified reference date arrangement is being discussed, according to which cash denominated in Deutsche Mark can remain in circulation for a limited period in parallel to cash denominated in euro.

Completion of the technical prerequisites for monetary policy and payment system

The report specifying the operational framework for a single monetary policy of the ESCB, already presented in January 1997 by the EMI, was given more concrete shape in September 1997 by a supplementary report[1] on the procedures and instruments to be used. In addition, in September 1997 the EMI and the Bundesbank published the interim list of "monetary financial institutions" based in the EU (status as of end-1996) in the Internet. This was followed in January 1998 by the interim list of money market funds existing in the EU. Moreover, provisional lists were published about the institutions affected by the introduction of minimum reserves and on the ESCB's counterparties as well as on the eligible assets for monetary policy operations (each as of end-1997). Besides, the payment system TARGET is just before the test phase, and the EMI has published guidelines for the use of EU securities settlement systems in ESCB credit operations.

Important Resolutions to secure stability

In 1997 the European Council and the Council of Ministers passed a number of Resolutions designed to ensure that EMU would be launched as a community of stability on January 1, 1999. They are the Resolution of the European Council on the Stability and Growth Pact of June 1997 and the associated Council Regulations on the "strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies" and on "speeding up and clarifying the implementation of the excessive deficit procedure". Additionally, the European Council adopted a "Resolution on economic policy coordination in stage three of the European monetary union and Treaty Articles 109 and 109b".

Support for monetary policy by coordinating general economic policies

These Resolutions and Regulations are focused on orienting national fiscal policies to the provisions of the EC Treaty and the stricter requirements of the Stability and Growth Pact so that in this manner the single monetary policy, which is required to pursue the primary objective of maintaining price stability, can be

1 See: EMI, "The single monetary policy in Stage Three. General documentation on ESCB monetary policy instruments and procedures", September 1997.

given the support it absolutely requires. Moreover, the resolutions of the European Council on growth and employment of June 1997 and on economic policy coordination of December 1997 envisage increasing involvement of national structural policies in economic surveillance in future, too. The objective is to dismantle regulations that impair the efficiency of EU economies, such as tax regulations that provide performance disincentives and rigidities in the labour, goods and services markets. In addition, it is envisaged that the available coordination instruments (economic policy orientations and recommendations; early warning of undesirable economic trends; exchange of information) be used more intensively so that stability-oriented monetary policy can receive support from this angle, too. In principle, the coordination Resolutions mentioned here are valid for all EU countries from the beginning, i.e. regardless of whether a country already introduces the single currency in 1999 or waits until later.

Council of Economic and Finance Ministers remains central coordinating body

The Resolution of December 1997 on economic policy coordination makes it clear that the Council of Economic and Finance Ministers (ECOFIN) remains the central body for this. It is envisaged that now and then (e.g. in multilateral surveillance) the Council can meet with a limited circle of participants – one minister per country and one further representative – in order to facilitate an open discussion. The informal meetings of the Economic and Finance Ministers, in which the central bank governors and the Commission usually take part, and which have been held for quite some time now, will continue in future, with the ECB President also joining in. Further informal get-togethers of the ministers from the euro nations (informal meetings of the Ministers of the states participating in the euro area) will serve to discuss problems particularly arising from participation in the euro area.

EMS II to link the currencies of EU countries to the euro

In June 1997, the European Council passed a further Resolution in which it agreed on the principles and features of a new exchange rate mechanism (EMS II). This new monetary system is designed to enable those EU countries not participating in EMU to peg their currencies to the euro under certain conditions. In the meantime, the EMI has prepared a draft version of an appropriate implementing agreement which, upon approval by the ECB, will form the basis for the concrete shape of exchange rate relations between the euro and the currencies of the other EU countries.

In view of the provisions of the Treaty concerning exchange rate policy (Article 109 of the EC Treaty), in its Resolution of June 1997 the European Council agreed that the Council of Ministers could provide general orientations for

Orientations by the Council for exchange rate policy only in exceptional cases

the exchange rate policy of the euro area vis-à-vis non-Community currencies only under extraordinary circumstances, such as in the event of obvious exchange rate distortions. Such orientations are subject to the proviso stipulated in the Treaty that they shall be without prejudice to the primary objective of the ESCB to maintain price stability. The Resolution particularly takes account of the fact that the exchange rates, with floating rates among the major currencies being prevalent over the foreseeable future, are largely the result of economic and monetary policy and thus not available as a specifically manageable variable.

External representation of EMU not clarified in detail yet

Under Article 109 of the EC Treaty, the Council is also required to take a decision on representation of the euro area at the international level. What is involved here is relations to individual non-Community countries, to international organisations or to informal international bodies (e.g. G-7 or G-10). On this matter, the Council, in its aforementioned Resolution of December 1997, for the most part merely affirmed the principles set out in the Treaty. Under the Treaty, the member states themselves represent their interests in the area of their own economic policy responsibilities while taking due account of Community interests. In monetary policy matters, external representation is the responsibility of the ECB, whereas in questions of external monetary policy, the Council and the ECB jointly represent the euro area in compliance with the allocation of powers laid down in the Treaty. Detailed institutional arrangements will need to be discussed in the second half of 1998.

Exchange of information between the Council and the ECB while maintaining central bank autonomy

The close interlocking of monetary and exchange rate policies, for one thing, and the significance of a coherent "policy mix" in the euro area, for another, make it necessary for the Council and the ECB to exchange information and views. Article 109b of the EC Treaty provides that the President of the Council of Ministers and a member of the Commission may participate in the meetings of the Governing Council of the ECB. Conversely, the President of the ECB is to be invited to the meetings of the Council of Ministers when matters are being discussed relating to the objectives and tasks of the ESCB. Besides, this article of the Treaty governs the reporting requirements of the ECB vis-à-vis other European organs (Parliament, the Council and the Commission). In view of the already comprehensively defined organisation of the cooperation, the European Council, in its Resolution of December 1997, did not set any further framework. However, it called on the Council of Ministers to fully utilise the available structures for exchanging information and views. The Economic and Financial Committee, which will replace the Monetary Committee upon the beginning of EMU, will prepare the discussions.

(d) Further development of the EU

Expansion of the EU through the Treaty of Amsterdam

The Treaty of Amsterdam, which was concluded on October 2, 1997 and still needs to be ratified, is intended to expand the EU, not least in order to secure EMU on a lasting basis. The Treaty expands the common foreign and security policy and establishes Community competencies in the area of free movement of people and in asylum, visa and immigration legislation. Additionally, the social regulations of the Community are supplemented and a chapter on employment is incorporated into the EC Treaty. The envisaged development of a coordinated employment strategy has already been implemented for 1998 in the form of structural policy guidelines. Under the Treaty of Amsterdam, employment policy will primarily remain the domain of the member states. Employment policy initiatives, however, must always be in accord with the Community's economic policy orientations which are to be aimed at monetary stability and structural change ("Broad guidelines of economic policy"). In addition, under certain conditions, the Treaty of Amsterdam is supposed to make a closer cooperation possible between individual member states in certain policy areas (flexibility clause). In the institutional sector, however, the agreed amendments to the EC Treaty remain insufficient to ensure a lastingly satisfactory functioning of Community organs. The reforms necessary here are still to be carried out before new members are accepted.

Beginning of negotiations for accession with six countries

Within the framework of its comprehensive EU reform strategy "Agenda 2000", in July 1997 the European Commission presented its opinions on the applications of a total of eleven countries[1] for accession. Thereafter, in December 1997 the European Council decided to begin the process of enlargement with all applicants simultaneously, in principle. However, in the meantime concrete negotiations towards accession have only been begun with Cyprus, Hungary, Poland, Estonia, the Czech Republic and Slovenia, since only these countries are expected to be able to fulfil the necessary preconditions for accession in the foreseeable future. In view of the different starting positions, the conditions for accession are to be clarified individually in bilateral government conferences. The significance of this enlargement round, but also the potential burdens on today's EU member states and the increasing need for reforms in this regard

1 In chronological order of applications for accession: Cyprus, Hungary, Poland, Romania, the Slovak Republic, Latvia, Estonia, Lithuania, Bulgaria, the Czech Republic, and Slovenia.

(which particularly affect agricultural policy and the fiscal system), are reflected in the fact that under the current conditions, if all eleven candidates were to accede to the European Union, the EU's population would rise by more than a quarter, to nearly 500 million citizens, but the extended EU's economic output would only increase by just under 5 %.

2. The debt crisis of East Asian emerging economies

(a) Main causes

Unexpected domino effects through sudden losses of confidence

In the second half of 1997, Thailand, Indonesia and South Korea successively got into serious balance of payments difficulties through massive withdrawals of foreign capital. Malaysia and the Philippines were also hit hard by the loss of confidence among international lenders and investors. All those countries suffered drastic devaluations of their currencies and slides in securities prices. The servicing of foreign exchange liabilities by banks and enterprises thus became more and more difficult, resulting in impending or actual suspensions of payments. At the same time, the sharp increases in the prices of imports had a paralysing effect on the economies of the crisis countries; whenever this involved high price increases for imported foodstuffs, there were sometimes also major social tensions. Given all that, the possibility could not be ruled out that further countries could be pulled into the maelstrom of confidence-related capital withdrawals. In the autumn of 1997, even in the securities and foreign exchange markets of fundamentally solid economies such as Hong Kong, Singapore and Taiwan, there was considerable downward pressure. At times, there was even the danger that the Asian turbulence could spill over to central and east European countries and to Latin America. Although the economic difficulties Thailand was having were known for a fairly long time already, neither the key international organisations nor the markets thought that developments there could generate far-reaching domino effects. The decades-long economic momentum of the East Asian emerging economies had put these countries' structural deficiencies, and in some cases even undesirable trends, which explain the extent of the East Asian crisis, on the back burner.

Large inflows of capital prior to the outbreak of the crisis

In macroeconomic terms, the East Asian emerging economies' performance before the crisis broke out was rather impressive. Their powerful economic growth was accompanied by high national saving rates which, in some cases, also include government budget surpluses. In addition, most countries showed progress in combating inflation. These good preconditions for sustainable economic expansion attracted a strong, continually rising stream of foreign capital into the East Asian region and helped continue to buoy investment activity. Foreign bank loans with increasingly short maturities were a dominant factor here. In most countries, these inflows were mostly in the form of interbank credits; in Indonesia, however, foreign banks mainly granted direct business loans. The current account deficits associated with this trend initially seemed unproblematic because they reflected buoyant investment activity.

Increasing exaggeration of capital imports by "moral hazard" on the part of the lenders

In retrospect, however, the capital imports by the East Asian countries apparently exceeded the level which seemed appropriate in terms of the economic fundamentals. In the capital-importing countries, the de facto largely stable exchange rates against the US dollar there lured many to take advantage of the lower world market interest rates without forward cover. A considerable share of the foreign funds flowed into projects, especially investment in real estate, which were not associated with a direct increase in export capacities. Moreover, it was quite normal in Asian countries to finance long-term projects with short-term funds. These undesirable trends would not have been possible, however, if the lenders had not also neglected their credit risks to a considerable degree. This was partly the consequence of a world-wide liquidity glut. Besides, in many cases the creditor banks were encouraged to conduct an expansive credit policy by implied government guarantees of the debtor countries. These included official commitments to a policy of stable exchange rates against the US dollar. But in the East Asian emerging economies, in particular, widespread fraternisation between the government and industry fed expectations that in a crisis scenario the governments would assume the liabilities of the banks and enterprises having foreign debts. The banks of the debtor countries likewise considered themselves to be backed up by the governments under these conditions in their excessive lending supported by foreign funds. Given the widespread gaps of supervision, the debtor countries' banking supervision was not a hurdle for the banks' business policy. In addition, the massive international financial aid which was provided during the Mexican crisis of 1994-5 probably reinforced expectations both of the debtor and the creditor banks that in the case of balance of payment crises, far-reaching international assistance would be forthcoming, too. In the final analysis, therefore, the excessive capital imports of the East Asian emerging economies can also be traced back to "moral hazard" problems on the part of domestic and foreign credit institutions, i.e. to a discrepancy in their favour between yield expectations and the risk of incurring losses.

Economic trends in selected Asian emerging economies since 1990

Table 11

Country (1997 GDP in US$ billion)	1990–1994 [1]	1995	1996	1997 [2]
South Korea (480)				
Real GDP growth (change from previous year in %)	7.6	8.9	7.1	5.9
Inflation rate	7.0	4.5	4.9	4.5
Budget balance (in % of GDP)	– 1.0	...	...	...
National saving (in % of GDP)	35.4	35.1	33.3	32.9
Gross capital formation [3] (in % of GDP)	36.8	36.6	36.8	36.6
Current account balance (in % of GDP)	– 1.3	– 2.0	– 4.9	– 1.9
Short-term interest rates [4] (in %)	[5] 12.4	13.8	12.8	13.5
Indebtedness to foreign banks (in US$ billion)	[6] 56.6	77.5	100.0	[7] 103.4
of which: short-term	[6] 40.1	54.3	67.5	[7] 70.2
Weighted external value of the currency [8] (1990 = 100)	86.9	82.8	79.2	48.8
Indonesia (230)				
Real GDP growth (change from previous year in %)	8.0	8.2	8.0	5.0
Inflation rate	8.6	9.4	7.9	6.6
Budget balance (in % of GDP)	0.2	0.8	1.4	2.0
National saving (in % of GDP)	28.9	29.9	28.8	27.3
Gross capital formation [3] (in % of GDP)	27.0	28.4	28.1	26.5
Current account balance (in % of GDP)	– 2.3	– 3.3	– 3.3	– 2.6
Short-term interest rates [4] (in %)	[5] 11.8	15.4	15.5	17.8
Indebtedness to foreign banks (in US$ billion)	[6] 34.9	44.5	55.5	[7] 58.7
of which: short-term	[6] 21.3	27.6	34.2	[7] 34.6
Weighted external value of the currency [8] (1990 = 100)	84.0	69.1	70.8	38.7
Thailand (180)				
Real GDP growth (change from previous year in %)	9.1	8.7	6.4	0.0
Inflation rate	4.8	5.8	5.9	5.6
Budget balance (in % of GDP)	3.1	2.6	1.6	– 0.4
National saving (in % of GDP)	34.4	34.3	33.1	31.8
Gross capital formation [3] (in % of GDP)	40.1	41.8	40.8	35.8
Current account balance (in % of GDP)	– 6.4	– 7.8	– 7.8	– 2.2
Short-term interest rates [4] (in %)	[5] 9.3	12.3	10.7	13.6
Indebtedness to foreign banks (in US$ billion)	[6] 43.9	62.8	70.1	[7] 69.4
of which: short-term	[6] 31.0	43.6	45.7	[7] 45.6
Weighted external value of the currency [8] (1990 = 100)	94.2	88.1	91.5	57.5
Malaysia (100)				
Real GDP growth (change from previous year in %)	8.7	9.5	8.6	7.3
Inflation rate	3.5	3.4	3.5	2.7
Budget balance (in % of GDP)	– 1.1	3.8	4.2	1.6
National saving (in % of GDP)	30.9	33.5	36.7	37.0
Gross capital formation [3] (in % of GDP)	36.6	43.0	42.2	42.7
Current account balance (in % of GDP)	– 5.5	– 10.0	– 4.9	– 4.6
Short-term interest rates [4] (in %)	[5] 5.2	6.1	7.3	8.0
Indebtedness to foreign banks (in US$ billion)	[6] 13.5	16.8	22.2	[7] 28.8
of which: short-term	[6] 6.6	7.9	11.2	[7] 16.3
Weighted external value of the currency [8] (1990 = 100)	96.4	93.1	97.2	72.7
Philippines (80)				
Real GDP growth (change from previous year in %)	1.8	4.8	5.7	5.1
Inflation rate	11.4	8.1	8.4	5.1
Budget balance (in % of GDP)	– 2.0	– 1.4	– 0.4	– 0.9
National saving (in % of GDP)	18.8	17.8	19.7	21.0
Gross capital formation [3] (in % of GDP)	22.5	22.2	23.2	25.1
Current account balance (in % of GDP)	– 4.0	– 4.4	– 4.7	– 4.5
Short-term interest rates [4] (in %)	...	[9] 15.7	12.4	15.6
Indebtedness to foreign banks (in US$ billion)	[6] 6.8	8.3	13.3	[7] 14.1
of which: short-term	[6] 3.2	4.1	7.7	[7] 8.3
Weighted external value of the currency [8] (1990 = 100)	87.1	82.8	86.3	65.8

Sources: IMF, BIS, Bloomberg. — **1** Annual average. — **2** Figures partly estimated. — **3** Excluding replenishment of stocks. — **4** Three-month funds; annual average. — **5** 1994. — **6** At the end of 1994. — **7** June 1997. — **8** Compared with 21 or 22 (South Korea) OECD countries and four countries in the region; December values in each case. — **9** At the end of 1995.

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Comeback of the US dollar acted as the principal catalyst for the crisis

The comeback of the US dollar proved to be the most important factor triggering the East Asian crisis. Since the currencies of the emerging economies affected were tightly pegged to the US dollar de facto, their external values rose along with the US dollar particularly against the yen, which was tending to be weak at the time. Thailand was hit particularly hard by the resulting deterioration of its competitiveness, since at the same time the prices on the world market for electronic chips, where Thai industry is a significant supplier, had tumbled. On balance, Thailand's current account deficit was barely less than 8 % of GDP since as early as 1995, which generated increasing doubts about the ability to sustainably finance the deficit. Because of the pressure generated by the beginning of the withdrawal of capital, which swelled up quickly owing to the short-term nature of a large percentage of the funds borrowed, in July 1997 the Thai monetary authorities saw no other option but to allow a major devaluation of the baht. The resulting improvement in Thailand's competitive position was in turn a key factor in the crisis expanding to affect other countries in that region. In addition, the foreign banks began to subject their involvement in the emerging economies to a closer general review. Beyond the Asian region, those countries which, like Thailand, had taken up large short-term foreign-currency loans for longer-term use, proved to be particularly vulnerable to crises.

(b) The reactions of the international community

Massive official financial assistance despite contradictory earlier recommendations

The massive financial assistance granted during the Mexican crisis of 1994-5 had increased the industrial countries' worries that the associated repayment of private loans by the international community could undermine the proper functioning of the financial markets and, in the end, could just about provoke new crises. A study published by the G-10 in 1996 on avoiding and handling debt crises, therefore, comes to the conclusion and issues a warning that neither the borrowers nor the lenders should expect in a crisis situation to be protected by comprehensive official financial aid from undesirable financial consequences of their behaviour. All the same, the international community, with the IMF playing a major role, reacted to the Asian capital account problems once again by providing previously unheard-of amounts of financial aid. Beyond the lending commitments of the IMF, the World Bank and the Asian Development Bank, the prospect of considerable bilateral financial assistance by various groups of countries was offered for Indonesia and South Korea. In South Korea's case, Germany contributed by granting a lending commitment of US$ 1.25 billion (credit line of the Bundesbank guaranteed by the Federal Government). The comprehensive

Lending commitments and disbursements by international financial institutions to selected Asian countries

Table 12

US$ billion

Item	Thailand	Indonesia	South Korea
Commitments in 1997 (month)	(August)	(November)	(December)
IMF [1]	3.9	9.9	20.9
(% of the quota)	(505)	(490)	(1,938)
World Bank	1.5	4.5	10.0
Asian Development Bank	1.2	3.5	4.0
Total	6.6	17.9	34.9
Disbursements up to the end of March 1998			
IMF [1]	2.7	3.0	15.1
World Bank	0.4	–	5.0
Asian Development Bank	0.6	–	3.0
Total	3.7	3.0	23.1

Sources: IMF, World Bank and Asian Development Bank. — **1** The commitments and disbursements by the IMF are on the basis of SDRs; the rate of December 30, 1997 is used here for the purposes of conversion into US dollars.

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international aid packages, however, have only in part had the desired calming effect on the financial markets.

Debt rescheduling by the private creditors contributed in a key fashion to calming the situation

It is true that substantial international financial assistance can be appropriate in extreme situations if the purpose is to avert a destabilising effect on the international monetary system and far-reaching shocks to the world economy ("systemic risks"). Particularly threats to the financial systems of the creditor countries can constitute such a critical situation. When answering the question to what extent these conditions exist, though, very strict standards should be applied. This is precisely the case then, too, when the assertion is made that considerable emergency credit is necessary to avert international knock-on effects. Experience in Asia suggests, rather, that major aid packages, in the final analysis, can have the same effect as an offer to lenders to bail out of comparable countries. In any event, the situation in Asia was calmed only after the crisis countries announced their willingness to work closely together with the IMF in implementing adjustment programs and also when the creditor banks active there recognised their share of the responsibility for overcoming the crisis by prolonging their credits. Involving the private creditors in crisis management early on can therefore be seen as strengthening the basis of confidence in the debtor countries. Against this background, at the meeting of finance ministers and central bank governors of the G-7 countries in February 1998, an important course was set. The communiqué calls for appropriate procedures to be developed in order to be able to involve private creditors quickly and smoothly in future crisis solution scenarios.

(c) Improvement in crisis prevention and crisis management

Broad-based efforts to improve crisis prevention

In the light of the East Asian debt crisis, the international debate on possibilities of improving crisis prevention and crisis management, which had been started after the Mexican crisis of 1994-5, was rekindled and intensified across the board. In the meantime, a consensus has been reached that determined efforts are necessary to make the economic and fiscal situation of the emerging economies as transparent as possible to prevent lenders from being led by superficial assessments and by the herd instinct. In this connection, work is also being done with determination at the BIS to improve the available public statistics on international indebtedness; the "time lags" are to be shortened, and the classification according to maturities, currencies and instruments is to be expanded. Moreover, it is also important to strengthen the financial systems of the emerging economies as quickly as possible by implementing the minimum requirements for banking supervision and internal management formulated during the last few years in an international context under the aegis of the Basle Committee. In addition, the question is being considered of whether banking regulatory measures can be taken on the part of the creditor countries to prevent excessive lending to the emerging economies. It is also to be discussed to what extent the IMF, as part of its surveillance duties, can issue public warnings about critical trends without impairing its confidential dialogue with the member countries or even triggering otherwise preventable crises. It is not least a matter of urgency that any tendencies towards a "moral hazard" be largely nipped in the bud by developing procedures to involve private creditors in the crisis solution and by reassessing the role of government guarantees of private liabilities.

Involvement of private creditors in crisis solutions requires a complex strategy

The international discussion of the important issue of how private creditors can be systematically involved in the solution of international debt crises in future has not yet come up with any clear results. To the extent that claims by private creditors on public debtors are involved, as early as 1996 the Group of Ten had laid out proposals for solutions in the follow-up to the Mexican crisis ("The Resolution of Sovereign Liquidity Crises", May 1996), yet they need further study. Through the East Asian crisis, an additional question has entered the focus of attention: what should be done if creditors are no longer confronted with just one single debtor (i.e. the government of the debtor country) but instead with a number of private debtors. Without wishing to get ahead of the international discussion, it can be stated that the involvement of private creditors will create the need for a complex strategy requiring, in the Bundesbank's view, three types of preparation:

– The debtor countries should have efficient bankruptcy legislation in that private debtors, in the event of default on payment, have enough time to possibly negotiate a consensual solution with their creditors. However, improving national bankruptcy legislation is not sufficient if – as is now the case in Indonesia – large sections of the enterprise sector default on servicing foreign debt.

– The preparation of voluntary debt restructuring between the private creditors and a country's private debtors should therefore play a key role. To the extent that the creditor banks are affected, there already exist the London Club procedures. The best way of representing the interests of the private creditors would have to be the subject of a detailed study. The IMF could, and should, play a role as an intermediary in arranging voluntary debt restructuring.

– In an extreme case, the possibility of a moratorium for debtor countries should not be ruled out (as was allowed in Indonesia de facto in January 1998 concerning the foreign currency debts of the enterprises). In every individual case, it would need to be considered whether the international community is able to give the debtor country a certain protection of confidence – provided the corresponding will to adjust is demonstrated – to make it easier for it to return to the financial markets later. It would have to be clarified how such flanking protection could best be provided under these conditions.

3. Recent developments regarding international financial institutions

New IMF facility for exceptional balance of payments difficulties

In the light of the strong increase in the mobility of international capital flows, and the potential financing gaps resulting therefrom, many member states considered the IMF's traditional credit facilities inadequate for a number of reasons. In particular, the usual maturities seemed inappropriately long and the usual conditions not suited to the current crises. The new "Supplemental Reserve

Facility" established in December 1997 is therefore intended to enable special financial assistance to be provided in the event of exceptional balance of payment difficulties. The situations being borne in mind are, in particular, a sudden loss of confidence on the part of the international financial markets and associated outflows of capital and reserves. This new facility was the IMF's reaction particularly to the experience of the most recent balance of payments crises in Thailand, Indonesia and South Korea.

Financial assistance on the basis of the new facility requires strict conditionality

The new facility has the following characteristics: (1) Its use is intended primarily for cases where balance of payment difficulties may create an international risk of contagion and pose a potential threat to the international monetary system. (2) In order to massively counteract losses of confidence, relatively high amounts of financing are available which are not subject to a formal upper limit. The IMF cannot provide financing beyond its available resources, though. (3) Lending is subject to a strict conditionality aiming at eliminating as quickly as possible the causes for the loss of confidence. Here, a relatively large percentage of the lending commitments can be disbursed right at the beginning of the adjustment programme agreed with the Fund if the debtor countries commit themselves convincingly to implementing the often lengthy adjustment measures. (4) The amounts are only provided for a relatively short period, in the expectation that the amount of financial assistance and the strict conditionality will lead to a quick change of market sentiment. (5) The interest rate, at 300 to 500 basis points over the regular Fund charges, is relatively high. That is intended to ensure sparing use and/or early repurchase. (6) To minimise the risk of a "bailout" of other creditors at the IMF's expense, the borrowers are expressly called upon to include every option of widespread burden sharing in their plans. In the event of large or sustained outflows of capital, the IMF can, in a pinch, also make its financial assistance contingent on the debtor country introducing capital controls.

Bundesbank only agreed to new facility with considerable reservations

In the light of the widespread international support, the Bundesbank agreed to the establishment of the new facility. However, in the end, this was only upon putting aside the concern that massive IMF assistance could run counter to the objective of involving the private creditors in the solution to the crisis. It is therefore to be hoped that the current international discussion on limiting "moral hazard" leads to solutions which make future activations of the facility as unnecessary as possible.

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

Table 13

SDR billion

Item	1993	1994	1995	1996	1997
Disbursements					
Credit tranches 1	1.1	1.8	14.4	2.5	13.3
Extended Fund Facility	1.9	0.9	2.0	2.6	2.7
Compensatory and Contingency Financing Facility	0.7	0.3	0.0	0.2	0.1
Systemic Transformation Facility 2	1.4	1.9	0.6	–	–
Structural Adjustment Facility 3	0.3	0.9	1.4	0.7	0.7
Total disbursements	5.3	5.9	18.4	6.0	16.8
Repurchases and repayments	3.9	4.8	7.1	5.6	6.3
Net disbursements	1.4	1.1	11.3	0.4	10.5
Total IMF credit outstanding 4, 5	29.2	30.3	41.6	42.1	52.6
of which					
Europe	6.2	8.0	11.4	13.9	15.7
Asia	6.4	5.8	4.8	3.7	15.5
Latin America	10.4	9.5	18.0	16.6	13.8
Africa	5.9	6.5	7.1	7.5	7.1

Source: IMF. — **1** Including the Supplemental Reserve Facility (SRF). — **2** Temporary facility for transition countries; purchases were possible until the end of 1995. — **3** Including both the Structural Adjustment Facility (CSAF) 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. — **4** Definition is the same as for purchases: credits from general quota resources and SAF, ESAF and Trust Fund credits; end-of-year levels. — **5** Delineation of regions according to IMF definitions; "Europe" includes, inter alia, the regions of the former Soviet Union.

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High level of lending to Asian countries

In 1997, the Asian crisis had a decisive influence on the IMF's lending. Whereas outstanding loans to Latin America and Africa went down (by SDR 2.8 billion to SDR 13.8 billion and by SDR 0.4 billion to SDR 7.1 billion, respectively) and outstanding loans to east European countries rose just slightly (by SDR 1.8 billion to SDR 15.7 billion), outstanding loans to Asia rose on balance by SDR 11.8 billion (some US$ 16 billion). Especially Thailand, Indonesia and South Korea received considerable credit commitments from the IMF during the second half of the year (Thailand: US$ 4 billion; Indonesia: US$ 10 billion; South Korea: US$ 21 billion). The new Supplemental Reserve Facility was activated in South Korea's favour for the first time. Even though the Fund, in line with its role as a catalyst, also involved other lenders, it still assumed around one-third of the total official financial assistance agreed, with commitments which totalled around US$ 35 billion in the case of the three aforementioned countries. Commitments of considerable funds totalling US$ 25 billion were also granted by the World Bank and the Asian Development Bank. With these loans, which were for the most part balance of payment assistance, the multilateral development banks came very close to the functions of the IMF. This means cooperation and coordination between the international financial institutions are extremely important. Further financial assistance – as previously mentioned in this Report – has also been promised by bilateral official lenders. Overall, in the second half of 1997, financial assistance totalling some US$ 110 billion has been promised to the three main problem countries.

Liquidity situation of the IMF deteriorated

During the calendar year of 1997, the IMF disbursed to its member countries SDR 17 billion or around US$ 23 billion in financial assistance, or nearly three times as much as in 1996. After deducting repurchases and repayments, it provided SDR 10.5 billion, or US$ 14.5 billion. That means the Fund's liquidity situation worsened last year. The liquidity ratio of the IMF, i.e. the ratio of its uncommitted usable resources to its liquid liabilities, went down from 104 % to 48 % within a year. Compared over a period of many years, the liquidity ratio as of end-1997 seems relatively low; however, this is no reason for concern, all the more so since a decline in the liquidity ratio is quite normal in the run-up to a quota increase.

Increase in IMF quotas in the process of being ratified

The quota resources are the main source of funding for the Fund. The Eleventh General Review of Quotas was concluded by the Board of Governors at the end of January 1998; according to this review, the quotas are to be increased by a total of 45 % to SDR 212 billion. Owing to the change in the world economic weight of the individual member countries, the quota shares will undergo a shift. The German quota is rising from SDR 8.2 billion to SDR 13.0 billion, and the German quota share will rise from its previous level of 5.67 % to 6.14 %. The member countries are called upon to accept the individual quota increases offered to them by January 1999. The quota increase enters into force when countries which together make up at least 85 % of the present quotas notify the Fund of their acceptance.

Ratification of NAB already concluded by most countries

The New Arrangements to Borrow (NAB) have likewise not yet entered into force. The existing refinancing facilities of SDR 17 billion under the General Arrangements to Borrow (GAB) are to be doubled to SDR 34 billion under the NAB (around US$ 50 billion). They will provide the IMF with additional backing if its quota resources do not suffice to thwart crises which pose a threat to the international monetary system. The IMF Executive Board already gave the NAB its approval in January 1997. A large number of the 25 NAB countries have since ratified the arrangements and notified the IMF of their participation. However, the NAB only enter into force if at least 85 % of the overall credit volume of SDR 34 billion has been subscribed and at the same time the five largest lenders (United States, Japan, Germany, France and the United Kingdom) have given their approval.

Financing of the interim ESAF not yet secure

In 1997, hardly any progress was made on the issue of the further funding of the Enhanced Structural Adjustment Facility (ESAF). Under this facility, the Fund grants special longer-term loans at very low interest rates which come close to development assistance. Since this activity is not in line with the original mandate of the IMF, regular IMF resources should not be used to this end. For the years of 2001 to 2004 – later, ESAF loans will be self-financing owing to repayments of previous loans – the IMF is still searching for interim funding.

"Equity allocation" of SDRs yet to be ratified

What is known as the "equity allocation" of special drawing rights (SDRs) was approved by the Board of Governors in September 1997; accordingly, a total of SDR 21.4 billion are envisaged for allocation; the cumulative allocation for each country is thus intended to be increased to 29.32 % of its quota. This special allocation (without a proven global shortage of monetary reserves) requires an amendment of the Fund's Articles of Agreement. The member countries of the IMF are now called upon to have their legislative organs ratify this amendment. The allocation of the additional SDRs will take place as soon as the amendment of the Fund's Articles of Agreement enters into force. For that, the approval of three-fifths of the member countries is necessary; they have to have at least 85 % of the vote.

Financial support for the HIPC initiative by international financial institutions

A sizeable volume of the financial resources of the IMF, the World Bank and other agencies will be needed for the planned governmental debt reduction assistance for "Heavily Indebted Poor Countries" (HIPC). For the first time, the international financial institutions will participate in this initiative for relieving the debts of heavily indebted poor developing countries, too; instead of directly renouncing their own claims, they will complement the debt relief measures of the governments by providing grants and loans at concessional terms as well as by assuming debt servicing obligations. The Fund has therefore called upon its members to provide special bilateral contributions. Germany has already announced a substantial contribution to the IMF. The World Bank supplied a total of US$ 750 million to the HIPC Trust Fund it had founded, from which debt service relief is to be financed. Bilateral donors, too, have contributed to this Trust Fund of the World Bank. Moreover, both the African Development Bank and the Inter-American Development Bank are likewise participating in the HIPC initiative. Debt reductions for Uganda have already been authorised; five further countries (Bolivia, Burkina Faso, the Côte d'Ivoire, Guyana and Mozambique) have since been promised debt relief by the international community.

Strengthening of the World Bank's role as a catalyst by reviving the guarantee instrument

In 1997, the World Bank began to restructure its activities with the objective of being able to react faster, less bureaucratically and more cost-effectively to the financing needs of its member countries. One of the World Bank's special concerns is promoting the private sector, particularly in those countries which up to now have benefitted to a very limited extent or not at all from inflows of private funds. In the World Bank group (IBRD, IDA, IFC and MIGA), this takes place primarily by reviving the guarantee instrument. For instance, the IBRD is providing more and more guarantees for the private financing of infrastructural projects. The capital increase of the Multilateral Investment Guarantee Agency (MIGA) by US$ 850 million proposed by the Development Committee is aiming in the same direction.

Operations of the Deutsche Bundesbank

I. Processing cash payments and cashless payments

1. Cash payments

Banknotes and coins in circulation

The value of banknotes in circulation at December 31, 1997 was more or less the same as at the end of 1996. The value of coins in circulation rose by 1.3 %. At the end of 1997, 94.4 % of all currency in circulation consisted of banknotes, and 5.6 % of coins.

Currency in circulation and its pattern — Table 14

Trends over time

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
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
1997	276,242	260,686	15,556

Pattern at the end of 1997

Banknotes in circulation			Coins in circulation		
Notes of DM	DM million	Percentage of total	Coins of DM	DM million	Percentage of total
1,000	88,511	33.9	10.00	2,469	15.9
500	27,699	10.6	5.00	5,699	36.6
200	9,271	3.6	2.00	2,285	14.7
100	99,541	38.2	1.00	2,303	14.8
50	21,565	8.3	0.50	1,118	7.2
20	8,602	3.3	0.10	1,045	6.7
10	5,188	2.0	0.05	319	2.0
5	309	0.1	0.02	150	1.0
			0.01	168	1.1
Total	260,686	100	Total	15,556	100

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At the end of the period under review approximately 2.6 billion notes were in circulation. DM 100 and DM 200 banknotes with enhanced security features have been in circulation since August 1, 1997. Of the 1.041 billion banknotes in these two denominations in circulation at the end of 1997, as many as 432 million notes, or 41.5 % of the total, carried these improved security features. The notes in these two denominations issued prior to August 1, 1997 are likewise legal tender.

Destruction of banknotes

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

	1993	1994	1995	1996	1997
Number (million)	914	516	739	659	1,466
Value (DM billion)	120.0	28.2	50.6	27.7	118.9

The sharp rise in the number of notes destroyed in 1997 is essentially due to the fact that DM 100 and DM 200 notes of the old type were destroyed along with those that were no longer fit for circulation or had been called in. Although these DM 100 and DM 200 notes were still fit for circulation, they were not put back into circulation owing to the issue since August 1997 of notes of the same denomination with enhanced security features.

Coins

The stock of German coins held by the Bank at the end of 1997 amounted to DM 1,923 million (end-1996: DM 2,057 million). The Federal Government was redebited for the amount exceeding 10 % of the total coins in circulation. In 1997 about DM 151 million was credited to the Federal Government in respect of coins received from the mints and about DM 82 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1997 the Bank – acting for the account of the Federal Government – received coins amounting to DM 19,614 million and redeemed coins which were no longer fit for circulation or which had been called in, equivalent to DM 2,135 million. At the end of 1997 coins totalling DM 15,556 million were in circulation, equivalent (given 82 million inhabitants) to DM 190 per head of the population.

Counterfeits

The number of counterfeit banknotes detained in payments and appraised by the Bank increased compared with the previous year; by contrast, the number of counterfeit coins declined significantly.

Counterfeits detained in payments, as recorded by the Bundesbank Table 15

	Banknotes		Coins	
Year	Number	DM thousand	Number	DM thousand
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
1997	33,873	3,933	14,983	67

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Forgeries of the DM 100 notes of the type issued until the end of July 1997 without the improved security features accounted for 82 % of the total while false DM 5 coins accounted for 87 % of all coin forgeries.

2. Cashless payments

Slight fall in number of payments submitted

In 1997 there was a slight fall in the number of credit transfer orders and collection orders channelled through the Bank compared with the previous year. Overall, approximately 2.3 billion payments totalling DM 224,091 billion were submitted in 1997. This represents a decline of 1.2 % in the number of items processed whereas there was a significant increase in the total value, especially in the case of large-value payments.

Retail payments

In the year under review both the credit institutions and the Bank took further steps to process the payment transactions of their customers more efficiently and more cost-effectively. Since June 1997 all transfers still submitted in paper-based form have generally been converted by the first-commissioned credit institutions and passed on in a paperless form. The Bundesbank therefore closed down its paper-based credit transfer systems for retail and large-value payments (MAOBE procedure, local credit transfers and clearing operations) in that month. Furthermore, the banks generally agreed that from September 1998 they would convert and collect from the first-collecting bank all cheques for amounts below DM 5,000 under the paperless cheque collection procedure; at present, conversion is voluntary. As there has been a general obligation since November 1993 to convert all direct debits and to collect them in a paperless form, it is likely that from September 1998 only cheques for amounts of DM 5,000 and more will be passed on in paper form. However, these cheques will likewise be converted and processed float-free in a paperless form by the Bundesbank under the large-value cheque collection procedure introduced in November 1994; nevertheless, the original cheques, which are frequently made out for very large amounts, are still transmitted and presented separately.

Further development of Bundesbank systems

From the end of 1998 credit transfers handled by electronic data media (DTA procedure) will be settled float-free just as cheques and direct debits are collected float-free now. The principals' accounts will then be debited on the business day following presentation of the orders (instead of on the day of presentation, as they are now). However, cover will have to be available on the presentation day in the form of credit balances or – in the case of credit institutions – as freely

The Bank's cashless payments

Table 16

Item	1996 Number (million)	1996 DM billion	1997 Number (million)	1997 Change in %	1997 DM billion	1997 Change in %
Retail payments						
MAOBE transactions [1]						
Collection items	20.2	224	16.8	– 16.7	215	– 4.1
Credit transfers	57.7	16	10.9	– 81.2	4	– 78.3
Total	77.9	241	27.7	– 64.5	219	– 9.1
DTA transactions [2]						
Collection items	1,473.3	3,174	1,469.9	– 0.2	3,045	– 4.1
of which: Conversions	(91.8)	(2,127)	(78.0)	(– 15.1)	(1,987)	(– 6.6)
Credit transfers	724.8	1,214	747.3	3.1	1,277	5.2
of which: Conversions	(9.7)	(18)	(5.0)	(– 48.1)	(21)	(16.4)
Total	2,198.1	4,388	2,217.2	0.9	4,322	– 1.5
Grand total	2,276.1	4,628	2,244.9	– 1.4	4,541	– 1.9
Large-value payments						
Gross settlement procedures						
EIL-ZV	7.2	28,743	10.6	47.7	33,395	16.2
Local credit transfers	3.1	3,870	0.6	– 79.7	1,977	– 48.9
Other [3]	1.2	1,350	1.0	– 13.1	1,431	6.0
Total	11.5	33,964	12.3	7.0	36,804	8.4
Net settlement procedures (Daily local clearing system)						
Collection items [4] (conventional)	0.5	621	0.2	– 59.0	275	– 55.7
Local credit transfers [4] (conventional)	0.5	3,309	0.1	– 80.3	803	– 75.7
EAF/EAF 2	18.8	153,410	22.4	19.2	181,669	18.4
Total	19.7	157,339	22.7	14.8	182,746	16.1
Grand total	31.2	191,303	35.0	11.9	219,550	14.8
Cashless payments	2,307.3	195,931	2,279.9	– 1.2	224,091	14.4

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

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available collateral. An exception will be made in the case of Federal and Länder cash offices; here, cover need not be available until the first business day following presentation. It is planned to make it possible for retail payments to be settled by data telecommunication from the first quarter of 1999.

Large-value payments

In contrast to the trend in retail payments, greater use was again made of the Bank's systems for handling large-value payments during the year under review.

Telegraphic credit transfers and urgent credit transfers are executed in the gross system *Eiliger Zahlungsverkehr (EIL-ZV)* (express electronic credit transfer sys-

Same-day execution widely achieved in EIL-ZV

tem). In the year under review, however, same-day execution could be guaranteed only in the case of real-time telegraphic credit transfers; even so, same-day transmission of urgent credit transfers – not supported by contingency regulations – was achieved for more than 99 % of all orders. Same-day execution of urgent credit transfers has also been guaranteed since January 1998 provided these transfers can be received via data telecommunication and sent on to the recipient bank via data telecommunication and are covered by 2.30 p.m.

Urgent credit transfers

Urgent credit transfers are handled by the *EIL* system which came into operation in July 1996. The input of urgent credit transfers increased sharply in the year under review because the increased efficiency of the *EIL* system made it possible to abolish the amount limit of DM 50,000 in September 1996. A total of 5.8 million urgent credit transfers were made (+ 97 %).

Telegraphic credit transfers

In contrast to urgent credit transfers, telegraphic credit transfers are still executed via the decentralised computer systems installed at the Bank's branch offices and interlinked via data telecommunication. It is planned to transfer the execution of telegraphic credit transfers to the *EIL* system, too, from the middle of 1998. Express payments will then be divided into two priority categories; telegraphic credit transfers, as they are now known, will be called P1 payments, and the present urgent credit transfers P2 payments. In 1997 4.8 million telegraphic credit transfers (+13 %) were transferred between the branch offices of the Bank.

Submissions mostly in paperless form

The banking industry again made greater use of the possibilities afforded by paperless submission in the *EIL-ZV*, too. Thus, under the electronic counter procedure *(ELS),* more than three-quarters of all orders were placed by means of data telecommunication or diskette.

EAF 2

Credit transfers are likewise being executed in paperless form in the fully electronic system *EAF 2* in use in the Frankfurt am Main banking centre. This procedure also saves liquidity and reduces risk. In the year under review 22.4 million credit transfers totalling DM 181,669 billion (an average of DM 730 billion a day) were exchanged between the participating credit institutions. In terms of volume *EAF 2* handled more than 81 % of the Bank's total turnover in cashless payments. These figures reflect the significance which the banking centre in Frankfurt am Main has as the major money market in Germany and as the most important interface with other countries. Since 1998 access to *EAF 2* has also been granted to banks which do not have their headquarters or an office in

Frankfurt am Main; this applies both to German banks and – via remote access – to foreign banks. Consequently, German and foreign banks are being offered an attractive opportunity – particularly with the euro area in mind – to execute their large-value payments without the need for banks to have staff and technical resources in Frankfurt am Main.

3. Notable developments in domestic 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 central banks of the European Union (EU) and the European Monetary Institute (EMI) successfully continued their preparatory work for the introduction of TARGET, the Trans-European Automated Real-Time Gross Settlement Express Transfer system. With the beginning of stage three of economic and monetary union (EMU), TARGET is to provide support for the reliable implementation of the single monetary policy and make a speedy and efficient execution of cross-border large-value payments possible.

Interlinking network of national systems

TARGET is being set up as a decentralised system by interlinking national real-time gross settlement (RTGS) systems which already exist or which are currently being established; the *EIL-ZV* (telegraphic credit transfers) is the Bundesbank's real-time gross settlement system. The national systems will be linked internationally by what is known as the Interlinking System. Swift (Society for Worldwide Interbank Financial Telecommunication) will be used as the communications network for the Interlinking System – initially for the test phase and the beginning of stage three.

Progress of the project so far

The project has been in the development phase since July 1996. The technical prerequisites for testing the system were created in May 1997 with the provision by the EMI of an interlinking test centre. It was therefore possible to start the first tests in the second half of the year. Following the successful conclusion of the bilateral tests, multilateral tests between the central banks started at the beginning of 1998; these will be followed by a simulation phase commencing in July 1998, which will extend to selected customers of the central banks and cover all systems.

Agreement on …

During the year under review the following important agreements were reached between the EU central banks and the EMI regarding the operational and organisational arrangements for TARGET:

… role of the European Central Bank

The European Central Bank (ECB) will take over certain central functions for the TARGET system. These include the general supervision and testing of the system and the daily reconciliation, for which a special DP procedure is being developed at the EMI ("end-of-day application").

… ECB payment system

Furthermore, it is expected that the ECB will carry accounts for a restricted group of customers including international organisations and central banks in third countries and, to that extent, will execute customer payments. For this purpose the ECB will be connected direct to the Interlinking System through a payment mechanism of its own.

… business hours

In the interest of the credit institutions and the financial markets TARGET will have a standard operating time from 7 a.m. until 6 p.m. The reference time will be local time in Frankfurt am Main, the headquarters of the ECB. It is necessary to have a standard closing time for the national RTGS systems to prevent the emergence of national money market segments with different interest rate levels. If only for competitive reasons, opening times should also be uniform. However, the central banks may open their respective RTGS system before 7 a.m. for reasons that are precisely defined in advance (for example, to settle the payment leg of securities transactions). The extension in future of the operating time of the Bundesbank's electronic counter from the present seven hours (8 a.m. to 3 p.m.) to 11 hours means that the credit institutions in the business areas concerned will have to be prepared in due course for staggered working hours or possibly shift work. The extension may also have an impact on the banks' money market operations and on their internal processing flows.

… cut-off time for customer payments

The cut-off time for customer payments will be 5 p.m., one hour before TARGET closes down. After that time only interbank payments may be submitted.

… closing TARGET on two public holidays only

To promote the smooth functioning of the financial markets and to ensure a level playing field for all market participants TARGET is to have as many common days of operation as possible. The EMI Council has therefore agreed that TARGET will be closed only on two public holidays (December 25 and January 1), which are common to all EU countries. The majority of the representatives of the European banking associations and of the central securities depositories have likewise advocated this in the past. TARGET will be open on all other days, with the exception of Saturdays and Sundays. However, the national central banks may close their respective RTGS system on additional national public holidays if this is necessary for legal reasons or is requested by the banking industry. The Interlinking System will always be open if at least two RTGS systems are in operation.

Problems of legal restrictions on working hours

The Bundesbank is prepared, at the request of the banking industry, to offer its services in large-value payment transactions also on German public holidays when no close-down of TARGET is planned. Discussions on this are continuing with the banking industry. The legal questions associated with this have now been clarified. As present legislation on working hours prohibits the employment of staff to execute large-value payments on public holidays, the act governing the introduction of the euro, which the Bundestag has now passed, provides for a relevant amendment to this legislation.

Pricing policy

The EU central banks and the EMI have agreed to charge a standard price that will cover costs for cross-border TARGET payments. The price will not be fixed by the ECB Governing Council until the second half of 1998. Having a uniform cross-border price has the advantage that price-induced shifts of payment flows will be avoided. The prices for domestic payments within the national RTGS systems will continue to be set at national level and may vary considerably, at least at the beginning. However, the EU central banks will take care to ensure that the prices for cross-border TARGET payments and the prices for national payments do not diverge too greatly so that the integration of the single money market is not endangered. Consequently, the Bundesbank will also adjust its prices and will introduce a new system of charges in large-value payment transactions on December 1, 1998.

Participation of EU central banks outside the euro area

The EU central banks outside the euro area will also be able to use TARGET. One controversial question still under discussion is whether the European System of Central Banks (ESCB) should grant the EU central banks outside the euro area intraday credit to support their payment transactions. The Bank published a detailed statement on this in its 1996 Annual Report.

Another matter still in dispute is whether or not EU central banks outside the euro area are to be allowed to grant intraday credits in euros to their respective credit institutions. Some EU central banks, notably those in countries which have already declared that they will not be members of the euro area from the

Problem of granting intraday credits in euros by EU central banks outside the euro area

outset, regard the granting of intraday credits in euros by EU central banks outside the euro area to their credit institutions as necessary if all banks participating in TARGET are to execute payments smoothly. They fear that otherwise shortages of liquidity could arise in countries outside the euro area. Like other EU central banks, the Bundesbank, by contrast, is of the opinion that the granting of intraday credits in euros in countries outside the euro area could lead to undesirable disturbances in the money market. The money market rate could become more volatile. Another point is that the level of liquidity in euros could be raised by the granting of such intraday credit by an EU central bank outside the euro area. What is more, in the event of a currency substitution there could be a shift in the equilibrium interest rate as well as a deterioration in the information content and the controllability of the monetary aggregates. Moreover, distortions in competition are likely. The EU credit institutions outside the euro area would not be subject to the same – possibly stricter – monetary policy and credit policy rules although they would have access to money creation in euros through their central bank.

Settlement payments for the EBA settlement system

Another subject with which the EU central banks and the EMI were greatly involved during the year under review is the settlement payments for the net settlement procedure of the Euro Banking Association (EBA) through which private ECUs are currently settled and which is to be operated as a euro settlement system in stage three of EMU. To limit systemic risks the settlement payments of this future euro net settlement procedure are to be made through central bank accounts in the form of TARGET payments. For this purpose a settlement payments account is to be opened for the EBA at the ECB so that the payments from and to the participating banks can be settled through TARGET. As an additional facility it is planned to enable the national central banks to undertake a provisional clearing and settlement for their own national EBA banks by means of an extra account for the EBA.

(b) Electronic money

Legal amendment

In line with a recommendation of the Council of the European Monetary Institute of 1994, the legal definition of banking operations in Germany was extended by means of the Sixth Act Amending the Banking Act, which came into effect on January 1, 1998, to include, firstly, the issue of prepaid cards for payment purposes where the issuer and the payee (supplier of the goods or services) are not identical (prepaid card business) and, secondly, the creation and management of payment units in computer networks (network money business). This means that anyone wishing to carry out these forms of business in Germany needs a banking licence from the Federal Banking Supervisory Office.

Development in Germany…

The German banking industry's prepaid card system *GeldKarte,* which was tested in Ravensburg, was made available throughout Germany during the year under review. Pilot projects were also started with network money. While, as a rule, prepaid card money is used in face-to-face payments for low-priced goods and services and so directly displaces cash, network money is intended to be used mainly for the settlement of remote payments of small to medium-sized amounts (mostly through the Internet) and is therefore primarily a substitute for giro money. It is becoming apparent that the borderline between the two variants is not very rigid.

…so far moderate

Electronic money (e-money) is still not used very widely in Germany. This is true even of the *GeldKarte* system, which has the greatest potential given the fact that there are about 60 million *ec* and bank customer cards which are either already equipped or could be equipped to function as a prepaid card. Among the reasons given for this apparent lack of interest are widespread ignorance on the part of customers of the potential applications of the cards, relatively high costs and charges for the retail trade and the failure to take advantage of possible additional uses such as customer loyalty programmes. A further disadvantage often cited is that, owing to a lack of international standardisation and of the ability to operate in more than one currency, cross-border use of the cards is ruled out. Especially in view of the three-year transitional period following the start of stage three of EMU when the euro will be available only in the form of giro money, it is likely that cards will also be used increasingly to make payments in euros.

International discussion

Whether or not it is essential to restrict the issue of e-money to banks is an international topic of discussion, and in some cases a controversial one. Like most other central banks in the EU, the Bundesbank is of the opinion that it is not sufficient for non-banks – in the event of their being allowed to issue e-money – to be monitored and to be subject to the same prudential guidelines as banks. There must also be a guarantee that such institutions report to the monetary statistics of the central bank and that they are subject in the same way as banks are to the central bank's monetary policy management instruments and are possibly required to provide cover for the equivalent amounts of e-money. Only by meeting these conditions can the effectiveness of monetary policy be ensured given the possibility that cash might be largely displaced by e-money over the longer term.

(c) Reduction of foreign exchange settlement risks

Activities of the G-10

In 1996 and 1997 the central banks of the Group of Ten countries (G-10) conducted surveys of individual banks on the measures they had either taken or planned to take for managing their foreign exchange settlement risks. Furthermore, the G-10 central banks are cooperating with the "Group of 20", a group of large banks with a leading role in foreign exchange business to promote settlement systems for multi-currency payments designed to reduce risks.

This group is developing a settlement system for payments arising from foreign exchange transactions which ensures delivery against payment. This will rule out any one-sided payments in cross-currency deals. In 1997 the group founded CLS Services Ltd[1] with headquarters in London to continue the preparatory work on the system. To operate the new multi-currency settlement system the G-20 plan to set up a CLS Bank in New York. The bank is expected to commence operations at the end of 1999. CLS Services Ltd is to merge with the multilateral multi-currency clearing houses ECHO (London) and Multinet (New York), which offer net settlements.

Report on measures to reduce settlement exposure

During 1998 the G-10 central banks will publish their findings, in a report to be issued by the Bank for International Settlements, on the efforts of the private banking industry to reduce settlement exposure arising from foreign exchange transactions. That report will include an assessment as to whether or not the efforts of the private banking sector to reduce settlement exposure may be regarded as adequate.

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 two-thirds

1 In the CLS system (Continuous Linked Settlement System) foreign exchange transactions are to be settled on a continuous basis after cover has been obtained in the target currency.

compared with 1996. The key factor in this was another sharp increase in commercial business. Sales and purchases were as follows:

	1997 DM billion	1996 DM billion
Sales	34.1	22.2
Purchases	61.2	33.0
Turnover	95.3	55.2

Other foreign exchange deals

The volume of cross deals (foreign currency against another foreign currency) was unchanged at DM 3.0 billion. In addition, US dollar inter-centre switch transactions totalling US$ 82 million were concluded (against US$ 85 million in 1996).

Foreign bill of exchange and cheque deals

In the context of refinancing operations the Bank bought foreign bills of exchange worth DM 38 billion in 1997. It sold 29,292 foreign cheques payable to order amounting to DM 133 million (compared with 29,872 cheques totalling DM 101 million in the previous year). Another 38,294 cheques, to the value of DM 64 million, were presented in 1997 under the simplified collection procedure for foreign cheques; in 1996, 39,750 cheques worth DM 61 million had been presented in this way. For the rest, the Bank accepted 6,750 items bought on a commission basis (mainly bills and cheques) for realisation in foreign commission business; a year earlier 11,258 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 1997, too, the Bank granted credit institutions basic refinancing by supplying central bank money through the discount credit facility.[1] At December 31, 1997 the volume of fixed rediscount quotas amounted to DM 66.0 billion (in 1996: DM 65.9 billion). As usual, the quotas were recalculated on November 3, 1997 to take account of the increase in the liable capital which had occurred in the

1 The monetary policy regulations currently in force are being published by the Bank in a brochure that is appearing simultaneously with the 1997 Annual Report: Deutsche Bundesbank, Monetary policy regulations, Banking regulations 3, May 1998. This publication is available to interested parties on the Internet or, upon written request, from the Press and Public Relations Division.

meantime and of the changes in the business structure and bill operations of the individual credit institutions.

Purchases of domestic bills of exchange

The utilisation of the rediscount quotas ran at a high level throughout 1997. Overall, 1.1 million domestic bills totalling DM 276 billion were purchased under the rediscount quotas and (to a limited extent) on the basis of existing rediscount commitments under the special rediscount facility (ceiling B granted to the *Ausfuhrkredit-Gesellschaft mbH*) which had been set up to finance exports and which had been abolished at midnight on May 31, 1996 (in 1996: 1.2 million of such domestic bills had been purchased amounting to DM 278 billion). In the absence of payment, 5,616 bills totalling DM 142 million were returned and charged to the parties presenting them (in 1996: 6,883 bills amounting to DM 237 million).

Purchases of foreign bills of exchange

Purchases of foreign bills of exchange, which are counted towards the rediscount quotas, numbered 68,806 in 1997, and totalled DM 38 billion (in 1996: 74,821 bills totalling DM 44 billion). As in the previous year, the share of 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, 53 such transactions were concluded as fixed-rate tenders. The standard maturity of the transactions was two weeks. The volume of securities repurchase agreements outstanding at the end of 1997 was DM 170.2 billion.

Operational safe custody accounts

All debt securities eligible as collateral for lombard loans that are officially listed or traded in the Regulated Market may be purchased. (Treasury discount paper is included here even if unlisted.) At the end of 1997, securities amounting to DM 558 billion (in 1996: DM 485 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 2 billion were pledged in such safe custody accounts, exclusively for lombard purposes.

Fine-tuning operations

The Bank made use of fine-tuning operations only once during 1997. At the end of January, it provided short-term liquidity in the form of a quick (fixed-rate) tender on account of the fact that required reserves were unexpectedly high. This securities repurchase agreement was effected within one hour and, for that reason, was restricted to a small number of banks operating in the money market. The amount involved was DM 3.2 billion with a maturity of five days.

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 0.4 billion in 1996 to DM 0.3 billion in 1997. At DM 14.0 billion, the highest recourse to lombard loans was recorded on June 30, 1997.

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

Pursuant to section 20 (2) of the Bundesbank Act, in accordance with which the Federal Government, Federal special funds and Länder Governments should issue bonds and Treasury bills primarily through the Bank, the Bank acts as the fiscal agent of the public authorities. Besides issuing securities and price management, this includes advisory and coordinating functions. The Bank is therefore represented in the Committee for Public Sector Credit Issues and in the Central Capital Market Committee as those bodies in which the bond issuing requirements of the central, regional and local authorities are coordinated and recommendations are made by the banks on the planning of issues by the public sector. The Bank also takes an active part in a number of bodies which deal with capital and stock market issues in a broader sense.

Issuers

Since the Federal special funds (Redemption Fund for Inherited Liabilities, "German Unity" Fund, Federal Railways Fund, ERP Special Fund and the Equalisation Fund for Safeguarding the Use of Coal) again raised funds only through loans against borrowers' notes, the Bank was involved solely in the issuing of Federal securities in 1997. From 1998 the special funds can refinance their impending redemptions under the auspices of the Federal Government; the Federal Government, as the sole issuer, will ensure joint borrowing. Appropriate authorisation has been included in the 1998 Budget Act.

The Indemnification Fund continued to allocate bonds under the Indemnification and Compensation Act on a larger scale; by the end of the year, DM 59.1 million of such bonds were outstanding.

Issue of bonds

In 1997 the Bank participated in the launching of three Federal bonds with a total volume of DM 82.0 billion (in 1996: DM 51 billion). By reopening the issues by auction and raising the amount set aside for market management, the volume of two bonds issued through the Federal Bond Consortium was increased to DM 30.0 billion in each case, and that of the third to DM 22.0 billion. The tendency to reduce the number of securities and increase the volume of bonds outstanding thus continued.

Stripping

With a view to improving terms and conditions and to enhancing the German financial market's competitiveness, the Federal Government has authorised the separation of principal and interest payments (stripping) of newly issued ten-year and 30-year bonds with coupon dates January 4 and July 4 since July 1997 and has also made this possible retrospectively for the 30-year bond issued at the beginning 1994 and for the two bonds launched in the first half of 1997. While introducing stripping, the Federal Government used the opportunity to reopen the 30-year market segment with a new bond in July. At the end of the year, the volume of strippable bonds came to DM 102.0 billion, around DM 7.7 billion (or 7.6 %) of which was kept in strippable form. In the case of the 30-year bond of July (increased in October) alone the share came to 21.7 %, which indicates significantly greater interest for long-term principal and coupon strips.

Issuing procedures

As before, the bonds were 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 Federal Bond Consortium underwrote bonds totalling DM 13.0 billion. A further DM 38.4 billion was allotted to syndicate banks under the auction procedure. DM 30.6 billion was held back for gradual sale on the stock exchanges for the purpose of market management.

Bund Issues Auction Group

The Federal Bond Consortium to which 84 credit institutions (including 40 foreign-owned banks) latterly belonged was abolished at the end of the year. This signified the ending of a tradition of issuing bonds by syndicate in Germany which had been in existence for over 130 years. During the past few years the consortium had become less and less important than the auction procedure which takes place under competitive conditions. It was therefore an obvious step to dispense entirely with the syndicate procedure and to rely entirely on competitive market forces.

Bonds issued by the Federal Government in 1997

Table 17

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 113 502)	15.0	5.0	6.9	3.1	6.00	10/0	101.05/ 100.41	5.86/ 5.94	Jan. 7/ Jan. 8
1st increase	12.0	–	9.8	2.2	6.00	9/11	–/ 101.36	–/ 5.81	Jan. 28
2nd increase	1.0	–	–	1.0	6.00	9/11	–	–	Feb. 17
3rd increase	2.0	–	–	2.0	6.00	9/10	–	–	Mar. 5
Total volume	30.0								
Federal Government (WKN 113 503)	15.0	5.0	5.5	4.5	6.00	10/2	101.45/ 100.91	5.80/ 5.87	Apr. 22/ Apr. 23
1st increase	2.0	–	–	2.0	6.00	10/1	–	–	June 10
2nd increase	2.0	–	–	2.0	6.00	9/11	–	–	July 29
3rd increase	2.0	–	–	2.0	6.00	9/10	–	–	Sep. 5
4th increase	1.0	–	–	1.0	6.00	9/8	–	–	Oct. 24
5th increase	8.0	–	6.1	1.9	6.00	9/7	–/ 103.71	–/ 5.48	Nov. 26
Total volume	30.0								
Federal Government (WKN 113 504)	10.0	3.0	4.9	2.1	6.50	30/0	99.75/ 99.86	6.52/ 6.51	July 1/ July 2
1st increase	2.0	–	–	2.0	6.50	29/11	–	–	July 29
2nd increase	2.0	–	–	2.0	6.50	29/10	–	–	Sep. 5
3rd increase	8.0	–	5.2	2.8	6.50	29/8	103.89	6.20	Oct. 22
Total volume	22.0								

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Since January 1998, Federal bonds and five-year special Federal bonds (after the sale of a series in the open market has been closed), Federal Treasury notes and Treasury discount paper have been issued uniformly by tender through a newly formed "Bund Issues Auction Group". Resident credit institutions and German branches of foreign institutions may become members of the auction group provided they are in a position to submit successful bids for an average of at least 0.05 % of the total issues amounts allocated. A ranking list of the bidders by size of their shares in the issue volume allocated (without quoting percentages) will be published annually. In other cases, the placing on market terms of amounts set aside for the purpose of money market management through the stock exchange will continue.

Five-year special Federal bonds

In 1997, 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. In 1997 five series of five-year special Federal bonds were offered for sale. Of the total issue volume amounting to DM 59.7 billion (1996: DM 45.2 billion), sales on market terms accounted for DM 10.7 billion and allocations by auction for DM 32.2 billion. Of the DM 16.8 billion earmarked for market management operations, DM 9.0 billion was for subsequent increases of the amounts set aside for the purpose of market management in series 120, 121 and 123.

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 14.9 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, played a much smaller part in budget financing in 1997 than in 1996 (DM 25.3 billion). 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 no more than DM 3.9 billion (in 1996: DM 5.8 billion).

Treasury notes

Two-year Federal Treasury notes *(Schätze),* which have been offered for sale by auction every three months (March, June, September, December) since September 1996 were issued to a total of DM 42.0 billion in 1997. DM 32.1 billion of this was allocated by auction, and DM 9.9 billion was set aside for market management operations.

Issues of five-year special Federal bonds in 1997

Table 18

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 % series 120 of 1996 (2001)	–	–	–	–	–	–	–	–	–
1st increase	3,000	–	–	3,000	–	–	–	–	Jan. 20
2nd increase	1,000	–	–	1,000	–	–	–	–	Feb. 12
Total volume	[1] 4,000								
4.75 % series 121 of 1996 (2001)	[2] 11,173	1,661	8,515	997	100.75 – 101.70	4.34 – 4.58	101.52	4.38	Jan. 2/ Feb. 28
1st increase	2,000	–	–	2,000	–	–	–	–	Mar. 12
2nd increase	2,000	–	–	2,000	–	–	–	–	Apr. 9
Total volume	15,173								
4.50 % series 122 of 1997 (2002)	13,000	2,752	8,519	1,729	99.10 – 100.60	4.36 – 4.71	99.49	4.61	Feb. 24/ May 26
4.50 % series 123 of 1997 (2002)	12,000	2,139	6,598	3,263	99.30 – 100.65	4.34 – 4.66	99.23	4.68	May 20/ Aug. 25
Increase	1,000	–	–	1,000	–	–	–	–	Oct. 30
Total volume	13,000								
4.50 % series 124 of 1997 (2002)	13,000	2,629	8,560	1,811	97.80 – 99.60	4.59 – 5.02	97.50	5.09	Aug. 19/ Nov. 17
5 % series 125 of 1997 (2002)	[3] 1,490	1,490	[3] ...	[3] ...	100.00 – 101.70	4.60 – 5.00	[3] ...	[3] ...	[3] Nov. 11/ ...

1 Total amount issued: DM 13,000 million. — **2** Sales of this series began on November 26, 1996; total amount sold on market terms: DM 2,488 million, total amount issued DM 16,000 million. — **3** Sales were not completed at the end of the year.

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Issues of Federal savings bonds in 1997

Table 19

Issue	Sales period 1997	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
1996 / 13 + 14	1 Jan. 2 – Jan. 9	984	876	108	3.00 – 7.25	5.13	5.52
1997 / 1 + 2	Jan. 9 – Jan. 21	1,343	997	346	3.00 – 7.25	5.13	5.52
1997 / 3 + 4	Jan. 21 – May 5	5,918	5,098	820	3.00 – 7.00	4.85	5.24
1997 / 5 + 6	May 5 – July 16	3,009	2,457	552	3.00 – 7.00	4.85	5.24
1997 / 7 + 8	July 16 – Oct. 21	1,499	1,243	256	2.75 – 7.00	4.80	5.20
1997 / 9 + 10	2 Oct. 21 – Dec. 31	2,185	1,685	500	3.25 – 7.00	5.18	5.53

1 Sales began on October 1, 1996; total sales issue 1996/13: DM 4,356 million, issue 1996/14: DM 561 million. — **2** Sales were not completed at the end of the year.

Deutsche Bundesbank

Issues of Federal Treasury notes in 1997

Table 20

Issue	Amount issued (DM million) Total	Amount allotted by auction	Market management amount	Terms: Nominal interest rate (% p.a.)	Maturity (years/ months)	Average allotment rate (%)	Average yield (% p.a.)	Date of issue
Federal Government (WKN 113 677)	12,000	8,585	3,415	3.75	2/0	99.84	3.83	Mar. 18
Federal Government (WKN 113 678)	10,000	7,777	2,223	3.50	2/0	99.84	3.58	June 18
Federal Government (WKN 113 679)	10,000	8,230	1,770	4.00	2/0	100.12	3.93	Sep. 24
Federal Government (WKN 113 680)	10,000	7,470	2,530	4.25	2/0	100.03	4.23	Dec. 17

Deutsche Bundesbank

Issues of Federal Treasury discount paper (“Bubills”) in 1997

Table 21

Issue	Amount issued (DM million)	Date of issue	Terms: Maturity (months)	Average allotment rate (%)	Average yield (% p.a.)
January 1997 (WKN 111 421)	11,207	Jan. 15	6	98.533	2.94
April 1997 (WKN 111 422)	8,764	Apr. 16	6	98.457	3.10
July 1997 (WKN 111 423)	10,306	July 16	6	98.506	3.00
October 1997 (WKN 111 424)	9,672	Oct. 15	6	98.251	3.52

Memorandum item: DM 19,978 million outstanding at December 31.

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"Bubills"

The Bank has been offering Federal securities running for less than one year by auction since July 1996. The issue volume (gross value) of such discount paper, which is likewise issued every quarter (January, April, July, October) in the form of Federal discount paper *(Bubills)* with a maturity of six months, was DM 39.9 billion (in 1996: two issues totalling DM 19.5 billion). In 1997, too, the maximum amount outstanding was limited to DM 20.0 billion.

Issue calendar

In 1997 the Federal Government's issue calendar, which is regularly published for the following quarter, again attracted a great deal of attention. It contains the Federal securities to be issued every three months and Federal bonds issued at irregular intervals. All issues were conducted as planned.

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 placed DM 58.0 billion on the stock exchanges on behalf of and for the account of the Federal Government in 1997 (in 1996: DM 47.3 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 securities issued by the Kreditanstalt für Wiederaufbau and the Deutsche Ausgleichsbank. 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.

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

1. International harmonisation of banking supervision

In 1997, too, the Deutsche Bundesbank was involved in efforts to improve banking supervision worldwide through international cooperation.

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

International cooperation

As in previous years, the Basle Committee on Banking Supervision carried out its mandate in numerous contacts with banking supervisory authorities all over the world. In order to take due account of the ever-growing regional and sectoral integration, it again devoted particular attention to strengthening prudential oversight also in non-G-10 countries and to cooperating with insurance and securities regulators.

Core Principles for Effective Banking Supervision ("Core principles")

In September 1997 the Committee published the "Core Principles" with the agreement of the central bank governors of the Group of Ten countries (G-10). This list of principles, the observance of which is essential for effective banking supervision, was drawn up in collaboration with banking supervisors from 15 non-G-10 countries. It contains rules on the basic conditions for effective banking supervision, on the granting of authorisations and the structure of credit institutions (e.g. definition of types of business, licensing criteria), on the methods of ongoing banking supervision (for example, capital adequacy, management of credit and market risks, accounting standards), on the information requirements and powers of supervisory authorities and on the surveillance of cross-border banking business. These Principles are also aimed at extending internationally recognised supervisory standards to emerging markets. All countries and their respective supervisory bodies are requested to adopt the principles and to consider to what extent their prudential structures need to be brought into line with these Principles. The International Monetary Fund (IMF) and the World Bank will endeavour to ensure the rapid implementation of and subsequent compliance with the Core Principles as part of their responsibilities.

Millennium "time bomb"

Increasing attention is being devoted by banking supervisors both nationally and internationally to the problem of the millennium "time bomb". The financial sector is particularly affected by the difficulties many existing computer systems and programs have in correctly processing data which contain dates later than December 31, 1999. This is because trading, payment and settlement systems and many other business areas of credit institutions are highly dependent on electronic data processing. Faulty data processing or even computer system failures in the wake of the changeover to the new millennium could generally lead to considerable disruptions in output and financial losses in enterprises in all branches of industry. Owing to the close integration of the business sector, computer system problems of individual enterprises would spill over to other firms and could have serious consequences for the economy as a whole. Credit institutions might face substantial credit risk through lending to corporate clients.

A recent survey conducted by the Basle Committee on Banking Supervision on the banking industry's state of preparation for the year 2000 shows that many managers have recognised the millennium changeover problem but still appear to underestimate the amount of money, staff and time needed to overcome it. The survey was preceded by several banking supervisory measures at both international and national level aimed at raising awareness of the challenges involved in making computer systems millennium-compatible. In September 1997, for example, the Basle Committee published the report "The Year 2000 – A Challenge for Financial Institutions and Banking Supervisors". The report proposed a strategy for drawing up, reviewing and implementing system solutions. In November 1997 the German banking supervisory authorities appealed in a circular to the managers of all credit institutions not to underestimate the year 2000 problem and to press ahead with conversion work as a top-priority task. In addition, the Federal Banking Supervisory Office urged auditors to comment in their audit reports of credit institutions on each bank's degree of readiness for the changeover of its computers to the new millennium. Further possibilities which banking supervisors have to raise awareness and to accelerate the banking industry's preparations, in line with the example set by other countries, are under discussion. Moreover, increasing coordination of the activities of banking, securities and insurance regulators in respect of the millennium changeover problem is occurring at the international level.

Capital requirements for market risk

Within the framework of the Basle Capital Accord the recording of specific market risk relating to individual issuers using internal risk management models was made easier. Thereafter the 50 % floor ceased to apply; that had required institutions using internal models to back specific market risk with a level of own funds at least equal to half of the capital charge stipulated using the standard procedure. However, this is true only of institutions that meet certain qualitative and quantitative requirements. Moreover, a scaling factor of four has to be applied as a matter of policy to the calculated value-at-risk for specific exposure, whereas the value-at-risk stemming from general risk only has to be multiplied by a factor of three.

Transparency of derivatives activities

The Basle Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) once again issued a joint report on the progress made by international banks in annual report disclosures of their trading business. Although there has been a further improvement in the information provided by many institutions, the level of disclosure of some institutions – including German banks – still fails to come up to expectations. The Basle Committee will continue to monitor this trend and may extend its investigation to other important areas of banking business. One of the questions being examined is how accounting disclosure can play a part in stabilising the financial markets and complement the work of banking supervisors.

(b) Harmonisation and cooperation in the European Union

Amended Directives

At the end of the year under review the preparations for three Directives amending the EC Capital Adequacy Directive and the EC Solvency Ratio Directive had largely been completed, so that the Directives can be adopted in the course of 1998.

Amendment of the Capital Adequacy Directive: authorisation of internal risk management models

By means of an amendment of the EC Capital Adequacy Directive ("CAD II") the rules relating to market risk provisions at the EU level are being largely brought into line with those of the Basle Capital Accord. The amended Directive will permit institutions to use internal risk management models to determine the prudential capital requirements for market risk. The new version of the EC Capital Adequacy Directive, in contrast to the old version, will also require capital charges to cover the market risk of all commodity positions maintained by credit institutions and securities firms.

Amendment of the Solvency Ratio Directive: expanded matrix and ...

In accordance with an amendment to the EC Solvency Ratio Directive, the national authorities may in future set a lower credit risk weighting of 20 % – instead of 100 % at present – for churches and religious communities if they levy taxes in their own legal right. Furthermore, the method of calculating the counterparty risk arising from over-the-counter (OTC) derivatives has been slightly changed in that contracts bearing equity and commodity price risks are to be included according to the more precise marking-to-market method. In addition, the various maturity-related weightings under this method have been differentiated further for the individual risk categories. Institutions classified as "trading book institutions" must use exclusively the marking-to-market method for all risk categories. Lower capital requirements for OTC derivatives contracts result from the fact that netting agreements are now also taken into account in determining the add-ons for possible future counterparty risk. In the same way as the counterparty risk arising from derivatives traded on recognised stock exchanges are already exempt from capital requirements, OTC derivatives contracts can also be exempted, according to the amended Directive, for a transitional period up to December 31, 2006 if a clearing house acts as the contract partner and demands margin payments.

... mortgage loans

Pursuant to a further change in the EC Solvency Ratio Directive, mortgage-backed securities can in future be given a risk weighting of 50 % instead of the present weighting of 100 % in line with the mortgage credits. This is subject to the condition that the securities are secured completely and directly by mortgages. Moreover, the previous transitional period during which the lower weighting of 50 % applies to commercial and industrial mortgages, which expired on January 1, 1996, has been extended to December 31, 2006.[1] However, the lower weighting applies only to that part of the credit amount that does not exceed 50 % of the market value (or 60 % of the loan value) of the property. Thus the possibility of a lower weighting is now open to all EU member states, whereas this was the case hitherto only for Germany, Denmark and Greece.

Codification of banking Directives

The EU Commission has submitted a revised proposal for a codified Directive relating to the taking up and pursuit of the business of credit institutions aimed at unifying existing legal instruments in the field of banking legislation. The material contents of the codified regulations are to be maintained in their entirety. The aim of the draft Directive is to streamline Community law and to make it more transparent.

Planned amendment of the UCITS Directive

A few weeks ago the EU Commission continued its efforts aimed at updating the UCITS Directive[2] with a new initiative. Thus in future the Directive is to contain both new products and rules for expanded, Europe-wide business operations of investment firms.

Accounting and disclosure of financial instruments

In the year under review the Joint Working Group of the EU Contact Committee and the Banking Advisory Committee presented the first draft of a recommendation concerning disclosure of financial instruments in the annual accounts. In particular, the draft requires institutions to specify the scale of business, credit risk and market risk of financial instruments and incorporates existing international recommendations in this field.

1 At the time the new Principle I was announced, the draft amendment of the EC Solvency Ratio Directive had envisaged a transitional period up to January 1, 2001.
2 UCITS stands for "undertakings for collective investment in transferable securities", which in EU terminology denotes investment firms and investment funds.

Cooperation between EU central banks in the EMI

Although the Maastricht Treaty stipulates that banking supervisory powers are to remain a national responsibility in stage three of EMU, the EMI's duties include the submission of comments on issues which fall within the sphere of responsibility of the national central banks and which concern the stability of financial institutions and financial markets.

2. Amendments of national banking supervision legislation

Sixth Act Amending the Banking Act

The Sixth Act Amending the Banking Act was announced on October 28, 1997. With the exception of the provisions concerning own funds and large exposures, all the changes entered into force on January 1, 1998 at the latest. The changes to the Banking Act were designed primarily to translate into German law the EC Investment Services Directive, the EC Capital Adequacy Directive and the Post-BCCI Directive. The implementation of the EC Investment Services Directive created a level playing field for credit institutions and investment firms by laying down comparable prudential standards. The EC Capital Adequacy Directive regulates the capital backing of market and large exposures risk arising from the trading book. The Post-BCCI Directive corrects the prudential shortcomings that came to light during the collapse of the Bank of Credit and Commerce International (BCCI). At the same time, steps were taken in the Sixth Act Amending the Banking Act to streamline banking supervision.

Financial services institutions now subject to prudential supervision

German prudential legislation now distinguishes between banking business and financial services business. Financial services institutions are enterprises which provide financial services on a commercial basis or on a scale which requires a commercially organised business undertaking. Financial services comprise investment broking, contract broking and portfolio management of financial instruments as well as own-account trading in financial instruments as a service for third parties. Non-EEA deposit broking, money transmission services and dealing in foreign notes and coins were also added to the list of financial services in order to improve monitoring of the "grey capital market". Brokerage services and underwriting business, which are defined as investment services in the EC Investment Services Directive, have been classified as banking business in accordance with the universal bank principle. Hence the concept of the "Financial services institution" as defined in the Banking Act is not identical with the concept of the "Investment firm" as defined in the Investment Services Directive. As a matter of policy, financial services institutions are now supervised according to the same rules as credit institutions. The amended Banking Act provided for a simplified authorisation procedure up to April 1, 1998 for enterprises legitimately conducting financial services business on January 1, 1998 without a licence from the Federal Banking Supervisory Office. Authorised financial services institutions – just like credit institutions – now possess, as a matter of course, the "European Passport", which permits them to provide cross-border services or to set up a branch in another EEA state without requiring a licence from the host country.

"Regulation governing large exposures and loans of DM 3 million or more"

The "Regulation governing large exposures and loans of DM 3 million or more" supplements sections 13 to 14 of the Banking Act in material questions (e.g. the weighting of large exposures) and in respect of the reporting requirements. The previous *ad hoc* reports on the first-time incurrence of large exposures and their increase by 20 % or more as well as the annual summary reports have been replaced by quarterly reports. In addition, the reports on large exposures have been combined with the reports pursuant to section 14 of the Banking Act. This combined report on large exposures and loans of DM 3 million or more strengthens the qualitative element of supervision and at the same time simplifies the reporting procedure. For enterprises required to report, another innovation is the possibility of requesting information about the level of indebtedness of the potential borrower if the latter agrees to the request and the envisaged loan amounts to DM 3 million or more.

Simplification of banking supervision

The Sixth Act Amending the Banking Act has also introduced a number of additional relaxations for the institutions. The consolidation rules for monitoring capital backing and large exposures risk have been streamlined and simplified. Furthermore, the stipulation limiting credit institutions' investment in illiquid assets (real estate, buildings, plant and office equipment, etc.) to the amount of the liable capital has been revoked. Only the provision restricting the participating interests of deposit-taking credit institutions in enterprises outside the financial sector has been retained. Furthermore, the requirement to report loans to managers, etc. has been dropped. Finally, the threshold from which credit institutions have to disclose a borrower's financial circumstances has been raised from DM 250,000 to DM 500,000.

EC Directives still to be incorporated in German law

The task of adapting the Banking Act to the European prudential standards has been largely concluded with the implementation of the above three EC Directives. Still to be implemented is the Directive on investor compensation schemes, which was adopted by the European Parliament in March 1997. Now that the European Court of Justice has rejected the Federal Republic of Germany's complaint against the Directive on deposit guarantee schemes, that Directive, too, will have to be incorporated in German law without delay. The preparations for this have already begun. An "Act implementing the EC Directive on deposit guarantee schemes and the EC Directive on investor compensation schemes", which is oriented to the minimum requirements of those two Directives and does not call into question the existing structures of the German deposit insurance scheme, is to be passed in the first half of this year.

Principles concerning the capital and liquidity of credit institutions

The changes and additions to Principle I were announced on October 29, 1997. These implement parts of the EC Capital Adequacy Directive, the forthcoming Directives amending that Directive and the EC Solvency Ratio Directive as well as the extension of the Basle Capital Accord to include market risk (see also section 1b). When the new Principle I comes into force on October 1, 1998, the present Principal Ia, which limits certain market risk positions by requiring them to be backed by liable capital, will be abolished.

In contrast to the present situation, the new Principle stipulates that not only counterparty risk but also market risk is to be backed by capital. Institutions ("trading book institutions") must in future have sufficient own funds to cover their trading book positions involving interest rate-related and equity price-related risks commensurate to their risk potential unless they fall below the summary ceiling for trading book business. Positions entailing foreign currency or commodity price risk (entire portfolios) are to be included by all institutions in the capital weighting. The capital charge can be calculated using either the prescribed standard procedures or internal risk management models approved by the banking supervisory authorities.

As is already the case for credit institutions, the new Principle I stipulates a reduced counterparty weighting of 20 % for claims on securities firms which have their headquarters in a "zone A" country (mainly OECD countries). This equal treatment of the institutions is justified as the EC Investment Services Directive and the EC Capital Adequacy Directive subject securities firms to a harmonised supervision. In the case of non-EU states, on the other hand, a reduced counterparty weighting is permitted only if the national prudential rules in those countries are comparable to the above-mentioned Directives.

New liquidity standard in preparation

In the year under review a preliminary draft of the new liquidity principle pertaining to residual maturities was sent to the associations of the banking industry for them to comment upon. The concept of the new liquidity principle follows the approach of the present EU trial calculations. It is based on the assumption that the liquidity of an instituion[1] depends primarily on the scale of its maturity transformations and on the maintenance of a sufficient supply of liquidity in the form of a basic stock of highly liquid assets. Assets and liabilities (including off-balance-sheet commitments[2]) are listed in a maturity grid subdivided into various time bands.[3] The extent to which the maturities match is determined by comparing the liquid assets with the maturing liabilities. Listed securities in the institutions' portfolios count as highly liquid assets. The institutions must manage their liquidity so as to ensure that the liquid funds available up to the end of the next calendar month at least cover the liquidity outflows expected during the same period. The new provisions are to be introduced between January 1, 1999 and June 30, 2000, with each individual institution being free to determine the exact time of introduction itself.

Asset-backed securities

Following extensive preparatory work by a joint working group of the Federal Banking Supervisory Office and the Bundesbank, in May 1997 the Federal Banking Supervisory Office summarised the principal prudential requirements in respect of the sale and subsequent securitisation of customer receivables in a circular which it sent to the credit institutions. This action was taken in the knowledge that no harmonisation in this field is likely within the European Union in the near future. The new regulation incorporates the provisions of those European and non-European countries in which asset-backed securities transactions are already established and, in some cases, are already being conducted on a sizeable scale. This will ensure planning and legal certainty for credit institutions in basic questions concerning the preparation of such financial transactions. It remains to be seen to what extent the banks will make use of this form of financing. The number of transactions initiated since the circular was sent, however, indicates no great alacrity so far.

3. Ongoing banking supervision operations

Continuing process of concentration in the banking industry

At the end of 1997, 3,612 credit institutions were subject to banking supervision, which was 113 institutions fewer than in 1996. The process of concentration in the German banking industry has continued. 88 mergers took place in

1 The new liquidity standard is to apply to credit institutions and to (certain) financial services institutions.
2 For the time being excluding derivative financial transactions.
3 A total of four time bands are envisaged with a total time to maturity of up to one year.

the credit cooperative sector and 12 in the savings bank sector. A total of 130 deregistrations was accompanied by only 17 new registrations. Many of the new authorisations were accounted for by branch offices of foreign banks (8).

Division of labour in exercising supervision

Responsibility for the ongoing supervision of credit institutions lies very largely with the Land Central Banks. The Bank's Central Office carries out coordinating functions. Five credit institutions which perform central tasks nationwide *(AKA Ausfuhrkredit-Gesellschaft mbH, Deutsche Ausgleichsbank, Kreditanstalt für Wiederaufbau, Landwirtschaftliche Rentenbank and Liquiditäts-Konsortialbank GmbH)* are supervised directly by the Bank's Central Office in Frankfurt am Main pursuant to section 7 (1) sentence 3 (2) of the Bundesbank Act. The table on this page lists the types and number of the reports processed in total in the year under review as well as the audits carried out.

Causes of material changes

Some of the changes from the previous year were due to the fact that overhangs from the year 1996 arose exceptionally in connection with the reforms introduced by the Fifth Act Amending the Banking Act. This applies especially to the lists pursuant to section 13 of the Banking Act and the reports pursuant to section 24 of that Act. Furthermore, more of the latter reports than usual came from the credit cooperative sector owing to changes in participating interests in some regions. Concerning the number of reports on loans of DM 3 million or

Ongoing banking supervision operations

Table 22

Number of operations conducted

Item	1994	1995	1996	1997
Individual reports pursuant to section 13 of the Banking Act	65,908	66,714	71,951	72,303
Borrowers included in the lists submitted pursuant to section 13 of the Banking Act	76,987	77,317	59,759	79,063
Reports on loans of DM 3 million or more pursuant to section 14 of the Banking Act	1,109,990	1,184,719	1,382,914	1,751,974
Reports pursuant to section 16 of the Banking Act	14,887	13,795	26,582	39,074
Reports pursuant to section 24 of the Banking Act	49,312	51,245	40,339	56,327
Monthly returns pursuant to section 25 of the Banking Act	48,914	46,900	45,913	44,770
Reports on the volume of external lending	407	302	303	293
Annual accounts of credit institutions	4,147	4,008	4,054	3,788
Auditor's reports on annual accounts	2,450	2,429	2,647	2,746
Reports on the auditing of safe custody accounts	534	412	501	602
Routine, special and deposit guarantee fund auditor's reports	647	683	812	1,119
Audits commissioned by the Federal Banking Supervisory Office pursuant to				
section 44 (1) of the Banking Act	32	34	29	25
section 44 (2) of the Banking Act	141	103	34	31
Reports under the Capital Accord of the Basle Committee on Banking Supervision	96	97	97	96

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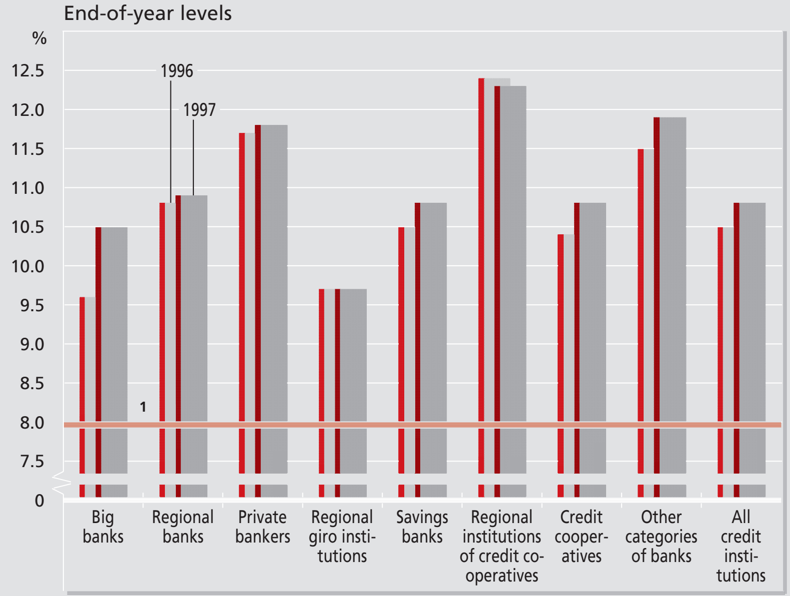
Capital ratio of credit institutions filing Principle I reports

Chart 24



1 The Principle I minimum capital ratio is 8%.

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more, it should be borne in mind that the range of institutions required to report was extended in 1996 and that a modified concept of what constitutes a loan was introduced; this led to an increase in the number of reports. The marked rise in routine and special audit reports was attributable to distinctly greater auditing activity on the part of regional auditing associations.

Principle I

Principle I requires that at least 8 % of the weighted risk assets both of an individual credit institution and of a group of credit institutions or a group of financial holding companies is backed by liable capital. The average capital ratio of all individual credit institutions at December 31, 1997 was 10.8 %, which was a slight improvement on the position at the end of 1996 (10.5 %). On a consolidated basis the capital backing of German banks stood at 10.0 % at the end of December 1997 (1996: 9.7 %). The average capital ratios of the various subsectors of the banking industry are contained in the chart on this page.

Principle Ia

Principle Ia, which will be superseded by the new Principle I, limits a credit institution's market price exposure in foreign currency positions and precious metals to 21 %, in interest rate derivatives to 14 % and in derivative positions containing other price risks to 7 % of the liable capital. At the end of December 1997

Credit register of loans of DM 3 million or more

Table 23

Third quarter	Volume of loans of DM 3 million or more		Number of loans of DM 3 million or more reported		Number of reporting		
	DM billion	Change (%)	Number	Change (%)	credit institutions	insurance enterprises	financial institutions
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	6,695	+ 139.3	405,983	+ 32.0	3,667	551	874
1997	8,056	+ 20.3	446,146	+ 9.9	3,635	584	893

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, 1996.

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the average respective exposures of all credit institutions were 5.1%, 3.0% and 1.3%, which were thus well below the prescribed ceilings.

Principles II and III

The average utilisation rate of Liquidity Principles II and III, which – as mentioned – are to be replaced by the new liquidity standard, at December 31, 1997 was 89.2% and 68.4%, respectively.

Credit register for loans of DM 3 million or more

The number of loans of DM 3 million or more to be reported quarterly under section 14 of the Banking Act increased – as the table on page 155 shows – in the twelve months from September 30, 1996 to September 30, 1997 by almost 10% to around 446,000 reports. The total volume of loans of DM 3 million or more reported went up during this period from approximately DM 6.7 trillion to DM 8.1 trillion on the reporting date, September 30, 1997. As at that reporting date, 3,635 credit institutions, 584 insurance enterprises and 893 financial institutions had submitted reports on loans of DM 3 million or more.

The Bank's central credit register ascertains the borrowers' overall debt and discloses it to the lending institutions in its notifications. The number of borrowers notified to lenders at the reporting date September 30, 1997 increased by about one-tenth compared with 1996 to roughly 295,000 borrowers. Just under two-thirds of borrowers were amalgamated into 61,400 single borrower units pursuant to section 19 (2) of the Banking Act. At the end of September 1997, 104 single borrower units had debts exceeding DM 2 billion; the total indebtedness of those borrowers amounted to just short of DM 575 billion. Some two-thirds of the total credit volume reported (DM 5.4 trillion) was taken up by domestic borrowers.

Insolvencies

In 1997 the credit register recorded a total 1,282 insolvencies of enterprises and individuals who, at the date when the insolvency became known, had loans of DM 3 million or more outstanding (1996: 1,299). The volume of loans of DM 3 million or more reported for insolvent borrowers amounted to just short of DM 11 billion, which was roughly DM 3 billion less than in 1996 (– 22 %).

International cooperation between European credit registers

Given the growing internationalisation of banking business, both banking supervisors and banks themselves increasingly need to obtain information on the borrowings of domestic debtors from banks abroad. Cooperation between the European credit registers was therefore continued in 1997. All the existing credit registers in Europe (in Austria, Belgium, France, Germany, Italy, Portugal and Spain) are now taking part in the agreed exchange of information between credit registers on the indebtedness of borrowers, which at present may be used solely for banking supervisory purposes. The efforts being undertaken to intensify this cooperation are now focusing on creating the legal and organisational prerequisites to enable the information received from foreign credit registers to be made available in future to credit institutions, too.

VI. Authorisations under monetary law

Value guarantee clauses

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

Applications for authorisations pursuant to section 3 sentence 2 of the Currency Act, and the decisions taken — Table 24

Year	Applications	Authorisations	Certificates of non-applicability of authorisation requirement 1	Applications rejected
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
1997	55,038	43,605	7,740	3,693

1 Declarations that authorisation is not necessary.

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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 eastern Germany.

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

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

There were only a few changes in UN financial sanctions in 1997.

Iraq

The embargo imposed on Iraq continues unchanged. The UN Security Council again extended the "oil-for-food" programme that has been in operation since December 1996. A leaflet giving the details was prepared jointly by the Federal Foreign Office and the Federal Ministry of Economics and is available from the Land Central Banks.

Libya

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

Sierra Leone

A new factor is the UN embargo imposed on Sierra Leone (UN Resolution No. 1132/97 of October 8, 1997), which the European Community implemented with immediate effect through EC Regulation No. 2465/97 of December 8, 1997 (Official Journal L 334, page 1). The aim of the restrictions is to restore constitutional order in Sierra Leone. They principally prohibit the sale or supply of petroleum or petroleum products in and to Sierra Leone. The EC regulation

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 the 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 3215.

goes beyond the UN resolution by prohibiting any form of assistance for these types of business, including the express prohibition of financial support. Infringements are deemed, in principle, to be criminal offences (section 34 (4) of the Foreign Trade and Payments Act read in conjunction with the announcement by the Federal Ministry of Economics of December 23, 1997, Federal Gazette 1998, page 290). Breaches of the EC regulation regarding assistance will be prosecuted only as regulatory offences, however, because the EC is going further than the UN in this particular case (section 70 (5c) of the Foreign Trade and Payments Regulation).

Serbia/ Montenegro

As is well known, the sanctions against Yugoslavia were suspended as long ago as November 1995 and were finally lifted by the UN Security Council's Termination Resolution No. 1074/96 of October 1, 1996. The UN Security Council's warning with respect to the assets of the former state of Yugoslavia will continue to apply, however, until the successor states have reached agreement (UN Resolution No. 1022/95).

The ban on meeting Serbia/Montenegro's claims arising from the embargo also still applies (EC Regulation No. 1733/94, Official Journal L 182/1).

Overview

The following provisions implementing UN financial sanctions applied at the end of 1997:

Iraq:	sections 52 and 69 e of the Foreign Trade and Payments Regulation
Libya:	section 69 n of the Foreign Trade and Payments Regulation;

and, as original EC financial sanctions:

Sierra Leone:	Article 1 b of the EC Regulation No. 2465/97.

VIII. Technical central bank cooperation by the Bank

For some years now the Bank has been providing training and advisory services for the staff of central banks in countries in transition and developing nations.

Rise in demand for technical cooperation continues

The basic reason for this is that an efficient central bank has a major role to play in the transformation and development process. The aim is to foster the process of monetary reform and the economic stability of the countries concerned by developing central banking systems which are geared to the market economy. What is known as technical central bank cooperation is concerned with the entire set of economic, bank-operational and legal instruments applied by modern central bank management. Although bilateral activities clearly predominate, the Bank joins forces with central banks of other industrial countries, also cooperates in a multilateral system of cooperation, for example, under the auspices of the International Monetary Fund and the Bank for International Settlements. The extent of the activities undertaken by the Bank in 1997 and the number of requests for cooperation it received were much the same as in 1996.

Regional and thematic shifts of emphasis

As in previous years, the regional emphasis of the Bank's technical central bank cooperation continued to shift eastwards to a certain extent. There was a further decline in the need for assistance in the central European countries in transition given the progress already achieved there in the development of the central banking system. By contrast, demand continued to be high in eastern Europe where the development of central banking in many cases has not advanced so far. Requests for cooperation from the Transcaucasian countries and from central and east Asia increased significantly. All in all, approximately 40 foreign central banks received assistance in 1997. About one-half of those participating in the Bundesbank's cooperation measures came from Russia, Ukraine, Poland and Kyrgyzstan. It is likely that requests for advice will come from South-East Asia in future in connection with the Asian monetary and financial crises. In addition, Latin American countries are showing increasing interest in support from the Bank.

Seminars and information visits arranged for more than 1,600 foreign central bankers

Staff of foreign central banks are given advice and training in a number of ways: through visiting experts or project support in the country concerned, through visits by the staff concerned to the Bundesbank's Central Office in Frankfurt am Main and to the Bank's Main Offices, the Land Central Banks, and through the staging of relevant seminars both in Germany and abroad. The Bundesbank's Training College in Hachenburg is also regularly involved in the Bank's technical central bank cooperation, especially as some of the main beneficiary countries have established their own banking schools for the training of their staff.

The various activities, which draw on the entire resources of the Bundesbank, are organised and coordinated by the Technical Central Bank Cooperation Division at the Bank's Central Office in Frankfurt and carried out by experts from the Bank as a whole. Approximately 1,600 members of staff from foreign central banks took part in a total of 179 information visits and seminars in 1997. Of these participants, 700 took part in events organised in Germany and more than 900 in events in their own respective countries. As a rule, it has proved worthwhile – not least for reasons of cost – to stage seminars for fairly large groups of participants in their own home countries and to invite comparatively small groups of visitors to Germany. This policy has also had a beneficial effect on the choice of visitor sent to the Bundesbank. It has become apparent that, in an increasing number of cases, the participants are already well trained young members of staff with promising development potential.

Standard and European seminars as well as project advice

In addition to this practice, junior executive staff from a wider group of interested central banks are being invited to Germany under the standard and European seminars scheme, as they are called. The standard seminars are held in German and deal with general fundamental aspects of modern central banking, with special emphasis being placed on the presentation of its theoretical principles. In the European seminars, which are conducted in English and to which mainly central bank staff from EU-associate countries are invited, the emphasis is on central-bank-related issues in connection with preparations for possible EU membership.

Encouraging signs of successful central bank cooperation

Generally speaking, it is the responsibility of the central banks themselves to put into practice the concepts and expertise which the Bundesbank tries to convey to them. As a result of the frequent lack of personnel resources and occasional resistance to reform, this is not always achieved immediately. Taking an overall view, the Bank's technical central bank cooperation is an integral part of a very wide range of international efforts to support market-oriented reform forces in central banking. It is therefore difficult to assess how much of the overall success of the work is attributable to the efforts of the Bank:

- A number of countries in transition have shown considerable progress in establishing a modern central banking system.

- In many cases an impressive degree of success has been achieved in stabilising the banking system and, above all, in combating inflation.

– The Bundesbank Act and the German Banking Act have been used in several countries in transition as a model for drafting their own legislation.

– Some central banks in the more advanced countries in transition have now begun to pass on their newly acquired expertise to central banks in less advanced countries through cooperation activities of their own.

IX. Organisation and staff

Further streamlining of branch office network

The continuous process of rationalisation and concentration in the banking industry has led to a further decline in the demand for an extensive network of central bank services. Consequently, the Bank undertook a further streamlining of its branch office network last year.

In 1997 the number of branch offices was reduced by four to 163. A further 16 offices are scheduled for closure in 1998; as a result, the number of branch offices will have declined from 210 in 1990 to 147 by the end of this year. Only branch offices in western Germany and in central Berlin are affected by the closures while in eastern Germany new branch offices have been opened in Bautzen and Dessau.

Staff levels again reduced

Owing to the branch closures and to further rationalisation measures within the Bundesbank and on the part of its customers, the number of staff employed in the branch office network declined by 209, or 2.4 %, during the year under review. Given a slight rise of 73 (1.5 %) and three (0.1 %) in the numbers of staff employed in the Main Offices of the Land Central Banks and in the Bank's Central Office, respectively, the total staff complement fell by 133 (approximately 1 %) to 15,881 persons. Owing to reunification, the Bank's total staff numbers had reached a record 18,237 at the beginning of 1992. This means that the number of employees is more or less back to the same level as before reunification (15,583 employees) although the Bank is now responsible in monetary terms for a substantially larger area and the scope of its work has been temporarily expanded as a result of the preparations for European economic and monetary union.

Trends in staff levels

Table 25

Beginning of 1998

Employed persons	Central Office of the Bank	Land Central Banks	Total 1	Male	Female
Civil servants	1,023	5,716	6,739	5,743	996
Other salaried staff	1,383	6,856	8,239	3,762	4,477
Wage earners	173	730	903	204	699
Total	2,579	13,302	15,881	9,709	6,172

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

1 of whom

	Beginning of 1998	Beginning of 1997
Trainee civil servants, civil servants undergoing training programmes and other trainees	555	384
Part-time employees:		
Civil servants and other salaried staff	1,344	1,230
Wage earners	594	612
The following are not included in the staff figures: persons who are seconded to work for 12 months or more for other public employers or international organisations or who are otherwise employed abroad;	79	79
members of the Bank's staff or leave without pay	697	691

Deutsche Bundesbank

Number of training places rises

The Bundesbank has been participating in the Federal Government's training initiative, and the number of trainees has risen by 74, or 48 %, to 228.

Part-time employment rises

Despite the decline in the overall number of staff, there was a further increase in the number of part-time staff in the year under review, namely a rise of 96 persons (plus 5 %) to 1,938. The ratio of part-time employees at the Bundesbank is therefore 12.2 %.

Training geared to meeting changing requirements

In 1997 training was geared in its scope and content to responding rapidly to changing requirements arising from increasing internationalisation, the globalisation of the markets and the resultant growth in the complexity of the work to be undertaken. It was with this in mind that the Central Bank Council decided on a radical reform of the training for the Bank's Higher Service. The aim of this reform is to provide junior executives with the expertise and skills needed for working within the European System of Central Banks. Training has been centred on issues relating to preparation for stage three of EMU, in particular, the set of monetary policy instruments, execution of payments and the introduction of the euro. Considerable emphasis was also placed on prudential issues in connection with the Sixth Act Amending the Banking Act. The Bank continues to attach great importance to developing and promoting the key qualifications of its members of staff as a means of keeping its human resources in step with the process of change.

Annual accounts of the Deutsche Bundesbank for 1997

I. Balance sheet of the Deutsche Bundesbank as at December 31, 1997

Assets

				DM	31.12.1996 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		10,666,597,438.82		(8,485)
	2.2 Loans under special borrowing arrangements		—		(—)
	2.3 Special drawing rights		3,206,940,796.75		(2,959)
				13,873,538,235.57	11,444
3	Claims on the European Monetary Institute				
	3.1 ECU balances	35,950,050,331.48			
	less: Difference between the ECU value and the book value of the gold and dollar reserves contributed	13,300,708,529.33			
			22,649,341,802.15		(22,047)
	3.2 Other claims		—		(—)
				22,649,341,802.15	22,047
4	Balances with foreign banks and money market investment abroad			76,641,662,629.56	72,333
5	Foreign notes and coins			31,712,396.61	31
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		750,000,000.00		(1,250)
	6.4 Other external assets		215,544,000.00		(191)
				965,544,000.00	1,441
7	Lending to domestic credit institutions				
	7.1 Securities bought in open market transactions under repurchase agreements		170,200,354,950.00		(161,615)
	7.2 Domestic bills of exchange		53,726,780,959.37		(52,286)
	7.3 Foreign bills of exchange		8,525,489,039.49		(8,968)
	7.4 Lombard loans		2,736,696,800.00		(3,282)
				235,189,321,748.86	226,151
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	German coins			1,580,118,833.86	2,057
10	Land and buildings			3,756,936,461.22	3,701
11	Furniture and equipment			279,420,924.36	217
12	Items in course of settlement			494,018,559.42	1,846
13	Other assets			2,631,054,035.85	2,701
14	Prepayments			63,631,135.70	63
				380,527,405,573.79	366,404

Liabilities

		DM	31. 12. 1996 DM million
1 Banknotes in circulation		260,686,407,780.00	260,390
2 Deposits of credit institutions			
2.1 Deposits on giro accounts	48,718,040,874.31		(51,911)
2.2 Other	20,685,403.44		(17)
		48,738,726,277.75	51,928
3 Deposits of public authorities			
3.1 Federal Government	86,631,402.97		(117)
3.2 Federal special funds	8,162,638.89		(14)
3.3 Länder Governments	156,649,560.46		(240)
3.4 Other public depositors	77,332,419.56		(112)
		328,776,021.88	483
4 Deposits of other domestic depositors		1,022,785,393.93	1,165
5 Liabilities arising from liquidity paper sold		4,541,500,000.00	2,571
6 Liabilities arising from external transactions			
6.1 Deposits of foreign depositors	12,356,680,196.35		(13,022)
6.2 Other	33,243,162.94		(11)
		12,389,923,359.29	13,033
7 Counterpart of special drawing rights allocated		2,930,559,826.80	2,702
8 Provisions			
8.1 for pensions	3,582,000,000.00		(3,360)
8.2 for other purposes	7,944,221,238.73		(7,629)
		11,526,221,238.73	10,989
9 Other liabilities		300,698,326.81	357
10 Accruals		233,856,095.72	361
11 Capital		290,000,000.00	290
12 Reserves			
12.1 Statutory reserves	13,019,500,000.00		(12,418)
12.2 Other reserves	290,000,000.00		(290)
		13,309,500,000.00	12,708
13 Unappropriated profit		24,228,451,252.88	9,427
		380,527,405,573.79	366,404

II. Profit and loss account of the Deutsche Bundesbank for 1997

Expenditure

			DM	1996 DM million
1	Interest expenditure		520,190,725.42	558
2	Staff costs			
	2.1 Wages and salaries	1,076,102,186.25		(1,070)
	2.2 Social security contributions, spending on retirement pensions and on maintenance payments	600,209,439.69		(639)
			1,676,311,625.94	1,709
3	Other operating expenditure		418,135,267.16	372
4	Banknote printing		172,166,829.12	170
5	Depreciation			
	5.1 of land and buildings	326,087,766.70		(272)
	5.2 of furniture and equipment and of other assets	113,798,463.80		(107)
			439,886,230.50	379
6	Write-downs of monetary reserves and other foreign currency positions		—	636
7	Other expenditure		55,060,146.40	59
8	Profit for the year (= unappropriated profit)		24,228,451,252.88	9,427
			27,510,202,077.42	13,310

Receipts

		DM	1996 DM million
1	Interest	13,835,463,921.74	12,933
2	Fees	120,104,743.94	112
3	Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	13,299,367,659.54	—
4	Other receipts	255,265,752.20	265
		27,510,202,077.42	13,310

Frankfurt am Main, May 6, 1998

Deutsche Bundesbank
The Directorate
Prof. Dr Dr h.c. mult. 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, May 6, 1998

C & L Deutsche Revision
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Windmöller
Certified Auditor

Langen
Certified Auditor

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Dr Nonnenmacher
Certified Auditor

Rönnberg
Certified Auditor

III. Notes on the annual accounts for 1997

1. Legal basis and classification

Legal basis

Notwithstanding its public-law status, the Deutsche Bundesbank is a business within the meaning of section 1 (2) 4 of the Commercial Code *(Handelsgesetzbuch)* because it conducts banking operations. Hence it, too, is 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)*. In accordance with those provisions, the layout of, and the notes on, the annual accounts must pay due regard to the Bank's functions. Regarding valuation, the provisions of the Commercial Code relating to incorporated enterprises are to be applied as appropriate, except for the provisions regarding the reinstatement of original values (section 280 (1) of the Commercial Code), which the Bank is free to apply or not as it sees fit.

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, with the lower of the purchase cost or market value being taken on the reporting date (section 253 (3) sentence 1 of the Commercial Code). A value may also be chosen in accordance with section 253 (3) sentence 3 of the Commercial Code. 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 value 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 asset item "Securities" as the Bank completely depleted its securities portfolio in 1996.

Audit and approval of the annual accounts

The annual accounts of the Bank for 1997 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 1997 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 1997, together with the profit distribution, on May 14, 1998.

Harmonisation of accounting on transition to stage three of European monetary union

The ESCB/ECB Statute contains regulations concerning the publication of the financial data of the European System of Central Banks (ESCB). Accordingly, the figures for the European Central Bank (ECB) and the individual national central banks must be ascertained on a harmonised basis. The European Monetary Institute (EMI), which is making the necessary preparations to this end, envisages principles which provide for a valuation of central bank assets, especially their monetary reserves, at rates that are close to market rates. Where hidden reserves are disclosed by the revaluation, they are to be allocated to a revaluation account which serves to even out fluctuations in the value of the monetary reserves.

In connection with the preparations for the introduction of the euro, the Sixth Act Amending the Bundesbank Act was passed on December 22, 1997 (Federal Law Gazette I, page 3274). That brought the German central bank statutes into line with the stipulations of Community law concerning Germany's participation in stage three of European monetary union (EMU). The rules on the Bank's capital and reserves as well as the statutory accounting requirements were modified at the same time.

In respect of the statutory accounting requirements, section 26 (2) sentences 2 and 3 of the Bundesbank Act have been amended; in future they will read as follows: "The annual accounts shall be drawn up with due regard to the functions of the Deutsche Bundesbank, especially as a component part of the ESCB, and shall be made public together with the corresponding notes on the annual accounts; the liability structure need not be disclosed. Regarding valuation, the provisions of the Commercial Code relating to incorporated enterprises shall apply as appropriate, unless other provisions arising from sentence 2 apply."

This amended clause enables the Bank to adopt the accounting rules that will apply to the ESCB from January 1, 1999.

2. Assets

Gold

The balance sheet value of the Bank's total gold reserves is about DM 17 billion. However, since the establishment of the European Monetary System (EMS) in 1979, the item "Gold" has included only 80 % of the gold holding, because 20 % of the gold and 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. The item "Gold" also contains claims in respect of gold lending operations, which are carried out on a limited scale only.

Reserve position in the International Monetary Fund and special drawing rights

This item contains the claims on the International Monetary Fund (IMF) financed and held by the Bank 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 (SDRs) and Deutsche Mark under the German quota. At December 31, 1997 they amounted to DM 10,666 million (= SDR 4,407 million), compared with DM 8,485 million (= SDR 3,803 million) at the end of 1996. They represent the difference between the German quota of SDR 8,242 million and the Deutsche Mark balances of DM 9,281 million (= SDR 3,835 million) at the disposal of the IMF at the end of the year. Mainly as a result of Deutsche Mark drawings and Deutsche Mark repayments by other member countries, the holding of drawing rights increased by SDR 604 million on balance in 1997.

During the year under review, the Bank did not grant the IMF any new loans under special borrowing arrangements. At the end of 1997, one credit line in favour of the IMF amounting to SDR 2.4 billion remained outstanding under the General Arrangements to Borrow (GAB), but the IMF can utilise it only subject to certain conditions.

Special drawing rights, by means of which convertible currencies can be obtained at any time, were originally allocated free of charge to the extent of SDR 1,211 million. Their counterpart is shown on the liabilities side. The level of special drawing rights held at the end of 1997 amounted to DM 3,207 million

(= SDR 1,325 million). Increases totalling SDR 127 million owing to interest receipts were offset by decreases amounting to SDR 128 million on account of freely agreed sales.

The SDR-denominated drawing rights in the reserve tranche, the special drawing rights and the counterpart item for allocated special drawing rights have been converted – in accordance with the IMF rules – at the market rate prevailing on December 31, 1997 (SDR 1 = DM 2.42043). The SDR item in the balance sheet is valued on the basis of that market rate. A provision amounting to the difference between the rate applying at year-end and the valuation rate determined by the Bank, with due regard to section 253 (3) sentence 3 of the Commercial Code (SDR 1 = DM 2.23113), exists under liability item 8.2.

Claims on the European Monetary Institute

This item comprises the Bank's ECU balances and its claims which are denominated in ECUs and which arise when other central banks avail themselves of the very short-term financing mechanism. The ECU balances amounting to DM 35,950 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 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. A difference of DM 13,301 million has been deducted from the ECU balances resulting from the temporary transfer of monetary reserves so that these ECU claims can be valued like the overall gold and US dollar position. No other claims denominated in ECUs arising from lending under the very short-term intervention-financing mechanism were outstanding at the end of 1997.

Balances with foreign banks and money market investment abroad

The balances with foreign banks and money market investments abroad, almost all of which are denominated in US dollars and are interest-bearing, amounted to DM 76,642 million at the end of 1997, against DM 72,333 million at December 31, 1996 (excluding the US dollar reserves temporarily contributed to the EMI). This increase, which arose despite lower US dollar holdings, was due to the fact that the positions denominated in US dollars were valued at a higher balance sheet rate (US$ 1 = DM 1.5396) than the one used in 1996 (US$ 1 = DM 1.3620) (see the notes below on the item "Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions").

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, 1997. The other external assets represent limited investment with foreign institutions. Owing to their lesser liquidity, external loans and other external assets do not count towards 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 170,200 million (1996: DM 161,615 million). The portfolio of domestic and foreign bills of exchange which the Bank purchases at the discount rate under the rediscount quotas increased by DM 998 million compared with December 31, 1996. 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 amounted to DM 2,737 million (1996: DM 3,282 million).

Equalisation claims

The 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 capita and per enterprise, and of the initial provision of credit institutions and public corporations with central bank money. Equalisation claims yield interest at the rate of 1% per annum. In connection with Article 104 of the Maastricht Treaty, it has been laid down that equalisation claims are to be redeemed in ten annual instalments, starting in the year 2024.

German coins

The Bank's stock of coins is held as a reserve for use in the payment system. The Bank, acting for the account of the Federal Government (which holds the coinage prerogative), receives new coins from the state mints at face value. The value of coins recorded declined by 23.2 % compared with 1996 because, under the supplementary provisions of Article 104 of the Maastricht Treaty, the Bank's coin stock as from January 1, 1997 must be kept below 10 % of the value of coins in circulation. A ceiling of 15 % had applied until December 31, 1996 as a transitional measure (as in the Coinage Act).

Land and buildings

In 1997 the balance sheet value of the Bank's land, offices and residential buildings increased by DM 56 million net. Net additions of DM 382 million were accompanied by depreciation amounting to DM 326 million.

Furniture and equipment

In the year under review the value of the Bank's furniture and equipment rose by DM 62 million, after net additions of DM 163 million and depreciation totalling DM 101 million.

Items in course of settlement

"Items in course of settlement" contains primarily the cheques and direct debits (asset items) and transfers (liability items) which circulate within the Bank and 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 outweigh asset items nearly every day. The credit balance shown at December 31, 1997 was due to the limited business hours of credit institutions on the last day of the year, with the result that the positive float stemming from collection items submitted on December 30 was only partly counterbalanced by the fairly small number of transfers submitted at the end of the year. The positive float at December 31, 1997 nevertheless declined by DM 1,352 million compared with 1996 to DM 494 million as a result of the introduction in November 1997 of same-day forwarding of direct debits submitted on electronic data media even for amounts less than DM 1,000.

Other assets

"Other assets" is primarily interest income from external assets and securities repurchase transactions, which was not due until 1998 but was assignable to the profit and loss account for 1997. This item also includes participating interests in the EMI, Frankfurt am Main, the Bank for International Settlements, Basle, the cooperative society SWIFT, La Hulpe (Belgium), and *Liquiditäts-Konsortialbank GmbH*, Frankfurt am Main. The capital share in the EMI 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

The prepayments consist mainly of payments booked in the year under review, but relating to 1998, for salaries and pensions, and for interest expenditure on liquidity paper sold.

3. Liabilities

Banknotes in circulation

Compared with the end of 1996, the volume of banknotes in circulation rose by only DM 296 million to DM 260,686 million, representing an increase of 0.1%. In the preceding year the increase had amounted to 4.8 %.

Compared with the previous year, the total amount of currency in circulation went up by DM 498 million to DM 276,242 million; coins accounted for DM 15,556 million of this sum.

Deposits of credit institutions

Credit institutions' deposits on giro accounts, totalling DM 48,718 million, (1996: DM 51,911 million) are mainly minimum reserves to be held at the Bank. The sub-item "Other" (DM 21 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 principally include the Equalisation of Burdens Fund. The deposits of other public depositors constitute the balances of social security funds and local authorities. At December 31, 1997 such deposits amounted to DM 329 million in all (1996: DM 483 million).

Deposits of other domestic depositors

This balance sheet item contains the deposits of enterprises and individuals. At the end of 1997 such deposits totalled DM 1,023 million, as against DM 1,165 million in the previous year.

Liabilities arising from liquidity paper sold

"Liabilities arising from liquidity paper sold" amounted to DM 4,541 million at the end of 1997 (1996: DM 2,571 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 profitably investing balances not required for payment purposes. In 1997 no Treasury bills were sold to domestic 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 12,390 million (1996: DM 13,033 million), consists primarily of the Deutsche Mark deposits of foreign monetary authorities. Specifically, DM 12,315 million (1996: DM 12,911 million) was accounted for by the balances of foreign banks and DM 75 million by other deposits.

Counterpart of special drawing rights allocated

The counterpart of the special drawing rights allocated by the IMF free of charge, and shown in item 2 on the assets side 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

Provisions for pensions rose by DM 222 million to DM 3,582 million; they match the actuarially computed required level.

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 315 million net at December 31, 1997. They now amount to DM 7,944 million (see the notes below on the item "Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions").

Other liabilities

The other liabilities, amounting to DM 301 million (1996: DM 357 million), constitute amounts not yet passed on and interest expenditure falling due in 1998 but relating to 1997.

Accruals

Accruals totalled DM 234 million at December 31, 1997 (1996: DM 361 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 17, 1997, the statutory reserves were increased by DM 601 million out of the unappropriated profit for 1996. Thereafter, the statutory reserves totalled DM 13,019 million; they thus reached the maximum level permissible by law of 5 % of the value of banknotes in circulation, which came to DM 260,390 million at the end of 1996. 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 38 million in the year under review – on both international and domestic operations.

Staff costs

Staff costs declined by DM 33 million in 1997 to a total of DM 1,676 million. Excluding the transfer to provisions, which was lower than the year before, staff costs went up by 1% in the year under review. This increase was due mainly to the changes in pay and social security obligations in 1997. These additional costs were partly offset by the fact that the average number of persons employed at the Bank in 1997 fell by 1.5 % compared with the preceding year.

Retirement pensions accounted for DM 435 million (1996: DM 479 million) of the staff costs. This sum includes the increase of DM 222 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 Bank's Directorate and of the Executive Boards of the Land Central Banks amounted to DM 10,559,500.39 in the year under review. Former members of the Bank's Directorate, of the Board of Directors and Board of Managers of the *Bank deutscher Länder*, and of the Executive Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 13,803,617.99.

Other operating expenditure

The other (non-staff) operating expenditure of the Bank increased by DM 46 million (13 %) compared with 1996 to DM 418 million; this resulted primarily from higher expenditure on computer hardware and software.

Banknote printing

In the year under review expenditure on banknote printing went up slightly (by DM 2 million) to DM 172 million.

Depreciation of fixed assets

The amount of 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".

5. Receipts

Interest

In the year under review the interest received, at DM 13,835 million, was DM 902 million higher than in 1996. The crucial factor here was the interest received from international operations, which went up by DM 725 million compared with the previous year to DM 7,357 million. Despite a fall in the dollar amounts, interest income from US dollar assets increased, in particular, after conversion into Deutsche Mark owing to the higher US dollar exchange rate. Interest received from lending to domestic credit institutions increased by DM 177 million, mainly on account of the larger purchases on average in the context of securities repurchase agreements.

Fees

Receipts from fees, which accrue primarily in connection with the handling of payments, went up by DM 8 million to DM 120 million.

Receipts from purchases and sales and from the valuation of the monetary reserves

This item contains the profits and losses ensuing from purchases and sales of foreign currencies and the result of the valuation of the monetary reserves and other foreign currency positions; the amount includes the change in the provisions that also relate to the external position. Income of DM 13,300 million resulted, in particular, from the valuation of the Bank's US dollar and SDR holdings at rates closer to market prices. This amount also includes realised US dollar exchange rate gains and securities price gains.

The valuation rates applied to the US dollar (DM 1.5396 per US dollar) and to the SDR (DM 2.23113 per SDR) were higher at the end of 1997 than the balance sheet rates used in 1996, which were based on the historically lowest market rates (US$ 1 = DM 1.3620 on April 19, 1995 and SDR 1 = DM 2.05392 on October 5, 1992). The valuations applied to the 1997 financial accounts were derived from the average purchase cost with due regard to section 253 (3) sentence 3 of the Commercial Code. They led to write-ups affecting the profit and loss result in the case of foreign currency holdings. This partly offset the write-downs carried out in previous years on the foreign currency holdings owing to the appreciation of the Deutsche Mark; given the current US dollar exchange rate trend, those write-downs are no longer necessary.

6. Profit for the year

The profit and loss account for 1997 records a profit for the year of DM 24,228,451,252.88, which is shown in the balance sheet as unappropriated profit (net profit). In accordance with section 27 of the Bundesbank Act, DM 14,800,000.00 of this sum will be transferred to the statutory reserves. The balance, amounting to DM 24,213,651,252.88, will be paid over to the Federal

Government. After this appropriation, the statutory reserves will total DM 13,034,300,000.00; they will thus come up to the statutory ceiling of 5 % of the value of banknotes in circulation.

Branch Offices of the Deutsche Bundesbank

on May 1, 1998

Locality number	Bank place	Land central bank[1]
390	Aachen	NRW
614	Aalen	BW
653	Albstadt	BW
752	Amberg	BY
765	Ansbach	BY
464	Arnsberg	NRW
795	Aschaffenburg	BY
720	Augsburg	BY
662	Baden-Baden	BW
532	Bad Hersfeld	H
560	Bad Kreuznach	RS
710	Bad Reichenhall	BY
770	Bamberg	BY
855	Bautzen	STH
773	Bayreuth	BY
412	Beckum	NRW
100	Berlin	BBB
573	Betzdorf	RS
480	Bielefeld	NRW
428	Bocholt	NRW
430	Bochum	NRW
380	Bonn	NRW
270	Braunschweig	BNS
290	Bremen	BNS
292	Bremerhaven	BNS
663	Bruchsal	BW
492	Bünde	NRW
257	Celle	BNS
870	Chemnitz	STH
180	Cottbus	BBB
241	Cuxhaven	BNS
508	Darmstadt	H
741	Deggendorf	BY
805	Dessau	BNS
476	Detmold	NRW
722	Donauwörth	BY
440	Dortmund	NRW
850	Dresden	STH
395	Düren	NRW
300	Düsseldorf	NRW
350	Duisburg	NRW
221	Elmshorn	HMS
820	Erfurt	STH
763	Erlangen	BY
360	Essen	NRW
611	Esslingen	BW
382	Euskirchen	NRW
215	Flensburg	HMS
500	Frankfurt/M.	H
170	Frankfurt/O.	BBB
680	Freiburg	BW
530	Fulda	H
703	Garmisch-Partenkirchen	BY
420	Gelsenkirchen	NRW
830	Gera	STH
513	Giessen	H
260	Göttingen	BNS
268	Goslar	BNS
478	Gütersloh	NRW
384	Gummersbach	NRW
450	Hagen	NRW
800	Halle	BNS
200	Hamburg	HMS
207	Hamburg-Harburg	HMS
254	Hameln	BNS
410	Hamm	NRW
506	Hanau	H
250	Hannover	BNS
672	Heidelberg	BW
632	Heidenheim	BW
620	Heilbronn	BW
494	Herford	NRW
259	Hildesheim	BNS
780	Hof	BY
594	Homburg (Saar)	RS
217	Husum	HMS
721	Ingolstadt	BY
445	Iserlohn	NRW
222	Itzehoe	HMS
540	Kaiserslautern	RS
660	Karlsruhe	BW
520	Kassel	H
733	Kempten	BY
210	Kiel	HMS
324	Kleve	NRW
570	Koblenz	RS
370	Köln	NRW
690	Konstanz	BW
320	Krefeld	NRW
548	Landau	RS
743	Landshut	BY
285	Leer	BNS
860	Leipzig	STH
266	Lingen	BNS
683	Lörrach	BW
604	Ludwigsburg	BW
545	Ludwigshafen	RS
230	Lübeck	HMS
458	Lüdenscheid	NRW
240	Lüneburg	BNS
810	Magdeburg	BNS
550	Mainz	RS
670	Mannheim	BW
840	Meiningen	STH
731	Memmingen	BY
490	Minden	NRW
310	Mönchen-gladbach	NRW
362	Mülheim	NRW
700	München	BY
400	Münster	NRW
150	Neubranden-burg	HMS
213	Neustadt	HMS

Locality number	Bank place	Land central bank[1]
574	Neuwied	RS
256	Nienburg	BNS
760	Nürnberg	BY
365	Oberhausen	NRW
505	Offenbach	H
664	Offenburg	BW
280	Oldenburg	BNS
462	Olpe	NRW
265	Osnabrück	BNS
472	Paderborn	NRW
740	Passau	BY
666	Pforzheim	BW
160	Potsdam	BBB
650	Ravensburg	BW
426	Recklinghausen	NRW
750	Regensburg	BY
340	Remscheid	NRW
640	Reutlingen	BW
403	Rheine	NRW
711	Rosenheim	BY
130	Rostock	HMS
642	Rottweil	BW
590	Saarbrücken	RS
593	Saarlouis	RS
613	Schwäbisch Gmünd	BW
622	Schwäbisch-Hall	BW
793	Schweinfurt	BY
140	Schwerin	HMS
386	Siegburg	NRW
460	Siegen	NRW
603	Sindelfingen	BW
414	Soest	NRW
742	Straubing	BY
600	Stuttgart	BW
673	Tauber-bischofsheim	BW
585	Trier	RS
641	Tübingen	BW
258	Uelzen	BNS
630	Ulm	BW
694	Villingen-Schwenningen	BW
602	Waiblingen	BW
753	Weiden	BY
356	Wesel	NRW
510	Wiesbaden	H
282	Wilhelmshaven	BNS
587	Wittlich	RS
790	Würzburg	BY
330	Wuppertal	NRW

1 Abbreviations

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