DEUTSCHE BUNDESBANK
EUROSYSTEM

ANNUAL REPORT

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(until 30 April 2007)

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We mourn the death

of the following members of our staff

Gisela Börner	18 January 2007
Axel Bosch	8 February 2007
Hans-Jürgen Linck	5 March 2007
Wolfgang Heinz Dinges	1 May 2007
Ernst Simanzik	7 May 2007
Joachim Rippel	30 May 2007
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Silvia Hlawatsch	29 June 2007
Adolf Schrottenbaum	7 July 2007
Bernhard Fischer	9 July 2007
Gerald Hoff	1 October 2007
Hanns Sroka	19 October 2007
Thomas Eurich	31 October 2007
Wolfgang Bauer	2 November 2007
Eckehard Kegel	5 December 2007

We also remember the retired staff members of the Bank who died in 2007.

We will honour their memory.

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Abbreviations and symbols

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	Figure unknown, not to be published or not meaningful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

Discrepancies in the totals are due to rounding.

Foreword
by the President
of the Deutsche Bundesbank

Foreword

Last year we celebrated 50 years of the Deutsche Bundesbank. In 2008, we can now look back on ten years of the Eurosystem. Both anniversaries are important milestones in German monetary history. The celebrations held to mark 50 years of the Bundesbank's existence revealed the keen interest which the general public takes in our work and endeavours. That has not been altered in the least by the fact that, for almost ten years now, we have been joint guardians, alongside the other central banks in the Eurosystem, of price stability in the single currency area. The Bundesbank's inputs into the common European System of Central Banks include its deep-seated stability culture and its extensive track record in the field of monetary policy. The focus of our efforts has not changed: both during the years of our sole responsibility for the Deutsche Mark and our present co-responsibility for the euro, ensuring stability has been our consistent objective down the decades. The Bundesbank's hallmark remains its clear and unwavering commitment to stability.

The past year forcefully demonstrated that risks to price stability persist even in an environment shaped by the forces of globalisation. The benign stability policy climate that had prevailed in the recent past became harsher last year in many countries. Germany and the euro area were not immune to this. Rising prices for energy and food led to a marked increase in the inflation rate in the second half of 2007, and there are no indications at present that these pressures will abate significantly in the current year. The crucial monetary policy requirement in this situation is to ensure that the temporary pick-up in prices does not harden into entrenched inflationary pressure. Wage bargainers therefore need to act responsibly in the forthcoming pay rounds and keep the bigger economic picture in mind. The general public can rest assured that we, for our part, shall do everything possible on the monetary policy front to safeguard price stability over the medium term in keeping with our European mandate.

In the first half of last year, we on the Governing Council of the ECB, in the light of the increasing risks of inflation, maintained the course of tightening monetary policy which we initiated in late 2005. Since the middle of last year, we have kept the key interest rate at 4%, as the turbulence in the international financial markets led to heightened uncertainty about the macroeconomic outlook and, therefore, about the medium-term price risks as well.

The turbulence in the international financial markets was triggered by the crisis in the US subprime mortgage market in the third quarter of 2007. Overall, the stability and functional viability of the German financial system nonetheless remained fully intact, since the institutions had markedly improved their risk-bearing capacity over the past few years. Only a few of the German banks were affected so severely that their risks had to be heavily shielded.

The turmoil in the money and capital markets meant that many Bundesbank and Eurosystem staff were working at full stretch. The first challenge, from early August, was to alleviate the liquidity tensions in the interbank market. This was achieved speedily by flexibly allotting funds at the short end of the money market; by contrast, some tensions in the term segment did not ease until the start of 2008. The Eurosystem's existing monetary policy framework proved flexible enough for the necessary monetary policy operations to be conducted using the normal instruments even in these abnormal circumstances.

The task of analysing the fall-out from the recent financial crisis was begun promptly in the latter part of 2007 at both national and international levels. Besides identifying causes and vulnerabilities, these efforts are focused on finding ways of improving the resilience of the financial system. The Financial Stability Forum (FSF) will present a report to the G7 finance ministers and central bank governors in April 2008. This report is being prepared by an FSF working group together with a number of other international supervisory bodies (including the Basel Committee on Banking Supervision, and the Committee on the Global Financial System). The Bundesbank was involved in these deliberations from the outset. A key principle for us in this respect is that the market players themselves have a primary duty to learn from – but also to act on – the dislocations that have occurred. This includes eliminating shortcomings in risk management and reviewing the work of the rating agencies.

Key objectives should be to ensure proper incentive structures in the financial industry and to strengthen market discipline, say, by enhancing transparency. There may also be a need to identify areas in which regulatory intervention is required. Banking supervisors will need to draw the conclusions from the distortions that became evident in the originate-to-distribute business model. In this respect, the entry into force of Basel II, the new international capital adequacy framework, as of 1 January 2008 has already led to improvements in key areas. A need for fine-tuning the new framework is already becoming apparent in some places, however, such as in the weighting factors for credit lines and liquidity facilities.

It is too early at present to make a final judgement on the macroeconomic implications of the tensions in the credit markets. It is conceivable that the process of adjustment in the international financial system may go on for some time yet. Key factors in this context are the scale of the cyclical slowdown in the United States and possible mutual frictions between the financial system and the real economy. As things stand at present, the most likely scenario is that the financial market turmoil will slightly dampen the current level of economic activity but will not have a substantial and sustained negative impact on the macroeconomic outlook. Against this backdrop, the risks to growth for the euro area and Germany have increased overall in the past few months. The upturn in Germany is nevertheless broadly based. It also proved sufficiently robust to cope with the strains caused by the increase in value added tax. Above all, the upswing on the labour market, which is also an indication of structural improvements, suggests that the real economy is well able to withstand the rougher wind blowing from the financial markets.

The events since the third quarter of last year have underlined how important it is that central banks apply their wide-ranging knowledge and know-how to overcoming and assessing such periods of stress for the domestic financial system. The Bundesbank's broad perspective is derived from its liquidity operations, from the microprudential and macroprudential aspects of financial stability analysis and from its experience and expertise in the field of macroeconomic analysis. It is therefore both apt and appropriate that the competencies of the Bundesbank in the supervision of financial institutions have been defined more precisely. To this end, the Bundesbank and the Federal Financial Supervisory Authority (BaFin) agreed at the beginning of 2008 on a new guideline detailing their collaboration in the area of prudential supervision. This defines the division of responsibilities between BaFin and the Bundesbank clearly and more transparently for the banks and, at the same time, reduces areas of overlap and duplication of work. Thus, BaFin is responsible for regulatory measures, while the Bundesbank – focusing on examination and evaluation – is responsible for the ongoing monitoring of all banks, including the systemically relevant credit institutions.

Secure and efficient payments systems form an integral part of the German financial system. The Bundesbank has long been actively involved in the initiatives aimed at the further integration of the European payment system infrastructure. TARGET2, the Eurosystem central banks' new Trans-European Automated Real-time Gross settlement Express Transfer System, was successfully launched on 19 November 2007. TARGET2 is based on a single shared platform (SSP) for all participants and will progressively replace the decentralised TARGET1 system, which has been in operation since January 1999. Together with Banca d'Italia and Banque de France, the Bundesbank is responsible for the ongoing development and operation of TARGET2. Via the credit institutions linked to it, the Bundesbank accounts for more than 40% of all payments routed through TARGET2.

As a next step, TARGET2-Securities (T2S) will permit the integrated settlement of securities transactions in central bank money on a single platform in future. To exploit synergies, T2S is to be developed within the Eurosystem, and operated by the Bundesbank, Banca d'Italia, Banque de France and Banco de España, as an additional service provided on the joint platform used for TARGET2. After the Governing Council of the ECB confirmed the basic economic, legal, operational and technical feasibility of T2S on 8 March 2007, the Eurosystem elaborated the user requirements for T2S in close cooperation with the market players and central securities depositories. Following the current consultations with the market participants, which are due to be concluded by 2 April 2008, the Governing Council will take a definitive decision on developing T2S based on the finalised user requirements, probably in the summer of 2008.

Further work was also performed last year on implementing the Single Euro Payments Area (SEPA). Since the launch of SEPA in January 2008, customers have had the option of making all cross-border credit transfers in euro via any bank in Europe just as easily, efficiently and securely as has been possible hitherto for national payments. The Bundesbank is taking an active part in this project both within the Eurosystem and in the relevant bodies of the Central Credit Committee (CCC). Furthermore, it is adapting its own payment systems to the new European payments requirements.

One focus of the Bundesbank's cash management activities last year was preparing for the introduction of the Cash Electronic Data Interchange (CashEDI) procedure. This enables the Bundesbank to optimise the settlement of cash payments on the basis of an international logistical standard and to play a pioneering role in this area in Europe. In future, all cash containers will be identifiable via a barcode. This scanner-based cash hand-over procedure will speed up the business processes. This modernisation of the Bundesbank's range of services takes account of the heightened demands of the market and of its customers. In addition, we enhanced the efficiency of banknote processing in 2007 by equipping 20 more of our branches with state-of-the-art multi-denomination banknote processing machines.

In March 2007, the Bundesbank and the CCC, with the participation of the Federal Criminal Police Office, concluded a model agreement on the national implementation of the European Framework for the detection of counterfeits and fitness sorting of euro banknotes by credit institutions and other professional cash handlers. One of the points of this agreement is that the credit institutions undertake to dispense banknotes through automated teller machines (ATMs) only if they have been checked by a recognised banknote processing system or by a Eurosystem national central bank. By the end of 2007, nearly three-quarters of all the credit institutions in Germany had signed the agreement.

Internally, the Bundesbank successfully completed its strategic cycle 2002-2007 at the end of last year. With its substantially more efficient organisational structure and its streamlined network of branches, the Bundesbank is well equipped to tackle future challenges, especially in the performance of its varied tasks within the Eurosystem. At €300 billion in 2007, the targeted annual savings of around €280 million in the cost of providing services were, in fact, exceeded in the reporting year. The strategic objective set for the period from 2008 to 2012 is "Raising the Bank's profile – continuing the consolidation process". After the core business areas and strategic objectives had been defined, the Bundesbank's individual departments drew up specific measures and projects in this regard and have already made a start on implementing them. Highly qualified staff are crucial to ensuring continued success in performing our tasks and will remain so in future. The Bundesbank's important macroeconomic functions, its modern and efficient structure, its network of national and international links as well as a high level of motivation and commitment on the part of its employees will continue to make it an attractive place to work in the future.

I am joined by the other member of the Executive Board in thanking all our members of staff for their work in 2007 and for their unfailing high level of dedication. I wish to thank the staff representative bodies for their invariably committed and constructive cooperation.

Frankfurt am Main, March 2008

Professor Axel A Weber
President of the Deutsche Bundesbank

Monetary policy and economic developments

Global economic growth remained strong in 2007. Towards year-end, however, momentum waned as the financial market turmoil emanating from the US real estate market placed a growing strain on the course of economic development, particularly in the USA. The deteriorating international setting as the year wore on also placed a damper on the upturn in the euro area, although without seriously jeopardising its progress, particularly as it had meanwhile become much more broadly based. But this was accompanied by rising upward pressure on prices and increased longer-term inflation risks. Monetary policymakers therefore continued to scale back their expansionary bias and to tighten their interest rate policy stance.

While the cyclical upswing which the German economy has been experiencing for more than two years has slowed somewhat, its underlying thrust remains intact, despite having to cope with a steep hike in value added tax (VAT). As well as fuelling price dynamics, the VAT rise also perceptibly dampened consumer demand. Consequently, robust export activity and ongoing investment momentum provided the most important impulses on the demand side. A more confident climate was created by the progress made towards consolidating public finances in 2007, with general government achieving a balanced budget for the first time since 1989. The labour market reforms undertaken in the last few years also clearly started to pay off.

I International and European setting

1 Global economy still on growth path

Global growth still buoyant, but slower towards year-end

Global output recorded strong growth again in 2007. According to IMF estimates, it rose by just under 5% – as measured by real gross domestic product (GDP) based on purchasing power parity. This means that the world economy expanded almost as buoyantly as in 2006 and once again significantly faster than the longer-term average. However, the good overall result for 2007 masks the fact that the global economy suffered a noticeable loss of momentum towards the end of the year. This was mainly attributable to the slowing cyclical momentum in the industrialised countries, particularly in the USA. By contrast, the economic dynamics in the emerging market economies (EMEs) slowed only marginally over the period under review. The average annual growth reported by this group of countries therefore remained strong at 7¾%, while the corresponding figure for the industrialised countries slipped by ½ percentage point to 2½%. Overall, three-tenths of global output growth in 2007 was generated in the advanced economies and seven-tenths in the emerging market economies. China alone accounted for almost a quarter of the overall expansion in GDP. The deceleration in world economic growth is consistent with the concurrent slowdown in real global trade last year, where – according to OECD estimates – growth fell markedly from 9½% in 2006 to 7%. This owed much to distinctly flatter export and import curves in the industrialised countries.

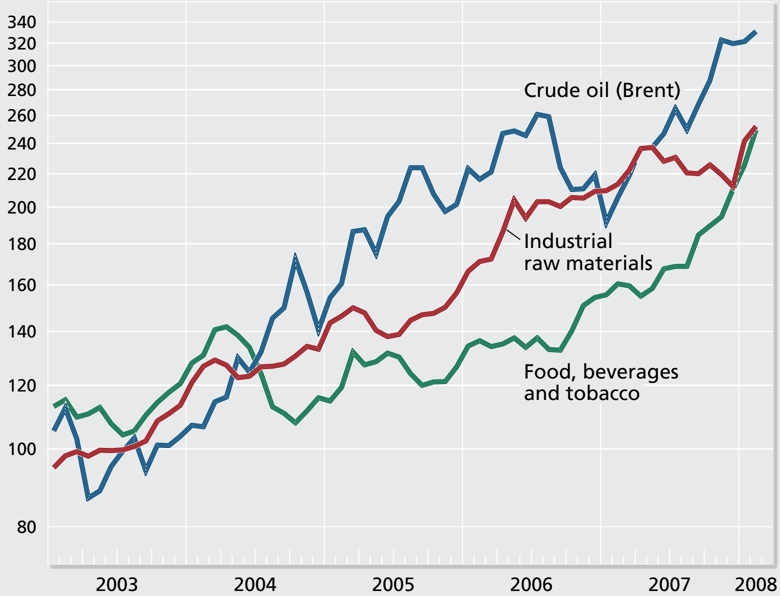
World economy facing greater pressure in 2007 H2

The noticeable slowdown in the pace of global growth in the fourth quarter of 2007 was caused by the significantly greater pressures which the world economy faced in the second half of 2007. Over the third quarter, the financial market turmoil spreading from the US real estate market brought about a comprehensive reassessment of financial risks. The concomitant widening of corporate bond spreads should, at least partially, be viewed as a normalisation of a previously overly optimistic assessment of risk, which had mainly facilitated favourable financing conditions for subprime borrowers. In regional terms, the consequences for the real economy obviously centred largely on the United States, where they notably prolonged and intensified the contraction in housing construction. Continental European countries, Japan and the EMEs have not yet been much affected. The dynamics of the global economy were additionally

World market prices for crude oil, industrial raw materials and food, beverages and tobacco

Chart 1

US$ basis, 2000 = 100, log scale



Sources: Thomson Financial Datastream and HWWI.

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constrained by the surge in oil prices. From their most recent low in January 2007 to the end of the year, Brent crude oil prices soared by no less than 67% in US dollar terms, or 48¾% in euro terms. At the beginning of March 2008 oil prices hit a new all-time high of US$102. Of the other commodities, prices for food, beverages and tobacco – as measured by the HWWA price index in US dollar terms – and industrial commodities posted average annual growth of 24¾% and 15½% respectively in 2007. These markets, too, experienced further price increases following the new year.

Marked rise in inflation since start of 2007

Price developments in the industrialised countries were largely determined by energy and food prices in 2007. The rate of inflation increased in several waves from 1.8% in January to a two-month average of 3.3% in November-December. This was largely the result of baseline effects in the fourth quarter, as seasonally adjusted consumer prices had dropped slightly towards the end of 2006. The erosion of monetary value nonetheless slowed by 0.2 percentage point compared to 2006, averaging 2.2% for the year. Excluding energy and food, the rate of inflation amounted to 1.9% in 2007, compared with previously 1.7% – pointing to a slight increase in home-grown price pressures. In the emerging market economies, in some cases very pronounced increases were reported for consumer prices, partly because food, which has become considerably more expensive, has a particularly large weight in the basket of household goods there.

Muted growth prospects combined with higher price pressures

The steep rise in energy prices during 2007 significantly reduced purchasing power in consumer countries. Past experience indicates that this contraction in real incomes affects global growth more rapidly than the expansionary stimuli of higher oil revenues in oil-producing countries. In addition, real estate prices in the industrialised countries appear to be stabilising at high levels or dipping somewhat, and the stock markets have suffered heavy price losses, particularly since the beginning of 2008, which will tend to produce negative wealth effects for private consumption in the foreseeable future. While higher risk premiums on certain financial products have, when looked at in isolation, increased financing costs for several rating categories and investor groups, this has been partly offset by a drop in capital market rates since mid-2007. Another positive factor is the ongoing dynamic performance of the emerging market economies, although there are no indications yet of a sustained cyclical decoupling of EMEs from the industrialised countries and particularly the USA. Overall, the general economic outlook for the near future has dulled somewhat. An IMF forecast made in mid-January 2008 estimates that global economic growth in the current year will be ¾ percentage point lower than in 2007, at just above 4%; this would still be slightly higher than the average of the past ten years. The deterioration in the global price climate currently being witnessed will probably continue to drive up inflation rates in the emerging market economies in 2008. The industrialised countries are also likely initially to continue to experience heightened price pressure.

USA: marked slowdown in growth in 2007 …

After expanding strongly in the second and third quarters, the US economy suffered a noticeable loss of momentum at the end of 2007. On average, real GDP rose by 2¼% in 2007, thus lagging behind potential output. The main damper on US growth was investment in housing construction, which was 17% lower than the already depressed prior-year level. This was mainly attributable to the fact that the downturn on the housing market, which had started at the end of 2005, was further accentuated by the problems on the subprime mortgage market in the second half of 2007. This was, however, partly offset by the fact that private consumption expanded at the same pace as a year earlier, namely 3%. Household demand was driven by favourable income developments, which were in turn the result of ongoing employment

Macroeconomic benchmark figures of selected industrialised countries

Table 1

Countries	Real GDP 2006	Real GDP 2007pe	Consumer prices[1] 2006	Consumer prices[1] 2007	Current account balance 2006	Current account balance 2007pe	Unemployment rate[2] 2006	Unemployment rate[2] 2007pe
	Annual percentage change				As a percentage of GDP		As a percentage	
OECD	3.1	[3] 2.7	2.6	2.4	– 1.8	[3] – 1.4	6.1	5.6
of which								
Euro area	2.8	2.6	2.2	2.1	– 0.1	0.2	8.2	7.4
United Kingdom	2.9	3.1	2.3	2.3	– 3.9	[3] – 2.9	5.3	[3] 5.5
United States	2.9	2.2	3.2	2.9	– 6.2	[3] – 5.6	4.6	4.6
Japan	2.4	2.1	0.3	0.0	3.9	4.8	4.1	3.8
Canada	2.8	2.7	2.0	2.2	1.6	0.9	6.3	6.0

Sources: ECB, OECD, BIS, national statistics. — **1** Euro area, United Kingdom: Harmonised Index of Consumer Prices (HICP). — **2** Standardised unemployment rate, based on OECD and Eurostat calculations. — **3** OECD forecasts (Economic Outlook, December 2007).

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growth. In addition, the saving ratio declined again in the fourth quarter; over the year, it averaged ½%, which is very low by international standards. Corporate investment was clearly up in 2007, although its pace of growth continued to slow. In addition, US foreign trade made its first positive contribution to the increase in real GDP in a long time. This was largely the result of a more moderate rise in imports accompanied by persistently buoyant exports. As a consequence, the US current account deficit narrowed noticeably despite the higher energy prices.

… and pronounced slowdown in 2007 Q4/ 2008 Q1

Towards the end of 2007 and in the first few months of 2008, the indicators paint a noticeably more pessimistic picture. The pronounced decline in consumer confidence and in the business climate in industry, in particular, point to a significant slowdown in the pace of US economic growth. This was due in part to the rise in the year-on-year inflation rate to 4.2% in November-December 2007 (two-month average) in the wake of higher commodity prices. Yet the annual rate of 2.9% was still 0.3 percentage point lower than in 2006. The core inflation rate (excluding energy and food) fell slightly to 2.3%.

Japanese economy also lost momentum

Japanese GDP growth slowed by ¼ percentage point to just above 2% in 2007 in a fairly erratic quarterly pattern, mainly as a result of stagnating gross fixed capital formation. A key factor in this were further cuts in public-sector investment as part of government consolidation efforts. In addition, investment in housing construction was sharply down in connection with a backlog in building permits following the implementation of new building regulations to improve earthquake protection. Finally, corporate investment also rose more slowly in 2007 than in previous years. Private consumption expanded by a moderate margin of 1½%, partly because employees' income did not rise much owing to the very modest wage growth combined with only a small increase in employment. Japanese exports remained on a clear upward curve, while real imports moved onto a considerably flatter path. In the overall consumer price index, higher energy and food prices cancelled out the ongoing decline in prices for consumer durables, in particular. Excluding these two volatile components, the price index dropped by a further 0.3% in 2007.

EMEs and oil-producing countries continue to expand

The emerging market economies in South and East Asia grew as briskly in 2007 as they had done in 2006. China maintained its role as the region's growth locomotive, again posting a double-digit real increase in GDP (+11½%). However, the economic outlook for China is overshadowed by strong inflationary pressures, which were fuelled by food prices, particularly in the second half of the year. At 4.8%, the average annual rate of inflation for 2007 was 3.3 percentage points up on the year. The Indian economy also continued on its steep growth path. The majority of Latin American countries, the oil-producing countries in the Middle East and the Commonwealth of Independent States benefited from the ongoing rise in prices for energy and other commodities. Growth momentum in Russia picked up further in 2007, partly because the upturn has become more broadly based there.

Robust growth in new EU member states

In the 11 new EU member states (excluding Slovenia, which joined the euro area on 1 January 2007), real GDP again posted strong growth last year, namely around 6%, compared with 6½% in 2006. This dynamic development was fuelled both by the ongoing buoyant export trend and robust domestic demand. Nevertheless, differences in growth rates between the individual countries remained very pronounced, ranging from 1½% in Hungary to 10½% in Latvia. However, the increase in the aggregate current account deficit of this group of countries to an estimated 7¼% of GDP has to be viewed as a negative corollary of booming demand. In addition, price pressures picked up noticeably. Inflation rose from 3.3% in January to 5.8% in December. The average figure for the year was 4.2%, compared with 3.3% in 2006. This average figure encompasses price hikes ranging from 10.1% in Latvia to just 0.7% in Malta.

2 Euro reaches new highs

US dollar exchange rate losses ...

Last year's developments in the foreign exchange markets were chiefly determined by market players' expectations concerning future economic and interest rate developments as well as the fallout from the problems on the US mortgage market. In this context, the US currency depreciated significantly, particularly in the second half of the year. As measured by the weighted average, the US dollar lost 9% overall during 2007.

... were matched by euro exchange rate gains

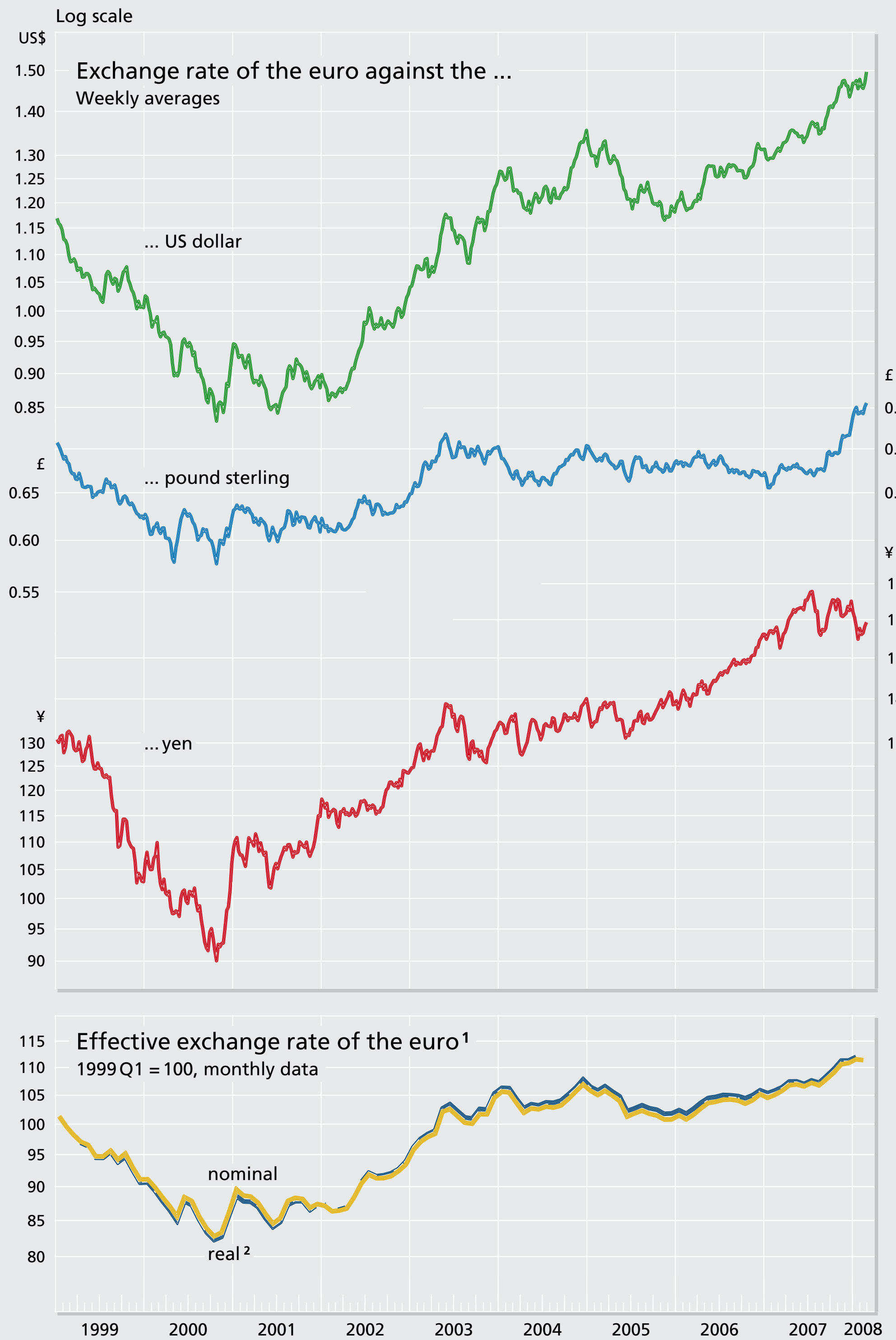
The shifts in exchange rate parities also resulted in strong gains for the euro, especially against the US dollar. In the first months of last year, the euro appreciated against the US currency, buoyed by positive cyclical data for the euro currency area and negative news on the US economy, and rose to a new high of more than US$1.38 in July, before subsequently falling back again slightly. This was probably prompted by profit-taking, the announcement of a surprisingly high growth rate for US GDP in the second quarter and increased demand for dollar liquidity. Although the United States reported high growth in the third quarter, too, the euro subsequently appreciated strongly as concerns about the economic impact of the crisis on the US mortgage market moved centre stage again and, aided by weak data from the US real estate and labour markets, raised expectations of a reorientation of US monetary policy. And indeed, the interest rate spread of short-term dollar investments over corresponding euro-denominated instruments was subsequently eroded by a total of five interest rate cuts by the US Federal Reserve and eventually turned negative. In 2007 as a whole, the euro gained just under 12% against the US dollar to US$1.47. The euro continued its upward movement at the beginning of 2008, trading at US$1.52 when this report went to press. It was thus slightly below the new high it had reached at the beginning of March.

Euro gained strongly against pound sterling, too

Vis-à-vis the pound sterling, the euro moved within a fairly narrow range of £0.66 to £0.68 up until September. However, the single currency then recorded strong gains against the pound sterling following news of the difficulties at a mortgage bank, which the Bank of England had to bail out with an emergency loan. The Bank of England's unexpected rate cut in December and the subdued

Exchange rate of the euro

Chart 2



1 According to ECB calculations against the currencies of 22 countries. — 2 Based on consumer prices.

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economic outlook for the United Kingdom further weakened the British currency towards the end of the year. Overall, the euro recorded a sizeable gain of more than 9% against the pound sterling in 2007. Speculation that the Bank of England might cut rates further pushed the euro-pound sterling parity up further in the new year. It recently marked a new high of almost £0.77.

Fairly small gains against yen

The euro also marked a new high, of just under ¥169, against the Japanese currency in July 2007; however, at 5% overall, gains were comparatively moderate over the year. The upward trend in the euro-yen exchange rate was repeatedly interrupted, as investors' risk appetite was dulled by the turmoil on the financial markets. According to market reports, this led to a massive unwinding of carry trade positions and consequently a broad-based boost in the value of the Japanese currency, which also depressed the euro. When this report went to press, the euro-yen exchange rate was trading at ¥158 and thus slightly lower than at the end of 2007.

Euro appreciation eases monetary policy pressure

The upshot of all this was that the weighted average euro exchange rate against 22 major trading partners appreciated during 2007 (+6½%). The single European currency also gained in real terms, ie after taking account of the differing rates of inflation within the euro area and in its trading partners' economies. However, the robust cyclical setting meant this had only a very limited negative impact on the euro-area economy. In addition, the stronger euro mitigated external inflation pressure in the euro area.

3 Capital market developments dominated by financial market turmoil

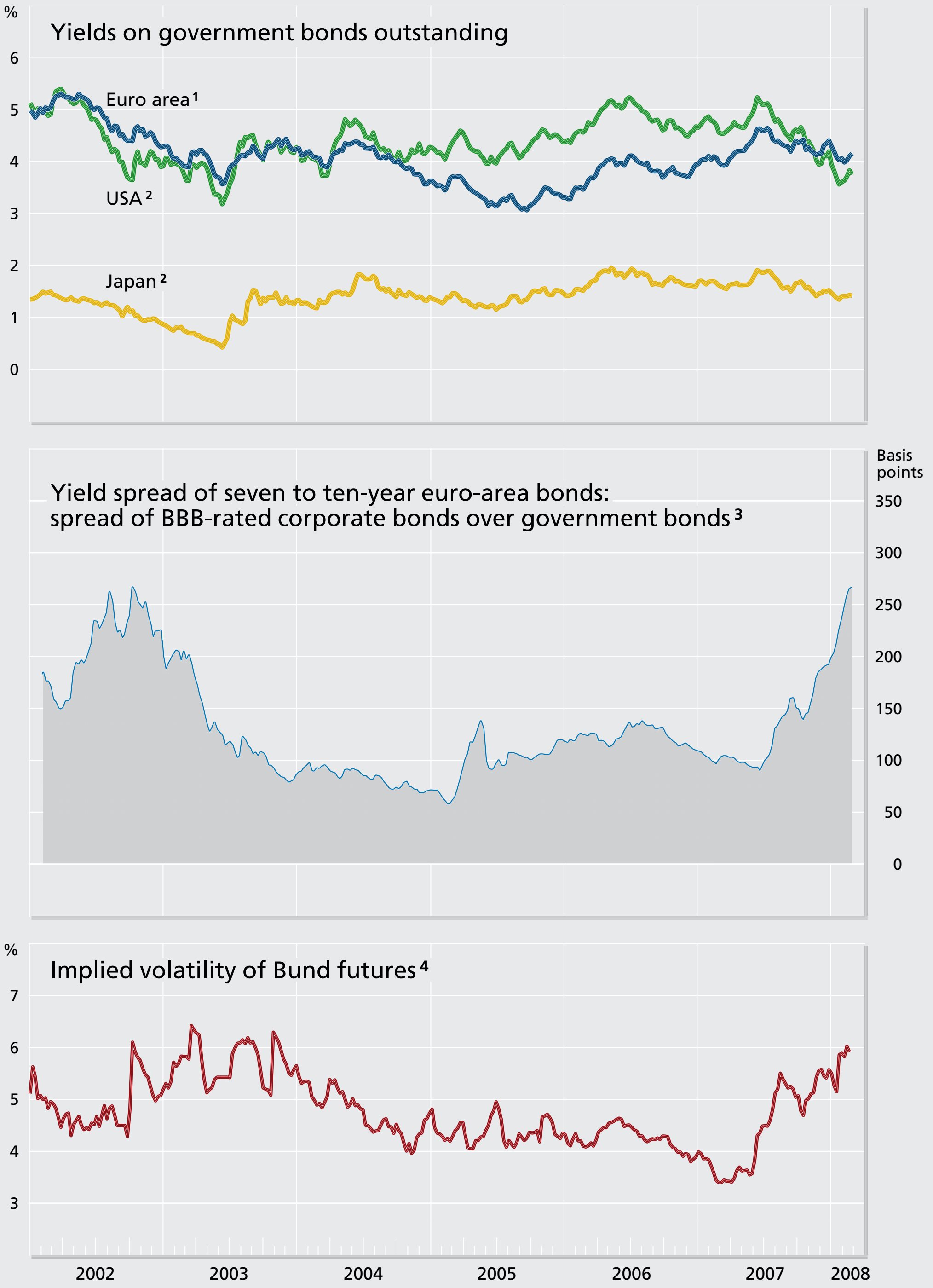
Financial market turmoil

In the course of 2007, the international financial markets were burdened by the credit market turmoil triggered by events in the US mortgage market, which entailed big losses for the financial sector and a deteriorating economic outlook, particularly for the USA. Up until the middle of 2007, improved economic expectations, robust global economic growth and lively takeover activity had ensured a benign stock market setting and rising yields in the euro area. It looked as though the slump in prices on the overheated Chinese stock market at the end of February 2007, which was briefly accompanied by higher volatility, and the incipient problems on the US mortgage market in March had been rapidly overcome. However, in the second half of the year, a higher number of defaults on US subprime mortgages started to have a knock-on effect on European banks and trade in structured credit products. This triggered a fundamen-

Bond market

Chart 3

Weekly averages



1 Average yield of ten-year euro-area government bonds outstanding (GDP-weighted). — **2** Government bonds with approximately ten-year residual maturity. — **3** Sources: Merrill Lynch and Bloomberg. — **4** Expected future volatility for constant three-month maturity, calculated from prices of options on Bund futures. Sources: Bloomberg and Bundesbank calculations.

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tal change in investors' risk perceptions, causing friction to spill over to other markets. The interbank money market and the corporate bond market were particularly hard hit as were the stock markets, albeit initially to a lesser degree. Although the interest rate reversal in the USA, together with the resolute injection of liquidity by various central banks, brought about a brief recovery at the end of September, ultimately, this failed to eliminate the uncertainty plaguing the financial markets.

Diverging trends for European and US yields

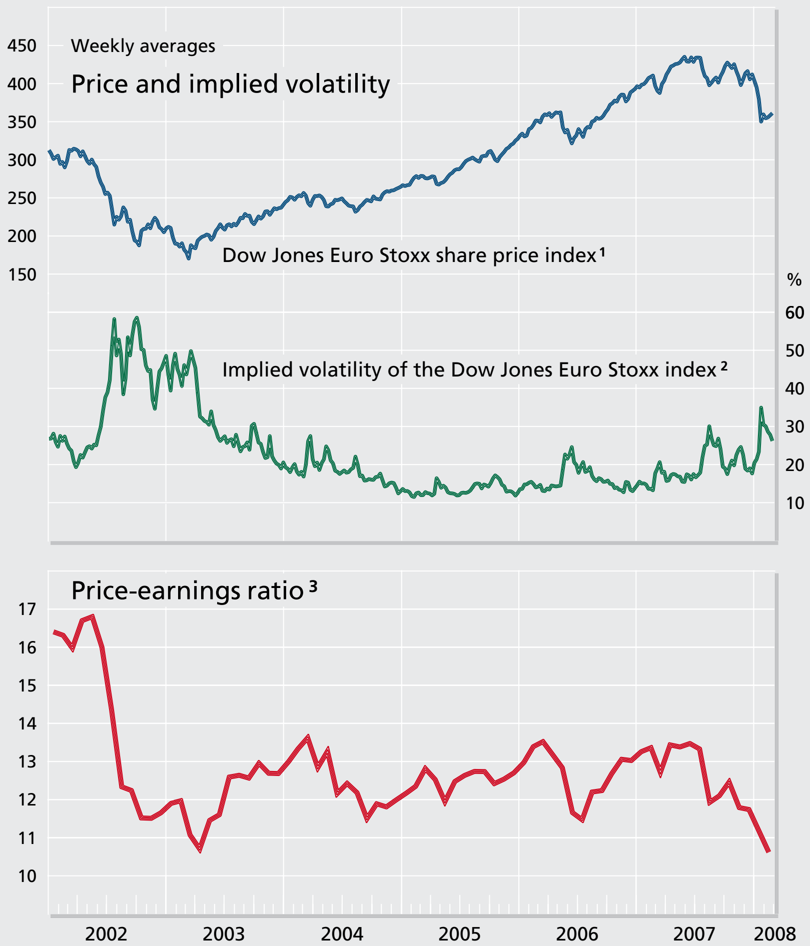
Up until the middle of last year, capital market returns in the euro area and the USA had largely been moving upward. In the third quarter, yields on long-term government bonds issued by euro-area member countries were up to ¾ percentage point above the level at which they started into 2007, reflecting not only the favourable cyclical setting but also expectations of further rises in Eurosystem interest rates following two increments in the first half of the year. However, yields on both sides of the Atlantic subsequently dropped again in connection with the US mortgage crisis, in part owing to the increased demand for safe-haven investments. In view of poorer US growth expectations and the prospect of more rate cuts by the US Federal Reserve, yields fell far more sharply in the United States than in the euro area. At the end of 2007, yields on ten-year euro-area government bonds stood at 4½% and were thus almost ½ percentage point higher than at the beginning of the year; they also yielded over ¼ percentage point more than comparable US Treasuries, which maintained a yield spread over their euro counterparts into the fourth quarter. The zigzag of interest rate movements was mirrored by uncertainty about future bond market price developments. After increasing markedly in the second half of the year, uncertainty briefly abated in October before surging again. Towards the end of 2007, implied volatility, calculated using options contracts with a constant three-month horizon, was significantly above the average of the past five years – an indication of market players' continued nervousness.

Corporate bond spreads almost doubled

Changes in risk assessment in the second half of 2007 had a particularly strong effect on corporate financing conditions on the bond market. The spreads of long-term BBB-rated corporate bonds over euro-area government bond yields almost doubled over the course of the year; on average, bonds issued by non-financial corporations in the lowest investment grade segment yielded almost 2 percentage points more than matched-maturity government bonds at the end of 2007. The spreads on lower-rated financial products were much higher still – where there was a receptive market for such issues at all.

Equity market

Chart 4



Source: Thomson Financial Datastream. — 1 31 December 1991 = 100. — 2 Expected future volatility, calculated from prices of options on the Dow Jones Euro Stoxx index. — 3 End-of-month levels; respective market value of shares in the Dow Jones Euro Stoxx share price index in relation to average expected earnings per share over the next 12 months according to I/B/E/S analyst estimates.

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Equity market prices subject to strong volatility and high uncertainty

The international stock markets were also dominated by the disruptions on the credit markets from July onwards, after witnessing benign price developments in the first half of the year. Investors' concern that the financial market turmoil could negatively impact financial institutions' earnings, economic activity in particularly hard hit countries and mergers and acquisitions (M&A) business, which had previously boosted equity prices, resulted in massive shifts out of equities and into safe-haven government bonds in July and August. Prompt central bank intervention led to a temporary recovery on the stock markets, too, which saw several key indices achieve record highs. At the end of October, however, share prices again started to drop, a development which became more pronounced particulary in January 2008. Overall, most equity indices in industrialised countries still ended the year ahead, with the CDAX heading the field in Europe with 17½%, while the EuroStoxx broad index gained 5% and the US S&P 500 was up 4%. The stock market gains were doubtless helped by the favourable earnings situation of many enterprises and the fact that expectations of corporate earnings growth remained robust despite the need for write-downs in the financial sector. As in 2006, the Japanese stock market, by contrast, underperformed other industrialised countries' bourses in 2007, recording a net loss of 11%.

Risk assessment revised

On balance, market players revised their, in some cases overly optimistic, risk assessment of the past few years in 2007 and have recently also come to a slightly more pessimistic assessment of the economic outlook in the light of the new uncertainty. The borrowing conditions on the capital market, which had previously been exceptionally favourable, have become more difficult overall.

II Economic and monetary developments in the euro area

1 Firm upswing with waning momentum

Rapid growth up to Q3 then slower pace

At 2½%, overall economic output in the euro area grew again in 2007, albeit not as strongly as in 2006 when it increased by 2¾%. The rate of GDP expansion was again higher than that of potential output, resulting in a further rise in capacity utilisation and almost full capacity operation being achieved. In the course of the year, the pace of economic growth in the euro area – taking into account the dip caused by one-off factors in the second quarter – remained robust into the third quarter, but it had slowed by the end of the year. The growth differentials between the member states remained relatively small in 2007. As in 2006, the weighted standard deviation was just under 1 percentage point.

Broader-based growth in 2007

The increase in real GDP in the euro area was sustained mainly by the growth in domestic demand in 2007, which rose by 2¼%, after an increase of 2½% in the previous year. The somewhat slower pace was partially due to the fact that, Economic performance in the euro area

Table 2

Country	Real GDP 2006	Real GDP 2007pe	Consumer prices[1] 2006	Consumer prices[1] 2007	Unemployment rate[2] 2006	Unemployment rate[2] 2007pe
	Annual percentage change				As a percentage	
Euro area	2.8	2.6	2.2	2.1	8.2	7.4
Germany	2.9	2.5	1.8	2.3	9.8	8.4
France	2.0	1.9	1.9	1.6	9.2	8.3
Italy	1.8	1.5	2.2	2.1	6.8	[3] 5.9
Spain	3.9	3.8	3.6	2.8	8.5	8.3
Netherlands	3.0	3.5	1.7	1.6	3.9	3.2
Belgium	2.9	2.7	2.3	1.8	8.2	7.5
Austria	3.3	3.4	1.7	2.2	4.7	4.4
Finland	4.9	4.4	1.3	1.6	7.7	6.9
Portugal	1.2	[3] 1.8	3.0	2.4	7.7	8.0
Greece	4.3	[3] 4.1	3.3	3.0	8.9	[3] 8.4
Ireland	5.7	[3] 4.9	2.7	2.8	4.4	4.5
Luxembourg	6.1	[3] 5.2	3.0	2.7	4.7	4.9

1 Harmonised Index of Consumer Prices (HICP). — **2** Standardised unemployment rate according to Eurostat calculations (ILOdefinition). — **3** European Commission projections (Economic Forecasts, autumn 2007).

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at 4½%, gross fixed capital formation grew noticeably more slowly than in the previous year. This relates very largely to the slowdown in housing construction, which also has to be seen against the backdrop of the turmoil in the financial markets. The expansion of non-residential investment was more or less as sharp as in 2006, however. Private consumption also lacked momentum in 2007. One factor in this was households' reluctance to purchase at the beginning of the year in connection with the significant drop in demand in Germany following the VAT increase. Another was weak private consumption at the end of the year owing to the considerable loss of purchasing power caused by energy and agricultural prices. The overall contribution of net trade to growth was again ¼ percentage point in 2007. This was due to less dynamic growth in exports as well as a slowdown in imports, however.

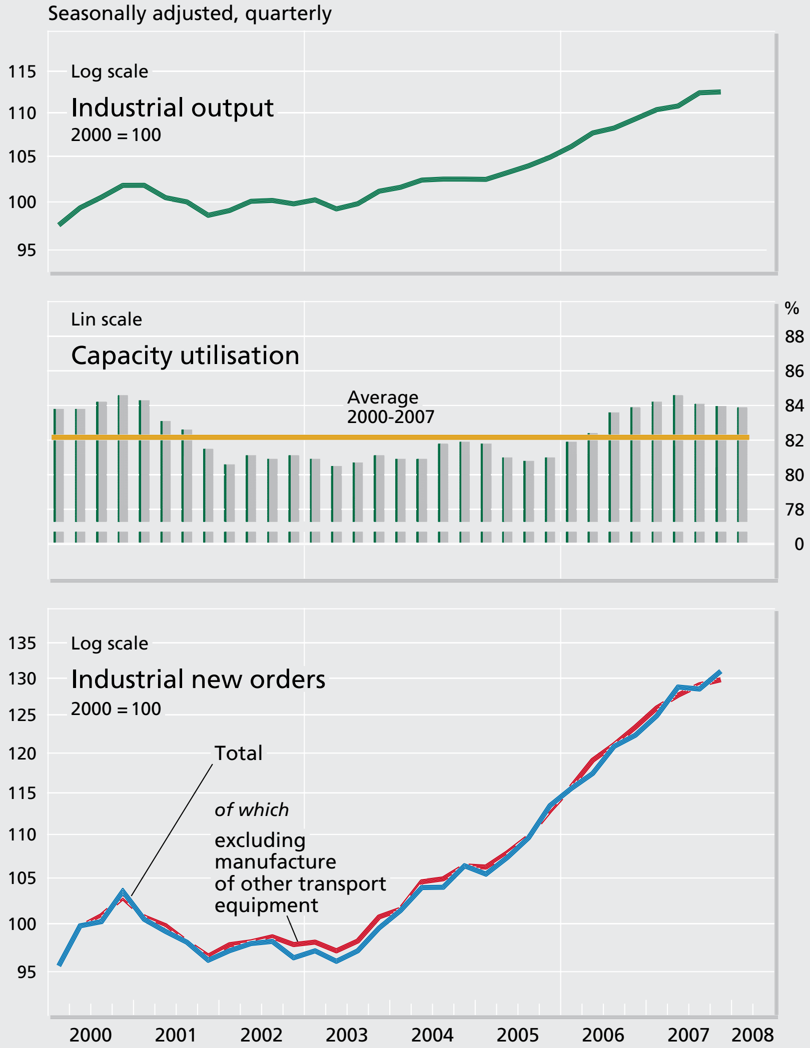
Euro-area economy lately in more difficult setting

The flatter growth rate of real GDP in the final quarter of 2007 may initially continue in the current year. This is suggested, first, by the marked deterioration of the international setting precipitated by the crisis in the USA. This and the strong appreciation of the euro may have a dampening effect on exports. High energy prices are placing a strain on consumer purchasing power. That the economic outlook is no longer untroubled is also reflected by sentiment

Selected indicators of industrial activity in the euro area

Chart 5

Seasonally adjusted, quarterly



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in industry having deteriorated again. At the end of 2007, however, orders received were very buoyant, thus probably ensuring a high level of capacity utilisation for the time being.

Employment up again, unemployment continues to fall

In 2007, the labour market in the euro area continued to benefit from the economic upswing. Employment growth in the first three quarters, at 1.8%, was up considerably on previous years. The number of unemployed fell by 1.2 million and the standardised unemployment rate dropped from 8.2% to 7.4%, thereby falling below its most recent cyclical low of 2001. Despite favourable

Consumer prices in the euro area*

Chart 6

Year-on-year change, quarterly

* Harmonised Index of Consumer Prices (HICP).

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developments in the labour market, wage growth remained subdued. Increasing by just 2.5%, wages and salaries per hour worked in the euro area were, in fact, somewhat lower than in prior years, but with marked variation among member states.

Broad-based increase in prices

Measured by the Harmonised Index of Consumer Prices (HICP), the rise in consumer prices of 2.1% on an annual average last year was, nonetheless, somewhat above the medium-term price norm. In contrast to previous years, however, this was not primarily due to energy and related more to a fairly large part of the basket of goods. The prices of unprocessed food rose most steeply (+3.0%), followed by processed food (+2.8%), which became more expensive owing to increased international demand and short supply. The prices of services went up by 2.5% and, at 1.0%, the inflation rate for industrial goods (excluding energy) was somewhat higher than in 2006. The last two items were also affected by the VAT hike in Germany which added roughly 0.4 percentage point to inflation in the euro area. The average annual rise in energy prices of 2.6% was perceptibly lower than in previous years.

Greater price risks

In the course of 2007, the rate of price increase accelerated sharply from 1.8% in January to 3.1% in December, chiefly on the back of rising crude oil and agricultural prices. In the first two months of 2008, the annual HICP inflation rate in the euro area was 3.2%. The relatively sharp increase in the cost of living together with the improved labour market conditions harbour the risk that upward pressure on wages may also mount and, as a result of price inflation, ease only a little in 2008.

2 Monetary policy and money market developments

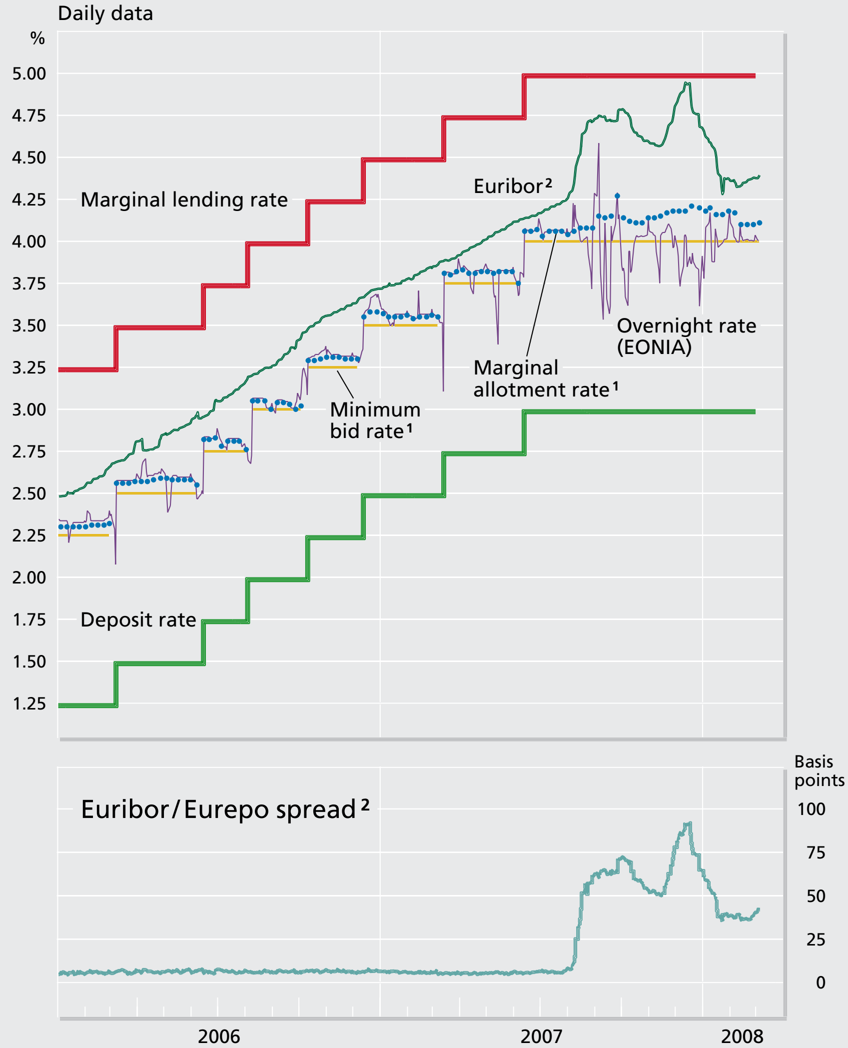
Interest rate decisions in an ever more difficult economic setting…

The expansionary stance of monetary policy continued to be scaled back in 2007 and the monetary policy reins were tightened again. The Governing Council of the ECB countered growing inflation risks by raising the interest rate in March and June, each time by ¼ percentage point. In the second half of the year, however, monetary policy ran into discernibly greater difficulties. Although inflation risks were still high across the board, the turbulence in the financial markets since August – stemming from the problems in the US subprime mortgage market – led the Governing Council to decide against a further increase in key rates. Since the interest rate increase on 13 June 2007, the main refinancing operations have therefore continued to be conducted as

Central bank rates and money market rates

Chart 7

Daily data



1 Interest rate for main refinancing operations. — 2 Maturity of three months.

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variable-rate tenders with a minimum bid rate of 4%; the interest rates on the marginal lending facility and the deposit facility have been 5% and 3% respectively.

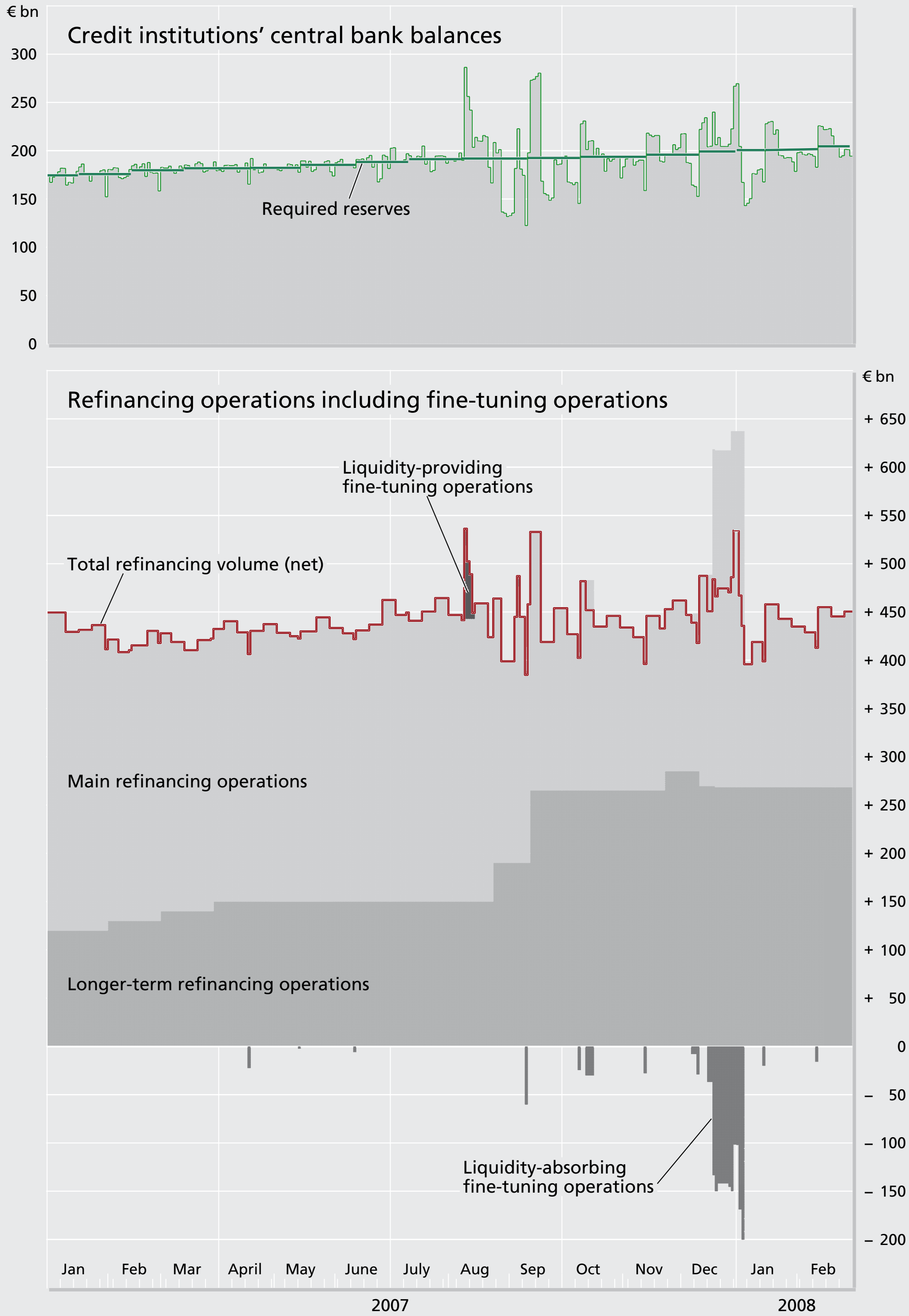
… with continued inflation risks

Given the medium-term risks to price stability, last year's key rate increases were necessary in light of both the economic and the monetary analysis. The economic analysis revealed trend price risks caused mainly by the increased cost of energy, higher food prices, the pick-up in economic activity and the positive development in the labour markets. During the course of the year, the current

Liquidity management of the Eurosystem

Chart 8

Daily data



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Money market management and liquidity needs

By supplying or absorbing central bank money via appropriate monetary policy operations, the Eurosystem's money market management enables euro-area credit institutions to fulfil their minimum reserve requirements in a smooth manner. The aim is to achieve an overnight interbank money market rate – measured in terms of the weighted average referred to as EONIA – which is close to the Eurosystem's key interest rate, ie the minimum bid rate for main refinancing operations. This ensures that the monetary policy stance of the Governing Council of the ECB is reflected accurately in the overnight money market.

Money market tensions as a particular challenge

In the 2007 financial year, liquidity management within the Eurosystem had to contend with particular challenges on account of the tensions arising in the money market in early August 2007. In order to keep the money market functioning as normally as possible and to ensure that the overnight rate remained close to the minimum bid rate, the Eurosystem not only provided generous liquidity but also enabled banks to fulfil their reserve requirements at an earlier juncture within the maintenance period (frontloading) by changing the structure of liquidity provision. In addition, the mix of maturities for the open market operations was adjusted to give three-month refinancing operations a greater weight than those with a weekly maturity. Overall, however, the Eurosystem did not provide any more liquidity than in the preceding periods. On the whole, the Eurosystem's monetary policy framework – including the application of minimum reserves as an effective buffer – proved capable of responding to special liquidity situations in a targeted and flexible manner.

Eurosystem reactions since August

On 9 August, during the August-September maintenance period, overnight funds ran low owing to concerns about the effects of the subprime crisis in the United States; rates climbed to 4.60% over the course of the day. This prompted the ECB to conduct larger liquidity-providing fine-tuning operations. As liquidity needs were not easy to quantify, the first fine-tuning operation was conducted as a fixed-rate tender at 4.00% with pre-announced full allotment of the bids received. All three subsequent procedures, however, were conducted using normal tender procedures, ie as variable-rate tenders with a minimum bid rate and without pre-announced allotment amounts. These rapidly acting operations were supplemented by a substantial topping-up of the Eurosystem's regular main refinancing operations (ie allotments of liquidity volumes well above the banks' benchmark requirement) and two supplementary longer-term tenders in order to revive longer-term segments of the money market. In addition, the Eurosystem intensified its communication with market participants.

Generous liquidity and measures at the turn of the year

The Eurosystem provided banks with a generous supply of liquidity in August and continued to do so in subsequent months in the light of banks' hoarding behaviour and the volatility of overnight funds. The main focus in this respect continued to be the volume allotted in the weekly main refinancing operations; this was supplemented by liquidity-absorbing fine-tuning operations, predominantly at the end of the reserve maintenance periods. After October, no more liquidity-providing fine-tuning operations were required. Alongside the regular longer-term refinancing operations,

Money market management and liquidity needs (cont'd)

the extension of the two special three-month refinancing operations approved by the ECB Governing Council, each adjusted to a volume of €60 billion, was also significant. Owing to fears of liquidity shortages at Christmas and New Year, it was already decided on 30 November that the corresponding main refinancing operation of 19 December would be extended to 16 days. The *de facto* fixed-rate tender proved a suitable measure for reducing uncertainty in the money market owing to the announcement that all bids of 4.21% and above would be satisfied, although the very high above-benchmark allotment[1] of €168 billion quickly brought the overnight rate back down well below 4.00%, which led the ECB to conduct liquidity-absorbing fine-tuning operations on a daily basis up until the maturity date of the main refinancing operation. In addition to the open market operations in euro, two liquidity-providing operations were conducted for the Eurosystem's counterparties, each with a volume of US$10 billion and with a maturity of 28 and 35 days, respectively. This US dollar refinancing move was a joint action involving five central banks.

Short and longer-term money market rates

While the EONIA rates were mostly just above the minimum bid rate up until August, larger fluctuations have been experienced since then. However, the EONIA stabilised towards the end of 2007, reaching 3.92% at the turn of the year. The longer-term euro money market rates, which reached peak levels in mid-December, fell markedly after the turn of 2007-08, when one of the main factors behind the elevated rates – the safeguarding of liquidity at the turn of the year – was eliminated (see chart on page 30).

Development of the factors determining bank liquidity

As well as responding to the tensions in the money market, money market management was also faced with the task of refinancing an increase of €19.1 billion in credit institutions' liquidity needs stemming from autonomous factors, the minimum reserve requirement and excess reserves to an annual average of €440.7 billion, although autonomous factors declined slightly by a total of €6.1 billion. This was primarily due to other autonomous factors, via which €59.9 billion flowed into the market (see table on page 34) and which, taken in isolation, led to a reduction in liquidity needs. Banknotes in circulation gave rise to the greatest liquidity needs, with a significant increase of €51.6 billion. On 28 December 2007, the volume peaked at almost €680.0 billion. Liquidity needs arising from general government deposits with the Eurosystem declined slightly by €3.1 billion. Government deposits in 2007 fluctuated within the usual broad band, ranging from €32.8 billion on 14 March to €76.2 billion on 7 December, although the peak figure was down on the year. The volatility of government deposits measured in terms of the intraday standard deviation was down on the year, falling to €10.6 billion. At €11.7 billion, the volatility of the autonomous factors as a whole was only somewhat higher in 2007. Once again, this emphasised the particular significance of government deposits for the Eurosystem's liquidity forecasts, which provide the basis for decisions regarding the volume of monetary policy operations. Thus, the development of the autonomous factors was determined primarily by the growth trend of euro banknotes in circulation and the short-term fluctuations in government deposits.

1 A main refinancing operation (MRO) benchmark allotment amount is the amount which will prospectively enable the credit institutions to fulfil their minimum reserve requirements without difficulty during the term of the MRO. See European Central Bank, Publication of the benchmark allotment in the main refinancing operations, Monthly Bulletin, April 2004, pp 16-18.

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Money market management and liquidity needs (cont'd)

In order to meet the increased demand for liquidity, the Eurosystem expanded its main and longer-term refinancing operations by €24.5 billion. The expansion was effected exclusively through longer-term refinancing operations with a three-month maturity, which were increased according to plan from €40.0 billion to €50.0 billion in the first few months of 2007 and were stepped up significantly through supplementary operations in the wake of the money market turmoil beginning at the end of August. As a result, the volume of the main refinancing operations was reduced. In 2007, the average volume of the main refinancing operations was €263.6 billion, which was €43.4 billion lower than in 2006. This represented a shift in favour of longer-term refinancing operations: the average share of longer-term refinancing operations in total refinancing increased from August onwards to around 50%.

On an annual average of 2007, credit institutions' central bank balances were up €24.9 billion on the year, roughly reflecting the increase in the minimum reserve requirement. Owing to the substantial monetary expansion in the euro area in 2006, the reserve requirement grew at a faster rate from 12.0% in 2006 to 14.5% in 2007.

All in all, the Eurosystem's money market management in 2007 once again proved reliable in implementing the ECB Governing Council's monetary policy stance in an extremely eventful environment. The integration of Cyprus and Malta into the euro area went smoothly in terms of liquidity management.

Factors determining bank liquidity

Year-on-year changes in annual average values, in € billion

Item	2006	2007
I Provision (+) or absorption (–) of central bank balances owing to changes in autonomous factors		
1 Banknotes in circulation (increase: –)	– 58.4	– 51.6
2 Government deposits with the Eurosystem (increase: –)	+ 2.6	+ 3.1
3 Net foreign assets[1]	+ 32.4	– 5.3
4 Other factors[1]	– 4.3	+ 59.9
Total	– 27.7	+ 6.1
II Monetary policy operations of the Eurosystem		
1 Open market operations		
(a) Main refinancing operations	+ 17.2	– 43.4
(b) Longer-term refinancing operations	+ 27.8	+ 67.8
(c) Other operations	+ 0.0	– 5.4
2 Standing facilities		
(a) Marginal lending facility	+ 0.0	+ 0.1
(b) Deposit facility (increase: –)	– 0.0	– 0.3
Total	+ 45.0	+ 18.8
III Change in credit institutions' credit balances (I + II)	+ 17.3	+ 24.9
IV Change in the minimum reserve requirement (increase: –)	– 17.3	– 23.6

1 Including liquidity-neutral valuation adjustments at the end of the quarter.

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inflation rate rose well above the Eurosystem target of "below, but close to 2%" in the medium term. From a monetary policy perspective, this gave cause for concern since second-round effects could result in a spiral of higher prices and increasing wages, which could lead to the perpetuation of the current swollen inflation rates in the future. Based on continued strong monetary and credit growth together with the abundant supply of liquidity, the conclusion of the monetary analysis was that inflation risks exist in the medium to long term.

Volatile interest rate development following financial-market turmoil in money market…

There was uncertainty about the scale of the credit and liquidity risks to which individual banks active in the money market were exposed as a result of the direct or indirect involvement of their financing and securitisation vehicles in the US subprime mortgage market. This led to considerable tensions at times from August onwards, particularly in the interbank market. Since credit institutions in this setting were no longer in a position to reliably assess their own liquidity needs, and were therefore managing their liquidity with greater caution, money market rates rose across the board. To defuse the tense situation in the money market and build confidence in the functional viability of the markets, the Eurosystem, as soon as the market tensions emerged, indicated its willingness to alleviate any sudden liquidity bottlenecks by offering generous refinancing facilities. Against this backdrop, the Eurosystem provided liquidity during the reserve maintenance periods more quickly than usual through main refinancing operations (frontloading) and, in addition to its regular main refinancing activities, carried out several generous liquidity-providing fine-tuning operations, especially when the turmoil in the money market began. As a result, the increase in the overnight rate (EONIA) was largely contained. Owing to the highly uneven distribution of liquidity over a single reserve maintenance period, the EONIA often fell well below the minimum bid rate, however. To counteract this, the Eurosystem carried out a number of liquidity-absorbing fine-tuning operations – especially towards the end of the maintenance periods.

…and increasing risk premiums

The fact that the market players were very nervous was primarily reflected in the longer-term money market rates, the risk premiums of which rose sharply as of August. The differential, for example, between the uncollaterised three-month Euribor and the security-backed three-month Eurepo initially increased to more than ¾ percentage point, although the Eurosystem had been considerably expanding its long-term tender operations since the end of August with supplementary special refinancing operations with a three-month maturity. After a slight, temporary decline as of mid-October, the interest rate spread had bounced back to over 0.9 percentage point by mid-December in connec-

Refinancing and eligible assets

In general, most liquidity needs in 2007 were again covered by weekly main refinancing operations, involving an average of 338 bidders throughout the Eurosystem. About 67% of these were counterparties of the Bundesbank, accounting for 45% of the volume of main refinancing operations on an annual average. However, at 59%, the share of main refinancing operations in meeting the total liquidity need was lower than in previous years. This was due not only to an increase in the volume of the longer-term refinancing operations by €10 billion to €50 billion each, which had already been decided in 2006, but also to four supplementary longer-term refinancing operations that were offered in addition to the 12 regular monthly operations. As usual, a major part (62%) of the volume of the longer-term refinancing operations was accounted for by the Bundesbank's counterparties, which, with an average of 85 bidders, also accounted for almost 60% of all bidders in the Eurosystem. In addition, as part of the ECB's standard liquidity management, which is marked by frontloading, a fine-tuning operation was carried out on the final business day of ten reserve maintenance periods.

Besides the cited supplementary longer-term refinancing operations, the following additional tenders were carried out for liquidity management and for controlling short-term interest rates in the money market in 2007: five liquidity-providing and nine liquidity-absorbing fine-tuning operations during reserve maintenance periods as well as two US dollar operations for a total of US$20 billion in a concerted action with other central banks. As usual, the standing facilities (marginal lending facility and overnight deposits) were drawn on only on a small scale (€216 million and €492 million respectively on a daily average) but more heavily than last year (€126 million and €171 million respectively).

The introduction of the single collateral framework of the Eurosystem (single list) was completed on 1 January 2007. This meant that the eligibility criteria for assets used as collateral for monetary policy operations and intraday credit were standardised throughout the Eurosystem.

At the end of 2007, the nominal volume of marketable eligible assets in the Eurosystem was around €9,670 billion. About €2,520 billion of this was accounted for by assets listed or held in custody in Germany. This was around 38% of the total number of marketable assets accepted by the Eurosystem.

The total value of assets submitted by the Bundesbank's counterparties went up from €553 billion in 2006 to €664 billion in 2007 (end-of-year levels). Of this, €415 billion was accounted for by assets held in custody in other Eurosystem member states and, therefore, on a cross-border basis for refinancing at the Bundesbank.

The fact that an increased volume of eligible assets was being submitted was especially noticeable in connection with the turbulence in the financial markets. Since the start of August 2007 alone, the Bundesbank's counterparties have increased their deposited pools of collateral by almost €100 billion. This increase has occurred spread equally through all available submission channels and through all types of eligible assets.

At the end of 2007, 45% of the eligible assets submitted as collateral to the Bundesbank were uncovered bank debt securities, 18% were covered bank debt securities (Pfandbriefe) and 14% were government bonds. The share of other marketable assets was 18%. The share of credit claims in the total pool of assets, at 5%, was ten times higher than in 2006. At over €35 billion, the value of deposited credit claims was higher than that of loans to enterprises in the period prior to European monetary union (around DM 65 billion in 1998), when trade bills still played a significant role as eligible collateral in Germany. In addition to the extended scope of eligible credit claims, this rise is due, in particular, to the web-based platform "Credit claims – submission and administration (KEV)", which was developed by the Bundesbank and introduced in January 2007.

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tion with the turn of the year and the associated accounting rules and habits. The very generous liquidity allotment prior to Christmas and the smooth transition to the new year then had a marked dampening effect on the interest rate differential. It was last measured at around 40 basis points, but was still higher than before the outbreak of the financial market turbulence (less than 10 basis points). Ultimately, the Eurosystem, in employing the above-mentioned measures, was aiming to keep the overnight rate close to the minimum bid rate of the main refinancing operations – the most important indicator of the monetary policy stance adopted by the Governing Council – and prevent long-term liquidity shortages having a destabilising effect on the financial system as a whole.

3 Strong monetary growth with continued dynamic credit expansion

Very strong monetary growth, especially of components at market rates

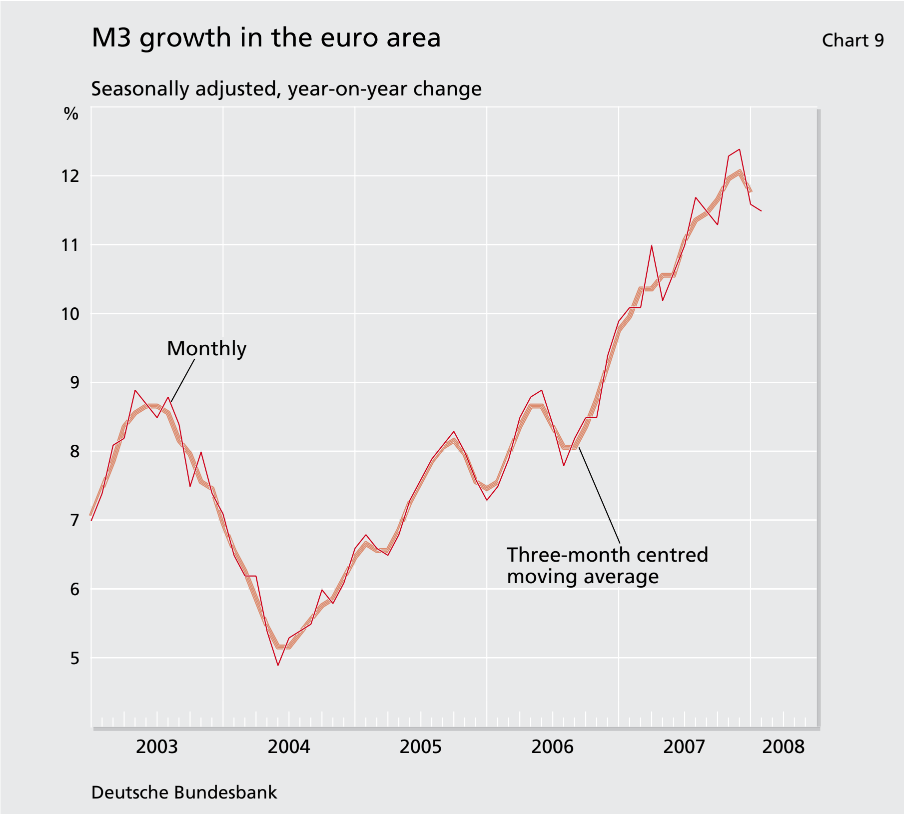
M3 growth was again very strong last year; for the October to December period of 2007, the moving three-month average of the annual M3 growth rates was 12.1%, its highest level since the start of monetary union. As in 2006, there was a sharp rise, above all, in M3 components remunerated close to market rates in 2007. The rise in short-term time deposits (41.4%), marketable instruments (money market fund shares (9.6%), short-term bank debt securities (60.3%) and repurchase agreements (14.7%)) was even more pronounced than in the previous year. The rapid pace of monetary growth was fuelled by the flat and, at times even, inverse yield curve. The increase in repurchase agreements and short-term bank debt securities witnessed in recent months may also be influenced by tensions in the money market. Overall, monetary growth as such in the reporting period nevertheless exceeded the level that is acceptable in terms of longer-term price stability.

Moderate rise in liquid components

In contrast, the higher opportunity costs of holding money following the rise in interest rates dampened the growth of the very liquid components last year. Cash holdings increased by no more than 8.2%; one year earlier, their growth rate had been in double figures. Growth in overnight deposits, at 3.3%, was also significantly down on the year. Deposits redeemable at notice of up to three months also reacted sensitively to the continued tightening of interest rate policy, falling by 3.6%.

Further strong growth in loans to the private sector

Among the counterparts of M3, loans to the domestic private sector were once again clearly the dominant determinant of money creation in the euro area. Unsecuritised lending to enterprises and households rose by 11.2% in



2007. This development was supported by strong growth in loans to MFIs, which again rose by more than 8 percentage points to 23.6%. Moreover, loans to non-financial corporations increased very sharply at 14.5%, which, in itself, implies that the financial market turbulence has yet to lead to notably more restrictive lending by banks in the euro area. Loans from domestic banks to households, by contrast, grew at a slower rate than in the previous two years. This development was under way before the onset of the recent financial market turmoil, however, and may be attributable to the gradual increase in interest rates and the slowdown in the real estate markets in some euro-area countries. Furthermore, banks in the euro area began purchasing large quantities of securities issued by the domestic private sector, while holdings of public bonds were significantly scaled back. Overall, loans to general government fell by 2.3%.

Monetary capital formation still strong

Unlike in the previous year, foreign payments had no significant effect on monetary growth. While inflows from abroad to euro-area members totalled €200½ billion in 2006, the net external asset position of the banks increased by no more than €17 billion in the reporting year. The continued strength of monetary capital formation by euro-area non-banks had a dampening effect on

Monetary developments in the euro area

Table 3

Changes in the course of the year[1]

Item	2006	2007
	as a percentage	
I Growth of the monetary aggregates		
M1[2]	7.5	4.1
M2[3]	9.3	10.2
M3[4]	9.9	11.6
	€ billion	
II Money stock and its counterparts		
M3 (= 1+2–3–4–5)	696.1	895.1
Currency in circulation and overnight deposits	255.5	150.1
Other shorter-term bank deposits	309.9	525.6
Marketable instruments	130.7	219.4
Balance sheet counterpart		
1 Total credit to non-MFIs in the euro area	991.1	1,310.0
Credit to general government	– 114.1	– 51.5
Credit to private-sector non-MFIs in the euro area	1,105.2	1,361.5
2 Net claims on non-euro-area residents	200.5	17.3
3 Central government deposits	– 17.2	– 11.0
4 Longer-term financial liabilities to other non-MFIs in the euro area	426.9	497.1
5 Other counterparts of M3[5]	85.8	– 53.9

1 Seasonally adjusted. — **2** Currency in circulation and overnight deposits held by euro-area residents with MFIs in the euro area. — **3** M1 plus other short-term bank deposits held by euro-area residents with MFIs in the euro area (deposits with an agreed maturity of up to two years and deposits with an agreed notice period of up to three months). — **4** M2 plus marketable instruments held by euro-area residents (repurchase agreements concluded by MFIs with non-MFIs in the euro area, money market fund shares/units and debt securities issued with a maturity of up to two years by MFIs in the euro area). — **5** Calculated as a residual.

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the growth of M3; these non-banks stepped up their longer-term investments at banks by 9.1% during the course of last year. Longer-term time deposits with an agreed maturity of more than two years accounted for the largest part of this (+9.9%) followed by the net issue of longer-term bank debt securities outside the domestic banking sector (+6.3%). The volume outstanding has been falling since September, however. The simultaneous marked increase in short-term bank debt securities suggests that, in the wake of the financial market turbulence, investors are waiting first to see how yields continue to develop in the financial markets before making long-term investment decisions.

III Economic trends in Germany

1 Sound upturn, increasing level of employment

Underlying trends

The German economy remained on a sound upward path in 2007. Real GDP was up by an average of 2.5% on the year. After adjustment for the varying number of working days, this represents an increase of 2.6%. Growth was therefore not quite as strong as in 2006. However, it should be noted that the German economy was having to cope with the sharp rise in VAT in 2007. The fact that growth was not affected to an even greater extent is a reflection of the underlying economic momentum and the scope of the current cyclical upturn. As in 2006, output again grew more strongly than potential, with the result that overall economic capacity utilisation also increased. The corridor of normal utilisation is now likely to have been reached. The improvement which the German economy has also made in terms of its longer-term growth fundamentals is particularly well illustrated by the – now strong – recovery in the labour market and the greater employment intensity on a cyclical comparison. However, the price climate in 2007 was no longer unimpaired. The year-on-year rise in consumer price inflation (CPI) averaged 2.3%. The unfavourable price trend also continued into the new year.

Export growth still strong

German exports of goods and services continued to be a strong driving force behind overall economic growth in 2007. In real terms, they went up by 7.8%. German exporters therefore managed to increase their market shares on the whole. This is striking given the fact that, owing to the appreciation of the euro, the price competitiveness of the German economy declined by an annual average of 1¼%. On the whole, however, price competitiveness remained comparatively favourable. The price and cost situation of German exporters improved more than that of euro-area partner countries. As a result, exports of goods to other euro-area countries went up somewhat more sharply than those to non-euro-area countries. However, the greatest growth in 2007 was achieved in the trade of goods with Russia (+21½%) and with the 11 new EU member states (+16%).[1]

Slower pace of growth in imports

At constant prices, imports of goods and services went up by 4.8% in 2007, which was markedly lower than in the previous year. Demand for foreign

1 The data on trade in goods also contain supplementary trade items and are calculated on an fob/fob basis, ie without the freight and insurance costs payable on imports, which are shown under services.

Key economic variables in Germany

Table 4

Annual percentage change

Item	2004	2005	2006	2007
Growth (real)[1]				
Private consumption	+ 0.2	– 0.1	+ 1.0	– 0.4
Government consumption	– 1.5	+ 0.5	+ 0.9	+ 2.1
Machinery and equipment	+ 4.6	+ 6.0	+ 8.3	+ 8.2
Premises	– 3.8	– 3.1	+ 4.3	+ 2.3
Other investment	+ 2.1	+ 4.8	+ 6.7	+ 6.6
Domestic use	– 0.2	+ 0.3	+ 1.9	+ 0.9
Exports[2]	+ 10.0	+ 7.1	+ 12.5	+ 7.8
Imports[2]	+ 7.2	+ 6.7	+ 11.2	+ 4.8
Gross domestic product	+ 1.1	+ 0.8	+ 2.9	+ 2.5
Contribution to GDP growth in percentage points				
Domestic use (excluding inventories)	– 0.2	+ 0.2	+ 1.8	+ 1.0
Changes in inventories	– 0.1	0.0	– 0.1	– 0.1
Net exports	+ 1.3	+ 0.5	+ 1.1	+ 1.6
Employment				
Employed[3]	+ 0.4	– 0.1	+ 0.6	+ 1.7
Average working time per employed person	+ 0.2	– 0.5	– 0.2	+ 0.0
Total number of hours worked	+ 0.6	– 0.6	+ 0.5	+ 1.7
Unemployed (in thousands)[4]	4,381	4,861	4,487	3,776
Western Germany	2,783	3,247	3,007	2,486
Eastern Germany	1,599	1,614	1,480	1,291
as a percentage of the civilian labour force	10.5	11.7	10.8	9.0
Western Germany	8.5	9.9	9.1	7.5
Eastern Germany	18.4	18.7	17.3	15.1
Prices				
Consumer prices	+ 1.7	+ 1.5	+ 1.6	+ 2.3
Producer prices of industrial products[5]	+ 1.6	+ 4.6	+ 5.5	+ 2.0
Construction prices[6]	+ 1.1	+ 1.3	+ 2.5	+ 7.2
Import prices	+ 1.0	+ 4.3	+ 5.2	+ 1.2
Export prices	+ 0.5	+ 1.3	+ 2.3	+ 1.8
Terms of trade	– 0.6	– 2.9	– 2.7	+ 0.5
GDP deflator	+ 1.1	+ 0.7	+ 0.6	+ 1.8
Productivity and labour costs				
GDP per hour worked by employed persons[1]	+ 0.5	+ 1.3	+ 2.4	+ 0.8
Compensation per hour worked by employees[3]	+ 0.1	+ 0.6	+ 1.3	+ 0.9
Labour costs per unit of value added in real terms in the economy as a whole[7]	– 0.4	– 0.7	– 1.1	+ 0.1

Sources: Federal Statistical Office; Federal Employment Agency. — **1** At constant prices and chained (2000 = 100). — **2** Balance of transactions in goods and services with the rest of the world. — **3** Domestic concept. — **4** As defined by the Federal Employment Agency. — **5** Domestic sales. — **6** Calculated by the Bundesbank on the basis of Federal Statistical Office data. — **7** Gross compensation generated in Germany per hour worked by employees divided by real GDP per hour worked by employed persons.

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goods was rather subdued, especially in the first half of the year. This was due primarily to the pressure on consumer demand arising from the increase in VAT. Furthermore, there was a perceptible decline in the volume of Germany's annual average energy imports, which was attributable mainly to the mild winter weather at the beginning on 2007. In addition, the annual average rise in the price of imported energy sources, at +2.2%, was relatively modest owing to the appreciation of the euro vis-à-vis the US dollar. Thus, the resulting additional loss of purchasing power in the economy as a whole, at €1½ billion, was lower than in previous years.

Investment growth continues

The growth in investment in machinery and equipment, which has been apparent since 2004, continued at a rapid pace in 2007 as well. Investment activity benefited from the high level of demand from abroad and the sound domestic sales prospects. The favourable depreciation conditions for movables, which expired following the implementation of the business tax reform at the beginning of 2008, are also likely to have provided a certain amount of additional stimulus. Admittedly, anticipatory effects, which will be missing from the figures in 2008, also played a part in this. The strong growth in output over the past two years was accompanied by a very high level of capacity utilisation, primarily in the manufacturing industry. With the continued sharp rise in new orders, the ratio of the order volume to available production capacity (order capacity index) reached its highest level since German reunification. In terms of the investment behaviour of enterprises, the incentive to expand production capacities has increasingly become more prominent as an investment motive. The Ifo business climate index was reaching peak levels well into the second quarter of 2007. Against the backdrop of the US mortgage crisis, sentiment indicators tended to be visibly weaker in the second half of the year but still remained at quite a high level. The financing conditions, not least as a result of the favourable earnings situation, did not prevent the demand for industrial machinery and equipment from expanding further.

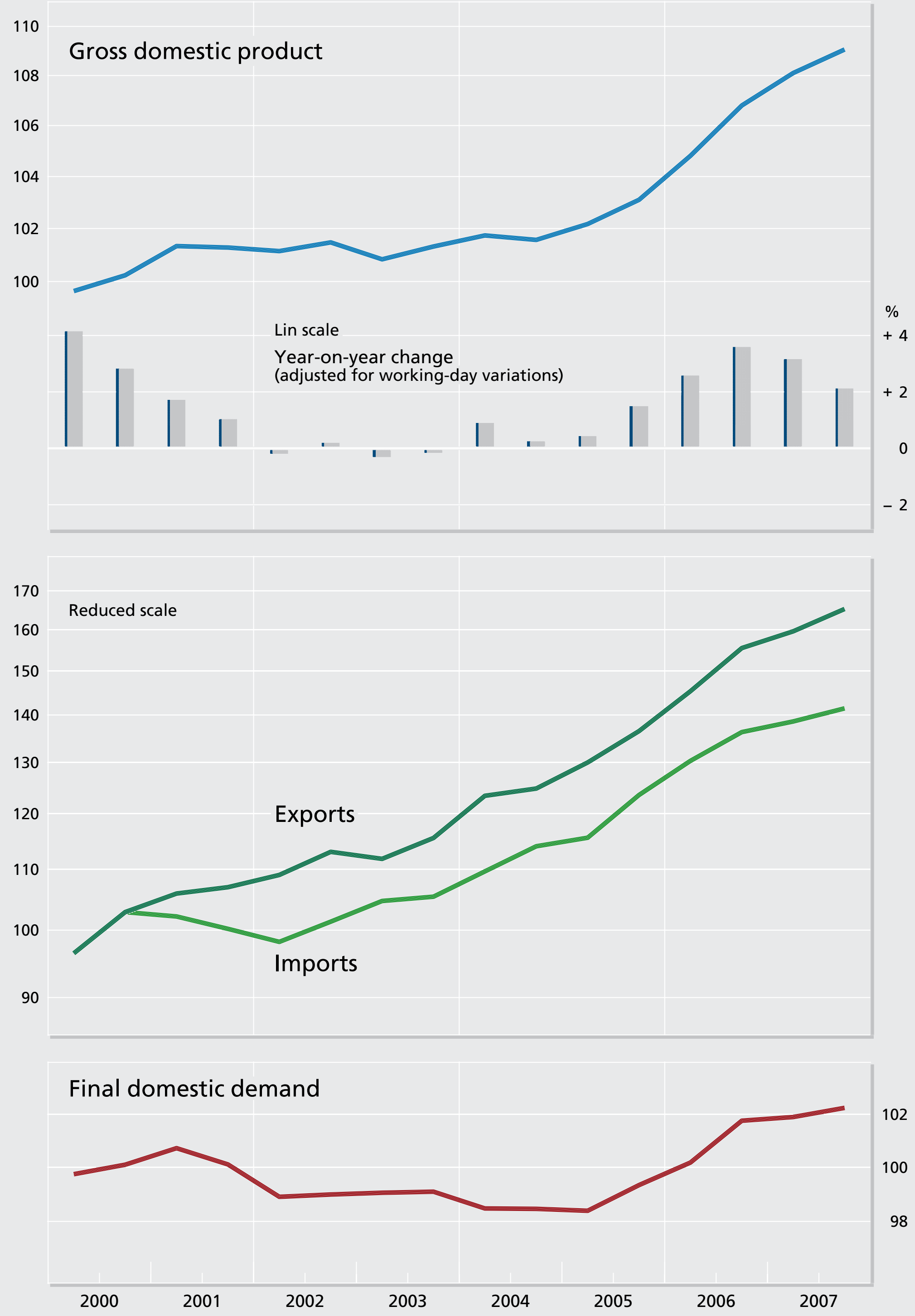
Mixed construction developments

Following the turnaround in construction activity in 2006, construction investment made a positive contribution to overall economic growth in 2007 as well. The growth pattern was fairly volatile, a development which was linked to the very mild weather at the beginning of the year. Construction activity in the first quarter of 2007 was therefore more buoyant than usual at that time of year. Accordingly, the upturn usually observed in the spring was weaker than in previous years. Construction stagnated in the second half of the year. Idiosyncratic effects continued to play an important role in housing construction.

Gross domestic product and
selected expenditure components

Chart 10

Price-adjusted, 2000 = 100, seasonally adjusted, half-yearly, log scale



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A large number of construction projects, which had been planned owing to the forthcoming abolition of the grant to homebuyers at the end of 2005, were – not least because of the rise in VAT – initiated in 2006 but not concluded until the beginning of 2007. As the anticipatory effects then petered out, there was a lack of subsequent orders. Developments in industrial construction were significantly better; this was due to the fact that the sustained high level of capacity utilisation in the economy implied that the construction of new production plant was required. The public sector also contributed towards the growth in construction, a development which was facilitated by the cyclical increase in tax revenue.

Private consumption hampered by anticipatory effects and sharp price increases

As expected, the loss in purchasing power induced by the VAT increase had a significant dampening effect on private consumption expenditure in 2007. Whereas in 2006 private consumption expenditure had gone up by 1.0% – again as a result of anticipatory effects – and thereby managed to break away somewhat from years of stagnation, it declined by 0.4% in 2007. The expenditure which had been brought forward was "missing", primarily in the first half of the year, and depressed households' demand for consumer durables, especially for new cars. In the retail trade sector (excluding cars), it was particularly the sales of furniture and construction materials that were affected. At the macroeconomic level, this was reflected in household saving. The percentage of disposable income that went into savings stood at a seasonally adjusted 10.4% in the fourth quarter of 2006. The saving ratio went up to 10.8% in the first six months of 2007. At 10.9%, the annual average rise in 2007 was 0.4 percentage point up on the year. In the latter part of 2007, energy and agricultural price-related upward pressure on prices largely restricted the scope for expenditure. According to the survey conducted by the Gesellschaft für Konsumforschung, there was a temporary deterioration in consumer price expectations between August and November owing to the pressure of higher food and energy prices. At the same time, consumers' propensity to spend also declined. This shows how important it is to maintain price stability in order to ensure continued economic growth and a spillover of the expansionary forces to consumer spending. However, the exceptionally favourable development in the labour market, which continued to characterise the first two months of 2008 as well, boosted private consumption throughout the year.

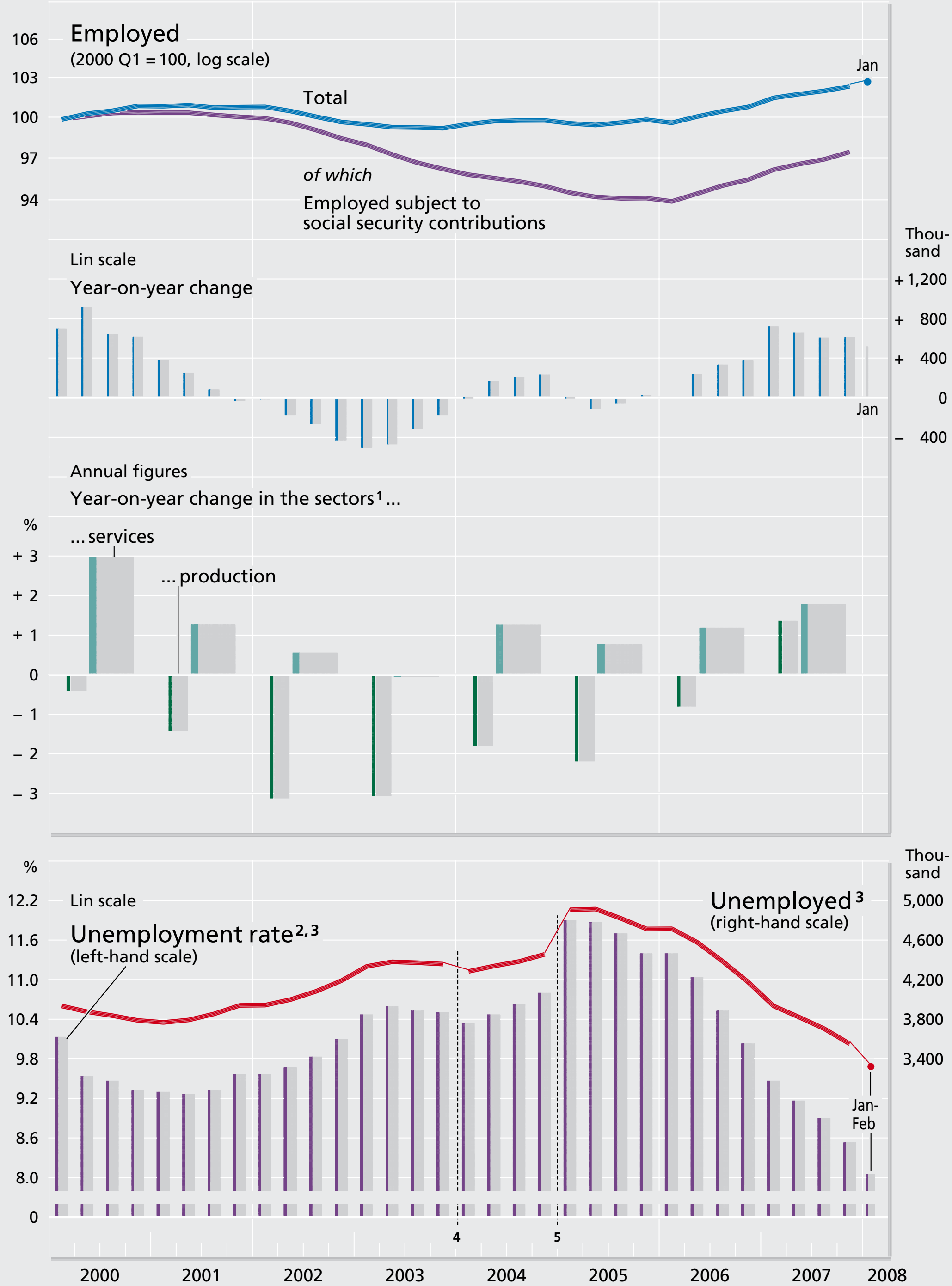
Labour market improves

The labour market improved substantially last year. Despite a slight deceleration in economic growth, the rate of increase in employment went up from 0.6% in 2006 to 1.7%. Thus, the current upturn is proving particularly employment-intensive; the wage restraint and the labour market policy reforms of the past

Labour market

Chart 11

Quarterly, seasonally adjusted



1 Column width proportional to the total number of persons employed. — **2** Unemployed as a percentage of the civilian labour force. — **3** As defined by the Federal Employment Agency. — **4** From January 2004, unemployed excluding participants in aptitude testing and training schemes. — **5** Increase influenced by inclusion of persons receiving social assistance who are able to work.

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few years also played a role in this. According to estimates by the Federal Statistical Office, the number of persons in employment averaged 39.74 million in 2007, 650,000 more than in the previous year. By far the majority of these were persons subject to social security contributions (+580,000 or +2.2%). There was also a further rise in the number of self-employed persons (+1.2%), despite the decline in government assistance. By contrast, there was little change in low-paid part-time employment. The number of one-euro jobs declined by 0.8%. The average number of hours worked in 2007 was just as high as in 2006. According to estimates by the Institute for Employment Research (IAB), the increase in the number of part-time positions was offset by a greater deployment of labour in full-time and part-time employment. This means that the total number of hours worked in the economy increased at the same pace as the number of persons in employment.

Structure of employment growth

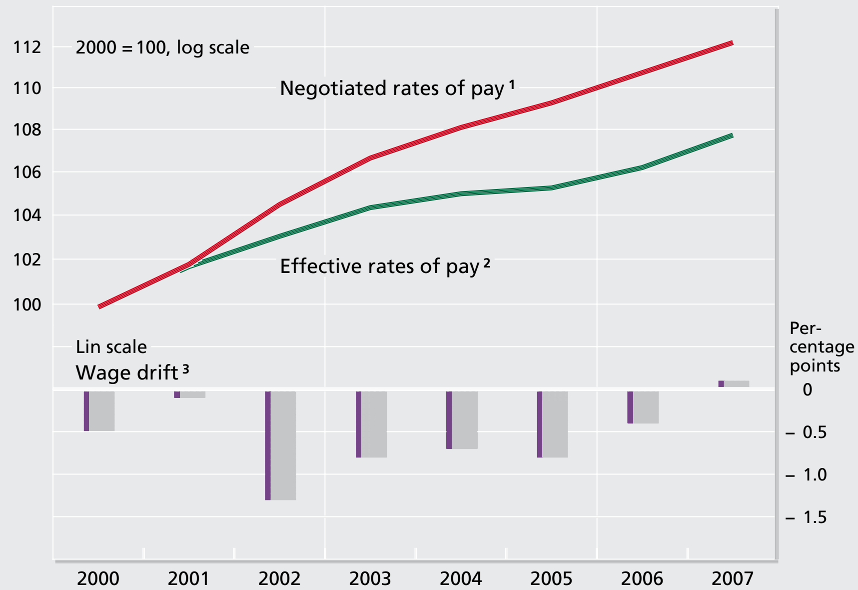
The growth in employment encompassed all areas of the economy. The process of contraction which had been under way for a number of years in manufacturing, in construction and in agriculture, hunting, forestry and fishing came to a halt in 2007. The greatest increase, at 1.9%, was recorded in the construction sector. The strong growth in the services sector (+1.8%) was due, to a large extent, to the expansion in labour leasing. According to calculations by the Federal Employment Agency, the number of employees subject to social security contributions in the "finance, renting and business services" sector, where subcontracted work is also recorded in the statistics, went up by 7.3% year on year. These workers were deployed to a large extent in industry, with the result that the growth rate in manufacturing, at 1.3%, is understating the contribution of this sector to overall employment growth. Surveys carried out by the IAB show that, despite the large number of new appointments, 1.1 million (non-government-assisted) positions were still vacant on an average of the first three quarters of 2007; this was 27% more than in the same period of the previous year. The 13-day increase in the average vacancy period to 66 days is a reflection of the increasing difficulties experienced by some sectors in filling vacancies.

Decline in long-term unemployment

The decline in unemployment was actually somewhat greater than the growth in employment in 2007; the intensified support and control measures by the Federal Employment Agency contributed to this. In 2007, an average of 3.78 million persons were registered as unemployed; this was 710,000 fewer than in 2006. Measured in terms of the labour force, unemployment decreased from 10.8% to 9.0%. The long-term unemployed also benefited increasingly from the improvement in the labour market situation. The number of unemployed

Labour income

Chart 12



1 Level of negotiated wages and salaries calculated on a monthly basis. — **2** Wages and salaries per employee. — **3** Deviation in rates of change between effective rates of pay and negotiated rates of pay.

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persons receiving minimum benefits – primarily the long-term unemployed – declined by 300,000 persons on the year. This development is to be evaluated even more highly given the fact that, at the beginning of 2007, the period of entitlement to insurance benefits was reduced to 12 months, and this accelerated the transition to unemployment benefit II. The decline in unemployment continued in the first two months of 2008. The seasonally adjusted unemployment rate fell from 8.4% in December 2007 to 8.0% in February 2008.

Wage developments differing by sector

Against the backdrop of rising employment, declining unemployment and a further improvement in enterprises' profitability, there were discernibly higher wage settlements in 2007, especially in export-oriented sectors. Nevertheless, the annual average increase in negotiated rates of pay, at 1.3%, remained subdued. Some of the newly agreed wage increases did not take full effect until later in 2007 or, in some cases, will not become effective until 2008. Furthermore, the majority of wage agreements in the services sector were significantly more moderate than in industry. Finally, contracts negotiated in the past and with a duration of more than one year which envisaged small increases in basic rates of pay, if at all, ie in the case of employees working for central and local government, for example, continued to have an effect. On the whole, negotiated rates of pay in the production sector went up by 2.3%, compared with 0.8% in the services sector. Actual earnings per employee in 2007, at 1.4%, increased a little more sharply than contractually agreed wages. The marked negative wage drift (on a monthly basis) observed over the past few years was due, in part, to a downward trend in the average number of hours worked; it also, however, reflected the home-grown pressure on wages. There was a slight rise in unit labour costs in 2007 of +0.2%, whereas they had experienced a constant decline in previous years. The rise in wage costs is likely to accelerate significantly in 2008 as a result of the higher wage agreements.

Major changes in collective bargaining

The strong sectoral differentiation of wage agreements was accompanied by a further relaxation of collective wage agreements. According to findings by the IAB, the number of employees working under collective wage agreements went down from 69% in 1996 to 57% in 2006 in western Germany and from 56% to 41% in eastern Germany. Small but well-organised break-away unions were increasingly able to achieve above-average wage increases for their members. However, wage agreements in many other sectors – especially in the services sector and the craft trades – have not been renegotiated for quite some time. The introduction of sector-specific minimum wages in accordance with the German Employee Posting Act is supposed to counteract the downward pressure on wages for low-skilled workers, which is due, not least, to the opening-up of eastern Europe and the deregulation of product markets. Minimum wages, which are significantly higher than those for comparable jobs in other sectors without minimum wages, were also set for unskilled work. Ultimately, these measures will jeopardise the increasingly evident success of the labour market reforms which have been initiated over the past few years. This applies, in particular, to low-skilled workers, who, as a result, are again likely to be increasingly affected by unemployment and dependent on transfer income.

Temporary lull in external upward pressure on prices

Domestic price developments in 2007 were heavily influenced by the sharp rise in VAT. By contrast, the external influences which had hitherto been in the forefront weakened for a time. The development was due not only to the more subdued rise in crude oil prices and the easing in prices for metal ores, but also to the strong appreciation of the euro. Later in the year, however, rising prices on the markets for crude oil and agricultural products caused external price impulses to intensify again. The annual rise in import prices averaged 1.2% in 2007, compared with 5.2% in the previous year. At the domestic producer level, too, the annual increase in domestic sales prices in 2007, at 2.0%, was

Prices at various levels of the economy — Table 5

Annual percentage change

Item	2006 Q4	2007 Q1	Q2	Q3	Q4
Import prices	2.6	0.8	0.7	0.4	3.2
Energy	2.1	– 6.8	– 4.2	– 0.9	21.8
Animal feed	8.0	11.3	15.9	14.0	12.3
Vegetable and animal oils and fats					
Dairy products	2.0	3.3	7.9	18.4	25.8
Bread and cereals	2.3	4.2	5.6	7.3	8.3
Basic metals and semi-finished products	27.3	21.5	16.1	5.7	– 0.8
Other	0.3	0.0	0.0	– 0.4	– 0.6
Industrial producer prices	4.6	2.9	1.7	1.2	2.2
Energy	9.5	2.4	– 1.2	– 2.5	2.1
Animal feed	7.5	12.0	13.4	20.3	31.4
Vegetable and animal oils and fats					
Dairy products	1.0	1.8	3.6	12.7	25.0
Bread and cereals	3.5	5.1	5.3	7.8	11.4
Basic metals and semi-finished products	16.2	13.3	10.1	4.7	1.3
Other	2.0	2.3	2.2	2.4	2.5
Construction prices	4.0	7.7	7.9	7.0	6.4
Residential buildings	3.6	7.6	7.7	6.9	6.3
Industrial and office buildings	3.9	7.8	8.0	7.2	6.5
Agricultural producer prices	9.5	8.6	5.9	12.7	p 18.5
Milk, eggs and oil-bearing plants	3.2	4.7	9.1	29.9	p 43.1
Cereals	39.4	41.6	34.9	73.0	67.9
Consumer prices	1.3	1.7	1.9	2.1	2.8
Energy	1.8	2.4	1.8	2.7	8.6
of which					
Refined petroleum products	– 4.1	– 1.9	– 1.0	1.2	14.5
Gas	14.6	8.8	3.4	1.8	– 2.2
Electricity	4.0	6.1	6.1	7.1	8.1
Food products	3.0	2.2	2.0	2.4	5.6
of which					
Dairy products and eggs; Edible fats and oils	– 0.1	– 0.1	0.4	5.7	17.5
Bread and cereals	1.8	2.2	2.5	2.7	5.0
Industrial goods (excluding energy)	1.0	1.7	1.7	1.8	1.3
Services (excluding rents)	1.0	2.0	2.8	2.8	3.0
of which					
Education	3.4	3.1	28.5	27.9	29.1
Housing rents	1.1	0.9	0.9	0.9	1.0

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more moderate than in the previous year when prices had gone up by as much as 5.5%. In the export trade, German enterprises were able to increase their prices by an average of 1.8%. As a result, there was again a slight year-on-year improvement in the terms of trade. Owing to the more favourable selling conditions in the international agricultural markets, producer prices for agricultural products went up sharply again, despite a rather abundant domestic supply. Unusually sharp price rises were recorded in the case of dairy products, with excess demand in the international markets being particularly pronounced.

Consumer prices driven by fiscal effects

On balance, consumer prices in 2007 rose much faster than in previous years. According to the national consumer price index, prices went up by 2.3%. In 2006, the corresponding rate stood at 1.6%. This increase in price pressure was primarily the result of major fiscal influences. At the beginning of 2007, the standard rates of both VAT and insurance tax went up from 16% to 19%. Furthermore, university tuition fees were introduced in a number of federal states. Finally, the compulsory blending of biofuels, which came into force at the beginning of 2007, led to an increase in the price of fuel for road vehicles. These measures contributed around 1½ percentage points to average price inflation. An additional factor – as already mentioned – was the significant rise in the prices of food and energy in the second half of the year owing to influences in the world market. The price of some products, such as butter, went up by as much as 50% within the space of a few months. Alongside dairy products, bakery products and other cereal products were primarily affected. These trends continued in the first few months of 2008. In January and February, seasonally adjusted prices rose by 0.2%. They went up by 2.8% on the year.

Sharp rise in construction prices

The rise in housing rents, at 1.2% on average, remained quite moderate in 2007. According to Bundesbank calculations based on data from BulwienGesa AG, rent increases for new lettings were not much steeper either. However, the sharp rise in the cost of construction services – construction prices went up by no less than 7.2% year on year, mainly as a result of the increase in the cost of materials and the increase in VAT – would suggest that a sharper rise in housing rents is to be expected in the future. According to Bundesbank calculations based on data provided by BulwienGesa AG, the higher construction costs have not yet had any major effects on property prices. While, in 2007, the price of new dwellings increased by around 1%, the average price of second-hand dwellings remained unchanged.

2 Public finances: further marked improvement

In 2007 general government budget was balanced for first time since 1989

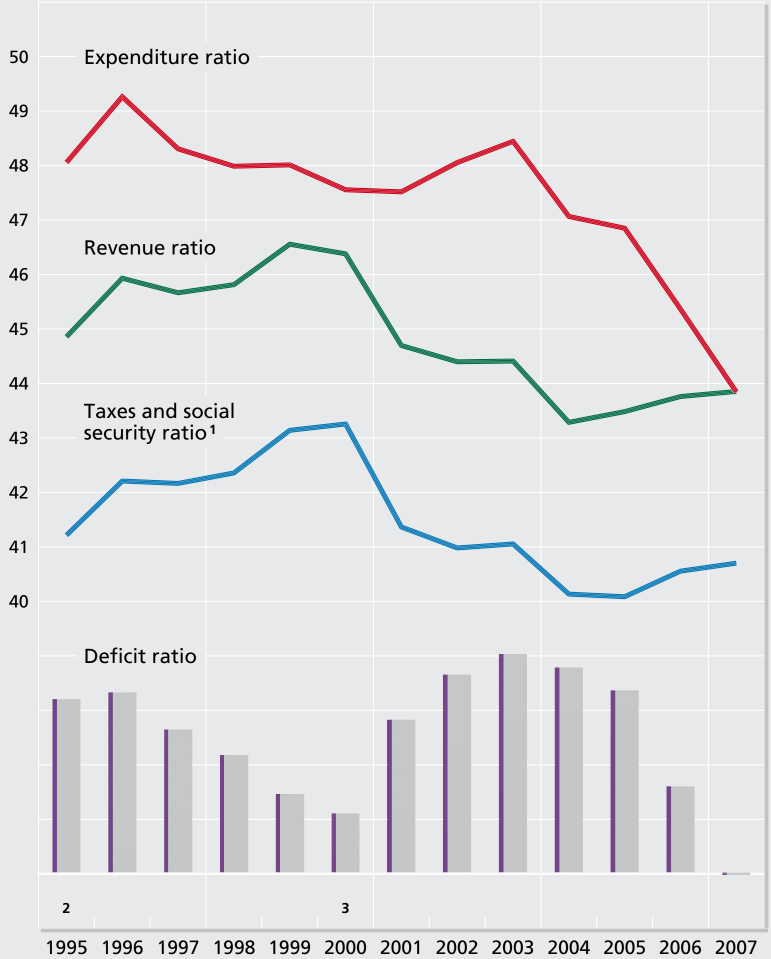
The public finance situation showed a further marked improvement last year. Following the prior-year fall in the general government deficit ratio, as defined in the national accounts, of 1.8 percentage points to 1.6%, 2007 was the first year in which a balanced general government budget was reported since 1989.[1] Although the favourable macroeconomic setting contributed to the de-

1 With the exception of the surplus in 2000 (1.3% of GDP) owing to one-off proceeds from the sale of UMTS mobile telephone licences (2.5% of GDP).

General government fiscal ratios*

Chart 13

As a percentage of GDP



* As defined in the national accounts. — **1** Tax and social contributions plus customs duties and EU share in VAT. — **2** Adjusted for transactions in connection with the dissolution of the Treuhand agency. — **3** Excluding proceeds from the UMTS auction.

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cline in the deficit, much of it is due to structural factors such as, notably, the increases in taxes and social security contributions that came into force at the beginning of 2007 and also to moderate expenditure growth. The goal that the Federal Government set itself in the context of the EU budgetary surveillance process of achieving a structurally balanced budget in the medium term was probably more or less met last year. However, the high volume of profit-related taxes which was, for the most part, interpreted as a structural component, implies a major potential for future consolidation reverses. The excessive deficit procedure which was initiated against Germany in 2003 was dropped in June

2007. At the end of last year, government debt as defined in the EC Treaty amounted to an estimated €1.57 trillion and thus increased slightly on the year. The debt-to-GDP ratio declined from 67.5% to approximately 65% owing to sharp nominal economic growth.

Hardly any rise in revenue ratio despite raised tax rates

In 2007, government revenue amounted to almost 44% of GDP. This means that the ratio hardly rose at all vis-à-vis 2006. It is true that the changes in legislation that came into force at the start of 2007 (rise in the standard rate of VAT and of insurance tax and higher contribution rates to the statutory pension insurance and health insurance schemes on the one hand, and lowering of the contribution rate to the Federal Employment Agency on the other) resulted in considerable revenue growth on balance. In addition, revenue from profit-related taxes continued to expand more strongly than was to be expected based on the changes in legislation and the sharp growth in entrepreneurial and investment income, which is used as an indicator for the tax assessment base. Yet this boost to revenue was largely offset by the fact that major macroeconomic reference variables for government revenue, such as gross wages and salaries and above all pre-tax private consumption, increased more slowly than nominal GDP.

Sharp fall in expenditure ratio

Government expenditure recorded a moderate increase of approximately 1% last year, which meant that in relation to GDP it went down sharply to just under 44%. Labour market-related spending fell appreciably, mostly thanks to the favourable employment development. The subdued increase in pension and personnel expenditure in comparison to nominal GDP also played its part in the decline in the expenditure ratio.

Government still has fiscal deficit

In 2007, the combined fiscal deficit of central, state and local government (as defined in the budget accounts) is likely to have fallen from €40 billion to around €10 billion. While state and local government recorded surpluses, central government's deficit still amounted to €14½ billion according to the preliminary budget outturn. Nevertheless, this was €5 billion lower than the original budget estimate. Significantly higher tax revenue was offset by lower privatisation proceeds and higher expenditure. The off-budget Federal special funds also recorded a deficit. It should be noted, however, that the Post Office pension fund again drew on proceeds from securitisation, which is recorded as borrowing. For state government, the fact that growth in tax revenue was more favourable than expected meant that the budgets – excluding Berlin's proceeds from the sale of the Landesbank – closed with a total surplus of

General government as defined in the national accounts* Table 6

Item	2005	2006	2007pe	2005	2006	2007pe
				Year-on-year change		
	€ billion			as a percentage		
Expenditure	1,052.6	1,054.5	1,063.8	1.0	0.2	0.9
of which						
Social benefits	598.2	600.1	597.9	0.9	0.3	– 0.4
Compensation of employees	168.5	167.7	168.4	– 0.6	– 0.4	0.4
Interest	62.5	64.9	67.1	0.2	3.7	3.5
Gross capital formation	30.7	32.8	36.3	– 3.0	6.9	10.6
Memo item						
Old-age provision[1]	289.3	290.3	292.2	0.2	0.4	0.7
Healthcare[2]	147.3	151.5	157.3	2.8	2.8	3.9
Revenue	977.0	1,017.2	1,064.0	2.0	4.1	4.6
of which						
Taxes	493.0	530.5	574.9	2.4	7.6	8.4
Social contributions	396.9	401.1	400.8	0.0	1.1	– 0.1
				€ billion		
Balance	– 75.6	– 37.3	0.2	8.0	38.3	37.5
Memo item						
As defined in the Maastricht Treaty				as a percentage		
Debt level	1,521.5	1,568.5	…	4.9	3.1	…
	as a percentage of GDP			in percentage points		
Debt ratio	67.8	67.5	…	2.2	– 0.3	…
Deficit[3]	3.4	1.6	– 0.0	– 0.4	– 1.8	– 1.6

* In accordance with ESA 95. — **1** Expenditure of the statutory pension insurance scheme and on civil servants' pensions. — **2** Expenditure of the statutory health insurance scheme and on government assistance towards civil servants' medical bills. — **3** In contrast to the budget balance in the national accounts, the Maastricht deficit is calculated taking into account interest payments from swap transactions and forward rate agreements.

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€3 billion, which was far better than planned at the beginning of the year (–€16 billion). Local government also concluded the year with a surplus. This is likely to be considerably higher than the previous year's level of €3 billion. As well as higher tax revenue, the increased revenue-linked transfers from state government, which more than offset accelerated expenditure growth, were a major contributory factor to this development.

Social security funds with another clear surplus

In 2007, the social security funds recorded a clear surplus (as defined in the budget accounts). The fact that this still meant a deterioration on the previous year is wholly attributable to the advancement of the deadlines for transferring social contributions to the funds introduced in 2006. As a result, the statutory pension insurance scheme and the statutory unemployment insurance scheme received almost 13 monthly contributions in 2006.[1] Once this effect has been eliminated, 2007 shows a year-on-year improvement. In spite of lowering its contribution rate by 2.3 percentage points, the Federal Employment Agency recorded a surplus of €6½ billion owing to the favourable labour market development and the introduction of a new VAT-financed grant from central govern-

1 This effect has been factored out of the national accounts and is therefore only of importance in the budget accounts.

Chronology of economic and monetary policy measures

1 January 2007
Subject to conditions, Bulgaria and Romania join the European Union. Slovenia is the 13th member of the European Union to introduce the euro.

New economic and fiscal policy regulations enter into force: the standard rates of VAT and of insurance tax are both raised by 3 percentage points to 19%. The rate of income tax for annual income above €250,000 for unmarried persons and €500,000 for married persons is raised to 45%. This does not apply to income from profits until 2008. The savers' tax-free allowance is nearly halved. Travel expenses between home and work are no longer deemed to be income-related expenses ("factory gate principle"), and commuters can now make use of the standard travel allowance only from the 21st kilometre onwards. The tax bias in favour of non-profit-making activities and donations is extended. Furthermore, German Real Estate Investment Trusts (REITs) are permitted, and thus Germany as a financial centre gains a new instrument for indirectly investing in real estate. The contribution rate to the Federal Employment Agency is reduced from 6.5% to 4.2%. By contrast, the contribution rate to the statutory pension insurance scheme increases from 19.5% to 19.9%. Many health insurance institutions also increase their contribution rates – on average by ½ percentage point to 14.8%.

With effect from today, bank loans are eligible as refinancing collateral throughout the euro area. In the context of the creation of a single list of collateral, one of the aims of this measure is to give banks the option of using these comparatively illiquid assets as collateral for their refinancing credit, thus increasing their collateral and liquidity cushion. On the other hand, the trade bill loses its eligibility, and now in Germany, too, it is no longer part of the single list of collateral.

24 January 2007
In its Annual Economic Report, the Federal Government expects a marked slowdown in the growth in real GDP to 1.7% in 2007. The number of unemployed people is expected to fall further, while the number of people in work is expected to rise by 300,000. Although the increase in employment and higher pay increases are likely to strengthen private

consumption, the growth in domestic demand will halve. The external contribution to GDP growth is expected to remain unchanged.

31 January 2007
The Federal Constitutional Court announces its decision that inheritance tax does not conform to the constitution. However, the existing law can continue to be applied until the end of 2008. A uniform valuation of various asset classes must be ensured in the future as the first step in calculating the tax base. Selective privileges, for example for corporate ownership and real property, are still possible, but they must be justified by public interest.

16 February 2007
The Act to promote competition among statutory health insurance institutions (*GKV-Wettbewerbsstärkungsgesetz*) is passed by the Bundesrat. The aim is to convert the financing of the statutory health insurance institutions to a health fund by 2009. The fund's revenue will consist of contributions from insured persons and employers as well as a tax grant, which will gradually increase by €1.5 billion per year up to a total of €14 billion. Health insurance institutions are to receive risk-adjusted insurance premiums. Furthermore, individual health insurance institutions can demand an additional contribution which, if it is more than €8 per month, must not exceed 1% of income subject to compulsory insurance contributions. It is also possible to reimburse contributions. Private health insurance providers must offer a basic tariff that does not include an individual risk analysis, is furnished with a discount for the needy and covers the range of services provided by the statutory health insurance institutions at no more than their maximum contribution. In the future, it will be possible for employees to change from statutory to private health insurance only if the individual's income is above the threshold for opting out of the statutory health insurance scheme (currently €48,150 per year) for three consecutive years.

6 March 2007
In its ruling in the Meilicke case, the European Court of Justice states that excluding corporation tax paid abroad from the income tax liability incurred in Germany prior to the introduction of income tax relief in 2001 does not conform to EU law. The retroactive scope of the judgement is not limited. The Federal Ministry of Finance expects reimbursement claims totalling €5 billion.

8 March 2007
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by ¼ percentage point to 3.75%, starting from the operation to be settled on 14 March. The interest rates on the marginal lending facility and the deposit facility are likewise raised by ¼ percentage point to 4.75% and 2.75% respectively, both with effect from 14 March.

12 March 2007
The German Council of Economic Experts presents its expertise on effectively limiting general government debt (*Staatsverschuldung wirksam begrenzen*). This calls for a tightening of the standard limit by reference to net investment. So as not to limit the effect of the automatic stabilisers, the limit is related to the cyclically adjusted budgetary balance. Any expenditure that exceeds the standard limit in the course of implementing the budget is to be credited to a settlement account which is to be provided with a debt ceiling. The accumulated debt is to be reduced again.

Chronology of economic and monetary policy measures

(cont'd)

13 March 2007
The Bundesbank presents its annual accounts for 2006 and transfers a profit of €4,205 million to the Federal Government (€3,500 million to the Federal budget and €705 million for repaying debts to the Redemption Fund for Inherited Liabilities) compared with €2,860 million in the previous year.

16 March 2007
The central rate of the Slovak koruna in the European Exchange Rate Mechanism II (ERM II) is revalued by 8.5%.

30 March 2007
In the spring notification the Federal Government reports a deficit ratio of 1.7% for 2006. Thus the deficit ratio fell below the 3% reference value for the first time since 2001. A further drop to 1.2 % is announced for 2007.

The Act adjusting the retirement age of the statutory pension insurance scheme (*RV-Altersgrenzen-anpassungsgesetz*) is passed by the Bundesrat. The main thrust of this act is that from 2012 the statutory retirement age will gradually be increased from 65 to 67. However, individuals who have paid in compulsory contributions for at least 45 years will still be entitled to draw a pension without reductions at the age of 65. Furthermore, the pension cuts that, owing to a safeguard clause, have been waived since 2005, will be offset against increases in pensions from 2011.

1 April 2007
The first elements of the Act to promote competition among statutory health insurance institutions (*GKV-Wettbewerbsstärkungsgesetz*) enter into force. On the one hand, these include an expansion of the benefits granted for treatment at health spas for older persons and for parents together with their children and also payments for vaccinations. On the other hand, the invoice amounts issued by hospitals to insurance institutions are reduced by 0.5% across the board (with retroactive effect for statutory health insurance patients who were discharged after 31 December 2006). Health insurance institutions are given new options for introducing varied deductible and premium refund tariffs.

1 June 2007
The Act on the creation of German REITs (*Gesetz zur Schaffung deutscher REITs*) is published in the Federal Law Gazette and enters into force

with retroactive effect from 1 January 2007.

5 June 2007
In the light of Germany's clear undershooting of the 3% limit, the Ecofin Council drops its excessive deficit procedure against Germany, which had been in operation since 2003. By contrast, the debt-to-GDP ratio remains at almost 68% and therefore continues to exceed the 60% reference value significantly.

6 June 2007
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by ¼ percentage point to 4.00%, starting from the operation to be settled on 13 June. The interest rates on the marginal lending facility and the deposit facility are likewise raised by ¼ percentage point to 5.00% and 3.00% respectively, both with effect from 13 June.

20 June 2007
The Financial Planning Council commits itself to further reducing the structural deficit ratio by an annual average of ½ percentage point. A structurally balanced general government budget is envisaged for 2010.

4 July 2007
The Federal Cabinet approves the draft Federal budget for 2008 and medium-term financial plan until 2011. With imputed receipts of €2 billion more across the board than in the May tax estimate, net borrowing in the amount of €13 billion is planned for 2008. Thus, compared with the expectations for 2007 – which are significantly more favourable than projected in the draft budgets – hardly any fiscal consolidation is envisaged for 2008. It is planned to eliminate net borrowing completely by 2011. However, these plans apparently also include considerable amounts of proceeds from asset realisations.

6 July 2007
The 2008 Business Tax Reform Act *(Gesetz zur Unternehmensteuerreform)* is passed by the Bundesrat.

9 July 2007
The Federal Constitutional Court announces its ruling that the Federal Government's 2004 budgetary acts did not breach the constitutional borrowing limits. The limited effectiveness of the regulations on the containment of general government debt is criticised, but no framework is laid down for changing them.

1 August 2007
The Deutsche Bundesbank celebrates the 50th anniversary of its foundation.

9 August 2007
In order to remedy liquidity shortages in the money market stemming from the subprime crisis, the Eurosystem carries out liquidity-providing fine-tuning operations on this day as well as on the following three business days. In the first quick tender, a fixed rate tender with a minimum bid rate of 4.00%, the ECB allocates the complete volume of bids totalling €94.8 billion. In the following three operations, which are conducted as variable-rate tenders, the ECB progressively reduces the volume from €61.1 billion to €47.7 billion and finally €7.7 billion.

24 August 2007
In an unscheduled operation, the Eurosystem initially makes €40 billion available to banks for a period of 90 days. At 4.49%, the marginal allotment rate for this supplementary long-term tender is significantly above the minimum bid rate of 4%. The high volume of bids also shows the banks'

Chronology of economic and monetary policy measures

(cont'd)

great need for longer-term refinancing. Over the following few months, the Eurosystem progressively increases the level of funds provided through three-month refinancing operations. The number of weekly MROs is correspondingly reduced.

11 September 2007
At the end of the August-September reserve maintenance period, the Eurosystem, for the first time since the outbreak of financial market turmoil, removes surplus liquidity from the market on a large scale. To this end, it carries out a liquidity-absorbing fine-tuning operation in the amount of €60 billion. Such measures will be needed again at the end of the following reserve maintenance periods to prevent a drastic reduction in the overnight rate.

12 September 2007
Against the backdrop of cases pending at the Federal Constitutional Court questioning the constitutionality of the revised rules for the standard travel allowance for commuters ("factory gate principle with regulation for cases of hardship"), it is again possible to claim these tax-free allowances for the time being under the old legislation during the year.

15 October 2007
The Act to further promote civic involvement (*Gesetz zur weiteren Stärkung des bürgerschaftlichen Engagements*), which is linked to tax shortfalls, is published in the Federal Law Gazette, and most of its provisions enter into force with retrospective effect from 1 January 2007.

17 October 2007
The Federal Cabinet approves the draft of a supplement to the 2007 Budget Act, under which just over €2 billion of the greater than previously expected tax revenue will be placed in an off-budget special fund to assist in extending day care facilities for infants. Since the privatisation proceeds are now set at a significantly lower level, net borrowing is to be reduced to only €14½ billion.

2 November 2007
The opening ceremony of the Johann Wolfgang Goethe-University's Institute for Monetary and Financial Stability (IMFS), which is largely financed by the Bundesbank's Monetary Stability Foundation, takes place in Frankfurt am Main. The IMFS has the tasks of

carrying out economic and juridical research and giving economic policy and legal advice in the field of monetary, currency and financial systems.

7 November 2007
In its 2007-08 annual report, the German Council of Economic Experts forecasts real GDP growth of 1.9% in 2008. The momentum, it argues, will be supported to a greater extent than previously by the growth in private consumption of 1.7%. Investment in machinery and equipment and construction investment will make a smaller contribution to GDP growth than they did last year. The unemployment rate is expected to fall from 9.0% to 8.3%. The turmoil triggered by the financial crisis in the USA will adversely affect the global economic setting, and thus the growth of exports (6%) will not be as strong as that of imports (6.5%). Consequently, foreign trade will provide only a small stimulus for economic development.

14 November 2007
The Financial Planning Council advocates using the favourable general government revenue trend to reduce outstanding deficits and repay debts. Further expenditure increases, beyond those measures that have already been decided, are rejected.

19 November 2007
The new Eurosystem central bank payment system for large-value and express credit transfers, TARGET2, is successfully launched. TARGET2, which was jointly developed by the Deutsche Bundesbank, the Banca d'Italia and the Banque de France on behalf of the Eurosystem, is based on a single shared platform for all participants and progressively replaces the decentralised TARGET system, which has been in operation since 1999. In the first stage, 259 banks from eight countries will be participating in TARGET2. Thirteen more countries of the European Union will follow in two migration steps in the period up to 19 May 2008.

30 November 2007
In accordance with the 2007 supplementary budget, the Bundestag approves the 2008 Budget Act. The more favourable tax estimate outcome is used to reduce net borrowing vis-à-vis the summer draft by €1 billion to €12 billion, with somewhat higher expenditure appropriations.
The Act promoting supplementary old-age provision and amending the Third Book of the Social Security Code (*Gesetz zur Förderung der zusätzlichen Altersvorsorge und zur Änderung des Dritten Buches Sozialgesetzbuch*) is passed by the Bundesrat. This means, in particular, that the option for employees to contribute to company pension schemes with direct payments which are not subject to social security contributions is maintained beyond 2008.

5 December 2007
The Federal Cabinet endorses the updated stability programme for Germany. A balanced general government budget will be achieved in 2007, although, viewed from a structural perspective, there is still a small deficit. Nevertheless, despite a continuing favourable economic trend, the deficit ratio will increase again to ½% in 2008. A structurally balanced budget is not envisaged until 2010. By contrast, the debt ratio is to be continuously reduced, and from 2010 it is to be below the 60% reference value.

11 December 2007
The Federal Cabinet adopts a bill to reform the inheritance tax and

Chronology of economic and monetary policy measures

(cont'd)

valuation law. This is intended to achieve uniform asset valuation, as specified by the Federal Constitutional Court. Furthermore, a rewording of the preferential treatment given to transfers of ownership of businesses will implement an arrangement reached in the coalition agreement.

12 December 2007
Concerted action from central banks in the euro area, the United States, the United Kingdom, Switzerland and Canada to ensure the viability of the money market. Furthermore, the ECB announces that the Governing Council has decided to lengthen the maturity of the main refinancing operation settling on 19 December 2007 to two weeks so that the operation ends on 4 January 2008 instead of 28 December 2007. This should give the banks certainty about the central bank money holdings available at the turn of the year at an early stage.

19 December 2007
Given the lengthening of the maturity of the main refinancing operation to two weeks, the ECB distributes just under €350 billion at a marginal allotment rate of 4.21%. This far exceeds the liquidity needs of banks. To prevent a drastic reduction in the overnight rate, the Eurosystem is forced on the following business days to remove amounts in triple-digit billions from the market with the help of liquidity-absorbing fine-tuning operations. Nevertheless, the overnight rate sometimes drops significantly below the minimum bid rate of 4%.

20 December 2007
The Sixth Act Amending the Third Book of the Social Security Code and other Acts (*Sechstes Gesetz zur Änderung des Dritten Buches Sozialgesetzbuch und anderer Gesetze*), under which the contribution rate to the Federal Employment Agency is lowered to 3.3%, is passed by the Bundesrat.

1 January 2008
Malta and Cyprus become the 14th and 15th member states of the EU to introduce the euro.

The 2008 business tax reform enters into force. The corporation tax rate is reduced by 10 percentage points to 15%. Including local business tax, for which various new regulations also apply, the taxation of corporations' profits is reduced to around 30%, assuming a 400% multiplier in the case of local business tax. For non-corporations, a retention reserve, among other things, is introduced, and this is also taxed initially at around 30%. A stabilisation of the revenue trend and a curbing of undesirable tax option arbitrage are expected from various counterfinancing measures. These include the "interest deduction ceiling" which restricts the important net principle of taxation by limiting the interest deductible. A withholding tax for private capital income (interest, dividend payments, capital gains from the sale of securities) will be introduced on 1 January 2009. The reform envisages net relief amounting to €5 billion over a whole year, but larger shortfalls in tax revenue are expected in the first few years.

The contribution rate to the Federal Employment Agency is reduced from 4.2% to 3.3%. The period of entitlement to unemployment benefit I for older recipients is extended to up to 24 months for persons aged 58 and over. By contrast, the preferential treatment given to older unemployed persons of being able to receive wage substitutes without having to be available for work ended on 31 December 2007. Contrary to the principle that social assistance is to be paid only if no other income is available, recipients of unemployment benefit II do not have to claim their retirement pension with reductions until they have reached the age of 63.

15 January 2008
According to the provisional figures, the Federal Government records a fiscal deficit of €14½ billion for 2007. The budgeted amount is therefore achieved, although the growth in tax revenue up until the end of the year slowed more markedly than expected and back payments had to be made to the EU.

The Federal Statistical Office records a balanced general government budget, as defined in the national accounts, for the first time since 1989 (excluding the proceeds from the sales of UMTS mobile telephone licences in 2000).

23 January 2008
In its Annual Economic Report, the Federal Government expects real GDP growth of 1.7% in 2008. The number of unemployed people is expected to fall by a further 330,000, while the number of people in work is expected to rise by 280,000. The increase in employment and higher wages than in recent years will strengthen private consumption.
The world economy will subsequently grow less strongly than last year, not least as a result of financial market turmoil. Furthermore, the high oil price and low US dollar exchange rate are putting a strain on German exports. Therefore, the external contribution to GDP growth is expected to fall to a mere 0.4%.

21 February 2008
The new Prudential Supervisory Guideline (*Aufsichtsrichtlinie*) pursuant to section 7 (2) of the German Banking Act (*Kreditwesengesetz*), enters into force. This guideline replaces the previous version from 2003 and sets out the cooperation between the Federal Financial Supervisory Authority and the Deutsche Bundesbank in banking supervision in greater detail.

11 March 2008
The Bundesbank's profit, amounting to €4,285 million, is distributed to the Federal Government.

General government finances* Table 7

Item	2005pe	2006pe	2007pe	2005pe	2006pe	2007pe
	€ billion			Year-on-year change		
Central, state and local government				as a percentage		
Expenditure	629.0	632.5	644	1.9	0.6	2
of which						
Central government	281.5	282.9	292	2.9	0.5	3
State government	260.3	259.7	265	1.2	– 0.2	2
Revenue	571.0	592.4	635	3.5	3.8	7
of which						
Taxes	452.1	488.4	538	2,1	8.0	10
				€ billion		
Balance	– 58.0	– 40.1	– 9.5	7.5	17.9	30.5
of which						
Central government	– 31.4	– 28.2	– 14.5	8.3	3.2	13.5
State government	– 23.5	– 9.8	3	0.0	13.8	13
Social security funds				as a percentage		
Expenditure	471.0	466.3	465.5	0.5	– 1.0	– 0
Revenue	467.8	486.3	475	– 0.4	3.9	– 2
				€ billion		
Balance	– 3.2	20.0	9	– 4.3	23.2	– 11
of which						
Statutory pension insurance scheme	– 4.2	7.3	1	– 2.5	11.5	– 6
Statutory health insurance scheme	1.7	1.7	2	– 2.2	0.0	0
Federal Employment Agency	– 0.4	11.2	6.6	3.8	11.6	– 4.6

* The budgetary definition used here differs from the definition of the government account within the national accounts.

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ment. The statutory pension insurance scheme also recorded a surplus (over €1 billion) thanks to a rise in contribution rates to 19.9% and an only moderate increase in expenditure. After adjusting for the effect of bringing forward the transfer date mentioned above, an estimated deficit of €3 billion was recorded in 2006. With a marked increase in spending and a significant rise in the average contribution rate to 14.8%, the health insurance institutions' surplus of €2 billion was on a par with that in 2006.

General government expected to be in deficit again in 2008

General government is expected to record a deficit in 2008 as defined in the national accounts. The budgetary situation will be handicapped not only by a further lowering of the contribution rate to the Federal Employment Agency to 3.3% but also notably by a drop in revenue from profit-related taxes. For one thing, considerable tax shortfalls will ensue from the reform of business taxation. For another, revenue from profit-related taxes, following the sharp growth of the past few years, is now likely to have reached a level that is perceptibly higher than normal. Bearing this factor in mind and given the financial market turbulence, this revenue item appears likely to record rather weak growth for the immediate future. Overall, the general government revenue ratio is likely to fall. The expenditure ratio will also decline as the growth of pension and labour market expenditure is likely to remain contained. However, the spending ratio will probably not contract to the same extent as the revenue ratio.

Initially renewed deficits forecast in stability programme

The stability programme for Germany, which was updated at the end of 2007, likewise predicts a deterioration of the budgetary situation and a deficit of ½% of GDP for 2008 although, according to the underlying assumptions, the macroeconomic environment is rather favourable and the revenue from profit-related taxes, adjusted for changes in legislation, indicates an exceptionally high level in 2008 as well. In the following years, the general government fiscal balance is then expected to improve so that a slight surplus should be recorded from 2010. In 2010, the debt ratio should fall below the reference value of 60% defined in the EC Treaty. This would mean that the European fiscal requirements (observing the deficit and debt ratio reference values and achieving the medium-term budgetary objective) should be met without having to invoke exemption clauses.

3 Investment and financing

Basic structures of financial flows in 2007

The real economic and fiscal developments described in the preceding sections were accompanied by matching investment and financing activities on the part of the market players. Within the German financial system, such financial activities are traditionally performed mainly through the banking sector, although financial markets, too, are increasingly being used for this. There are still no complete data for 2007 on the precise composition of the direct and indirect financial relations among the various sectors. Major structural features and the ranges of figures can be derived from the data available so far, however.

Marked increase in financial investment

According to the available financial accounts figures, financial investment of the German non-financial sectors showed a marked increase in the first three quarters of 2007. It amounted to roughly €215 billion, compared with €185 billion in the corresponding period of 2006. This was due essentially to the strong accumulation of financial assets in the corporate sector (€127 billion, compared with €57 billion in the first three quarters of 2006). This was, above all, a reflection of buoyant equity investment and the allocation of large amounts to bank deposits. By contrast, households' financial investment, at not quite €90 billion, was lower than in the year before. On balance, general government made no further increase in its financial assets. Public entities did top up their domestic bank balances and securities investment, but this was accompanied by matching asset disposals from privatisations and, in particular, a corresponding reduction in time deposits abroad.

Mainly short-term bank deposits in demand

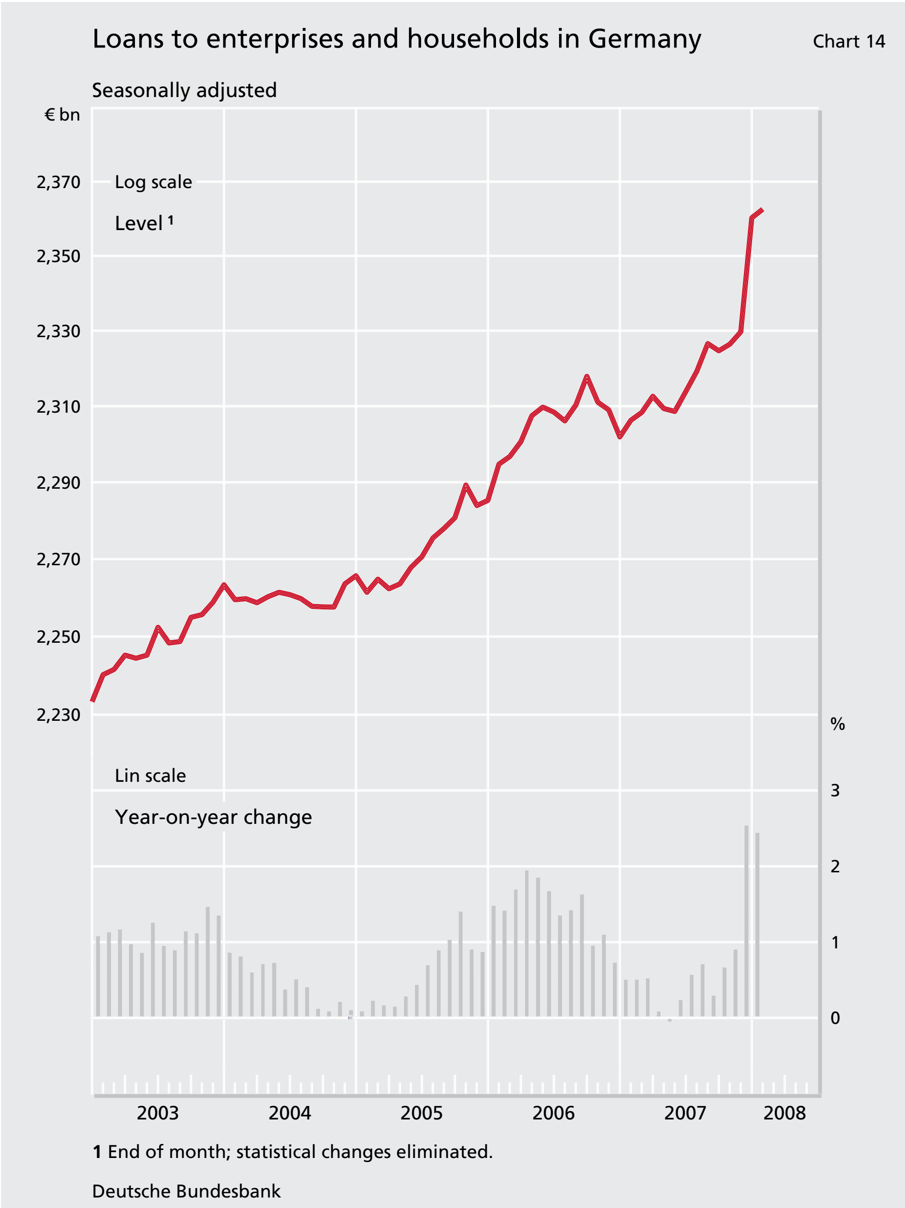
A considerable part of the financial investment of all the domestic sectors again flowed into deposits with domestic banks in 2007. These deposits grew by €177½ billion, or 7.4%, compared with €118½ billion, or 5.3%, in 2006. Once again, domestic non-banks increased mainly their liquid bank balances. Short-term time deposits were especially preferred by most types of investor. This was because such balances – owing to the rather flat, or even inverse, yield curve for much of last year – were remunerated at a relatively high rate. In the wake of the financial market turbulence, there are also likely to have been shifts of financial resources which had been invested outside the banking system before. There was also a further increase in domestic non-banks' overnight deposits in the reporting year. It was mainly households which allocated funds to their overnight deposits. Of the longer-term bank deposits, matching fixed-term deposits of insurance companies and households' savings deposits played a fairly major role in the reporting year.

Purchase of securities

Furthermore, domestic non-banks purchased mutual fund shares on a considerable scale last year (€51½ billion). They preferred issues of foreign mutual funds, which, in turn, are owned predominantly by German monetary financial institutions, however. By contrast, non-banks sold €9 billion worth of equities, all of which were foreign instruments on balance, whose prices in 2007 were clearly lagging behind those in the German market.

Marked decline in demand for external financing

External financing by the non-financial sectors in the first three quarters of 2007 combined amounted to no more than around €54 billion, which was only just over two-fifths of the corresponding figure for the previous year. What was crucial in this development was the progress made in the consolidation of government finances, resulting in very low government borrowing (roughly €3 billion) in the credit and capital markets. Furthermore, households reduced their indebtedness to banks and insurers by as much as €15 billion. Corporate demand for financial resources, at €66 billion, remained on a scale similar to that of the previous year, however. This primarily involved raising capital by the issuance of debt securities and shares and other equity. More bank loans and other financial credit from domestic and foreign entities were taken up than in the first three quarters of 2006 and accounted for as much as one-third of enterprises' total external financing.

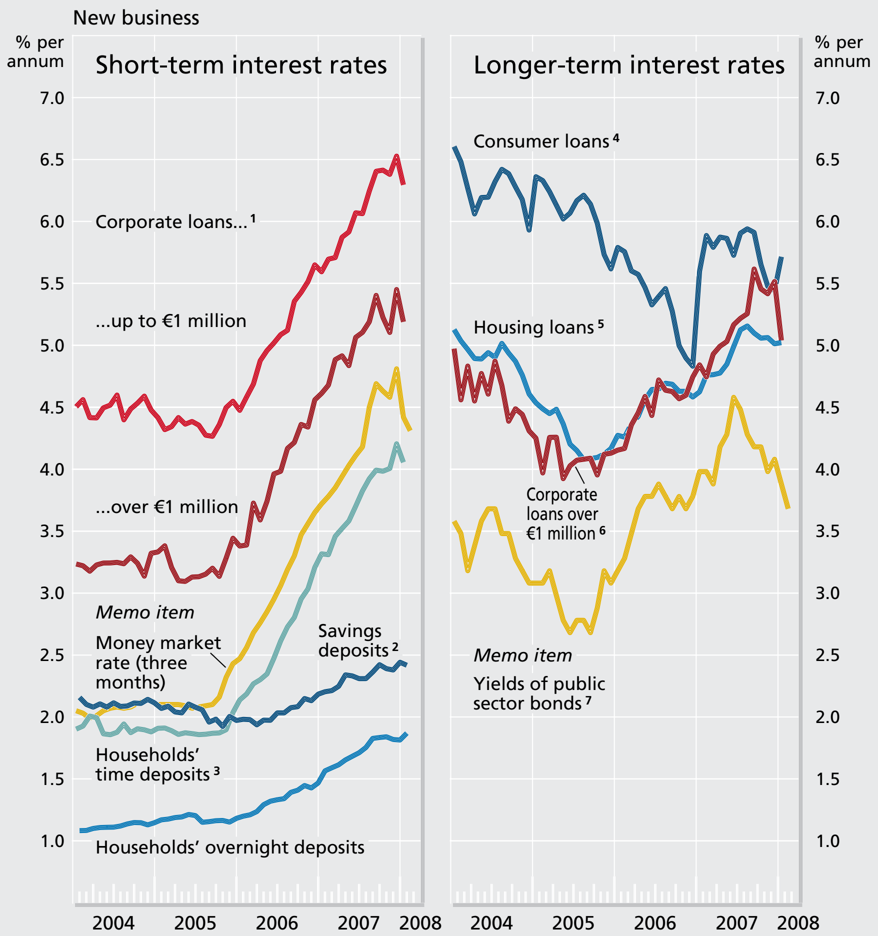


Accelerated growth in loans to enterprises

Overall, German banks' credit business with domestic customers stagnated in the reporting year. In particular, the decline in loans to general government of €29½ billion, or 7.5%, again had a dampening impact. By contrast, unsecuritised lending to the domestic private sector increased by €53 billion, or 2.4%. A considerable part of this consisted of loans to non-monetary financial corporations. In addition, there was growth in lending to non-financial corporations, its sharp 6.2% increase mainly reflecting buoyant fixed investment activity. The banks' credit business with domestic households declined, however. Consumer loans and other loans taken together, which had already been redeemed in

Bank interest rates in Germany

Chart 15



1 To non-financial corporations with an initial rate fixation of up to one year. — **2** Households' deposits redeemable at notice of up to three months. — **3** With an agreed maturity of up to one year. — **4** Loans to households with an initial rate fixation of over one year and up to five years. — **5** To households with an initial rate fixation of over five years and up to ten years. — **6** To non-financial corporations with an initial rate fixation of over five years. — **7** Residual maturity of over five years and up to six years.

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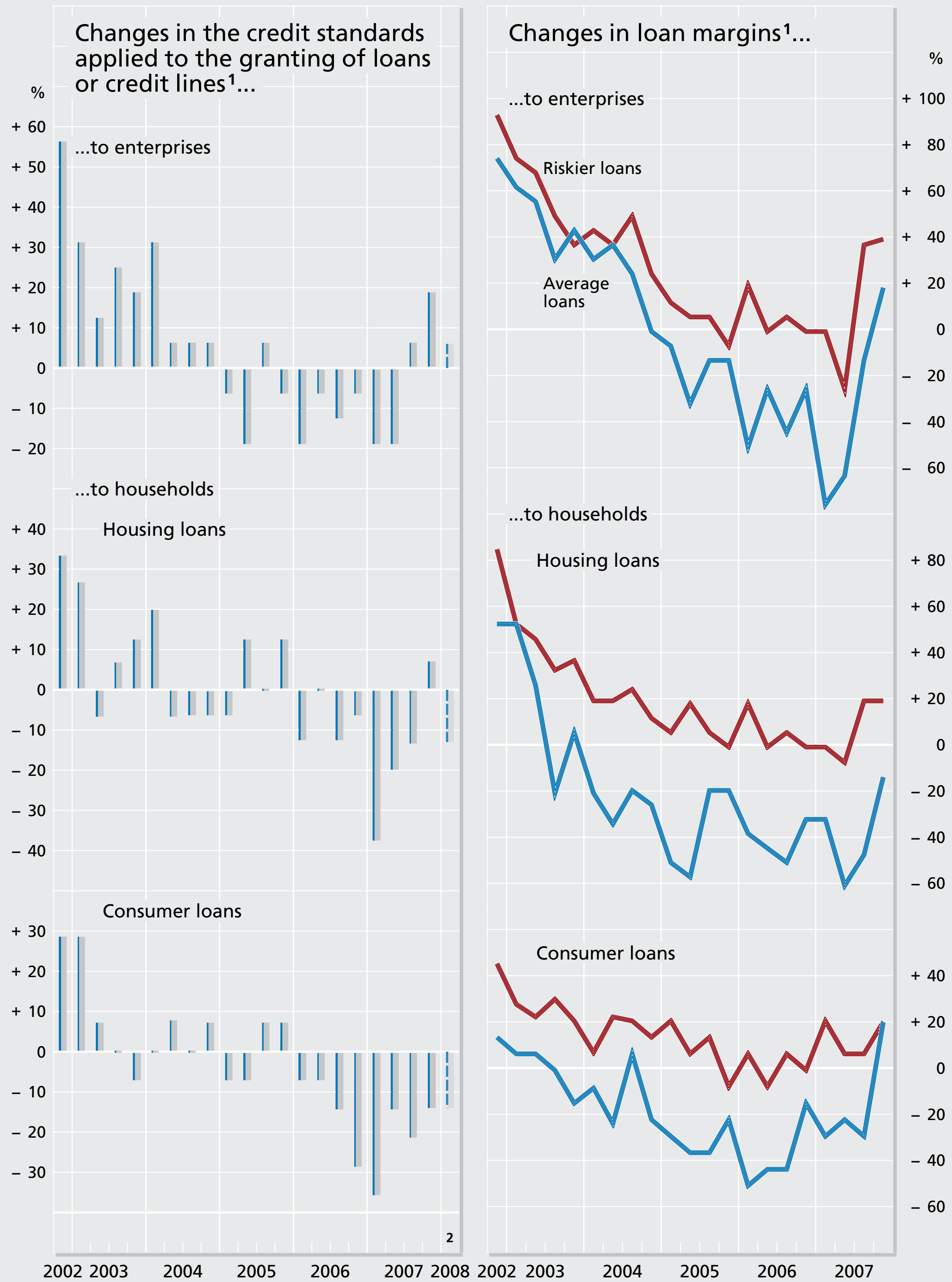
net terms in 2006, were not alone in being further reduced by 1.6% during the year. Following a temporary somewhat sharper rise in 2006 prior to the increase in value added tax, loans for house purchase were also reduced by households for the first time in years (–0.6%). As a "substitute", as it were, for the moderate traditional credit business, German banks sharply stepped up their portfolio investment in 2007, with the issuers of such paper coming solely from abroad.

Bank lending survey
Results for Germany

Chart 16



1 Difference between the sum of the percentages for "tightened considerably" and "tightened somewhat" and the sum of the percentages for "eased somewhat" and "eased considerably". — **2** Expectations for Q1.

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Financing costs at banks still low for households and non-financial corporations

The generally subdued demand for credit contrasts to a certain extent with the banks' lending rates, which are still at a low level, even though they went up in 2007. For much of the past few years, banks have been facing ongoing pressure on their margins and, for that reason, too, have not always passed on all of the higher refinancing costs to their customers. Money market rates rose by just over 1 percentage point in the reporting year, while short-term rates of interest for loans to enterprises went up by just under 1 percentage point. The rates for long-term loans, by contrast, went up roughly in line with developments in the capital market. At a rate of 5.0%, for example, the banks were asking about ½ percentage point more for long-term loans for house purchase than at the end of 2006. There was also a similar development in long-term loans to enterprises.

Slight decline in borrowing in the German bond market

The domestic sectors' net borrowing in the bond market in 2007 fell – despite a sharp increase in the issue volume – by €12 billion to €90½ billion. As already mentioned, however, this was due solely to the positive budgetary position of general government, which tapped the capital market for €28 billion – only just over half as much as in 2006. By contrast, the domestic credit institutions increased their borrowing in the German bond market to €42 billion. It was not least against the backdrop of the turbulence in the financial markets that they stepped up the issuance of other bank debt securities, which allow particularly flexible structuring (€55½ billion). The specialised credit institutions, some of which are guaranteed by government, tapped the capital market for the only slightly smaller amount of €42 billion. This contrasted with a reduction in the outstanding volume of mortgage Pfandbriefe and, in particular, public Pfandbriefe (€11½ billion and €44 billion respectively) in 2007 in connection with the weak demand for loans for house purchase and reduced general government borrowing. Domestic enterprises increased their borrowing in the German bond market to €20 billion (2006: €9 billion), although this consisted solely of short-term money market paper on balance.

No perceptible revival in share offerings

Despite rising share prices, domestic enterprises raised €10 billion in the German stock market last year, compared with €9 billion in 2006. Listed enterprises accounted for €7 billion, while €1 billion flowed into the real estate investment trusts that were introduced in Germany with retrospective effect from the beginning of 2007.

Declining inflows to domestic mutual funds

The inflow of resources to domestic mutual funds declined by roughly one-third in 2007 to €13½ billion. Savers' reluctance mainly affected mutual funds open to the general public, which recorded an overall outflow of funds amounting to €8 billion. This was mostly to the detriment of bond and share-based funds, although investors also withdrew resources from money market funds. Overall, €21½ billion flowed to specialised funds reserved for institutional investors. This was roughly one-third less than the amount raised in 2006. By contrast, foreign funds almost doubled their sales in Germany (€41 billion).

Rise in German net foreign assets

This means that, as in earlier years, a significant part of the domestic sectors' financial asset formation took place abroad in 2007. German net foreign assets increased by just under €29 billion in the first three quarters. The rise was ultimately due to Germany's current account surplus, which amounted to €184 billion (or around 7½% of GDP) in 2007 as a whole. This contrasted with the negative impact that sizeable valuation effects, caused principally by the appreciation of the euro, had on the external position.

Monetary and financial system

The international monetary and financial system was still marked by high global current account imbalances in the past year. In parts of Asia, in particular, the surpluses continued to grow, causing foreign currency reserves to rise sharply once again. Sovereign wealth funds, whose cross-border investments are in some cases meeting with reservations, are also becoming increasingly involved in the management of the vast public holdings of foreign currency in a number of countries. However, measures to ward off unwanted investment which are based on security and regulatory policy concerns must not be allowed to call the principle of the free movement of capital into question.

In the area of international financial organisations, the IMF's primary objective of exercising surveillance over the economic and monetary policy of its member countries was strengthened further in 2007. However, the discussion on central topics of the IMF reform is still in progress. The fundamental differences of opinion between industrial countries and emerging market economies with regard to quota reform have to date not been resolved. For a reform package to be generally acceptable, it must be consistent with the Fund's monetary mandate and its underlying principles such as equal treatment and fair burden-sharing.

Following the accession of Bulgaria and Romania to the European Union (EU) in early 2007, the introduction of the euro in Cyprus and Malta at the beginning of 2008 is a further step towards European economic and monetary integration. In addition, with the signing of the Treaty of Lisbon in December 2007 the institutional paralysis in Europe was overcome. Despite welcome progress in the consolidation of government budgets, the safeguarding of the long-term sustainability of public finances remains a central economic policy challenge in the EU member states.

In the past year, the turmoil on the international financial markets did not put the stability and functioning of the German financial system at risk, even though individual cases revealed major, in some cases potentially existence-threatening, weaknesses in the institutions' risk management. Despite considerable burdens on internationally active financial institutions, the profitability of German banks remained largely stable as a whole.

I Issues relating to the international monetary and financial system and to European integration

1 International monetary and financial system

(a) Cautious reduction of global imbalances and continued strong accumulation of foreign currency reserves

Limited progress in reducing global current account imbalances

The international current account structure is still marked by high imbalances. However, in the past year, a regionally more balanced pattern of growth contributed in some cases to a slight decline in the imbalances, with the US current account deficit, influenced by the economic slowdown, falling in 2007 for the first time since 2001 (to an estimated US$750 billion or 5½% of gross domestic product (GDP) following US$810 billion or over 6% of GDP in the previous year). In spite of a further rise in oil prices, the surplus of the oil-exporting countries also declined (by about one-tenth to an estimated US$420 billion). At the same time, however, the Chinese current account surplus, on the back of a continuously booming economy, is likely to have increased by almost one-half (to around US$350 billion or 11% of GDP). In particular in merchandise trade with the EU, China's surplus grew noticeably last year, with the EU countries replacing the United States as the largest importer of Chinese goods, according to data available up to November. The Japanese current account surplus also increased further (to US$210 billion or almost 5% of GDP), while the euro-area current account remained almost balanced last year.

Insufficient role of the exchange rate as adjustment mechanism

Global foreign currency reserves again rose sharply in 2007 and reached US$6.3 trillion in November, with the euro – at end-1999 exchange rates – accounting for about one-fifth for several years now. In November 2007, the Chinese foreign currency reserves amounted to US$1.5 trillion and were thus almost one-half higher than at the end of 2006. The reserves also grew sharply in other important emerging market economies, including Argentina, Brazil and India, as well as in the group of oil-exporting countries. For many countries, this financial security buffer should now be more than sufficient. The ongoing accumulation of foreign currency reserves thus also indicates that the exchange rate is still playing an insufficient role as an adjustment mechanism. A sustainable and preferably smooth reduction of global imbalances therefore requires not only increased national savings in the United States and a continuation of growth-enhancing structural reforms in Europe and Japan but also

Foreign currency reserves* of selected countries

Table 8

Country/ group of countries[1]	Year-end holdings		Year-on-year change					
	1998	2007[2]	2005	2006	2007[2]	2005	2006	2007[2]
	US$ bn					As a percentage		
Japan	203.2	946.5	4.5	46.1	78.0	0.6	5.6	8.9
Asian developing countries	575.3	2,935.4	254.2	407.7	729.3	15.8	21.9	32.2
of which								
China[3]	145.0	1,496.9	208.9	247.5	469.7	34.3	30.2	44.0
Hong Kong	89.6	150.3	0.7	8.9	18.7	0.6	7.2	14.1
India	27.0	264.7	5.9	39.2	103.1	4.7	29.9	60.6
Indonesia	22.4	52.8	– 1.8	7.9	13.0	– 5.2	24.1	31.8
Malaysia	24.7	100.4	4.5	12.4	20.4	6.9	17.8	24.9
Philippines	9.1	29.2	2.8	4.1	10.2	21.7	25.9	51.3
Singapore	74.4	160.3	3.9	20.1	26.7	3.5	17.4	19.6
South Korea	52.0	261.5	11.8	28.4	25.2	6.0	13.5	10.6
Taiwan	90.3	270.1	11.6	12.9	4.3	4.8	5.1	1.6
Thailand	28.4	82.4	2.0	14.6	18.8	4.1	29.0	28.9
Asia, total	778.5	3,881.8	258.8	453.8	807.4	10.7	16.9	25.7
Industrial countries excluding Japan	471.0	553.4	– 27.8	54.1	36.0	– 5.6	11.6	6.9
of which								
United States	36.0	46.0	– 4.9	3.1	5.5	– 11.4	8.2	13.4
Euro area[4]	288.0	209.9	– 14.0	16.9	28.2	– 7.8	10.1	15.3
Other developing countries	394.4	1,861.1	195.3	354.1	530.7	23.7	34.7	38.6
Africa	40.7	278.0	34.2	60.8	62.3	27.1	37.9	28.2
Europe[5]	97.4	843.0	96.1	183.7	260.0	29.6	43.7	43.0
of which								
Russia	7.8	451.8	54.9	119.6	170.7	45.4	68.1	57.8
Latin America and Caribbean	158.4	430.3	32.0	59.3	134.3	14.8	23.9	43.7
Middle East	97.9	309.9	32.9	50.3	74.2	20.8	26.2	30.7
Memo item								
Oil-exporting countries[6]	89.5	948.7	120.2	223.5	283.2	34.8	48.0	41.1
All countries	1,643.8	6,296.3	426.2	862.0	1,374.1	11.4	20.6	27.3

Sources: IMF and Bundesbank calculations. — ***** At current exchange rates. — **1** Classified into industrial and developing countries according to the IMF's International Financial Statistics. — **2** Figures as at November; changes in 2007 extrapolated to an annual basis. — **3** Reserves clearly reduced through transfers to state banks and the China Investment Corporation. — **4** Foreign currency reserves of the 13 member states (at end-2007) for the period prior to the beginning of monetary union. — **5** Including Turkey. — **6** 22 countries, excluding Iran, Syria and Turkmenistan, 1998 also excluding Iraq; figures partly estimated.

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greater exchange rate flexibility, especially in some of Asia's emerging market economies.

Growing importance of sovereign wealth funds

In many countries with high foreign reserves and/or significant foreign currency inflows, the question of using these assets in an economically sensible way is becoming increasingly important. Sovereign wealth funds offer more scope for diversification than monetary authorities have in the traditional investment of foreign currency reserves. Moreover, such funds have proven to be a useful tool for macroeconomic stabilisation and the creation of an intergenerational capital

Sovereign wealth funds

Sovereign wealth funds (SWFs) are state-controlled entities that invest public financial assets separately from the traditional management of foreign currency reserves by the monetary authorities. Unlike state pension funds, sovereign wealth funds invest mostly abroad and have no, or only few, explicit liabilities. However, there is no generally accepted definition of a sovereign wealth fund, and many of these funds disclose no information on their assets, which makes it difficult to capture them statistically.

Many SWFs have been in existence for several decades. They currently manage an estimated total of more than US$2 trillion to US$3 trillion in assets (see table on the next page) and have various sources of funding. Commodity funds obtain their financial means largely from export revenues on non-renewable resources, which are transferred either directly to the fund or indirectly via taxes or customs duties. The vast majority of SWFs belong to this category. Many oil-exporting countries have set up such funds. In addition, some funds are financed by transferring parts of a country's foreign currency reserves or other public resources. Besides capital inflows from abroad, the transferred foreign currency reserves often originate from current account surpluses which, in turn, may be the outcome of a specific growth and development strategy, supported by the exchange rate regime. Asian countries, in particular, are tending to channel some of their high reserves into such funds.

SWFs pursue several objectives, often simultaneously. Generating higher revenues by diversifying investments is a frequent goal. There are a large number of funds whose main objective is to accumulate wealth for future generations in order to cushion the financial consequences of an ageing population or a future drop in export revenues as commodity reserves dwindle. These savings or heritage funds have a long-term investment strategy. By contrast, stabilisation funds have a more medium-term horizon and are mainly designed to stabilise the macroeconomy and to cushion economic shocks. In practical terms, this means mitigating the budgetary consequences of commodity price volatility and facilitating the conduct of monetary policy. In particular, these funds are set up to prevent abundant government revenues from being spent immediately when commodity prices are high, thus further fuelling already rapid economic growth. At the same time, the government establishes a financial cushion for times of low commodity revenues. Furthermore, during a boom which is characterised by large foreign exchange inflows, sovereign wealth funds can help limit strong monetary expansion, inflationary pressure and an appreciation of the real exchange rate. Particularly for resource-rich countries, strong real appreciation is frequently a problem, as it impairs the domestic economy's international competitiveness outside the commodity sector ("Dutch disease"). Finally, SWFs can be used to promote and diversify the domestic economy. However, this can occasionally cause conflict with macroeconomic stability and an existing exchange rate target.

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Sovereign wealth funds (cont'd)

Selected sovereign wealth funds*

Name	Country	Source of funding[1]	Main objectives	Investment volume (US$ billion)[2]
Abu Dhabi Investment Authority	UAE[3]	Commodity	Intergenerational wealth building	500 to 850
Government Pension Fund – Global (GPF)	Norway	Commodity	Intergenerational wealth building, macroeconomic stabilisation	380
Saudi Arabian Monetary Agency (SAMA)	Saudi Arabia	Commodity	No data available	300 to 350
Government of Singapore Investment Corporation	Singapore	Non-commodity	Rate of return	100 to 330
Kuwait Investment Authority: General Reserve Fund, Future Generation Fund	Kuwait	Commodity	Macroeconomic stabilisation, intergenerational wealth building	250
China Investment Corporation	China	Non-commodity	Rate of return	200
Reserve Fund	Russia	Commodity	Macroeconomic stabilisation	125
Temasek Holdings	Singapore	Non-commodity	Rate of return, strategic investments	108
Future Fund	Australia	Non-commodity	Intergenerational wealth building	61
Qatar Investment Authority	Qatar	Commodity	No data available	40 to 70
Libyan Investment Authority	Libya	Commodity	No data available	40 to 50
Revenue Regulation Fund	Algeria	Commodity	Developing the domestic economy, macroeconomic stabilisation	45
Alaska Permanent Fund Corporation	United States	Commodity	Intergenerational wealth building	40
Brunei Investment Authority	Brunei	Commodity	Rate of return	30 to 35
National Wealth Fund	Russia	Commodity	Intergenerational wealth building, rate of return, developing the domestic economy	32
Korea Investment Corporation	South Korea	Non-commodity	Rate of return	20
Khazanah Nasional Berhad	Malaysia	Non-commodity	Rate of return, strategic investments, developing the domestic economy	20
National Fund of the Republic of Kazakhstan	Kazakhstan	Commodity	Macroeconomic stabilisation, intergenerational wealth building	20
Dubai International Capital	UAE[3]	Commodity	Rate of return	15 to 20
Alberta Heritage Savings Trust Fund	Canada	Commodity	Intergenerational wealth building	16
State General Reserve Fund, Oil Fund	Oman	Commodity	Intergenerational wealth building, macroeconomic stabilisation, developing the domestic economy	10
All funds listed here				2,352 to 3,032

* Sources: BIS, ECB, IMF, national websites, market studies; in each case most recent available data. — **1** The term "non-commodity" covers, in particular, the transfer of foreign currency reserves and other public monies. — **2** Partly rough estimates. Magnitude varies depending on reference source; ranges designate highest and lowest available data. — **3** United Arab Emirates.

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stock, especially in commodity-exporting countries. Total assets under management by sovereign wealth funds are probably somewhere between just over US$2 trillion and US$3 trillion.[1] This would mean that sovereign wealth funds are about the same size as hedge funds and private equity funds combined. However, their assets are relatively low compared with over US$50 trillion worth of assets under management by institutional investors. Nevertheless, sovereign wealth funds are likely to gain significantly in importance, with the IMF expecting the assets under management of sovereign wealth funds to increase to US$12 trillion by 2012.

Effects of sovereign wealth funds on financial markets tend to be positive ...

Owing to their high and still increasing investment volume, sovereign wealth funds are major players on the international financial markets. Their activities should therefore tend to have positive effects on the markets to the extent that their longer-term investment horizon dampens market volatilities.

... but recipient countries concerned about politically motivated investments

However, it cannot be ruled out that the motives underlying sovereign wealth funds' investments are sometimes political rather than economic. Against this background, there is an ongoing debate on whether existing regulations suffice to control unwanted foreign investment, for example, in security-related areas. Moreover, from a regulatory policy perspective, there is concern that investments by foreign sovereign wealth funds – or foreign state-controlled enterprises – might lead to "nationalisation through the back door". Reservations about sovereign wealth funds are also partly due to the fact that – with few exceptions – not much is known about their objectives and investment strategies. This lack of transparency promotes protectionist sentiment in the recipient countries.

Free movement of capital must not be called into question

If measures to ward off foreign investment are deemed necessary for overriding security or regulatory policy reasons, these should be proportionate and transparent and should be applied in a non-discriminatory fashion. From the Bundesbank's point of view, the principle of the free movement of capital must not be called into question. Rather, existing restrictions in this area should be further reduced, not least in countries with sovereign wealth funds. An open economy such as Germany, with a tradition of high current account surpluses, is reliant on investment opportunities abroad and, in turn, has benefited from inflows of foreign capital, including investments by sovereign wealth funds.

1 For the problem of statistically recording sovereign wealth funds, see the box on pages 74–75. According to IMF estimates, the volume of assets under management by sovereign wealth funds is somewhere between US$1.9 trillion and US$2.9 trillion; see Global Financial Stability Report, October 2007. Some market estimates even assume up to US$3.5 trillion.

Need for greater transparency

Against this background, and with a view to contributing to the stability of the international financial system, the Bundesbank supports efforts to develop best practices regarding transparency and accountability as well as the institutional structure and risk management practices of sovereign wealth funds. Moreover, with regard to recipient countries, it would be helpful to have in place generally recognised principles ensuring that state-controlled foreign investment is treated in a manner which is transparent, fair and fosters competition. In the autumn of 2007, the G7 finance ministers and central bank governors called on the IMF, the World Bank and the OECD to deal with these issues and prepare appropriate proposals.

(b) Current developments in the IMF and in the development banks

New IMF surveillance decision

The IMF's primary objective is the surveillance of economic and monetary policy of member countries. In the past year, it figured much more prominently in the Fund's activities and was made more effective, especially through a stronger focus on global financial stability and increased attention to the spill-over of national or supranational economic and monetary policies to other countries and regions. In June, the 30-year-old decision on surveillance over exchange rate policy was replaced by a new decision on surveillance, under which the emphasis of bilateral surveillance is to be on a country's "external stability" or "external instability". The latter is understood to mean current account imbalances which could bring about "disruptive" exchange rate changes. External stability should be achieved through internal stability and should not be put at risk by exchange rate policy measures. According to the wording of the official decision, in the case of members of a currency union, the analytical criteria for the assessment of external stability are applied not at national level but instead at the level of the currency union.

Greater importance of multilateral surveillance

In addition to traditional multilateral surveillance, which is reported on in the *World Economic Outlook* and in the *Global Financial Stability Report*, the IMF has used multilateral consultations as a new instrument for discussing with selected participants (the United States, the euro area, Japan, China and Saudi Arabia) measures to reduce global imbalances.

IMF quota reform still a central topic

The issue of quota and voice reform is still at the centre of the discussion on IMF reform. In order to ensure that the IMF retains its acceptance as a forum of international monetary cooperation in the future, it is important to give due regard to the weight in the world economy of countries that have grown dynamically in recent years and now account for a greater share of cross-border trade in goods and financial services. Following the first quota increase for the four most clearly underrepresented countries (China, Korea, Mexico and Turkey) in September 2006, the aim is to achieve agreement on more comprehensive reforms (new quota formula, further quota increase, at least a doubling of basic votes) by the spring of 2008.

Compromises in the quota reform must respect IMF's monetary mandate

Given the different positions of IMF members on the quota issue, the Bundesbank takes the view that it is important for the IMF to retain its character as a monetary institution and observe its basic principles such as equal treatment and fair burden-sharing among members. The Bundesbank therefore advocates that a country's weight in the world economy and its ability to contribute to the financing of the IMF be reflected adequately in the quota share. Ultimately, it will be a matter of reaching a sustainable compromise on the basis of a generally acceptable quota reform package.

Creation of a sustainable income mechanism for the IMF indispensable

The sharp decline in regular IMF lending has led to a significant reduction in interest income and thus to considerable income shortfalls. In the 2007 financial year, the Fund's administrative budget showed a deficit of SDR 111 million (approximately US$169 million or €119 million). In order to create a sustainable income base that is independent of lending volume, a Committee of Eminent Persons (the "Crockett Committee") proposed a fundamental reform in early 2007 which featured the following elements: an expansion of the IMF's investment mandate, the limited use of quota resources for capital market investment, the ring-fenced sale of IMF gold and the capital market investment of the resulting proceeds. These proposals have the general support of most member countries, including Germany. Nonetheless, in addition to the reform on the revenue side, the IMF's expenses must be carefully examined and reduced. From the Bundesbank's point of view, both have to go hand in hand. Decisions should be made soon in order to avoid an increasing recourse to the Fund's reserves for the financing of current expenditures.

Regular IMF lending business stagnating

With eight borrowing arrangements, the number of regular IMF lending programmes in 2007 was at about the same level as in 2006. At the same time, IMF credit outstanding declined further (to SDR 6.5 billion, or about US$10 billion or €7 billion, at the end of the year). At SDR 4.6 billion (around US$7 billion or €5 billion), two-thirds of this was accounted for by Turkey. The Fund's involvement in concessional lending to low-income countries, which is outside of the IMF's core mandate, also declined. The relatively new Policy Support Instrument, a programme for supporting the economic policy of low-income countries without providing financial assistance, has become further established.

New priorities at the World Bank

When the new World Bank president took office in early July 2007, public attention was drawn once again to the question of the future role of the World Bank and the multilateral development banks. In addition to the World Bank's ongoing central role in reducing poverty and (disputed) activities in medium-income countries, assistance to "fragile states" and the Arab world are now to be given greater prominence. Moreover, the Bank wants to give more consideration, in its programme, to global public goods (climate change, environment, combating communicable diseases etc). To fulfil this new strategic orientation, the World Bank is to be developed into a "knowledge bank".

(c) Informal international cooperation

Main focus of the German G7/G8 Presidency

In 2007, the informal cooperation within the G7 framework was presided over by Germany. In view of the potential risks for the stability of the financial system resulting from the strong growth of the hedge fund sector and the derivatives markets, the Federal Government and the Bundesbank continued to call for increased transparency in these areas. Moreover, one of the key issues of the German G7/G8 Presidency was the development of local currency bond markets in emerging market economies and developing countries (see page 119).

G7 and G20 discuss IMF reform

The IMF reform was also an important topic of the informal international cooperation within the framework of the G7 and the G20. The G20 was created in 1999 at the initiative of the G7 as an informal forum for dialogue between industrial countries and emerging market economies and has given – especially in the first few years of its existence – an important boost to the improvement of financial and monetary stability in the emerging market economies through constructive discussion and leading by example. However, despite some progress in the difficult question of IMF quota reform, the G20 has failed to bridge the fundamental differences of opinion which exist, in particular, between industrial countries and emerging market economies.

2 European integration

(a) Enlargement of the EU and euro area

Difficult accession talks with Croatia and Turkey

With the accession of Bulgaria and Romania to the EU, the enlargement process has been completed for the time being. The open-ended accession talks with Croatia and Turkey which started in October 2005 are moving forwards only very slowly. Out of a total of 33 negotiation chapters, Croatia has so far completed only two of 16 opened chapters and Turkey only one of six opened chapters.

Introduction of the euro in Cyprus and Malta

On 1 January 2008, Cyprus and Malta introduced the euro. On the basis of the convergence reports of the ECB and of the European Commission as well as a Council recommendation, the heads of state or government decided in June 2007 to allow Cyprus and Malta to join the euro area. In July 2007 the derogations for both countries were subsequently lifted and the conversion rates of their currencies to the euro were determined, matching the central rates in the exchange rate mechanism (ERM II).

Appreciation of the Slovak koruna within ERM II

In the ERM II, the Slovak koruna was realigned through an 8.5% revaluation on 16 March 2007. The revaluation, which was justified by the fundamentals and corresponded to market expectations, was based on a commitment by Slovakia to pursue supportive policies towards sustainable convergence.

(b) Economic policy coordination in the European Union shows continued need for consolidation and reform

Ensuring sustainability of consolidation successes

After the Ecofin Council had abrogated the excessive deficit procedure for Germany and other countries in June 2007, six EU member states (including euro-area member states Italy and Portugal) were still in the excessive deficit procedure at the end of 2007. However, unexpectedly high tax revenues amid favourable economic development, as well as consolidation efforts, have contributed to the average budget deficit of the euro area being almost halved on the year to an expected 0.8% of GDP. For the EU as a whole, net public sector borrowing will probably have been reduced by ½ percentage point to 1.1% of GDP in the past year. This positive development, however, must not tempt governments in the member states to relax fiscal restraint, since a deterioration of the economic outlook appears likely and the ageing of the population in many countries will lead to major burdens on the government budgets. Ensuring the

The Treaty of Lisbon

The Treaty of Lisbon, which was signed on 13 December 2007 by the heads of state or government of the 27 EU member states, amends the Treaty on European Union and the Treaty establishing the European Community. The latter will be known in future as the Treaty on the Functioning of the European Union. All stages leading to ratification have to be completed before the new treaty can enter into force on 1 January 2009. This box explains some of the new elements contained in the Treaty of Lisbon with regard to changes in the section on economic and monetary policy.

ECB as an institution

Under the Treaty of Lisbon, the ECB will become an institution of the European Union. It is now listed in Article 9 along with the other institutions – the European Parliament, the European Council, the Council of the Union, the European Commission, the Court of Justice of the European Union and the Court of Auditors. In this point, the Intergovernmental Conference (IGC) 2007 failed to fulfil its mandate not to open the monetary chapter. At present, the ESCB and the ECB are listed in a separate article (Article 8 of the EC Treaty) in line with their *sui generis* status. The ECB differs from the other institutions in that it has its own legal personality and its capital belongs to the national central banks. It is thus not part of the Community budget but is financially independent. Whereas, under current law, both the ECB and the ESCB are mentioned prominently in the first part ("Principles") of the EC Treaty, in the new Treaty on the Functioning of the European Union the ESCB will be mentioned for the first time in Part Three. For Part Three, there will, in future, be a simplified revision procedure whereby the European Council, acting unanimously, may adopt a decision amending all or some of the provisions of this part without calling an IGC. In the case of institutional changes in the monetary area, the ECB must be consulted. However, such a decision can enter into effect only upon its approval by the member states in accordance with their respective constitutional requirements, which means that, for amendments to Part Three of the Treaty on the Functioning of the European Union, the legal requirements to be met will remain high.

Appointment of members of the Executive Board of the ECB

The President, Vice-President and other members of the Executive Board of the ECB will, in future, be selected and appointed by the European Council acting by a qualified majority. Under current law, they are appointed by common accord of the governments of the member states at the level of the heads of state or government.

External representation of the euro area

A new Chapter 3a, "Provisions specific to member states whose currency is the euro", contains the rules governing the external representation of the euro area, which had previously been laid down in Article 111 (4) of the EC Treaty. One striking change in comparison with current

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The Treaty of Lisbon (cont'd)

law is the mention of "common positions" and "unified representation" as opposed to merely "positions" and "representation" in the EC Treaty. Moreover, Article 115c does not incorporate the current provisions which stipulate that the allocation of responsibilities set forth in Articles 99 and 105 of the EC Treaty must be complied with in the area of external representation.

Protocol on the Euro Group

The Euro Group, which was established as an informal committee at the Luxembourg European Council in December 1997, is now specified in a protocol. The Euro Group will continue to be a forum for the informal exchange of opinions. It will consist of meetings of the ministers of the member states whose currency is the euro, with the participation of the European Commission. In line with current political practice, the ECB will also in future be invited to attend Euro Group meetings. The ministers shall elect a president for a term of two-and-a-half (currently two) years.

Changes to economic policy coordination in the euro area

Within the framework of economic policy coordination, the European Commission may, in future, address a warning to the member state concerned if it finds that the member state's economic policy is not consistent with the broad economic policy guidelines adopted by the Council. This early warning right did not previously exist. Under current law, the Council, on a recommendation from the Commission, can address a recommendation to the member state concerned if it is established that the member state's economic policy is not consistent with the guidelines. The Council will retain this competence in future, too. However, the amendment envisaged in the Treaty of Lisbon will allow the Council to make a decision without taking into account the vote of the member state concerned. In addition, member states that have not introduced the euro are excluded from decisions concerning euro-area countries. This also applies, by analogy, to the excessive deficit procedure.

As part of budgetary surveillance, the Commission is currently required to submit an opinion to the Council if it believes that an excessive deficit exists in a member state. Under the new Treaty of Lisbon, the Commission will address the opinion directly to the member state concerned and merely inform the Council accordingly. In addition, the Council will decide on the basis of a Commission "proposal", rather than a "recommendation" as is currently the case, whether an excessive deficit exists in the member state concerned. This change of terminology will, at least formally, increase the Commission's influence: the amendment of a Commission proposal requires a unanimous decision by the Council, whereas no such restriction applies to changes to recommendations. The Treaty of Lisbon gives the member state concerned no say in the decision on the existence of an excessive deficit. Lastly, the two-thirds majority envisaged for further procedural steps will be replaced by a qualified majority.

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long-term sustainability of public finances and thus the credibility of the Stability and Growth Pact requires sustained budget consolidation and a rapid reduction of the high debt ratios. The Euro Group's agreement to reach its medium-term budgetary targets by 2010 at the latest is therefore to be welcomed. In this case, national fiscal policy rules can make a further important contribution to the sustainability of budgetary discipline.

Lisbon targets require further determined reform steps

At the end of 2007, as part of the renewed Lisbon strategy for growth and jobs, the EU member states presented the second progress reports on their national reform programmes for the 2005–2008 period. In a first assessment, the Ecofin Council noted that, in spite of successes already achieved, many Lisbon targets would not be achievable without further determined efforts. Action was deemed necessary, for example, to foster competition in the services and energy sectors as well as to make labour markets more flexible. The economic and employment policy recommendations set forth in the Integrated Guidelines for the three-year period from the spring of 2008 to 2011 therefore place the emphasis on the implementation of previously defined targets and not on fundamentally new reform proposals.

(c) Agreement on the Treaty of Lisbon

Institutional paralysis in Europe overcome

Following a time of reflection owing to the negative referendums on the constitution, a comprehensive mandate for the next Intergovernmental Conference was adopted under the German EU Presidency in the first half of 2007. In December, the heads of state or government signed the Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community. In order for the Treaty of Lisbon (see box on pages 81–82) to enter into force as planned on 1 January 2009, it must be ratified by the 27 member states.

II Current issues relating to the German financial system

1 Stability of the German financial system

Turbulence in the international financial markets

The German financial system was in a robust state at the beginning of 2007, which meant that it was in a good position to cope with the test of its resilience by the turbulence in the international financial markets. The fact that developments in the German financial system have been shaped crucially by these dislocations in the international markets since the middle of last year demonstrates the major impact that the international setting has on the German financial sector.

Dislocations in the US mortgage market…

These dislocations originated in the summer from the US subprime mortgage market. Rising default rates in this market segment led to numerous rating downgrades of securitised mortgage portfolios, resulting in uncertainty on the part of market players, an increase in risk aversion and liquidity tensions. The turbulence then spread to other market segments and beyond country borders.

… led to reassessment of credit risks, …

An extended period of extremely favourable financing conditions was followed from the third quarter of 2007 onwards by a comprehensive reassessment of credit risks, leading to a sharp rise in risk premiums. The securitisation market was at the centre of the adjustment process. In this market, loans and isolated credit risks are packaged, structured and sold on as asset-backed securities (ABS) or collateralised debt obligations (CDOs).

… tensions in the money market…

Banks had invested in these instruments on a large scale through off-balance-sheet special purpose vehicles (SPVs), which refinanced themselves through highly rated money market paper, resulting in considerable maturity transformation risk. In the wake of the rising number of defaults in the US mortgage market, these SPVs ran into refinancing difficulties when general doubts arose about the intrinsic value of their assets. From August 2007 onwards, there was growing uncertainty about the SPVs' own future liquidity needs and the potential direct or indirect risk exposures of counterparties. This caused the crisis of confidence to spill over into the interbank money market, where it led to considerable dislocations. In a setting where building up liquidity buffers had become a priority, this severely impaired the intermediation function that is usually performed by interbank trading. In order to dampen the – by historical standards – extreme widening of risk spreads and sharp fluctuations in money market rates, the Eurosystem used open market operations to make abundant liquidity promptly available at various money market maturities in line with demand – in some cases in consultation with other major central banks.

… and impacts on other market segments

The crisis led to a marked decline in 2007 in mergers and acquisitions activity, especially leveraged buy-outs, which had hitherto been booming. As the year went on, effects were also apparent in the market for covered bonds, ie paper that is usually characterised by high credit ratings. Towards the end of the year, there was a sharp rise in risk premiums, which led to market-smoothing with jumbo covered bonds being temporarily suspended throughout Europe. There were also signs that the turbulence might spread to various types of US consumer credit. At the same time, problems with US monoline insurers, which have specialised in default risks arising from financial instruments, became evident.

Strains for internationally active financial institutions

Developments in the financial markets clearly left their mark on the profit and loss accounts of large international financial institutions. The revaluation of credit instruments necessitated considerable write-downs. Some banks consolidated SPVs – including losses – on their balance sheets. Moreover, institutions whose business model was heavily based on investment banking, and especially on repackaging and selling on credit risks, suffered a marked decline in their earnings from commissions in this area. Overall, the institutions' ample capital base meant that they were able to cope with these strains. However, some large foreign institutions felt compelled to strengthen their equity capital and were able to attract sovereign wealth funds from Asia and the Middle East as suppliers of capital. Poorer profitability as well as investor uncertainty were also reflected in large financial institutions' stock prices. There were strong stock price declines in the case of the most severely affected institutions.

German banking system remains stable

In this setting, the German banking system found itself facing considerable challenges in 2007. Major shortcomings were revealed in specific cases, necessitating the intervention of the owners as well as other banks and/or banking groups. On the whole, however, the German banking system remained fully functional and stable at all times. First, owing to its highly diversified refinancing base and the substantial role played by retail deposits, the German banking system is comparatively robust with regard to disruptions in the interbank market. Second, German banks' risk-bearing capacity has been improving steadily since 2003. This assessment has been confirmed by the prudential discussions and stress tests conducted by the Bundesbank.

Analysis of turbulence

The Bundesbank participates in a number of international committees which are analysing the causes and dynamics of the financial market turbulence with the aim of identifying and remedying shortcomings. The Financial Stability Forum, on behalf of the G7, is coordinating the work of the various expert committees in this area (Basel Committee on Banking Supervision, International Organization of Securities Commissions, Committee on the Global Financial System). Although it is too early for a final assessment, a number of structural deficiencies and misjudgements can be identified.

Risks underestimated

It has become apparent, for example, that, in their risk management, many market players underestimated the interdependencies between various market segments, such as the money, mortgage and bond markets, as well as between the financial market and the real economy. The importance of liquidity for the functioning of the financial system was highlighted by the tensions in the money market. It also became clear that the mutual dependency of financing liquidity and market liquidity[1] has increased with the importance of the originate-to-distribute business model. Inadequate consideration of the risks associated with complex securitisation structures also played a part in the financial market turbulence.

2 Profitability of German banks

Stable profitability despite financial market crisis

Despite the financial market crisis that started in the second half of 2007, German banks' profitability remained largely stable last year. The turbulence in the international financial markets led to increased loan loss provisioning at the internationally active credit institutions. Furthermore, banks focusing on investment banking recorded a slump in earnings from net commissions received. Nevertheless, apart from isolated cases, German credit institutions were able to offset such negative stimuli largely by a growth in earnings in other lines of business and by drawing on provisions. In this context, the German banks benefited from the fact that the economic setting continued to be positive. Essentially, the profitability of savings banks and credit cooperatives remained unaffected by the financial market turbulence. The fact that the yield curve continued to flatten generated dampening effects on net interest received, but these were offset by the positive stimuli of developments in the domestic economy as a whole.

Consolidation process continues at a slower pace

The process of consolidation in the German banking sector continued to advance in 2007, albeit at a somewhat slower pace than in previous years. Bank mergers were again focused mainly on banks active in retail business. In 2007, the number of savings banks declined by 11 and credit cooperatives by 25. At the same time, there was an increase of three in the number of branches of foreign banks active in Germany. The banking statistics recorded a total of only 2,015 credit institutions at the end of 2007, which was 33 fewer than in 2006.

1 Financing liquidity refers to the availability of financial resources. Market liquidity is defined as market participants' ability to carry out large-volume transactions at any time without causing a significant price effect.

Banking supervision

Owing to the problems on the US mortgage market, the year 2007 was a major test of resilience for the financial markets. The central banks' response to the market turmoil demonstrated how important their involvement in banking supervision and their market proximity is in overcoming crisis situations. In addition, the turbulence clearly illustrated how essential it is to quickly and extensively apply the new Basel capital standards framework, whose transitional arrangements were phased out at the end of last year. Significant progress was made in the convergence of supervisory practices in Europe, for example by creating supervisory networks which advance the direct cooperation of supervisors overseeing banking groups operating on a cross-border basis. The aim is to further intensify this convergence, though without carrying out any institutional restructuring which would reduce supervisors' flexibility, particularly in dealing with crisis situations.

I Current developments, lessons to be learned from the financial market turmoil

Consequences for the German banking industry

The turmoil that hit the financial markets as a result of the problems on the US mortgage market led to refinancing difficulties for asset-backed commercial paper (ABCP) programmes. As a consequence, the banks involved closed the relevant positions and thus suffered valuation losses. The German banking industry was also impacted by these developments. Nevertheless, the liquidity and solvency situation of the German banking system proved to be robust overall. In this respect, the direct contact between central banks and credit institutions on prudential matters – in Germany, the involvement of the Bundesbank in banking supervision – proved to be advantageous for ensuring banks' liquidity. In connection with the financial market turmoil, support measures had to be taken to aid two institutions that, in the course of their business activities, had severely overstretched themselves on the ABCP market.

Careful analysis of the need for change

Given the complexity of cause and effect in connection with the turmoil on the financial markets, it would be advisable to avoid making hasty statements on stricter regulation ("Basel III") and to conduct a careful analysis of the causal relationships before drawing conclusions for banking supervision.

Quick and extensive application of the Basel II supervisory rules

The financial market turmoil demonstrates how essential it is to implement Basel II as quickly and extensively as possible. Several of the problems that occurred on the market were the result of inadequate risk mapping and the arbitrage possibilities that this created under the old capital standards framework, which most banks still chose to apply at their discretion in 2007.

By contrast, Basel II is expected to provide important positive stimuli for financial stability through the interaction of its minimum capital requirements (Pillar 1), supervisory review process (Pillar 2) and disclosure requirements (Pillar 3).

Areas where supervisory action is required from a German perspective

However, over and above the anticipated positive impact of the new supervisory regime, the financial market turmoil has already brought to light some preliminary areas in which banking supervisors will have to become active and which are being discussed by the appropriate international bodies (in particular, the Basel Committee on Banking Supervision). The following points appear to be particularly important: (a) reviewing the weighting factors for credit commitments and liquidity facilities, (b) improving the transparency of rating agencies' activities in order to restore market players' confidence in ratings and (c) guaranteeing adequate prudential treatment of concentration risk to ensure appropriate risk diversification. Banks' liquidity management as well as the supervisory review thereof will also play a more important role going forward. Moreover, institutions should further improve their risk identification by employing more qualitative processes, in particular stress tests, in addition to quantitative, backward-looking models.

II Development of the national and international prudential supervisory standards

1 Development of the national prudential supervisory standards

Phasing-out of the transitional provisions with regard to the Solvency Regulation and the Liquidity Regulation

The transitional provisions under the Act Implementing the Capital Requirements Directive (CRD) (*CRD-Umsetzungsgesetz*), which allowed institutions to continue to apply the old rules governing capital adequacy and liquidity as well as the monitoring of large exposures in 2007, were phased out on 31 December 2007. Since January 2008, all institutions have had to apply in full the provisions under the Solvency Regulation (*Solvabilitätsverordnung*), the Liquidity Regulation (*Liquiditätsverordnung*) and the revised Regulation governing large exposures and loans of €1.5 million or more (*Grosskredit- und Millionenkreditverordnung*).

Transitional Regulation Governing Consolidated Financial Statements

The amended version of the German Banking Act (*Kreditwesengesetz*) provides the option of switching to calculating the consolidated own funds requirement using group balance sheet data. To this end, the Transitional Regulation Governing Consolidated Financial Statements (*Konzernabschlussüberleitungsverordnung*) was put into force on 1 January 2007, eliminating the prudentially undesirable capital effects resulting from international accounting standards through the use of prudential filters.

Transposition of the MiFID via the Act Implementing the Markets in Financial Instruments Directive

At the national level, the Markets in Financial Instruments Directive (MiFID) was implemented, replacing the Investment Services Directive (ISD) of 1993. The MiFID was transposed into national law by the Act Implementing the Markets in Financial Instruments Directive (*Finanzmarktrichtlinie-Umsetzungsgesetz*) which involved, in particular, a revision of the Securities Trading Act (*Wertpapierhan-*

Ongoing banking supervision operations

At the end of 2007, 2,282 domestic credit institutions had been registered as being subject to the German Banking Act (*Kreditwesengesetz*) (the figure had been 2,307 at the end of 2006).[1] The fact that the number of credit institutions dropped by a total of 25 indicates a slowdown in the streamlining of the German banking network for the eighth year in succession (257 fewer institutions in 2000, 213 in 2001, 164 in 2002, 146 in 2003, 71 in 2004, 54 in 2005 and 43 in 2006). A total of 59 credit institutions closed down, owing predominantly to mergers; 25 of these institutions were credit cooperatives and 11 were savings banks. This decrease was partly offset by 34 new institutions, mainly regional banks, branches of foreign banks – mostly from the European Economic Area (EEA) – and securities trading banks. The number of supervised financial services institutions declined slightly to 793 (there were 831 institutions in 2003, 827 in 2004, 800 in 2005 and 811 in 2006).

Meetings with senior management, which are generally conducted once a year, have become established as a key instrument of banking supervision and, together with the reports on the audit of annual accounts, have developed into one of the main sources of information on an institution's risk situation.

In 2007, the Bundesbank performed 115 on-site inspections on the basis of the "Minimum requirements for risk management" (*Mindestanforderungen an das Risikomanagement*) pursuant to section 44 (1) sentence 2 of the Banking Act. The on-site inspections took the form of risk and process-oriented system audits, focusing on the organisation of risk management practices pursuant to section 25a (1) of the Banking Act. The majority of these on-site inspections related to the requirements for an adequate business organisation of credit business.

Ongoing monitoring of institutions

Number of operations conducted

Item	2005	2006	2007
1 Reports, monthly and other returns			
Individual reports pursuant to sections 13 to 14 of the Banking Act	165,477	153,653	148,244
Single borrowers listed in the summary reports submitted pursuant to sections 13 to 14 of the Banking Act	2,035,187	2,104,412	2,143,835
Reports pursuant to sections 24 and 24a of the Banking Act	34,951	27,589	21,998
Monthly returns and other data pursuant to sections 25 and 25a of the Banking Act	30,086	34,486	33,558
Reports under Principle I or pursuant to the Solvency Regulation	28,452	27,572	27,523
Reports under Principle II or pursuant to the Liquidity Regulation	27,140	26,467	26,322
2 Audit reports and reports on activities (new definition as from 2006)	12,331	10,734	8,740
3 Meetings with senior management	2,047	2,400	2,314
4 Audits of banking operations	106	186	214

1 Credit institutions pursuant to section 1 (1) of the German Banking Act (including institutions which are in liquidation or being wound up). For the sake of systematic classification, all 52 securities trading banks are also included here although 45 of these institutions provide only financial services.

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Ongoing banking supervision operations (cont'd)

Activities in connection with the approval of internal ratings-based systems were stepped up slightly in comparison with 2006. At the end of the year, 63 institutions had submitted applications for approval to use an Internal Ratings-Based (IRB) Approach, 28 of them to use the Advanced IRB Approach.

In 2007, the Bundesbank also conducted four initial and three follow-up examinations for approval of an Advanced Measurement Approach (AMA) for operational risk. These institutions are already using AMAs for the majority of their business activities. In Germany, the loss distribution approach has established itself as the market standard.

The Bundesbank conducted one follow-up examination of an internal market risk model in 2007. In addition, it stepped up its meetings with senior management in this area. Here, the main focus for institutions that model the specific market risk pertaining to interest rate and equity positions was on the future requirements for modelling the default risk in the trading book (the "incremental default risk charge" or IDRC). This was against the background of the IDRC principles that came into force on 1 January 2007 and must be complied with by 1 January 2010 at the latest.

Following the entry into force of the Liquidity Regulation on 1 January 2007, discussions were held with interested banks and industry associations on the approval of internal procedures to measure and manage liquidity risk. In preparation for these examinations, a notice on the application and approval procedure was published. The Bundesbank is expecting to carry out several initial approval audits in 2008. The results of the study on liquidity risk management at selected German credit institutions, which the Bundesbank and BaFin conducted jointly in 2007, is scheduled to be published in a joint range-of-practices paper in early 2008.

In the period from 30 September 2006 to 30 September 2007, the number of loans of €1.5 million or more to be reported quarterly pursuant to section 14 of the Banking Act fell by 0.7% to 504,052. Meanwhile, over the same period, the total volume of reported loans of €1.5 million or more increased by 7.3% from €8,069 billion to €8,656 billion on the reporting date of

Credit register of loans of €1.5 million or more

	Volume of loans of €1.5 million or more		Number of loans of €1.5 million or more reported		Number of reporting		
Third quarter	€ billion	Percentage change	Number	Percentage change	Institutions[1]	Financial enterprises	Insurance corporations
2000	6,487	+ 14.6	509,567	+ 5.2	3,129	993	645
2001	7,087	+ 9.2	525,020	+ 2.9	2,946	955	644
2002	7,161	+ 1.0	526,552	+ 0.3	2,777	1,075	621
2003	6,995	– 2.3	514,433	– 2.3	2,624	1,174	633
2004	7,118	+ 1.8	503,632	– 7.0	2,547	1,271	635
2005	7,843	+ 10.1	503,290	– 0.1	2,517	1,428	623
2006	8,069	+ 2.9	507,821	+ 0.7	2,489	1,362	615
2007	8,656	+ 7.3	504,052	– 0.7	2,405	981	618

1 Credit institutions and financial services institutions.

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Ongoing banking supervision operations (cont'd)

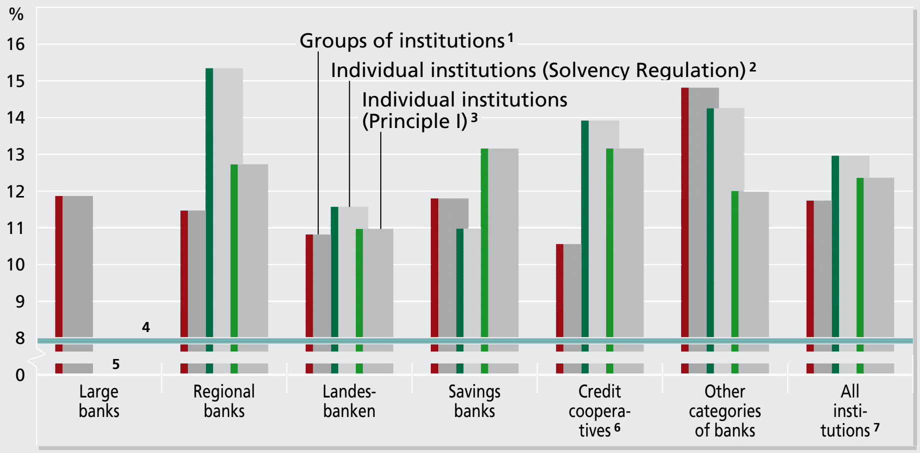
30 September 2007. At this date, 2,405 institutions, 981 financial enterprises and 618 insurance corporations had submitted reports on loans of €1.5 million or more.

During the revision of the Regulation governing large exposures and loans of €1.5 million or more (*Grosskredit- und Millionenkreditverordnung*), the amended version of which entered into force on 1 January 2008, reviewing the data to be reported became another focal point of the activities performed by the credit register for large exposures and loans of €1.5 million or more. In view of increasingly qualitative banking supervision, the integration of risk-relevant information about the borrower to be reported on, such as probabilities of default, risk-weighted assets and specific loss provisions, was given priority.

Since the beginning of 2007, the Capital Requirements Directive obliges the banking supervisory authorities throughout Europe to conduct their own annual assessment of the risk situation and risk management of every institution, ie independently of the institution and its external auditors. In Germany, this is effected through supervisory risk profiles, in which the insights gained in the supervisory review process are evaluated in partial assessments comprising all of an institution's key risk aspects. A four-level quality scale is applied to the partial assessments as well as to the overall assessment into which they are consolidated. The main aim of the risk profile is to ensure that the frequency and intensity of supervisory activities are aligned with the institutions' individual risk situations and thus to supervise the institutions in

Overall capital ratio* of individual institutions as well as groups of institutions and financial holding groups submitting reports pursuant to the Solvency Regulation

End-2007 levels



* Overall capital ratio = (eligible own funds ÷ (risk-weighted assets + capital charges for market risk x 12.5)) x 100. — **1** Groups of institutions and financial holding groups pursuant to section 10a of the Banking Act. — **2** Credit institutions and financial services institutions on a non-consolidated basis. — **3** Credit institutions and financial services institutions on a non-consolidated basis submitting data pursuant to the former Principle I in accordance with section 339 (9) of the Solvency Regulation. — **4** The minimum percentage is 8% under the Solvency Regulation. — **5** Non-consolidated data are not available owing to the provisions of section 2a of the Banking Act (waiver rule). — **6** Excluding regional institutions of credit cooperatives. — **7** Including regional institutions of credit cooperatives.

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Ongoing banking supervision operations (cont'd)

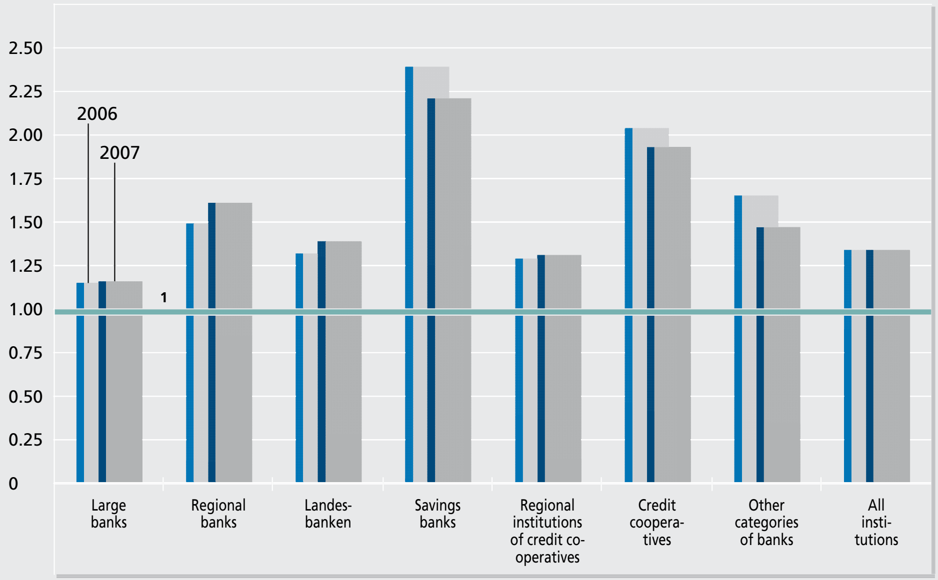
keeping with their respective risk situations. At the same time, supervisory practices are rendered more transparent as supervisors grant an insight into their perception of the institution.

With the transposition of Basel II into the Banking Act on 1 January 2007 and as part of the Solvency Regulation, the solvency ratio reporting framework was also revised. The previously reported capital ratio (according to Principle I) is no longer calculated. However, institutions are still required to report the overall capital ratio, which gives the ratio of all risk positions that have to be backed by capital to own funds. The average overall capital ratio of institutions reporting on a non-consolidated basis was 12.5% on 31 December 2007, while the average overall capital ratio of groups of institutions/financial holding groups was 11.7%. This includes all institutions reporting on a non-consolidated basis – provided they are not partially exempt from supervision on a solo basis pursuant to section 2a of the Banking Act – and groups of institutions/financial holding groups. In the transitional year, the overall capital ratio may be based either on the hitherto applicable Principle I or on the new Solvency Regulation.

Reporting in connection with the previous liquidity standard, Principle II, has also been adapted by means of the new Liquidity Regulation. As before, institutions are still required to demonstrate adequate liquidity for payment purposes at all times by maintaining a liquidity ratio of at least 1. On 31 December 2007, the average liquidity ratio was 1.34.

Liquidity ratio of individual institutions submitting reports pursuant to the Liquidity Regulation *

End-of-year levels



* Credit institutions and financial services institutions on a non-consolidated basis (Liquidity Regulation and Principle II reporting formats). Liquidity ratio = total payment assets ÷ total payment liabilities. — **1** Under the Liquidity Regulation, the required minimum liquidity ratio is 1.0.

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delsgesetz) and amendments to the Stock Exchange Act (*Börsengesetz*). The Act Implementing the Markets in Financial Instruments Directive also led to changes in the Banking Act, the most important of which were the introduction of new definitions for investment advice, placement business, operation of a multilateral trading system and own-account business pursuant to section 1 (1a). With the transposition of the MiFID, the rules contained in the circular on outsourcing have now also been integrated into the "Minimum requirements for risk management" (*Mindestanforderungen an das Risikomanagement*).

Act Amending the German Investment Act

The Act Amending the German Investment Act (*Investmentänderungsgesetz*) was also passed. An important new development is that investment companies will lose their status as credit institutions. Pursuant to the Act Amending the German Investment Act, supervision in this respect will now be carried out only by BaFin (the Federal Financial Supervisory Authority). In order to ensure that the Bundesbank can continue to monitor financial stability, the Act specifically requires that all relevant information and documents be passed on to the Bundesbank.

2 Activities in the Basel Committee on Banking Supervision

New organisational structure and publications

The Basel Committee on Banking Supervision reworked its organisational structure and set up the Policy Development Group (PDG) as well as the International Liaison Group (ILG) in addition to the existing Accord Implementation Group (AIG) and the Accounting Task Force (ATF) in order to streamline the management of its various project working groups. The groups' work is related, among other things, to liquidity risk, the definition of capital, economic capital and "fair value" aspects of accounting. The "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book" were published for consultation, and a recommendation on capital allocation in the case of cross-border Advanced Measurement Approach (AMA) methodologies was passed.[1]

1 Basel Committee on Banking Supervision, Principles for home-host supervisory cooperation and allocation mechanisms in the context of Advanced Measurement Approaches (AMA), November 2007 (http://www.bis.org/publ/bcbs135.htm).

3 Activities in connection with the Committee of European Banking Supervisors

Convergence of supervisory action and practical cooperation

The main task of the Committee of European Banking Supervisors (CEBS) is to promote supervisory convergence and practical cooperation. A key element of this is formed by the supervisory networks created by supervisors for direct cooperation among the supervisory authorities overseeing cross-border banking groups, which are becoming increasingly important.

Review of the Lamfalussy procedure – no institutional changes

The Lamfalussy procedure and thus the progress made with regard to supervisory convergence and cooperation was reviewed after having been applied in practice for five years. The market participants were of the view that the procedure has proved successful and thus no institutional restructuring should be undertaken. Individual improvements to the rules were proposed to further promote convergence.

Cash management

The Bundesbank's strategy in the area of cash management is to participate in the smooth and efficient supply of cash at all times, including in times of crisis. In doing so, it fulfils its statutory mandate. By formal agreement, the Bundesbank has transposed into national law the Eurosystem "Framework for the detection of counterfeits and fitness sorting of euro banknotes by credit institutions and other professional cash handlers". Almost three-quarters of all the credit institutions in Germany have concluded an agreement of this kind with the Bundesbank. Furthermore, the Bundesbank has made significant progress with the upgrading of its cash-processing machinery. The Bundesbank's ongoing participation in the development of the second series of euro banknotes and the introduction of electronic procedures for optimising cash payment operations (CashEDI) have also presented the Bundesbank with a number of demanding challenges.

Euro currency in circulation in the Eurosystem

During 2007, the volume of banknotes in circulation issued by the Eurosystem increased again sharply by 7.7% to €676.6 billion. The volume of coins in circulation rose by 7.6% to €19.2 billion.

Euro currency in circulation in the Eurosystem — Table 9

Trend

€ million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation[1]
2005	581,860	565,217	16,643
2006	646,119	628,242	17,877
2007	695,860	676,621	19,239

Breakdown at year-end 2007

Banknotes in circulation			Coins in circulation		
Notes of €	€ million	Percentage of total	Coins of €	€ million	Percentage of total
500	226,325	33.4	2.00	7,591	39.5
200	31,137	4.6	1.00	5,701	29.6
100	120,933	17.9	0.50	2,321	12.1
50	222,112	32.8	0.20	1,565	8.1
20	49,354	7.3	0.10	988	5.1
10	19,655	2.9	0.05	614	3.2
5	7,105	1.1	0.02	285	1.5
			0.01	174	0.9
Total	676,621	100.0	Total	19,239	100.0

1 Circulation of euro coins excluding commemorative coins.

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Besides regular issue coins, euro collector coins were issued in all the euro-area countries; these are legal tender only in their country of issue. In Germany, issues of German euro collector coins in 2007 had a total value of €125 million.

In the financial year 2007, the Bundesbank paid out 15.2 billion euro banknotes with a value of €471.7 billion. During the same period, the Bundesbank received lodgements from its customers of 14.4 billion euro banknotes with a value of €442.0 billion.

The Bundesbank endeavours to be continuously involved in the cash cycle in order to ensure the quality of the banknotes in circulation. The aim of this is to ensure that banknotes are of high quality not only at the time of issuance, but also during their time in circulation, thereby guaranteeing a high level of acceptance of banknotes paid out via ATMs, and, at the same time, laying the foundation for effectively preventing and combating counterfeit money.

Euro counterfeits

The number of counterfeit euro banknotes detained in German payments and recorded by the Bundesbank declined for the third year in succession. The

Number of counterfeit euro banknotes and coins detained in German payments and recorded by the Bundesbank — Table 10

Year	Banknotes		Coins	
	Number (thousand)	€ thousand	Number (thousand)	€ thousand
2005	74	4,896	46	90
2006	46	3,233	77	150
2007	40	3,769	82	157

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number of counterfeit euro coins recorded was the highest since the introduction of the euro.

The incidence of both counterfeit coins and notes was spread evenly throughout the year. Despite the declining trend, the €50 note was still the most frequently counterfeited denomination in Germany in 2007, accounting for 38% of the total volume of counterfeits. The rise in the number of counterfeit €100 and €200 notes led to an increase in the loss arising from counterfeits compared with 2006. In relative terms, the incidence of counterfeit banknotes detected is exceptionally low in Germany at around five counterfeits per 10,000 inhabitants per year. In the case of counterfeit coins, it is striking in comparison with the previous year that, in addition to counterfeit €2 coins (93%), there was an increasing number of counterfeits of the €1 and 50 cent denominations.

Counterfeit prevention

The training courses offered free of charge by the Bundesbank as part of its counterfeit prevention programme were again very well attended by the banking industry, the retail sector and other interested parties. In total, around 750 training courses were organised across Germany, attracting some 15,000 participants.

Number of Deutsche Mark and euro banknotes and coins submitted to the Bundesbank's National Analysis Centre for reimbursement — Table 11

Year	Banknotes		Coins	
	Number (thousand)	€ million	Number (thousand)	€ million
2005	367	13.7	264	0.06
2006	428	17.2	242	0.07
2007	452	16.6	192	0.05

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Damaged and mutilated banknotes and coins

In the financial year 2007, the National Analysis Centre for damaged banknotes and coins received around 19,600 applications (2006: 22,500). Deutsche Mark and euro coins and notes for reimbursement were submitted with these applications.

At the beginning of 2007, the number of "brittle" banknotes, ie banknotes which have come into contact with sulphuric acid, was very much lower than in the second half of 2006. Since the fourth quarter of 2007, only a very small number of these banknotes have been detected in payment transactions. A total of 4,715 "brittle" banknotes have been recorded to date. It is still not clear how these banknotes came into contact with the sulphuric acid.

Deutsche Mark currency in circulation

The volume of Deutsche Mark currency in circulation had declined to DM14.1 billion by the end of 2007. Banknotes accounted for around DM7.0 billion of this amount and coins for roughly DM7.1 billion.

Deutsche Mark currency in circulation — Table 12

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
2005	14,725	7,497	7,228
2006	14,380	7,218	7,162
2007	14,086	6,990	7,096

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Involvement in the development of euro series II banknotes

In March 2003, the Governing Council of the ECB made a policy decision to develop a second series of euro banknotes (ES2), which will replace the current banknote series in a few years' time. In order to maintain continuity, the essential design elements of the first series of euro banknotes (ie the main motifs depicting "gateways and bridges" as well as the prevailing colour scheme) will be adopted for the second series as well. Unlike the current banknote series, the individual banknote denominations of the new series will be introduced in stages. The €50 note is scheduled to be the first denomination to be issued.

In October 2007, the Governing Council of the ECB selected the security features to be adopted for the second series of euro banknotes; these new security features should enable the general public to identify counterfeit banknotes more easily than before. Further steps are still needed before large-scale printing of these banknotes can begin. First, the design of the banknotes has to be finalised. Then, the printing plates have to be produced. Following this, further tests will be carried out as part of the pilot production, which will take place at a number of printing works that have already produced euro banknotes.

Introduction of CashEDI

In the fourth quarter of 2007, the Bundesbank began the implementation of its Cash Electronic Data Interchange (CashEDI) procedure, which allows cash handlers to exchange cash payment data electronically based on international standards. This makes a significant contribution to the efficient, transparent and secure management of cash processes.

Bundesbank's range of services reflects its statutory mandate

During the financial year, a further 20 branches were converted to multi-denomination processing. This meant that, by the end of December 2007, 39 of the total of 47 branches were providing their customers with the option of making multi-denomination lodgements. This adjustment to the range of services also entailed changes to the Bundesbank's lodgement requirements. Market participants no longer have to sort the banknotes laboriously by orientation and denomination. The Association of German Cash Service Industry (*Bundesvereinigung Deutscher Geld- und Wertdienste – BDGW*) had brought an action at the Frankfurt Regional Court against the fee of €1 which the Bundesbank levies for each multi-denomination lodgement. The court dismissed the case and, in its decision, confirmed the Bundesbank's interpretation of the law that, by accepting and processing banknotes, it is acting in accordance with its statutory mandate.

Framework for the detection of counterfeits and fitness sorting by credit institutions and other professional cash handlers

Up until now, this statutory mandate has been supplemented by a voluntary (gentleman's) agreement of 1994 that only banknotes which have been inspected by the Bundesbank may be paid out by credit institutions through ATMs. This agreement is now being superseded by the "Framework for the detection of counterfeits and fitness sorting by credit institutions and other professional cash handlers". In March 2007, the Bundesbank and the Central Credit Committee, in collaboration with the Federal Criminal Police Office, concluded a model agreement on the national implementation of this framework. At the end of May 2007, agreements were sent to the credit institutions through the branches of the Bundesbank for signing. Once the agreement has been concluded, credit institutions are allowed to pay out banknotes via ATMs and other customer-operated machines again provided that the credit institutions

- use banknotes which have been inspected by a Eurosystem central bank
- have themselves checked banknotes for authenticity and fitness in accordance with the contractual agreements, or
- outsource the checking of banknotes to a third-party service provider.

By the end of 2007, more than 70% of all credit institutions had signed the agreement and were listed on the Bundesbank's website.

Range of coin-related services

As part of its cash management strategy, the Bundesbank is aiming to confine its involvement in coin processing to meeting marginal stock requirements. The requirements for this were put in place in 2003 with the introduction of the coin roll standard. Since then, cash handlers have been able to equalise their coin stocks among each other, without the involvement of the Bundesbank. Only limited use has been made of this option to date, however.

Cashless payment and securities settlement systems

The Bundesbank's strategic objectives include promoting the secure and efficient execution of cashless payments and securities transactions as well as encouraging innovations in payment operations. In the case of cashless payment operations, this is based on a legal mandate. The Bundesbank's interest in securities settlement is founded on the close interaction between securities settlement and payments and its relevance for financial stability in Germany. The Bundesbank's activities are three-fold:

- *offering market participants settlement services and acting as a service provider within the Eurosystem;*
- *influencing general developments at the national, European and G10 levels (catalyst function);*
- *also overseeing payment operations and – together with other responsible authorities – asserting its interests with regard to securities settlement.*

In 2007, the Bundesbank focused its activities on further enhancing its own range of services. It worked on developing and launching TARGET2, introduced a paperless procedure for the collection of large-value cheques (€6,000 or more) and carried out project work on TARGET2-Securities (T2S) and preparations for the Single Euro Payments Area (SEPA). In addition, the Bundesbank modernised its settlement system for its securities trading and safe custody account business and successfully introduced a self-collateralisation procedure in Germany.

Further progress being made on SEPA

Preparations for the introduction of the Single Euro Payments Area (SEPA) went ahead apace in 2007. The aim of this European banking industry project is to offer citizens, companies and public administrations within Europe a single set of instruments for settling payments on the basis of common standards and rules, thus eliminating the existing fragmentation in the European retail payments market. Since 28 January 2008, the service has initially comprised payments via SEPA credit transfer. SEPA direct debits are not expected to be introduced across the board until the EU Payment Services Directive has been transposed into national law (by 1 November 2009 at the latest).

SEPA activities at the European and national levels

The Bundesbank's activities cover political and conceptual areas both at a European level and within a national context. In this connection, for example, it observes the progress made on national migration, promotes the rapid adoption of the new SEPA procedures – particularly in cooperation with public administrations, which generate a considerable portion of payment transactions – and actively follows the debate on the creation of a pan-European card system. In addition, preparations for processing SEPA payments in the new RPS SEPA clearer featured large in 2007.

Preparations for the provision and settlement of SEPA credit transfers

From mid-October to end-December 2007, banks were able to conduct tests with the SEPA clearer. Numerous banks completed the tests successfully and were granted permission to participate in the SEPA clearer. Two efficient, modern communication channels are available to submit and deliver SEPA payments: SWIFTNet FileAct and EBICS (Electronic Banking Internet Communication Standard).

The Bundesbank signed off on the European Payments Council (EPC) Rulebook on SEPA Credit Transfers in December 2007 – as did the vast majority of other German banks – and will also offer non-bank customers (in particular public administrations) clearing services for SEPA credit transfers.

Participation in G10 Committee on Payment and Settlement Systems (CPSS)

In 2007, the Bundesbank was again very involved in the work of the G10 central banks' Committee on Payment and Settlement Systems (CPSS) at the Bank for International Settlements in Basel. In January 2007, the CPSS published a report it had drawn up in cooperation with the World Bank on the general principles for international remittances services from a payment transactions perspective. A report adopted in March 2007 gave an overall assessment of the progress made since 1998 on reducing risk and strengthening the infrastructure in the market for the clearing and settlement of over-the-counter (OTC) deriva-

Cashless payment and securities settlement systems

With its RTGS^{plus} system and the launch on 19 November 2007 of the "TARGET2-Bundesbank system" as its legal successor within the Eurosystem's single technical TARGET2 platform, the Bundesbank's contribution to overall European individual payments stands at around 28%. In total, 157 institutions in Germany and the European Economic Area (EEA) settle their European payments via the Bundesbank. The number of transactions processed through the Bundesbank posted a strong year-on-year increase of almost 11%. The volume of processed payments recorded even more significant growth (of 20%), not least as a consequence of the turmoil on the financial markets. In German interbank clearing, the Bundesbank offers its Retail Payment System (RPS) for the settlement of retail payments as a complement to other providers' services. Overall, payment transactions executed via these Bundesbank systems have developed as follows:

Cashless payments of the Deutsche Bundesbank

Item	2006 Number (million)	2006 € billion	2007 Number (million)	2007 Percentage change	2007 € billion	2007 Percentage change
Individual payments	38.8	162,629	42.6	9.8	185,089	13.8
RTGS^{plus}/TARGET2-BBk	37.9	150,776	41.9	10.5	181,241	20.2
National	32.7	104,025	36.2	10.5	126,527	21.6
Cross-border	5.1	46,751	5.7	10.2	54,714	17.0
Other[1]	0.9	11,853	0.8	– 18.9	3,848	– 67.5
Retail payments	2,301.3	2,196.3	2,346.4	2.0	2,263	3.0
RPS	2,297.9	2,195	2,343.0	2.0	2,262	3.0
National	2,294.5	2,189	2,339.0	1.9	2,255	3.0
Cross-border	3.4	5	4.0	17.6	7	30.7
Other[2]	3.4	2	3.4	0.4	2	4.9
Total	2,340.1	164,825	2,389.0	2.1	187,352	13.7

1 CAM: Customer Access Mechanism (access to RTGS^{plus}/TARGET2-BBk, correspondent banking), in specific. — **2** MASSE: Procedure for cross-border retail payments of public authorities.

In addition, the Bundesbank fulfils an important function on the German financial market (*Finanzplatz Deutschland*) by providing clearing and settlement procedures for exchange-traded and over-the-counter (OTC) spot and forward transactions in central bank money. These procedures are used by both the German central securities depository Clearstream Banking AG Frankfurt (CBF) and the central counterparties Eurex Clearing AG and European Commodity Clearing AG. Since 26 November 2007, the majority of securities transactions have been settled directly using "TARGET2-Bundesbank".

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tives. In addition, the CPSS reported on the efforts made by the banking industry and central banks at handling and/or reducing foreign exchange settlement risks. Currently, the CPSS is studying the interdependencies between payment and securities settlement systems and the implications this has in terms of risks and efficiency. Following on from a report on procedures in the cross-border use of collateral published in 2006, existing systems and their key features are described in more detail to assist non-G10 central banks with an interest in this topic.

Payment systems oversight …

As part of its task of payment systems oversight, the Bundesbank undertook a number of basic and ongoing oversight activities in 2007. One focal point was the assessment by the participating central banks of the new individual payment system TARGET2 to ascertain whether it complied with internationally recognised oversight standards prior to its launch. In this connection, the Bundesbank also assessed its in-house Customer Access Mechanism, which is necessary for the settlement of TARGET2 payments in Germany, as well as its KTO2 account management system.

… and oversight of SWIFT and CLS by G10 countries …

In addition to the oversight of payment systems used in Germany, the Bundesbank also continues to be involved in the joint oversight of SWIFT and Continuous Linked Settlement (CLS), a global system for settling foreign exchange transactions, at a global level. Specially developed oversight standards known as "High Level Expectations for the Oversight of SWIFT" were, for the first time, used to assess SWIFT, the largest global provider of communication services to the financial sector – a task performed by the G10 countries under the aegis of the Belgian central bank. These standards are intended to help assess existing risks and their management. In 2007, monitoring CLS included not only regularly assessing the system's risk but also involved an intense study of the political implications of CLS' new business strategy. On top of foreign exchange settlement, CLS is expanding its range of services to include settlement for payments related to derivatives transactions.

… and oversight of card payments, electronic access procedures, e-money and correspondent banks

The expansion of oversight activities for payment instruments involved preparing oversight standards for card payment systems in the Eurosystem, which the Governing Council of the ECB passed at the beginning of 2008 following public consultation. In addition, the Bundesbank is monitoring developments in electronic access procedures and electronic money. The Bank also conducted the survey on correspondent banking, which takes place in the EU every two years, among German participants.

Projects in a European context involving the Bundesbank: TARGET2-Securities

TARGET2-Securities (T2S) represents another contribution the Eurosystem makes to integrating European financial market infrastructures. T2S is to allow the integrated settlement of securities transactions in central bank money on a single platform. To exploit synergies, T2S is to be developed within the Eurosystem and operated by the Bundesbank, Banca d'Italia and Banque de France as well as Banco de España as another service provided on the joint platform also used for TARGET2. The Governing Council of the ECB confirmed the basic feasibility of T2S under economic, legal, specialist and technical aspects on 8 March 2007, whereupon the Eurosystem developed user requirements in close cooperation with market players and central securities depositories (CSDs). The user requirements are still open to public consultation until 2 April 2008. Based on the finalised user requirements, the Governing Council will make a final decision on the development of T2S, probably in the summer of 2008.

CCBM2 project

While work was being carried out on T2S, a first public consultation on the principles of developing Collateral Central Bank Management (CCBM2), a joint platform to manage the domestic and cross-border use of collateral posted by counterparties to the Eurosystem, was also held in the summer of 2007. In view of its importance for payment transactions and given its interdependencies with securities settlement, CCBM2 should be closely linked to TARGET2 and T2S, in particular via shared access to all three procedures. The Eurosystem central banks would have the option of using CCBM2 as an alternative to an application of their own.

TARGET2 project: specifically, from RTGS^{plus} to TARGET2-Bundesbank

TARGET2, which will progressively replace the "old" TARGET1 system as the system used for the real-time settlement of express euro payments, was successfully launched on 19 November 2007. TARGET2 was jointly developed by the Bundesbank, Banca d'Italia and Banque de France and is operated by these three central banks on behalf of the Eurosystem. It is based on a single technical platform offering participants a fully harmonised range of services and giving them direct technical access. At the same time, the responsible central banks will remain in charge of individual customer services. From a legal perspective, the TARGET2 system will retain its multiple-layer structure, meaning that each central bank will be regarded as an independent system operator. The German system has the name of TARGET2-Bundesbank.

On 3 September 2007, the central associations of the German banking industry, which together make up the Central Credit Committee, and the Bundesbank launched the new image-based cheque collection procedure (ISE procedure). This procedure replaced the large-value cheque collection procedure

Projects in a national context: image-based cheque collection procedure (ISE procedure), …

(GSE procedure), which was comparatively complex for the participating credit institutions involving as it did the exchange among credit institutions of some 30,000 paper vouchers per working day. The ISE procedure now also eliminates the need to submit large-value cheques (€6,000 and more) in paper form. Instead, it is sufficient to submit an electronic image of the cheque together with the data record to the Bundesbank as the so-called clearing house.

… new procedures for settling cash payments for cash-in-transit companies, …

Following the insolvency of a number of cash-in-transit (CIT) companies in 2006 and extensive consultation with the associations representing the banking sector, the retail trade and CIT service providers, the Bundesbank modified its account-based and non-account-based cash payment settlement services on 2 April 2007. From that date on, so-called own accounts held by CIT service providers are only maintained to provide customers with coins and collect coins from them. Retailers are to dispose of banknotes either by means of a non-account-based procedure or, as a stopgap measure, via collective trustee accounts. Cash is supplied to and withdrawn from banks via their own accounts, which, in most cases, mimics previous practice. By modifying its services, the Bundesbank is helping increase transparency and security of settlement in the interests of all involved.

… enhanced efficiency as a result of self-collateralisation procedure …

In securities settlement, the Bundesbank has, since 29 October 2007, been offering a self-collateralisation procedure for transactions settled in the course of night-time processing by CBF. Here, the Bundesbank offers an interest-free intraday loan, which means purchases of securities eligible for this service finance themselves – after deduction of a haircut. Banks can therefore further optimise management of their central bank liquidity and make up for any counterparty liquidity defaults. In adopting this procedure, the Bundesbank is making a contribution to increasing the efficiency of securities settlement in the German financial market (*Finanzplatz Deutschland*). It was implemented at the same time that a new settlement system for the Bundesbank's safe custody account business was introduced.

… and indirect links between securities settlement systems assessed for the first time

In July 2007, the Governing Council of the ECB, for the first time, approved five so-called relayed links, ie indirect links between CSDs that had all been applied for by CBF. As a result, collateral can be transferred via a third system, which acts as an intermediary, between two securities settlement systems not directly linked to one another. Collateral may, for instance, be managed using CBF's Xemac collateral management system, which is also used to collateralise interbank money market transactions (Euro GC Pooling). This makes it possible to switch rapidly between central bank and interbank refinancing.

Organisation and staff

I Strategy

Strategic cycle 2002–2007 completed on schedule; new business policy innovations

The strategic cycle which began in 2002 was successfully completed in the 2007 financial year. During this period, the Deutsche Bundesbank also modernised selective aspects of its service profile and imparted new stimuli to the markets. Through being involved, for example, in the introduction of TARGET2, converting to multi-denomination banknote processing, implementing Basel II and enhancing its work in the field of financial system stability, the Bundesbank has initiated new business policy innovations.

Targeted cuts achieved

The Bundesbank's branch network was streamlined through downsizing by just over 60% to 47 branches and one operating unit. Staff numbers were reduced by around 30%. The targeted annual cut of around €280 million in the cost of providing services compared with 2002 was surpassed in the reporting year, with a decline of around €300 million.

Strategy 2012: raising the Bank's profile – continuing the consolidation process

The follow-on strategic cycle from 2008 to 2012 commenced at the beginning of 2008. Its objective is that of "Raising the Bank's profile – continuing the consolidation process". In the reporting year, the Bundesbank developed specific measures for the next strategic cycle aimed at achieving the objectives set by its Executive Board for the period up to 2012.

Core business area: monetary policy

In the core business area of monetary policy, the Bundesbank will intensify application-oriented economic research. In particular, specific expertise in the field of monetary analysis is to be strengthened. Furthermore, the Bundesbank plays a key role in the implementation of monetary policy for the euro area and therefore aims to take on joint operational tasks. It will also contribute to the further development of efficient instruments and management procedures in this context.

Core business area: financial and monetary system

Application-oriented research in the field of financial stability will also be enhanced. In order to further improve the quality of stability analysis and of its Financial Stability Review, the Bundesbank aims to intensify its interaction with representatives from both the markets and the academic sphere. Furthermore, as a central bank, the Bundesbank plays a responsible role in managing any financial crises. The Bundesbank will continue to be intensively involved in shaping the regulatory and institutional framework for the German financial market (*Finanzplatz Deutschland*) in the future.

Regional Offices and branches of the Deutsche Bundesbank on 1 April 2008

Locality number	Bank location	Regional Office[1]	Locality number	Bank location	Regional Office[1]
390	Aachen	D	660	Karlsruhe	S
720	Augsburg	M	520	Kassel	F
			210	Kiel	HH
773	Bayreuth	M			
100	Berlin	B	860	Leipzig	L
480	Bielefeld	D	545	Ludwigshafen	MZ
430	Bochum	D	230	Lübeck	HH
290	Bremen	H			
			810	Magdeburg	H
870	Chemnitz	L	550	Mainz	MZ
570	Coblenz	MZ	840	Meiningen	L
370	Cologne	D	700	Munich	M
180	Cottbus	B			
			150	Neubrandenburg	HH
440	Dortmund	D	760	Nuremberg	M
850	Dresden	L			
300	Düsseldorf	D	280	Oldenburg	H
350	Duisburg	D	265	Osnabrück	H
820	Erfurt	L	750	Regensburg	M
360	Essen	D	640	Reutlingen	S
			130	Rostock	HH
215	Flensburg	HH			
500	Frankfurt/Main	F	590	Saarbrücken	MZ
680	Freiburg	S	600	Stuttgart	S
	Lörrach[2]				
			630	Ulm	S
513	Giessen	F			
260	Göttingen	H	694	Villingen-Schwenningen	S
450	Hagen	D			
200	Hamburg	HH	790	Würzburg	M
250	Hanover	H			

1 Abbreviations: B = Berlin; D = Düsseldorf; F = Frankfurt am Main; H = Hanover; HH = Hamburg; L = Leipzig; M = Munich; MZ = Mainz; S = Stuttgart. — **2** Operating unit.

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Core business area: banking supervision

In the field of banking supervision, the Bundesbank supports cooperation at a European level. In order to extend the range of analytical instruments, the Bank plans, among other things, to develop a tool for analysing the stress indicators of systemically important banks. The integration of inspection activities and ongoing supervision is to be intensified with the aim of generating synergies without jeopardising the quality of the work performed.

Core business area: cash management

The Bundesbank will continue to play an appropriate role in the cash management cycle in order to safeguard the quality and security of the supply of banknotes. In this respect, the efficiency of banknote processing will be significantly improved further by the introduction of the new multi-denomination processing operations. At the same time, the Bundesbank is actively pushing ahead with the implementation of the European "Framework for the detection of counterfeits and fitness sorting of euro banknotes by credit institutions and other professional cash handlers". With the cash management market being opened up to private operators, the Bundesbank aims to maintain a share of around 50% of the recycling volume in banknote processing.

Core business area: cashless payments

By maintaining a reliable infrastructure, the Bundesbank makes a key contribution to the smooth functioning of the payment and securities settlement systems and thus to financial stability. In cooperation with its Eurosystem partners, the Bundesbank aims to take on a leading role, both operationally and strategically, in the provision and transfer of liquidity (including the transfer of collateral) through, for example, the joint introduction and operation of TARGET2 and its work on the TARGET2-Securities project. In addition, together with the banking industry, the Bundesbank is actively pushing ahead with the project to create a Single Euro Payments Area (SEPA). Further information on these projects can be found in the section headed "Cashless payment and securities settlement systems".

II Staff

Further reduction in staff numbers

The number of core staff continued to fall, decreasing by 613 (around 5%) to 11,160. As in previous years, the branch network bore the brunt of this downsizing. If part-time and full-time employees are aggregated on the basis of their contractual working hours, the Bundesbank had a weighted core headcount of

Bundesbank staff on 31 December 2007* Table 13

Item	Staff numbers[1] Total	Regional Offices	Branches	Central Office	Year-on-year changes Total	Regional Offices	Branches	Central Office
Civil servants	5,655	1,683	1,924	2,048	– 173	5	– 207	29
Salaried staff	5,987	1,610	2,492	1,885	– 439	– 18	– 416	– 4
Total	11,642	3,293	4,416	3,933	– 611	– 13	– 623	25
of which Trainees	482	174	41	267	2	22	– 36	16
Remainder Core staff	11,160	3,119	4,375	3,666	– 613	– 35	– 587	9
of which Staff with permanent contracts	11,079	3,111	4,357	3,611	– 611	– 33	– 578	0
Staff with temporary contracts	81	8	18	55	– 2	– 2	– 9	9
Memo item Core staff *pro rata* (full-time equivalent)	10,391.0	2,870.8	4,055.1	3,465.1	– 581.1	– 52.8	– 528.2	– 0.1

	End-2007	End-2006
* Not included:		
Members of staff on secondment	207	146
Members of staff on unpaid leave	458	472
Members of staff in the second phase of the partial retirement scheme	408	425
1 *Of which* part-time employees	1,923	1,964

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10,391 full-time equivalent (FTE) employees (in 2006, the number was 10,972; ie this staff figure likewise decreased by approximately 5%). Part-time employment accounted for a share of around 17%, virtually unchanged from 2006.

On 31 December 2007, 901 staff members had been admitted to the pre-retirement part-time work scheme. The vast majority have contracts based on a “phase model”, which means that a phase of full-time employment with reduced remuneration is followed by a second pre-retirement phase in which the employee does not work but receives the same (reduced) remuneration as in the first phase. There are now 408 employees in the second, pre-retirement phase.

Branch strategy facilitated by human resources management

The now completed strategic phase 2002-2007, in which the number of branches was reduced to 47, placed great demands on the geographical and professional mobility of many members of staff. The Bundesbank facilitated these staff changes using instruments made available as part of the comprehensive human resources management strategy in order, in particular, to transfer employees to positions in other areas within the Bundesbank and, in some cases, in other public authorities.

The early retirement scheme available to salaried employees was used by around 300 staff members.

Number of trainee places remains stable

The number of trainee civil servants and other salaried trainees remained almost the same as in 2006. In total, 482 members of staff (480 in 2006) were undergoing preparatory professional training or attending other basic training programmes in the year under review.

Bundesbank involvement in "training pact"

Whereas the Bank was very cautious about taking on staff with civil servant status in the Upper Intermediate Service and Higher Service owing to the general staffing situation, there were again far more commercial training vacancies at the Bundesbank than were needed to ensure an intake of junior staff in the year under review (255). In so doing, the Bank is participating in the "training pact" between employers and the Federal Government aimed at helping to reduce youth unemployment.

Bundesbank staff at the European Central Bank

At the end of the year under review, 82 members of the Bundesbank's staff were on secondment to the European Central Bank. Most of the seconded members of staff at the ECB are employed at expert and managerial levels.

III Offices held by members of the Executive Board of the Deutsche Bundesbank

At its meeting on 14 July 2004, the Executive Board of the Deutsche Bundesbank, in consultation with the Corporate Governance Compliance Adviser, Professor Theodor Baums, approved a Code of Conduct for the members of the Executive Board of the Deutsche Bundesbank. This code states, *inter alia*, that details of offices held by Board members on supervisory boards or similar inspection bodies of business enterprises shall be disclosed in the Annual Report.

The Board members hold the offices indicated below.

– Professor Axel A Weber, President:
  Member of the Board of Directors, BIS[1]

1 Ex officio.

– Professor Franz-Christoph Zeitler, Vice-President:
Member of the Administrative Council, Liko-Bank;[1]
Member of the Board of Trustees, Monetary Stability Foundation

– Mr Rudolf Böhmler, Member of the Executive Board since 16 July 2007:
Member of the Supervisory Board of Aradex AG, Lorch[2]

– Dr Hans Georg Fabritius:
Alternate, Administrative Council, Liko-Bank;[1]
Alternate, Credit Committee, Liko-Bank;[1]
Member of the Administrative Council, Rhineland-Westphalian Institute for Economic Research

– Professor Hans-Helmut Kotz:
Member of the Administrative Council, Liko-Bank;[1]
Member of the Credit Committee, Liko-Bank;[1]
Standing guest on the Central Capital Market Committee

– Dr Edgar Meister, Member of the Executive Board until 30 April 2007:[3]
Member of the Administrative Council, Liko-Bank[1] (until 30 April 2007);
Member of the Auditor Oversight Commission in Germany

– Dr Hans Reckers:
Alternate, Administrative Council, Liko-Bank;[1]
Member of the Stock Exchange Expert Commission of the Federal Ministry of Finance

– Professor Hermann Remsperger:
Alternate, Board of Directors, BIS;[4]
Chairman of the Board of Trustees, Monetary Stability Foundation

1 Partnership agreement.
2 Membership will elapse upon expiry of the current mandate, which was accepted before Mr Böhmler joined the Deutsche Bundesbank's Executive Board.
3 Offices held at the time he stepped down from the Executive Board of the Deutsche Bundesbank on 30 April 2007.
4 Ex officio.

Other activities

I Conferences and workshops

Anniversary conference

Last year, the Bundesbank celebrated its 50th anniversary. To celebrate this anniversary, the Bank organised a gala dinner on 21 September followed by a conference the next day with the title "Monetary policy over fifty years". At the event, high-ranking representatives from national central banks and world-renowned university professors looked back over half a century of international and German monetary and economic policy, identified the successes and failures of national central banks and drew lessons for the future.[1] The great significance of the Deutsche Bundesbank in guaranteeing a stable currency and as a model in the creation of the European Central Bank became evident time and again. The 2007 "Bundesbank lecture" in Berlin was given by the Chairman of the US Federal Reserve, Ben Bernanke, on the topic of "Global imbalances: recent developments and prospects".

Other academic conferences and workshops

In 2007, the Bundesbank once again organised a series of academic conferences and workshops. The ninth spring conference looked at the question of how important it is for macroeconomic analysis that consumers, enterprises, credit institutions and other economic agents differ from one another. New methods are increasingly making it possible to move away from the simplifying models of homogeneous economic agents. This research is also being supported by economists having improved access to micro data than was previously the case. Over the past few years, the Bundesbank's Research Centre has made significant efforts to scientifically evaluate such data. Monetary policy strategy and the institutional structure of central banks were also discussed at conferences. Finally, a conference was held to look at the interaction of market and credit risks at banks and the implications for the stability of the financial system.

Cooperation with other institutions

The Bundesbank organised many of these events in cooperation with other institutions. Last year the Bundesbank cooperated with, among others, the French and Finnish central banks, the Federal Reserve Bank of Cleveland, the National Bureau of Economic Research and the Basel Committee on Banking Supervision. The purpose of this cooperation is to go beyond the organisation of conferences to increase research collaboration.

1 For conference papers see http://www.bundesbank.de/vfz/vfz_konferenzen_2007.en.php#anniversary.

High Level Workshop on developing local bond markets in emerging market economies and developing countries

As part of the German presidency of the G7/G8, the Bundesbank, in cooperation with the Federal Ministry of Finance, organised a High Level Workshop in Frankfurt entitled "Developing Bond Markets in Emerging Market Economies". The workshop was attended by representatives of the G8 central banks and finance ministries, selected emerging market economies and developing countries, as well as experts from the BIS, the IMF, the World Bank, the OECD, regional and national development banks and market participants. The aim of the workshop was to develop recommendations (best practices) for further reform steps which are regarded as most urgently needed in the process of deepening domestic bond markets in emerging market economies and developing countries.[1] These recommendations are included in the action plan adopted by the G8 finance ministers on 19 May 2007 in Potsdam. In this context, the Bundesbank, in cooperation with the Federal Ministry for Finance, also organised an international conference held at the end of January 2008 which focused on broadening the database for local bond markets in emerging market economies and developing countries.

II Research Centre

Last year, Research Centre staff carried out independent research and also worked in various international research networks and research-orientated working groups in which the Bundesbank is represented. As has been the case in the past, topics which are important for monetary policy and issues concerning financial stability were at the forefront. Several research groups were established to improve the structure of the work in the Research Centre. These groups help improve the exchange of ideas between employees with similar research interests and promote joint initiatives.

Involvement in research networks

The international research network on the dynamics of wage setting behaviour and the resultant consequences for price developments continued its work in 2007. The ECB, the national central banks of the currency union and other central banks in Europe all participate in this network. In this framework, Bundesbank staff use dynamic general equilibrium models to model labour markets

1 See Deutsche Bundesbank, Bond markets in emerging market economies, Financial Stability Review 2007, pp 113–131.

and the wage setting procedure and also carry out studies on the wage setting process using micro data. Micro data are also at the centre of a planned new research network for the measurement and analysis of households' financial situation in the different countries of the euro area. In an ECB working group on econometric models, Research Centre staff contributed to, above all, the development and evaluation of equations for short-term GDP forecasting. Several studies were carried out as part of the work of the Research Task Force of the Basel Committee on Banking Supervision. The studies looked at the measurement of credit risks in credit portfolios and the probabilities of default of corporate loans as well as the effects of securitisation on bank behaviour and bank risks.

Additional focal points

Alongside the projects already mentioned, the Research Centre concentrated on several other areas. Several studies looked at the significance of the development of the money stock and credit as well as the role of globalisation in price developments in Europe. Staff also looked closely at the effects of fiscal policy on the economy. In the area of financial stability, continued efforts were made to improve stress tests of individual banks and the German banking system.

Publications and lectures

The Research Centre published 53 discussion papers in 2007. The majority of these papers were discussion papers written by Bundesbank staff, some of which were written in co-authorship with external experts. In Series 1 (Economic Studies) 35 papers were published and in Series 2 (Banking and Financial Studies) 18 were published. In 2007, staff published 49 articles in academic journals and books and their research results were presented at numerous conferences. In addition, the Research Centre organised several weekly seminars, some of which were held in cooperation with the ECB and the University of Frankfurt.

Visits by guest researchers

As in previous years, last year once again saw a large number of guest researchers visiting the Bundesbank's Research Centre. Such visits enable cooperation with Bundesbank staff and the conduct of research projects in which the Bundesbank is interested. Often, guest researchers use their stay at the Bundesbank to work with micro data that, due to confidentiality reasons, cannot be removed from the Bundesbank. In recent years, the Research Centre has made several data sets – regarding, among other things, credit institutions and enterprises – available for research purposes.

III Technical central bank cooperation

Commitment to stability policy consistent with foreign policy interests

The political upheavals in recent decades have changed the face of the world. Many countries have been newly founded, while others are undergoing a fundamental systemic transformation, which has brought about far-reaching changes in many areas of political, social and economic life. They all face the difficult task of establishing efficient economies that guarantee lasting stability. In view of this, the Bundesbank has for many years considered it to be its responsibility to contribute to setting up and developing market-oriented central bank systems in many countries around the world. This commitment on the part of the Bundesbank fits in seamlessly with politicians' growing interest in many regions of the world. Alongside the EU's Central Asia strategy which was adopted in June of last year, an important role is played by the greater attention being paid to Africa as part of the Federal President's "Partnership with Africa" initiative and the second EU-Africa summit in Lisbon in December 2007.

Wide range of projects in TCBC and increasing Europeanisation of larger projects

The international central banking seminars held in Germany for more than ten years, the bilateral activities in Germany and abroad which are tailored to the needs of the respective partner central banks and, to a growing degree, the projects – some of which are major – conducted in collaboration with other ESCB central banks are cornerstones of the Bundesbank's cooperation with interested central banks from all over the world. Along with joint activities with other large national central banks, particularly in African countries, joint ESCB projects which are supported financially by the EU are playing an increasingly important role. In this context, the extensive MEDA project (EuroMediterranean Partnership) with the Central Bank of Egypt for the reform of banking supervision in Egypt and the comprehensive Eurosystem needs assessment programme for the Central Bank of Bosnia and Herzegovina financed from the CARDS (Community Assistance for Reconstruction, Development and Stabilisation) programme were completed successfully during the reporting period.

Demand for central bank expertise and reciprocal exchange of ideas remains high

There is high demand for the services offered by the Bundesbank, which last year once again meant that demand far exceeded the available resources. More than 3,500 central bank staff members from over 90 central banks took part in the programme of around 300 activities organised by the Bundesbank both in Germany and abroad. In terms of content, the entire spectrum of modern central banking business was covered. There was a lot of interest in leading-edge problems such as questions regarding financial stability, recent developments in payment systems and good governance in central banks. In the light of the welcome catching-up process in many countries and in view of the constantly changing framework, the Deutsche Bundesbank's projects have developed more and more into a forum for the reciprocal exchange of ideas about all questions relating to central banking. What was originally, in the narrower sense, technical cooperation based on the concept of knowledge transfer has, with time, become a fruitful exchange for all involved.

IV Services the Deutsche Bundesbank provides for the Federal Government

Involvement in the issuance of Federal securities

The Bundesbank conducts the auctions of one-off issues of Federal securities and carries out market management operations for listed Federal securities on the German stock exchanges on behalf of the Federal Republic of Germany – Finance Agency. One-off issues of Federal securities are sold by auction via the electronic "Bund Bidding System" (BBS) developed by the Bundesbank. In 2007, 36 auctions were carried out which included, for the first time, two auctions of inflation-linked instruments. The allotment volume was €184.4 billion (2006: €180.4 billion in 34 auctions). In the reporting year the Bundesbank continued to be involved, through credit institutions, in selling tap issues of Federal Treasury financing paper and Federal savings notes.

Asset management …

In its role as fiscal agent, the Bundesbank also performed asset management services on behalf of the Federal and state governments. A passive strategy is used in the management of these assets.

… for the Federal Government …

Asset management for the Federal government was expanded to cover not only the pension reserve, which had already been managed, but also the pension fund. The purpose of this pension fund is to finance the pension claims of all Federal civil servants, judges and professional soldiers newly hired from the beginning of 2007. At the same time, the spectrum of investment instruments was extended from Federal securities to include euro-denominated debt securities issued by various borrowers of top credit quality. For the pension fund, Parliament also created the possibility of a passive, index-linked investment of up to 10% of the assets in shares.

… and for the Federal Employment Agency and the Federal Financial Supervisory Authority

At the beginning of 2008, the Federal Employment Agency's pension scheme was revised and the Bundesbank appointed as asset manager. The investor regulations for the Federal Government's pension fund now apply. For some years already, the funded pension insurance system for civil servants working at the Federal Financial Supervisory Authority has been funded outside the scope of the "Act on a Federal Government Pension Reserve" (*Versorgungsrücklagegesetz des Bundes*). Nevertheless, the portfolio managed by the Bundesbank has a similar structure to the portfolio of the Federal Government's pension fund.

The Bundesbank also provides varying levels of services in managing several types of state government pension reserves and funds and also manages the assets of the Monetary Stability Foundation.

Own portfolio

The Bundesbank's own portfolio of euro-denominated covered debt securities was topped up in 2007. Having previously formed a balance sheet counterpart to the pension reserves for civil servants employed at the Bundesbank, it now also covers the capital base, the statutory reserves and the provisions for general risks.

V Managing the foreign reserves

Composition

The management of the Bundesbank's foreign reserves includes the investment of foreign currency reserves, stewardship of the IMF reserve position as well as management of gold reserves. Along with its own foreign reserve assets, the Bundesbank also manages the foreign reserves which it has transferred to the ECB.

Benchmark portfolios

The framework for managing the foreign currency reserves of the Bundesbank and the ECB is defined by benchmark portfolios for each currency (US dollar and yen). These benchmarks reflect the desired long-term risk level and serve as a yardstick. Reserve management decisions may deviate from the benchmark within a narrow margin in order to achieve the most favourable result possible through duration and yield curve management and the choice of instruments.

Investment instruments

In addition to US and Japanese government bonds, a very limited volume of fixed-income securities of other investment-grade issuers represent eligible investment instruments. Furthermore, investments can be made in the money market, in particular in the form of repo transactions and short-term time deposits. Business activities with individual counterparties in the different business lines are regulated by a differentiated limit system.

Reserve management benchmarks

The benchmarks for the Bundesbank's own reserves are specified by the Executive Board each year. The Bundesbank manages the ECB reserves for which it is responsible using two-tier benchmarks fixed by the Governing Council and Executive Board of the ECB.

Annual accounts of the Deutsche Bundesbank for 2007

I Balance sheet of the Deutsche Bundesbank as at 31 December 2007

Assets

				31.12.2006
			€ million	€ million
1	Gold and gold receivables		62,433	53,114
2	Claims on non-euro-area residents denominated in foreign currency			
	2.1 Receivables from the IMF	2,418		(3,011)
	2.2 Balances with banks, portfolio investment, external loans and other external assets	27,694		(28,640)
			30,112	31,651
3	Claims on euro-area residents denominated in foreign currency		7,051	—
4	Claims on non-euro-area residents denominated in euro		300	300
5	Lending to euro-area credit institutions related to monetary policy operations denominated in euro			
	5.1 Main refinancing operations	133,095		(173,940)
	5.2 Longer-term refinancing operations	134,769		(82,329)
	5.3 Fine-tuning reverse operations	—		(—)
	5.4 Structural reverse operations	—		(—)
	5.5 Marginal lending facility	91		(79)
			267,955	256,348
6	Other claims on euro-area credit institutions denominated in euro		13,077	3,049
7	Securities of euro-area residents denominated in euro		—	—
8	Claims on the Federal Government		4,440	4,440
9	Intra-Eurosystem claims			
	9.1 Participating interest in the ECB	1,196		(1,183)
	9.2 Claims arising from the transfer of foreign reserves to the ECB	11,821		(11,762)
	9.3 Claims related to the allocation of euro banknotes within the Eurosystem (net)	—		(—)
	9.4 Other claims within the Eurosystem (net)	70,933		(5,328)
			83,951	18,273
10	Items in course of settlement		4	1
11	Other assets			
	11.1 Coins	626		(599)
	11.2 Tangible and intangible fixed assets	1,472		(1,613)
	11.3 Other financial assets	9,799		(2,813)
	11.4 Off-balance-sheet instruments revaluation differences	158		(—)
	11.5 Accruals and prepaid expenses	1,979		(1,034)
	11.6 Sundry items	316		(301)
			14,351	6,360
			483,674	373,535

Liabilities

				31.12.2006
			€ million	€ million
1	Banknotes in circulation		183,781	170,881
2	Liabilities to euro-area credit institutions related to monetary policy operations denominated in euro			
	2.1 Current accounts	64,032		(47,913)
	2.2 Deposit facility	4,931		(43)
	2.3 Fixed-term deposits	40,550		(—)
	2.4 Fine-tuning reverse operations	—		(—)
			109,513	47,956
3	Other liabilities to euro-area credit institutions denominated in euro		—	—
4	Liabilities to other euro-area residents denominated in euro			
	4.1 General government deposits	43		(36)
	4.2 Other liabilities	405		(369)
			448	404
5	Liabilities to non-euro-area residents denominated in euro		14,045	3,746
6	Liabilities to euro-area residents denominated in foreign currency		4	3
7	Liabilities to non-euro-area residents denominated in foreign currency		1,951	1,061
8	Counterpart of special drawing rights allocated by the IMF		1,300	1,382
9	Intra-Eurosystem liabilities			
	9.1 Liabilities to the ECB arising from promissory notes	—		(—)
	9.2 Liabilities related to the allocation of euro banknotes within the Eurosystem (net)	99,498		(84,334)
	9.3 Other liabilities within the Eurosystem (net)	—		(—)
			99,498	84,334
10	Items in course of settlement		5	4
11	Other liabilities			
	11.1 Off-balance-sheet instruments revaluation differences	—		(0)
	11.2 Accruals and income collected in advance	1,168		(736)
	11.3 Sundry items	2,442		(2,519)
			3,610	3,255
12	Provisions		5,190	5,370
13	Revaluation accounts		55,044	45,933
14	Capital and reserves			
	14.1 Capital	2,500		(2,500)
	14.2 Statutory reserves	2,500		(2,500)
			5,000	5,000
15	Profit for the year		4,285	4,205
			483,674	373,535

II Profit and loss account of the Deutsche Bundesbank for the year 2007

				2006
			€ million	€ million
	– Interest income	13,111		(8,859)
	– Interest expense	– 5,609		(– 3,423)
1	Net interest income		7,502	5,436
	– Realised gains/losses arising from financial operations	158		(163)
	– Write-downs on financial assets and positions	– 2,256		(– 201)
	– Transfers to/from provisions for general risks, foreign exchange risks and price risks	152		(78)
2	Net result of financial operations, write-downs and risk provisions		– 1,946	41
	– Income from fees and commissions	59		(50)
	– Expense relating to fees and commissions	– 14		(– 13)
3	Net income from fees and commissions		46	37
4	Income from participating interests		16	16
5	Net result arising from allocation of monetary income		– 113	– 71
6	Other income		140	174
7	**Total net income**		5,644	5,633
8	Staff costs		825	902
9	Other administrative expenses		241	234
10	Depreciation on tangible and intangible fixed assets		147	162
11	Banknote printing		128	110
12	Other expenses		18	19
13	**Profit for the year**		4,285	4,205

Frankfurt am Main, 19 February 2008

DEUTSCHE BUNDESBANK
Executive Board

Professor Axel A Weber — Professor Franz-Christoph Zeitler

Mr Rudolf Böhmler — Dr Hans Georg Fabritius — Professor Hans-Helmut Kotz — Dr Hans Reckers — Professor Hermann Remsperger

III Unqualified auditor’s report for statutory audits of annual financial statements

We have audited the annual financial statements – consisting of the balance sheet and the profit and loss account – together with the bookkeeping system of the Deutsche Bundesbank for the business year from 1 January 2007 to 31 December 2007. The maintenance of the books and records and the preparation of the annual financial statements in accordance with generally accepted accounting principles and the principles for the accounting of the Deutsche Bundesbank approved by the Executive Board pursuant to section 26 (2) of the Bundesbank Act are the responsibility of the Executive Board of the Deutsche Bundesbank. Our responsibility is to express an opinion on the annual financial statements, together with the bookkeeping system, based on our audit.

We conducted our audit of the annual financial statements in accordance with section 317 HGB [“Handelsgesetzbuch”: “German Commercial Code”] and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer [*Institute of Public Auditors in Germany*] (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the annual financial statements in accordance with [German] principles of proper accounting are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Deutsche Bundesbank and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the books and records as well as the annual financial statements are examined primarily on a test basis within the framework of the audit. The audit includes assessing the accounting principles used and significant estimates made by the management, as well as evaluating the overall presentation of the annual financial statements. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the annual financial statements comply with the legal requirements and the additional provisions of the principles for the accounting of the Deutsche Bundesbank and give a true and fair view of the net assets, financial position and results of operations of the Deutsche Bundesbank in accordance with [German] principles of proper accounting.

Frankfurt am Main, 4 March 2008

PricewaterhouseCoopers
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Borgel Wirtschaftsprüfer	Theobald Wirtschaftsprüfer

Overview of the principles for the accounting of the Deutsche Bundesbank

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

Recording of spot transactions
Spot transactions in gold and foreign currencies shall be taken into account as from the trade date for ascertaining the average acquisition costs and the realised gains and losses. The balance sheet recording of these spot transactions and of spot transactions in securities shall be based on the date of payment (settlement date).

Balance sheet valuation rules
Gold, foreign currency instruments, securities and financial instruments shall be valued at mid-market rates and prices on the balance sheet date.

No distinction shall be made between price and currency revaluation differences for gold, but a single gold revaluation difference shall be accounted for on the basis of the euro price per defined unit of weight of gold derived from the euro-US dollar exchange rate on the balance sheet date.

Revaluation shall take place on a currency-by-currency basis for foreign exchange (including off-balance-sheet transactions).

In the case of securities, revaluation shall be on a code-by-code basis (same ISIN number/type).

Repurchase agreements
A repurchase agreement (repo) shall be recorded as a collateralised inward deposit on the liabilities side of the balance sheet while the item that has been given as collateral remains on the assets side of the balance sheet. A reverse repurchase agreement (reverse repo) shall be recorded as a collateralised outward loan on the assets side of the balance sheet for the amount of the loan.

In the case of security lending transactions, the assets shall remain in the balance sheet of the transferor.

Income recognition
Realised gains and realised losses can arise only in the case of transactions leading to a reduction in securities items or currency positions. They are derived from a comparison of the transaction value with the acquisition value as calculated using the average method; they shall be taken into the profit and loss account.

Unrealised gains and unrealised losses arise as a result of the revaluation of assets through a comparison of the market value with the acquisition value as calculated using the average method. Unrealised gains shall not be recognised as income but shall be transferred direct to a revaluation account.

Unrealised losses shall be taken into the profit and loss account if they exceed previous unrealised gains registered in the corresponding revaluation account. Unrealised losses recorded in the profit and loss account in previous years shall not be reversed in subsequent years in the event of new unrealised gains. There shall be no netting of unrealised losses in any one security, in any currency or in gold holdings against unrealised gains in other securities, currencies or gold.

The average method shall be used on a daily basis for calculating the acquisition cost in the case of assets that are subject to exchange rate and/or price movements. The average cost price or rate of the assets shall be reduced by unrealised losses taken into the profit and loss account at the end of the year.

Premiums or discounts arising on purchased securities shall be treated as part of interest income and shall be amortised using either the straight-line method or the implicit rate of return method. The implicit rate of return method shall be used in the case of zero-coupon bonds with a residual maturity of more than one year at the time of acquisition.

Accrual and deferral items covering foreign currency holdings shall be converted at the mid-market rate on each business day and change the respective foreign currency position.

Accounting rules for off-balance-sheet instruments

Foreign exchange forward transactions, the forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date shall be included in the foreign currency position as from the trade date.

Interest rate swaps, futures, forward rate agreements and other interest rate instruments shall be accounted for and revalued on an item-by-item basis.

Gains and losses arising from off-balance-sheet instruments shall be treated in a similar manner to those from spot transactions.

Tangible and intangible fixed assets

Tangible fixed assets shall be valued at cost less depreciation, which shall be calculated on a straight-line basis and applied over the expected economic life of the assets. A distinction shall be made as follows:
- Computers, related hardware and software, and motor vehicles: four years
- Equipment, furniture and installed equipment: ten years
- Building and capitalised refurbishment expenditure: 25 years
- Depreciation shall not apply to land

Tangible fixed assets whose acquisition value after deduction of value added tax is less than €10,000 shall be fully amortised in the year in which they were acquired.

Provisions

The regulations set out in the Commercial Code apply to the reporting of provisions in the balance sheet. Pursuant to section 26 (2) of the Bundesbank Act, the creation of liability items for general risks associated with domestic and foreign business is possible.

Transitory rules

The assets and liabilities shown in the closing Deutsche Mark balance sheet of 31 December 1998 shall be revalued on 1 January 1999. Unrealised gains arising on or before 1 January 1999 are to be recorded separately from the unrealised gains which arise after 1 January 1999. The market rates/prices applied by the Bundesbank in the euro-denominated opening balance sheet of 1 January 1999 shall be deemed to be the average acquisition rates/prices as at 1 January 1999. The revaluation items for unrealised gains accruing on or before 1 January 1999 shall be dissolved only in connection with decreases in value and in the event of disposals after 1 January 1999.

IV General information on annual accounts

Legal basis

Sections 26 and 27 of the Bundesbank Act form the legal basis for the annual accounts and the distribution of profit. In accordance with the provisions on accounting laid down in the second sentence of section 26 (2), the Bundesbank may apply the accounting principles governing the annual accounts of the ECB.

Accounting principles of the Bundesbank

The Governing Council of the ECB adopted the principles it applies to its annual accounts in accordance with Article 26.2 of the ESCB Statute. The Deutsche Bundesbank decided to adopt those principles as the "accounting principles of the Deutsche Bundesbank".[1] An overview of the principles for the accounting of the Deutsche Bundesbank is given above.

Notes on balance sheet entry of euro banknotes and associated intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem

The ECB and the national central banks of the euro-area countries, which together comprise the Eurosystem, issue banknotes denominated in euro. The following allocation procedure was approved for recording the euro banknotes in circulation in the financial statements of the individual central banks in the Eurosystem.[2] The respective share of the total value of euro banknotes in circulation due to each central bank in the Eurosystem is calculated on the last business day of each month in accordance with the key for allocating euro banknotes. The ECB has been allocated an 8% share of the total value of the euro banknotes in circulation; 92% of the euro banknotes has been allocated to the national central banks in proportion to their paid-up shares in the capital of the ECB. In the year under review the Bundesbank had a 29.5% share in the fully paid-up capital of the ECB and therefore a 27.2% share of the euro banknotes in circulation in accordance with the banknote allocation key. The value of the Bundesbank's share in the total amount of euro banknotes issued by the Eurosystem is shown in item 1 "Banknotes in circulation" on the liabilities side of the balance sheet.

The difference between the value of the euro banknotes allocated to each national central bank in accordance with the banknote allocation key and the value of the euro banknotes that this national central bank actually puts into circulation also gives rise to remunerated intra-Eurosystem balances.[3] If the

1 Published as a revised edition in Bundesbank Notice No 10001/2007 of 22 January 2007.
2 Decision of the European Central Bank of 6 December 2001 on the issue of euro banknotes (ECB/2001/15).
3 Decision of the European Central Bank of 6 December 2001 on the allocation of monetary income of the national central banks of participating member states from the financial year 2002 (ECB/2001/16) and amended by its decisions of 19 May 2006 (ECB/2006/7) and 22 November 2007 (ECB/2007/15).

value of the euro banknotes actually issued is greater than the value according to the banknote allocation key, the difference is recorded in the balance sheet in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem". If the value of the euro banknotes actually issued is less than the value according to the banknote allocation key, the difference is recorded in asset sub-item 9.3 "Claims related to the allocation of euro banknotes within the Eurosystem". These balances are remunerated at the latest available marginal rate of the main refinancing operations.

In the year of the cash changeover and in the following five years the intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are being adjusted in order to avoid significant changes in NCBs' relevant income positions from those in previous years. The adjustments are effected by taking into account the differences between the average value of the banknotes which each national central bank had in circulation in the reference period and the average value of the banknotes which would have been allocated to them during that period in accordance with the ECB's capital key. The adjustments are being reduced in annual stages until the first day of the sixth year after the year of the cash changeover when income on banknotes will be allocated fully in proportion to the NCB's paid-up shares in the ECB's capital. For the Bundesbank, the adjustment was to be made between 2002 and 2007. The period between July 1999 and June 2001 was taken as the reference period. The interest income and interest expense arising from the remuneration of the intra-Eurosystem balances are cleared through the accounts of the ECB and are shown in the profit and loss account of the Bundesbank in item 1 "Net interest income".

Furthermore, the ECB's seigniorage income from the transfer of 8% of the euro banknotes in circulation to the ECB is allocated to the national central banks of the Eurosystem in the form of an interim distribution of profit in the financial year in which the income arose unless the ECB's net profit for the year is less than the income earned on euro banknotes in circulation or, as a result of a decision by the Governing Council of the ECB, the amount is retained for allocation to a risk provision.[1] For the financial year 2007, all of the ECB's income from the banknotes allocated to it will be required to fund the risk provision.

1 Decision of the European Central Bank of 17 November 2005 on the distribution of the income of the European Central Bank on euro banknotes in circulation to the national central banks of the participating member states (ECB/2005/11).

Change to ECB capital key on 1 January 2007

As a result of the accession of two new member states to the EU, the key establishing the respective subscriptions of the ESCB national central banks to the ECB's capital was adjusted on 1 January 2007. As, in accordance with Article 49.3 of the ESCB Statute, the ECB's subscribed capital grows proportionately when new member states join the EU, the ECB's capital was increased to €5,761 million on 1 January 2007. At the same time, the Bundesbank's share of the ECB's subscribed capital declined from 21.1% to 20.5%. The main results of this on the Bundesbank balance sheet as from 1 January 2007 were that the Bundesbank's participating interest in the ECB (see asset sub-item 9.1 "Participating interest in the ECB") increased by €6 million to €1,182 million owing to the topping-up of the subscribed capital and the Bundesbank's euro-denominated claims arising from the transfer of foreign reserves to the ECB rose from €11,762 million to €11,821 million (asset sub-item 9.2).

Furthermore, the Slovenian central bank joined the Eurosystem on 1 January 2007 and paid up its capital share to the ECB in full. As a result, the Bundesbank's share in the fully paid-up capital of the ECB dropped from 29.6% to 29.5% on 1 January 2007.

Change to ECB capital key on 1 January 2008

As of 1 January 2008 the Eurosystem was expanded owing to the accession of the Maltese and Cypriot central banks, which paid in their capital shares to the ECB in full. As a result, the Bundesbank's share in the fully paid-up capital of the ECB declined from 29.5% to 29.4% on 1 January 2008.

Preparation and auditing of financial statements

The Executive Board drew up the Bundesbank's financial statements for the financial year 2007 on 19 February 2008. The financial statements were audited by PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Frankfurt am Main. The Executive Board had appointed the firm as external auditors on 16 January 2007 in accordance with section 26 (3) of the Bundesbank Act. The auditors confirmed without qualification on 4 March 2008 that the Bundesbank's financial statements for 2007 – consisting of the balance sheet and the profit and loss account – comply with the statutory provisions and the additional provisions of the principles for the accounting of the Deutsche Bundesbank and give a true and fair view of the net assets, financial position and results of operations of the Deutsche Bundesbank. After studying the external auditors' report, the Executive Board decided to publish the financial statements and transfer the Bundesbank's profit to the Federal Government on 11 March 2008.

V Notes on the individual balance sheet items

1 Assets

Gold and gold receivables

At the end of 2007 the Bundesbank's holdings of fine gold (ozf) amounted to 3,417,408 kg or 110 million ounces. The gold was valued at market prices (1 kg = €18,269.21 or 1 ozf = €568.236). In the year under review the gold holdings declined by 5,134 kg or 0.2 million ounces. This was due to the sale of gold to the Federal Government at market prices for the purpose of minting gold coins.

Claims on non-euro area residents denominated in foreign currency

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

Receivables from the IMF

This sub-item contains the claims on the IMF which are financed and held by the Bundesbank and which arise from the Federal Republic of Germany's membership of the IMF. The claims, which total SDR 2,252 million (€2,418 million), consist of drawing rights within the reserve tranche and special drawing rights.

The drawing rights within the reserve tranche correspond to the amounts actually paid to the IMF in gold, special drawing rights (SDRs), foreign exchange and national currency under the German quota. The drawing rights held represent the difference between the unchanged German quota of SDR 13,008 million (€13,971 million) and the euro balances amounting to €13,022 million (SDR 12,125 million) at the disposal of the IMF at the end of the year. In 2007

Receivables from the IMF — Table 14

Item	31.12.2007		31.12.2006		Change from previous year			
	SDR million	€ million	SDR million	€ million	SDR million	As a percentage	€ million	As a percentage
German quota	13,008	13,971	13,008	14,850	–	–	– 879	– 5.9
less euro balances	– 12,125	– 13,022	– 11,707	– 13,364	– 418	– 3.6	342	2.6
Drawing rights within the reserve tranche	884	949	1,302	1,486	– 418	– 32.1	– 537	– 36.1
Special drawing rights	1,368	1,469	1,336	1,525	32	2.4	– 56	– 3.7
Total	2,252	2,418	2,637	3, 011	– 386	– 14.6	– 593	– 19.7

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there was a net decline of SDR 418 million (€537 million) to SDR 884 million (€949 million) in the holdings of drawing rights.

Special drawing rights, by means of which convertible currencies can be obtained at any time, were originally allocated free of charge to the extent of SDR 1,211 million. A corresponding counterpart is shown as liability item 8, "Counterpart of special drawing rights allocated by the IMF". The level of special drawing rights held at the end of 2007 amounted to SDR 1,368 million (€1,469 million) compared with €1,525 million (SDR 1,336 million) on 31 December 2006.

If all items on the assets side and the liabilities side of the balance sheet are taken into account, the net SDR item amounted to SDR 1,045 million compared with SDR 1,434 million in 2006. The year-end revaluation is based on the market rate of SDR 1 = €1.0740 (2006: SDR 1 = €1.1416) calculated by the ECB at the end of the year for all central banks participating in the Eurosystem.

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

The balances with banks, portfolio investment, loans and other foreign currency claims which are shown in this sub-item amounted to €27,694 million at the end of 2007 compared with €28,640 million on 31 December 2006. These are almost exclusively US dollar holdings amounting to US$40,023 million (= €27,188 million), representing an increase of US$2,996 million from the previous year. This sub-item also contains holdings in yen (¥81,999 million = €497 million) and a very small amount in other currencies. The holdings are interest-bearing. If all US dollar items on the assets side and the liabilities side of the balance sheet are taken into account, the net US dollar item valued at mar-

Balances with banks, portfolio investment, external loans and other external assets — Table 15

Item	31.12.2007	31.12.2006	Change from previous year	
	€ million	€ million	€ million	As a percentage
Current account holdings and overnight deposits	794	513	281	54.8
Claims arising from reverse repurchase agreements (reverse repos, held in US dollars)	1,972	1,538	435	28.3
Fixed-term deposits and deposits at notice (held in US dollars)	3,726	4,161	– 435	– 10.5
Marketable securities	21,099	22,305	– 1,206	– 5.4
of which: amount held in US dollars	20,641	21,816	– 1,175	– 5.4
Other	102	124	– 22	– 17.4
Total	27,694	28,640	– 947	– 3.3

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ket prices amounted to US$37,467 million compared with US$35,957 million in 2006 and the net yen item valued at market prices amounted to ¥82,107 million compared with ¥81,425 million in 2006. The foreign currency items were valued at the end-of-year market rate; in the case of the US dollar item this amounted to €1 = US$1.4721 (compared with €1 = US$1.3170 at the end of the previous year) and for the yen item €1 = ¥164.93 (2006: €1 = ¥156.93).

Claims on euro-area residents denominated in foreign currency

This item contains claims on credit institutions arising from two US dollar refinancing operations. On 12 December 2007 the Governing Council of the ECB decided to take joint action with the Federal Reserve (Fed) to address elevated pressure in short-term funding markets. As part of a US dollar term auction facility established by the Fed, the ECB transfers US dollars provided by the Fed by means of a swap line to the central banks in the Eurosystem, which then offer US dollar funding to credit institutions in the Eurosystem. The operations were carried out on 20 and 27 December 2007 and have a maturity of 28 and 35 days, respectively.

Claims on non-euro area residents denominated in euro

A long-term interest-free loan amounting to €300 million which the Bundesbank made available to the IMF in agreement with the Federal Government in 2000 is shown in this item. The loan is in connection with the financing of debt relief which the IMF grants to the heavily indebted poor developing countries (Heavily Indebted Poor Countries Initiative or HIPC initiative). The interest income from the investment of this money is at the disposal of a trust fund which is administered by the IMF and from which the debt relief granted by the IMF is financed. The loan has a maturity of ten years.

Lending to euro-area credit institutions related to monetary policy operations denominated in euro

This item reflects the volume and composition of the Bundesbank's refinancing of the credit institutions. At the end of the year under review the amount of funds loaned for refinancing purposes was €11,607 million higher than on 31 December 2006.

The main refinancing operations undertaken for money market management purposes are regular weekly transactions with a normal one-week maturity, the purpose of which is to provide liquidity. In the year under review the main refinancing operations were conducted as variable-rate tenders with a minimum bidding rate. At the end of the year the main refinancing operations amounted to €133,095 million, which was €40,845 million less than the level on 31 December 2006. On a daily average the main refinancing operations amounted to €119,854 million (2006: €155,578 million).

The longer-term refinancing operations held at monthly intervals and with a maturity of three months are used to provide longer-term liquidity. In the year under review they were held as variable-rate tenders. The volume of longer-term refinancing operations amounting to €134,769 million at the end of 2007 was €52,440 million above that of the previous year owing to two additional operations. On a daily average the volume of longer-term refinancing operations amounted to €113,364 million (2006: €73,192 million).

The marginal lending facility (overnight liquidity) is permanently available at a predetermined interest rate (standing facility). The extent to which recourse to the marginal lending facility was being taken on 31 December 2007 had risen by €12 million since the previous year to €91 million. The extent to which it was being used on a daily average amounted to €107 million (2006: €80 million).

Other claims on euro-area credit institutions denominated in euro

This item, amounting to €13,077 million (2006: €3,049 million), consists almost exclusively of fixed-term deposits which are held at credit institutions and which arise from funds received in connection with central bank services (see liability item 5 "Liabilities to non-euro-area residents denominated in euro"). This item also contains balances which are held at commercial banks in other euro-area countries and which are used for settling payments.

Claims on the Federal Government

This item shows the equalisation claims on the Federal Government and the non-interest-bearing debt register claims in respect of Berlin; both date back to the currency reform of 1948. They form the balance sheet counterpart of the amounts paid out at that time in cash per capita and per enterprise and of the initial provision of credit institutions and public corporations with central bank money. Equalisation claims yield interest at the rate of 1% per annum. In conjunction with Article 101 of the EC Treaty it has been stipulated that equalisation claims and the debt register claims are to be redeemed in ten annual instalments, starting in the year 2024.

Intra-Eurosystem claims

The Bundesbank's claims on the ECB and on the other central banks participating in the Eurosystem are combined in this item.

Sub-item 9.1 shows the Bundesbank's participating interest in the ECB. Pursuant to Article 28 of the ESCB Statute, the national central banks of the ESCB are the sole subscribers to the capital of the ECB (*see General information on annual accounts*). On 31 December 2007 the Bundesbank had a 20.5% share of the ECB's capital. This share amounts to €1,182 million excluding the net increase in the Bundesbank's share of the accumulated net assets of the ECB (also referred to as net equity) in connection with the last capital key changes on 1 May 2004 and 1 January 2007, which amount to a cumulative €14 million.

Sub-item 9.2 contains the Bundesbank's euro-denominated claims arising from the transfer of foreign reserves to the ECB. In accordance with Article 30 of the ESCB Statute, the central banks participating in the Eurosystem transferred foreign reserves (15% in gold and 85% in foreign currency) to the ECB at the beginning of 1999. Adjustments to the key for subscribing to the ECB's capital also result in adjustments to the Bundesbank's claims arising from the transfer of foreign reserves to the ECB. On 31 December 2007 these claims amounted to €11,821 million. As the transferred gold does not earn interest, the claims are remunerated at 85% of the latest available marginal rate for the main refinancing operations.

Sub-item 9.3 "Claims related to the allocation of euro banknotes within the Eurosystem" shows the claims which arise from applying the banknote allocation key. As at the end of 2006, the Bundesbank again had no claims at the end of 2007 but, instead, liabilities, which are shown in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem".

A daily net balance vis-à-vis the ECB is derived from the TARGET/TARGET2 settlement balances between the central banks of the ESCB. This balance is generally remunerated at the latest available marginal rate for the main refinancing operations. At the end of the year the Bundesbank had net claims amounting to €71,046 million (2006: €5,399 million), which are shown under sub-item 9.4 "Other claims within the Eurosystem". On a daily average the interest-bearing net claims arising from TARGET/TARGET2 settlement balances amounted to €32,815 million (2006: €11,956 million). This item also contains the liabilities amounting to €113 million in 2007 arising from the allocation of monetary income to the national central banks (see profit and loss item 5 "Net result arising from allocation of monetary income").

Items in course of settlement

This item contains the asset items arising from payments still being processed within the Bundesbank.

Tangible and intangible fixed assets

Table 16

€ million

Item	Purchase/ production costs 31.12.2006	Additions	Disposals	Accumu-lated depreci-ations	Book value 31.12.2007	Book value 31.12.2006	Depreci-ation in 2007
Land and buildings	2,937	25	– 201	– 1,492	1,270	1,425	– 84
Furniture and equipment	774	81	– 112	– 547	196	181	– 58
Computer software	109	5	– 1	– 106	7	8	– 6
Total	3,820	111	– 313	– 2,145	1,472	1,613	– 147

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Other assets

The Bundesbank's holdings of euro coins are shown in sub-item 11.1 "Coins". New coins are received from the federal mints at their nominal value for the account of the Federal Government, which holds the coin prerogative.

Sub-item 11.2 "Tangible and intangible fixed assets" amounted to €1,472 million compared with €1,613 million in 2006; it comprises land and buildings, furniture and equipment and computer software.

Sub-item 11.3 "Other financial assets" amounted to €9,799 million compared with €2,813 million in 2006. It contains fixed-interest euro assets of €9,709 million as a counterpart to the capital, statutory reserves, provisions for general risks and provisions for pensions and healthcare assistance. The euro assets are held until maturity and valued at acquisition cost. This item also includes €90 million in participating interests of the Bundesbank. The participating interest in the Bank for International Settlements, Basel, was unchanged at €50 million at the end of 2007. The Bundesbank holds 50,100 shares. As in the previous year, the balance sheet value of the participating interest in the Liquiditäts-Konsortialbank GmbH, Frankfurt am Main, amounted to €38 million. This 30% interest continues to entail a maximum additional commitment of €300 million for the Bundesbank. As in 2006, the participating interest in the cooperative society SWIFT, La Hulpe (Belgium) amounted to €2 million.

Sub-item 11.4 "Off-balance-sheet instruments revaluation differences" essentially comprises €158 million for the year-end valuation of the US dollar forward liabilities to the ECB arising from the US dollar term auction facility established by the Fed. (See asset item 3 "Claims on euro-area residents denominated in foreign currency".)

Sub-item 11.5 "Accruals and prepaid expenses" contains the accrued and prepaid expenditure identified at 31 December 2007. These chiefly consist of interest income which is due in the new financial year from monetary policy operations, from the transfer of foreign reserves to the ECB and from securities that were undertaken or acquired in the financial year just ended.

2 Liabilities

Banknotes in circulation

The total value of euro banknotes issued by the central banks in the Eurosystem is distributed among these banks on the last business day of each month in accordance with the key for allocating euro banknotes (*see General information on annual accounts*). In accordance with the banknote allocation key applying on 31 December 2007, the Bundesbank has a 27.2% share of the value of all euro banknotes in circulation. During the year under review the total value of euro banknotes in circulation within the Eurosystem rose from €628,240 million to €676,637 million. In accordance with the banknote allocation key, the Bundesbank shows holdings of euro banknotes worth €183,781 million at the end of the year compared with €170,881 million at the end of 2006. The value of the euro banknotes actually issued by the Bundesbank in the year under review increased from €255,216 million to €283,279 million. As this was more than the allocated amount, the difference of €99,498 million (2006: €84,334 million) is shown in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem".

Liabilities to euro-area credit institutions related to monetary policy operations denominated in euro

Sub-item 2.1 "Current accounts" contains the deposits of the credit institutions, amounting to €64,032 million (31 December 2006: €47,913 million), which are used to meet the minimum reserve requirement and settle payments. The main criterion for including these deposits in this sub-item is that the respective business partners appear in the list of institutions which are subject to the minimum reserve regulations in the Eurosystem. Minimum reserve balances are remunerated at the average marginal interest rate for main refinancing operations in the maintenance period. On a daily average the current account deposits amounted to €44,757 million (2006: €40,469 million).

Sub-item 2.2 "Deposit facility" amounting to €4,931 million (31 December 2006: €43 million) contains overnight deposits at a predetermined interest rate (standing facility). On a daily average the deposit facility amounted to €232 million (2006: €82 million).

Sub-item 2.3 "Fixed-term deposits" includes liquidity-absorbing fine-tuning operations amounting to €40,550 million. In the reporting year, they were settled as a fixed-rate tender at a prescribed rate of interest. On 31 December 2006, the item was zero. On a daily average the fixed-term deposits amounted to €2,255 million (2006: €82 million).

Liabilities to other euro-area residents denominated in euro

Sub-item 4.1 "General government deposits" encompasses the balances of the Federal Government, its special funds, the state governments and other public depositors. The deposits of other public depositors constitute balances held by social security funds and local authorities. On 31 December 2007 general government deposits amounted to €43 million in all (31 December 2006: €36 million).

Sub-item 4.2 "Other liabilities" amounted to €405 million compared with €369 million on 31 December 2006. The deposits of enterprises and individuals are the main items shown here.

Liabilities to non-euro-area residents denominated in euro

This balance sheet item, amounting to €14,045 million (31 December 2006: €3,746 million) contains primarily the fixed-term deposits of central banks and the working balances of central banks, monetary authorities, commercial banks and international organisations held for settling the payments and other services provided by the Bundesbank. These deposits are accepted mainly as part of the Bundesbank's central bank services; the proceeds are invested in the money market (see asset item 6 "Other claims on euro-area credit institutions denominated in euro").

Liabilities to euro-area residents denominated in foreign currency

This item contains the US dollar deposits of banks domiciled in the euro area and those of euro-area branches of banks domiciled outside the euro area and the US dollar deposits of central government.

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

The foreign-currency-denominated liabilities towards banks outside the euro area are recorded in this item. These are liabilities in US dollars, amounting to US$2,873 million (€1,951 million) compared with US$1,395 million (€1,059 million) in 2006, which have arisen from securities repurchase agreements (repos).

Counterpart of special drawing rights allocated by the IMF

The counterpart of the special drawing rights allocated by the IMF free of charge and shown in sub-item 2.1 "Receivables from the IMF" on the assets side of the balance sheet corresponds to the allocations of SDRs to the Federal

Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,211 million.

Intra-Eurosystem liabilities

The Bundesbank's liabilities to the ECB and to the other central banks participating in the Eurosystem are combined in this item.

The "Liabilities to the ECB arising from promissory notes" shown as sub-item 9.1 arise in connection with the issue of ECB debt certificates. The ECB did not issue such paper during the year under review.

Sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem" contains the liabilities arising from the application of the banknote allocation key (see liability item 1 "Banknotes in circulation"). At the end of 2007 these liabilities amounted to €99,498 million (2006: €84,334 million).

The net liabilities balance arising from other assets and liabilities within the Eurosystem would be shown in sub-item 9.3 "Other liabilities within the Eurosystem". At the end of 2007 the Bundesbank had a net claim, and this is shown on the asset side under sub-item 9.4 "Other claims within the Eurosystem" and explained in the explanatory notes above.

Items in course of settlement

This item contains the liabilities items arising from the payments still being processed within the Bundesbank.

Other liabilities

Sub-item 11.2 "Accruals and income collected in advance" contains the accrued income identified at 31 December 2007. This consists essentially of interest expenditure which is due in the new financial year but was incurred in the financial year just ended and which arose in connection with the allocation of banknotes within the Eurosystem and from deposits which are used to fulfil the minimum reserve requirement.

Sub-item 11.3 "Sundry items" essentially consists of the liabilities arising from the Deutsche Mark banknotes still in circulation. Although Deutsche Mark banknotes are no longer legal tender, the Bundesbank has publicly undertaken to redeem Deutsche Mark banknotes that are still in circulation for an indefinite period. The Deutsche Mark banknotes still in circulation belong to the series BBk I/Ia and BBk III/IIIa and at the end of 2007 amounted to a total of €3,574 million. The banknote series BBk I/Ia accounted for €1,305 million of this sum (2006: €1,322 million) and the banknote series BBk III/IIIa for €2,269 million

Provisions Table 17

Provisions for	31.12.2007	31.12.2006	Change from previous year	
	€ million	€ million	€ million	As a percentage
General risk	1,848	2,000	– 152	– 7.6
Direct pension commitments	2,062	1,991	71	3.6
Indirect pension commitments (supplementary pension funds)	360	352	8	2.2
Healthcare subsidy commitments to civil servants	384	366	18	5.0
Pre-retirement part-time work	79	84	– 5	– 6.4
Staff restructuring schemes	242	308	– 66	– 21.5
Other	215	269	– 54	– 20.1
Total	5,190	5,370	– 181	– 3.4

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(2006: €2,368 million). In 2004 part of the liabilities arising from Deutsche Mark BBk I/Ia series banknotes still in circulation and amounting to €1,237 million were taken off the books and reported as income as it is highly unlikely that this amount of the banknote stock will now be exchanged for euro. As a result of this partial write-off, the liabilities arising from Deutsche Mark banknotes still in circulation on 31 December 2007 amounted to €2,337 million.

Provisions

The provisions for general risks are created pursuant to the regulations governing the Bundesbank's annual accounts contained in section 26 (2) of the Bundesbank Act. They are established against foreign exchange risks in the bank's US dollar, SDR and yen positions not already covered by existing revaluation items. The level of funds to be allocated to risk provisions is reviewed annually using value-at-risk methods amongst others. In doing so, bank holdings of risk-weighted assets, the financial situation expected for the coming year and the statutory reserves (currently €2.5 billion) are taken into account. Taking the aforementioned factors into consideration and particularly the fact that the value of the foreign currency positions in euro has dropped on the year, it was deemed appropriate to reduce the provisions by €152 million compared with the previous year (see asset item 2 "Claims on non-euro-area residents denominated in foreign currency").

The provisions for direct pension commitments were increased by €71 million and now amount to €2,062 million. As a result of the Bundesbank's obligation to act as guarantor for pension payments out of the supplementary pension funds for public sector employees, indirect pension commitments amounted to €360 million on 31 December 2007 (2006: €352 million). The provision for healthcare subsidy commitments to civil servants was increased by €18 million to €384 million. The calculations of the provisions for pensions and healthcare assistance are based on an actuarial expert opinion, resulting in an increase in "Staff costs". For accounting purposes an interest rate of 5.4% was applied in the year under review (2006: 5.6%).

After a reduction of €5 million, a provision of €79 million for pre-retirement part-time work was shown in the balance sheet as of 31 December 2007. The provision for payment commitments arising from staff restructuring schemes that had already been carried out by the balance sheet date was reduced by €66 million to €242 million. These provisions are reduced on the basis of an actuarial expert opinion, with €39 million being included in the profit and loss item 6 "Other income" and €33 million in the profit and loss item 8 "Staff costs".

The other provisions were created primarily for the risk of losses on the sale of property as well as for holiday entitlement not taken, overtime and positive balances of flexible working hours as well as for uncertain liabilities.

Revaluation accounts

This item contains the disclosed hidden reserves from the initial valuation at the time of the changeover to market valuation on 1 January 1999 (revaluation items "old") and the unrealised profits arising from market valuation on 31 December 2007 (revaluation items "new").

Revaluation items "old"

A revaluation item "old" now remains only for the gold position. It represents the difference between the market value of gold on 1 January 1999 and the lower value of gold prior to that date. In the balance sheet on 31 December 1998 the value for gold was 1 ozf = DM 143.8065 (€73.5271) while the market value on 1 January 1999 was 1 ozf = €246.368. Although the valuation gains arising from the initial valuation of the gold holdings are not eligible for

Revaluation accounts Table 18

Item	Revaluation items "old"	Revaluation items "new"	Total 31.12.2007	Total 31.12.2006	Year-on-year change	
	€ million	€ million	€ million	€ million	€ million	As a percentage
Gold	18,990	35,364	54,355	45,023	9,332	20.7
US dollars	–	–	–	738	– 738	– 100.0
Securities	–	690	690	172	518	300.5
Total	18,990	36,054	55,044	45,933	9,112	19.8

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distribution, they will be dissolved under certain circumstances. Besides a dissolution in the case of valuation losses on the gold item, a proportionate dissolution also takes place in the event of net reductions if the end-of-year gold holdings are below their lowest end-of-year level since 1999.

The reduction of 0.2 million ozf (see asset item 1 "Gold and gold receivables") in the gold holdings resulted in a dissolution amount of €29 million in the year under review. The dissolution amount is included in the profit and loss item 2/sub-item "Realised gains/losses arising from financial operations".

Revaluation items "new"

In the case of gold holdings, the net positions in each foreign currency and the securities portfolio, the positive difference between their market value on 31 December 2007 and their value in terms of the average acquisition costs carried forward from 1 January 1999 is shown in the revaluation items "new".

In the case of gold the acquisition cost is 1 ozf = €246.370. At the end of 2007 the market value of the gold position exceeded its acquisition value, with the result that a revaluation item amounting to €35,364 million arose (2006: €26,004 million). The market value of the US dollar position at the end of 2007 was below its acquisition value (€1 = US$1.3540), with the result that there was a valuation loss. In the case of the SDR and yen positions, the market values at the end of the year were also below the respective acquisition values (€1 = SDR 0.8776, €1 = ¥157.0086), resulting in valuation losses (see profit and loss item 2/sub-item "Write-downs on financial assets and positions"). There were only slight valuation gains in the case of the other foreign currencies.

In the case of the valuation of securities, gains of €689 million arose from US-dollar-denominated assets and gains of €1 million from yen-denominated paper.

Capital and reserves

In accordance with section 2 of the Bundesbank Act, the liable capital amounts to €2.5 billion. The statutory reserves are in line with the fixed upper limit which is laid down in section 27 (1) of the Bundesbank Act and which is likewise €2.5 billion.

Profit for the year

The profit and loss account for the year 2007 closed with an annual surplus of €4,285 million. Pursuant to section 27 of the Bundesbank Act, it will be transferred in full to the Federal Government as the statutory reserves were at their maximum level of €2.5 billion at the end of 2007.

VI Notes on the profit and loss account

Net interest income

This item shows interest income less interest expenditure. Net interest income was greater than in the previous year, rising by €2,065 million to €7,502 million. Of this total amount, €1,330 million was in foreign currency (primarily foreign reserves) while the euro holdings amounted to €6,172 million (primarily from the use of monetary policy instruments).

Interest income

Interest income in foreign currency fell year on year by €47 million to €1,433 million, mainly as a result of the depreciation of the US dollar. The interest income from gold is derived from gold leasing transactions, which are remunerated in US dollars.

Interest income in euro increased year on year by €4,299 million to €11,678 million. Income from the refinancing of credit institutions rose by €2,895 million to €9,532 million (see asset item 5 "Lending to euro-area credit institutions related to monetary policy operations denominated in euro"). This was

Interest income Table 19

Item	2007	2006	Change from previous year	
	€ million	€ million	€ million	As a percentage
Interest income in foreign currency				
Gold	1	0	1	220.2
IMF	34	57	– 23	– 40.8
Current account holdings and overnight deposits	5	5	– 0	– 5.4
Reverse repo transactions	115	163	– 47	– 29.2
Fixed-term deposits and deposits at notice	197	213	– 16	– 7.6
Marketable securities	1,076	1,036	40	3.8
Other	6	6	– 0	– 5.0
Total	1,433	1,480	– 47	– 3.2
Interest income in euro				
Main refinancing operations	4,750	4,477	273	6.1
Longer-term refinancing operations	4,761	2,155	2,605	120.9
Other refinancing operations	22	5	17	339.1
Claims arising from central bank services	187	37	149	401.1
TARGET/TARGET2 balances in the ESCB	1,302	264	1,038	393.3
Claims arising from the transfer of foreign reserves to the ECB	400	285	115	40.3
Financial assets	205	104	102	98.0
Other	51	52	– 1	– 1.9
Total	11,678	7,379	4,299	58.3
Grand total	13,111	8,859	4,252	48.0

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Interest expenditure

Table 20

Item	2007	2006	Change from previous year	
	€ million	€ million	€ million	As a percentage
Interest expenditure in foreign currency				
Repo transactions	96	87	9	10.8
Other	7	0	7	.
Total	103	87	16	18.8
Interest expenditure in euro				
Minimum reserves	1,774	1,149	625	54.4
Time deposits/deposit facility	98	4	95	.
Liabilities arising from central bank services	201	95	106	111.3
TARGET/TARGET2 balances in the ESCB	3	30	– 26	– 88.5
Net liabilities related to the allocation of banknotes	3,426	2,056	1,370	66.6
Other	3	2	1	57.5
Total	5,506	3,336	2,170	65.1
Grand total	5,609	3,423	2,186	63.9

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due mainly to the higher average interest rate level for the year. Interest income from TARGET/TARGET2 settlement balances rose by €1,038 million to €1,302 million (see asset sub-item 9.4 "Other claims within the Eurosystem"), mainly because the average annual volume increased.

Interest expenditure

Interest expenditure increased by €2,186 million to €5,609 million year on year. This was due primarily to the fact that expenditure on remunerating intra-Eurosystem balances arising from the allocation of euro banknotes increased by €1,370 million owing to the annual average rise in the interest rate level and the increase in the euro banknotes in circulation (see *General information on annual accounts* and liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem"). The €625 million year-on-year rise in expenditure on remunerating the minimum reserve balances was due mainly to the increase in the average interest rate.

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

The net income shown in sub-item "Realised gains/losses arising from financial operations" amounted to €158 million compared with €163 million in 2006.

Most of the valuation losses of €2,256 million recorded in the sub-item "Write-downs on financial assets and positions" occurred in the US dollar position (€2,160 million), but also in the yen (€25 million) and the SDR positions (€68 million).

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

Table 21

Item	2007 € million	2006 € million	Change from previous year € million	Change from previous year As a percentage
Realised gains/losses				
Gold	68	69	– 1	– 1.0
Foreign currency	– 8	134	– 142	.
Securities	98	– 39	137	.
Total	158	163	– 6	– 3.5
Write-downs				
Foreign currency	– 2,253	– 78	– 2,175	.
Securities	– 3	– 123	120	97.9
Total	– 2,256	– 201	– 2,055	.
Transfers to/from provisions for general risks, foreign exchange risks and price risks	152	78	74	94.9
Grand total	– 1,946	41	– 1,987	.

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The sub-item "Transfers to/from provisions for general risks, foreign exchange risks and price risks" contains the reduction of €152 million in the provision for general risks (see liability item 12 "Provisions").

Net income from fees and commissions

There was a year-on-year increase of €9 million to €46 million in net income from fees and commissions.

Income from participating interests

This item contains the Bundesbank's profit from its participating interests in the BIS and the Liquiditäts-Konsortialbank GmbH. Total income amounted to €16 million.

Net result arising from allocation of monetary income

The monetary income of the Eurosystem national central banks is allocated in accordance with a decision taken by the Governing Council of the ECB.[1] Since 2003 the amount of monetary income allocated to each national central bank is measured on the basis of the actual income which arises from the earmarked assets that each holds as a counterpart to its liability base.

The liability base contains the following items: liability item 1 "Banknotes in circulation"; liability item 2 "Liabilities to euro-area credit institutions related to

1 Decision of the European Central Bank of 6 December 2001 on the allocation of monetary income of the national central banks of participating member states from the financial year 2002 (ECB/2001/16) and amended by its decision of 19 May 2006 (ECB/2006/7) and 22 November 2007 (ECB/2007/15).

Net income from fees and commissions

Table 22

Item	2007	2006	Change from previous year	
	€ million	€ million	€ million	As a percentage
Income				
Cashless payments	31	29	2	8.1
Cash payments	6	5	1	20.2
Securities business and security deposit business	11	10	1	5.0
Other	11	6	5	78.9
Total	59	50	9	17.6
Expenditure				
Securities business and security deposit business	9	8	0	5.2
Other	5	5	– 0	– 5.5
Total	14	13	0	1.1
Grand total	46	37	9	23.7

Deutsche Bundesbank

monetary policy operations denominated in euro"; liability sub-item 9.1 "Liabilities to the ECB arising from promissory notes"; liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem"; and the net liabilities arising from TARGET/TARGET2 accounts contained in liability sub-item 9.3 "Other liabilities within the Eurosystem". All interest expenditure which a national central bank has paid on the items of the liability base mentioned reduces the amount of the monetary income to be transferred by the national central bank concerned.

A national central bank's earmarked assets consist of the following items: asset item 5 "Lending to euro-area credit institutions related to monetary policy operations denominated in euro", asset sub-item 9.2 "Claims arising from the transfer of foreign reserves to the ECB", asset sub-item 9.3 "Claims related to the allocation of euro banknotes within the Eurosystem", the net assets arising from TARGET/TARGET2 accounts contained in asset sub-item 9.4 "Other claims within the Eurosystem" and a limited amount of the national central banks' gold holdings corresponding to their capital share. Gold is considered to generate no income.

If the value of a central bank's earmarked assets is above or below the value of its liability base, the difference is offset by applying to the value of the difference the average income from the earmarked assets of all the national central banks. At the end of each financial year the total monetary income transferred by all national central banks is distributed among the national central banks in proportion to their respective paid-up shares in the capital of the ECB.

Staff costs Table 23

Item	2007	2006	Change from previous year	
	€ million	€ million	€ million	As a percentage
Salaries and wages	507	513	– 5	– 1.1
Social security contributions	82	90	– 7	– 8.3
Expenditure on retirement pensions	235	299	– 64	– 21.4
Grand total	825	902	– 77	– 8.5

Deutsche Bundesbank

In the year under review the allocation of monetary income resulted in a net liability of €113 million for the Bundesbank. This net liability represents the difference between the €6,950 million in monetary income paid by the Bundesbank into the common pool and the Bundesbank's claim of €6,838 million – corresponding to the Bundesbank's share of the ECB's paid-up capital – on the common pool. In 2006 the distribution of monetary income among the national central banks resulted in net expenditure of €71 million.

Other income

The remaining income amounted to €140 million compared with €174 million in 2006. This decline was mainly the result of lower profits from the sale of buildings and land.

Staff costs

Staff costs, which were €77 million (8.5%) down on the year at €825 million, are made up of salaries and wages, social security contributions and expenditure on retirement pensions. This last item comprises €97 million net (2006: €165 million) in transfers to the provisions for pension and healthcare subsidy commitments to civil servants, mainly as a result of the discount rate being lowered from 5.6% to 5.4%. Further notable staff-related provisions are those for commitments under staff restructuring schemes and pre-retirement part-time working agreements (see liability item 12 "Provisions").

Pursuant to the *Code of Conduct for the members of the Executive Board of the Deutsche Bundesbank*, the remuneration received by each member of the Bundesbank's Executive Board is published. In 2007 the President of the Bundesbank received a pensionable salary of €280,383.00, a special non-pensionable remuneration of €76,693.78, a special payment of €7,002.08 in accordance with the *Bundessonderzahlungsgesetz* and a standard expenses allowance of €5,112.96, amounting to a total of €369,191.82. In 2007 the Vice-President received a pensionable salary of €224,366.40, a special non-pensionable remuneration of €61,355.03, a special payment of €5,601.66 in accordance with the *Bundessonderzahlungsgesetz* and a standard expenses allowance of €3,067.80, amounting to a total of €294,390.89. A member of the Executive Board was replaced in 2007. For the period from 1 January 2007 until the date he relinquished his office on 30 April 2007, the outgoing Executive Board member received a pensionable salary of €56,166.64, a special non-pensionable remuneration of €15,338.76, a special payment of €1,400.42 in accordance with the *Bundessonderzahlungsgesetz* and a standard expenses allowance of €852.16, amounting to a total of €73,757.98. For the period from the date he took up his office on 16 July 2007 until the end of the year, his successor received a pensionable salary of €77,248.75, a special non-pensionable remuneration of €21,090.79, a special payment of €1,931.22 in accordance with the *Bundessonderzahlungsgesetz* and a standard expenses allowance of €1,175.16, amounting to a total of €101,445.92. In 2007 each of the four other members of the Executive Board received €221,123.92; €168,349.92 of this was in the form of a pensionable salary, €46,016.27 as a special non-pensionable remuneration, €4,201.25 as a special payment in accordance with the *Bundessonderzahlungsgesetz* and €2,556.48 as a standard expenses allowance.

Total payments to serving and former members of the Executive Board, former members of the Bundesbank's Directorate, of the Central Bank Council, of the Board of Managers of the Bank deutscher Länder and of the Executive Boards of Land Central Banks, including their surviving dependants, amounted to €11,614,648.50 in 2007.

Other administrative expenses

The other (non-staff) operating expenditure increased year on year by €7 million (2.9%) to €241 million.

Depreciation on tangible and intangible fixed assets

The depreciation of land and buildings, of furniture and equipment and of computer software amounted to €147 million compared with €162 million in 2006 (see asset sub-item 11.2 "Tangible and intangible fixed assets").

Banknote printing

Expenditure on banknote printing increased by €18 million to €128 million because the Bundesbank procured a greater number of banknotes than in 2006. This was due mainly to the rise in the number of banknotes in circulation and to the increased replacement of banknotes that were no longer fit for circulation.

Other expenses

Other expenses declined by €1 million to €18 million year on year.

The Deutsche Bundesbank: key figures

	2006	2007
Staff[1]		
Core staff (full-time equivalents)	10,972	10,391
– Contraction since 31 December 2001[2]	3,828 (= 25.9%)	4,409 (= 29.8%)
Projected core staff (full-time equivalents) end-2012 = 9,000		
Locations/core staff (full-time equivalents)[1]		
Central Office	1 / 3,465	1 / 3,465
Regional Offices	9 / 2,924	9 / 2,871
Branches[3]	71 / 4,583	47 / 4,055
Annual accounts[1]		
Profit for the year	€4,205 million	€4,285 million
Net interest income	€5,436 million	€7,502 million
Balance sheet total	€373,535 million	€483,674 million
Foreign reserve assets (total)	€84.8 billion	€92.5 billion
– *of which* foreign currency	€28.6 billion	€27.7 billion
– *of which* gold	(3,423 t) €53.1 billion	(3,417 t) €62.4 billion
– *of which* receivables from the IMF	€3.0 billion	€2.4 billion
ECB capital key[4]		
Share of subscribed capital		20.5211%
Share of paid-up capital		29.4436%
Amount of the participating interest in the ECB		€1.18 billion
Foreign reserve assets transferred to the ECB		€11.82 billion
Money market transactions (main refinancing operations)		
Banks participating in the Eurosystem (average)	377	338
– *of which* using the Bundesbank as an intermediary	254	227
Amount outstanding for main refinancing operations in the euro area[5]	€307 billion	€264 billion
– *of which* counterparties of the Bundesbank	€156 billion	€120 billion
Cash payments		
Volume of euro banknotes in circulation (Eurosystem)[1]	€628.2 billion	€676.6 billion
Volume of euro coins in circulation (Eurosystem)[1]	€17.9 billion	€19.2 billion
Value of DM/euro exchange transactions	DM240.4 million	DM211.3 million
Unreturned DM banknotes and coins	DM14.38 billion	DM14.09 billion

1 On 31 December.
2 Core staff (full-time equivalents) on 31 December 2001 (year before the structural reform began):14,800.
3 Including operating units in 2006.
4 Since 1 January 2008.
5 Daily average.

	2006	2007
Incidence of counterfeit money in Germany		
Euro banknotes	46,000 banknotes	40,200 banknotes
Euro coins	77,000 coins	82,000 coins
Cashless payments		
Payments via the Deutsche Bundesbank (number of transactions)	2,340.1 million	2,389.0 million
– *of which* via RPS	2,297.9 million	2,343.0 million
– *of which* via RTGSplus [6]	37.9 million	41.9 million
Payments via the Deutsche Bundesbank (value)	€165 trillion	€187 trillion
– *of which* via RPS	€2,195 billion	€2,262 billion
– *of which* via RTGSplus [6]	€151 trillion	€182 trillion
Share of RTGSplus [6] transactions in EU-wide TARGET system	46%	45%
Banking supervision		
Number of institutions to be supervised	3,117	3,075
Audits of banking operations	186	214
Monthly returns processed	34,486	33,558
Audit reports processed	10,734	8,740
Own Funds Principle (Principle I/Solvency Regulation) reports	27,572	27,523
Liquidity Principle (Principle II/Liquidity Regulation) reports	26,467	26,322
Meetings with senior management	2,400	2,314
Cooperation with foreign central banks		
Training and advisory events	311	282
– Number of participants (total)	3,066	3,716
– Number of participating countries (total)	85	91
Selected publications (number per year/average number of copies)		
Annual Report	1/23,600	1/23,000
Financial Stability Review	1/22,000	1/19,100
Monthly Report	12/19,300	12/17,650
Statistical Supplements	52/3,400	52/3,400
Research Centre Discussion Papers	60/800	53/400
Publications in journals/books	73/–	46/–
External communication/public relations		
Visitors to the Money Museum	36,600	38,600
Written answers to queries	13,200	18,500
Press releases	217	219
Visits to the website (www.bundesbank.de)	–	5,116,700
Total number of copies of educational material for schools	900,000	160,000
Training sessions on counterfeit prevention	550	750
– Number of participants	11,000	15,000

6 From 19 November 2007: TARGET2-BBk