DEUTSCHE BUNDESBANK
EUROSYSTEM

ANNUAL REPORT

2006 2007 2008 2009 2010

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President of the Deutsche Bundesbank

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Vice-President of the Deutsche Bundesbank
(since 1 June 2006, until 31 May 2006
Member of the Executive Board)

Professor Jürgen Stark
Vice-President of the Deutsche Bundesbank
(until 31 May 2006)

Dr Hans Georg Fabritius

Professor Hans-Helmut Kotz

Dr Edgar Meister

Dr Hans Reckers

Professor Hermann Remsperger

We mourn the death

of the former President of the Land Central Bank in Baden-Württemberg
and Member of the Central Bank Council

Professor Norbert Kloten

† 5 April 2006

and of the following members of our staff

Joachim Biedenkapp	21 January 2006
Maria Kowalsky	28 March 2006
Rolf Lehmann	17 April 2006
Heinz-Jürgen Seving	18 April 2006
Heinz Ulfert	14 June 2006
Ute Wohlfarth	6 August 2006
Hermann Zwiegel	27 August 2006
Claus-Günter Locke	2 September 2006
Klaus-Ulrich Werner	6 September 2006
Dieter Nikolaus	16 November 2006
Hans-Dieter Schreck	17 November 2006
Harald Cleven	3 December 2006

We also remember the retired staff members of the Bank who died in 2006.

We will honour their memory.

DEUTSCHE BUNDESBANK

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EUROSYSTEM

Annual Report
2006

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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	Figure unknown, not to be published or not meaningful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

This year, the Deutsche Bundesbank will be 50 years old. General price pressure has been contained and a monetary policy setting anchored to price stability has been ensured in Germany for five decades now. This positive track record is something we wish to continue in a European context since this is the mandate conferred on the Eurosystem central banks by the Maastricht treaties. Besides helping to shape European monetary policy, our core tasks are monitoring the stability of the financial system, supervising banks, safeguarding an efficient payment system and supplying currency to the economy. The format of the *Annual Report* has been changed to reflect our focus on these five core business areas.

Last year, the rate of inflation averaged 1.8% in Germany and 2.2% across the euro area as a whole. We on the Governing Council of the European Central Bank (ECB) raised the key interest rate in six stages from 2.25% to 3.75% in order to counter the higher medium-run inflation risks. This progressively reined back the scope of monetary policy latitude, although the monetary policy stance, at the level attained, is still on the accommodating side. This year, too, we shall continue to analyse price risks very closely on the basis of both real economic data and monetary growth dynamics. If necessary, we shall act in a resolute and forward-looking manner in order to avert any medium-term risks to price stability in the euro area.

Some academics and observers have criticised our monetary policy analytical framework, the two-pillar monetary policy strategy, essentially because they regard it as too complex and therefore insufficiently transparent. It should be pointed out, however, that the underlying rationale for comprehensively analysing inflation risks within the framework of the two pillars is the lack of a generally accepted theory that can supply a consistent link between the real economic and monetary determinants of inflation. Neglecting the information content of one of the two pillars, far from enhancing transparency, would foster a restricted view that does not capture the complexity of the inflation process. A simplification of this kind would increase the risk of inaccurate assessments in the monetary policy analysis.

It is, not least, in communicating with the general public that the strategy serves to make our monetary policy decisions understandable. This enables us to make clear the processes from which a risk to price stability might, in principle, emerge, thereby providing a comprehensive picture of the current and future factors that are relevant to inflation and of their respective significance. We are, of course, aware that the analyses and instruments we apply have to be constantly reviewed and refined. Thus, the Bundesbank, acting also in cooperation with the other Eurosystem central banks, is working on improving both the real economic and monetary inflation forecasting methods as well as on reaching a deeper understanding of the connection between monetary growth and inflation.

A tension-free monetary policy is only possible, however, if, first and foremost, fiscal and wage policies – in their respective spheres of responsibility – operate in a manner that is consistent with stability. Consequently, the EC Treaty and the Stability and Growth Pact contain explicit fiscal rules for the individual states in the EU and, above all, within the euro area. In this regard, there was a gratifying development in Germany last year. The general government deficit ratio fell to 1.7% of GDP, thereby undershooting the 3% ceiling for the first time since 2001. It should not be overlooked, however, that this marked reduction – given a moderate growth in expenditure – was due primarily to the extremely positive and unexpectedly strong cyclical recovery and, additionally, to the sharp increase in revenue from the very volatile profit-related taxes. Moreover, despite the lower deficit ratio and relatively robust nominal economic growth, the general government debt ratio was merely stabilised at the very high figure of roughly 68%, which is still clearly above the 60% ceiling stipulated by the EC Treaty. Not least in view of the favourable macroeconomic outlook, policymakers should vigorously pursue the task of consolidating public finances and seek to achieve a budget that is structurally close to balance in 2009 – also to comply with the provisions of the Stability and Growth Pact.

I would like to add a few comments on the Bank' other core business areas. Given the close integration of the international financial markets, it is becoming a matter of increasing importance for central banks to give due attention to the stability of the national and international financial system in their analyses. This concerns, not least, appropriate underlying conditions for the monetary and financial systems. Another crucial factor, however, is the infrastructure that interconnects the central banks, the banking industry, stock markets and financial markets.

A key project in banking supervision in the year under review was the transposition into German law of the new Basel II Capital Accord so that it could enter into force as scheduled on 1 January 2007 and the banking industry could familiarise itself with the application of the new rules from the outset. Our experts have made a major input to the new Accord and, together with the Federal Financial Supervisory Authority, they have staged training courses for the employees in the banking industry.

Acting jointly with Banque de France and Banca d'Italia, the Bundesbank will be operating the new TARGET2 system for individual payments on behalf of the Eurosystem from November 2007 onwards as a key component of the European financial infrastructure. The technical construction of TARGET2 was continued in the reporting year as scheduled. In addition, the Bundesbank will have a particular role to play in the preparations and tests which begin for the banks in May 2007. This is because Germany represents the largest groups of users, accounting for almost 50%, and will be one of the first countries to switch to TARGET2.

With a view to assisting the integration of the European capital market, the Eurosystem launched the TARGET2 Securities (T2S) initiative in summer 2006. On 8 March 2007, the Governing Council of the ECB reaffirmed its economic, legal, operational and technological feasibility as well the use of the single shared platform constructed for TARGET2. To maximise synergies, T2S is to be developed within the Eurosystem and operared on the TARGET2 platform. The Bundesbank, Banque de France and Banca d'Italia (3CB), which are already responsible for the development and operation of TARGET2, are ready to develop the new service jointly with Banco de España (3CBplus) on behalf of the Eurosystem and to operate it on the single shared platform.

In the field of retail payments we continued to make our own in-depth preparations in the past year for the start of the Single Euro Payments Area (SEPA). The launch of SEPA, which is scheduled for 1 January 2008, will put in place an integrated single European market for payment services with enhanced competition and ensuing advantages for the users. The Bundesbank is playing an active role in this project both within the Eurosystem and at national level and is reinforcing this by reshaping its own portfolio of cashless payment services.

In the reporting year, we also improved collateral management for the banks' refinancing operations at the Bundesbank. Together with the banking industry, the Bundesbank developed and successfully introduced an electronic procedure called KEV for the submission and administration of credit collateral. This means that an efficient and customer-friendly procedure for using banks loans as collateral is now available.

The great importance of ensuring an appropriate infrastructure in cash management operations, too, was highlighted in 2006 by the insolvency of a number of cash-in-transit companies. We have learned the lessons from the considerable risks and frictions inherent in cash handling and have taken appropriate steps to overhaul our range of cash payment services so as to heighten transparency and settlement security for all the parties involved. We intend to carry on optimising the handling of cash payments on the basis of an international logistical standard. In future, a barcode will allow the labelling of cash containers. This scanner-based cash hand-over will speed up the business processes.

Preparations for the ongoing development of the euro banknotes are also under way in the Eurosystem. In this area, the Bundesbank is placing particular emphasis on user-friendly security features. The current banknote denominations, ranging from €5 to €500, will be retained in the second series.

Internally, at the end of 2007 we shall be concluding the comprehensive structural reform that was initiated in 2002. We have clearly streamlined our organisational structure, decision-making processes and reporting lines. The number of employees is already some 26% lower than in 2001 and, by the end of this year, will have fallen by nearly 30%. The cut of around €280 million annually in the cost of providing operational services, which had been targeted for 2008, was almost achieved as early as last year. In December 2006, the Executive Board adopted its "Strategy 2012" which defines our operational policy objectives from 2008 onwards with the aim of ensuring that the Bundesbank can perform its role in Germany and in the European System of Central Banks even more effectively in the future. To do this, it is essential to have highly qualified staff. This means that the Bundesbank has to remain an attractive employer.

I am joined by the other member of the Executive Board in thanking all our members of staff for their work in 2006 and 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 2007

Professor Axel A Weber
President of the Deutsche Bundesbank

Monetary policy and economic developments

The cyclical upturn in the euro area became noticeably more dynamic and more broadly based in the course of 2006. This applies especially to Germany, which increasingly exerted expansionary impulses on the rest of the euro area. The buoyancy of the global economy, which withstood both the slowdown in growth in the United States and the persistently high oil prices, helped to boost not only export business but also domestic demand in Germany. The number of registered unemployed persons fell unexpectedly sharply, while the faster build-up of jobs also gave a fillip to core employment subject to social security contributions for the first time since 2000. The positive macroeconomic setting was also reflected in a favourable development of public finances. The general government deficit declined appreciably, falling below the 3% ceiling laid down in the EC Treaty for the first time since 2001.

Despite this propitious general economic climate, it is important not to lose sight of the ongoing structural challenges. For example, unemployment remains worryingly high and the structural position of public finances problematic. At the same time, however, the improvement on the labour market demonstrates that that the wage moderation exercised during the past few years and the reforms which have been initiated are now definitely beginning to have a positive impact on the overall economy. The key need now is to build on this.

In terms of monetary policy, that means keeping the appropriate stability policy framework in place. With this objective in mind, the Governing Council of the ECB has progressively tightened its monetary policy stance since December 2005. The ongoing challenge for the Eurosystem's monetary policy is to anticipate and combat the risks to price stability and to anchor long-term expectations at a level compatible with price stability.

I International setting

1 Global economy still on a solid growth path

Continuing global upturn

The world economy continued to grow strongly in 2006. According to IMF estimates, global gross domestic product (GDP) went up by well over 5% on average, and thus slightly more sharply than in 2005. The robust growth dynamics were again accompanied by a rapid expansion of world trade, which rose by 9% in real terms, compared with 7½% in 2005. The increase in global output was fuelled both by the industrial countries and the emerging market economies, with a significant shift occurring in the course of the year in the relative weight of the expansionary forces emanating from the major industrialised economic zones. The noticeable slackening of cyclical momentum in the United States contrasted with fairly robust growth in the euro area. Overall, however, the underlying momentum in the industrial countries has slowed down somewhat since the start of 2006. The renewed acceleration in the euro area at the end of the year can be attributed largely to special factors, such as the mild winter as well as anticipatory effects ahead of the looming rise in value added tax (VAT) in Germany. In Japan, growth strenghtened again in the fourth quarter, partly as a reaction to weak growth in the second and third quarters.

Rising interest rates and high commodity prices

The exceptionally robust pace of global growth seen at the start of 2006 was subsequently tempered by various factors. One was a rise in short and long-term interest rates. In the United States, in particular, this had the desired effect of helping to dampen the inflationary pressure and also helped to calm the real estate markets. The economic policy measures taken in China to cool the investment boom also started to have an effect. Another factor was the dampening impact on global expansion of the surge in energy prices which continued into the third quarter. In the first eight months of 2006, the price of Brent crude oil, in US dollar terms, climbed by 28½%. Industrial raw material prices, which kept on rising throughout 2006, were 32½% higher on average than in 2005.

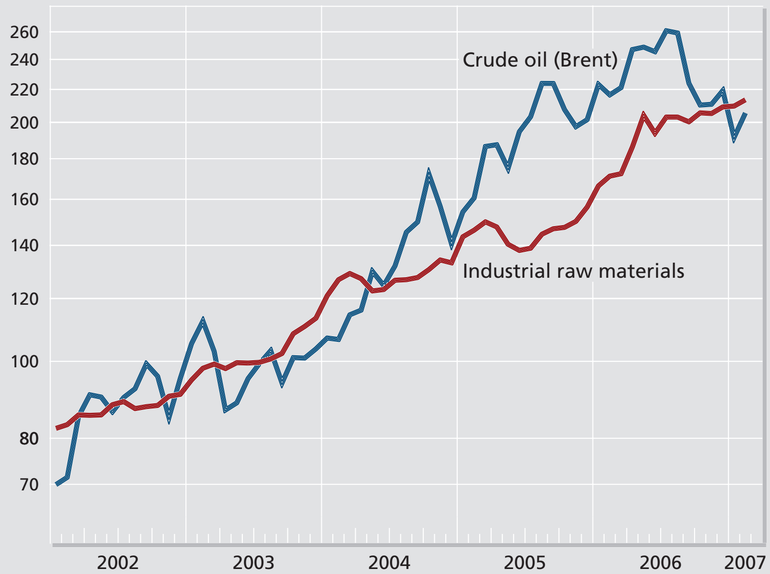
Outlook for global growth remains bright

The sharp fall in prices in the oil markets since August 2006 has strengthened purchasing power in the oil-consuming countries. On balance, this has stimulated global economic momentum, as past experience suggests that this expansionary effect will be felt more quickly than the contractionary stimuli of lower oil revenues in the oil-producing countries. In addition, the bullish state of the stock markets in 2006 is likely to have positively influenced aggregate demand.

World market prices for crude oil and industrial raw materials

Chart 1

2000 = 100, US$ basis, log scale



Sources: Thomson Financial Datastream and HWWI.

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All in all, the current indicators suggest that the global economy has remained on a growth path since the turn of the year. In mid-January, for example, the IMF confirmed its forecast of September 2006 that – for the fourth time in a row – global growth of around 5% is expected for 2007, which implies that the world economy is still in one of its most rapid periods of expansion since the 1950s.

Inflation in the industrial countries marked by oil price movements

The evolution of the price level in the industrial countries in 2006 was largely shaped by the ups and downs in energy prices. Following a fall in consumer price inflation during the first quarter of 2006, the rate went up from 2.3% in March to 2.9% in May, holding steady at around 3 % until August. After that, it dropped to 1.4% in October. Besides the calmer mood of the oil markets, another factor in this was that the year-on-year rate of change in consumer prices was automatically pushed downwards by baseline effects connected with the sharp rise in energy prices in the third quarter of 2005. Conversely, the year-on-year rate of change in consumer inflation rose again at the end of 2006 owing to a corresponding fall in oil prices a year earlier. On an annual average, consumer prices in the industrial countries increased by 2.4% last year, thus matching the 2005 figure. By contrast, core inflation (ie excluding food and energy) rose more or less continuously from 1.3% in January to 1.8% in December. For 2006 as a whole it stood at 1.7%, compared with 1.5% in 2005. This slight increase in domestic inflationary pressure may be attributed primarily to the indirect effects of the higher oil prices. In most industrial countries, however, second-round effects resulting from wage increases to compensate for the energy price-related losses in purchasing power remained within narrow bounds.

USA: pace of expansion dampened by cooling of real estate market

After starting off very dynamically, the rate of growth in the United States slowed significantly. On an annual average, GDP again increased by 3¼% in 2006. The slowdown in the underlying momentum of business activity during the course of the year can be attributed mainly to the fact that housing investment contracted by 12½% in seasonally adjusted terms from the start of 2006. This was linked to the rise in interest rates and the fact that house prices are now very high. Furthermore, private consumption did not increase as sharply in the second and third quarters as it had previously. Among the reasons for this are the higher interest rates and the fact that the stabilisation of house prices meant that the lending value of mortgages – and hence the corresponding scope for borrowing – likewise rose more moderately. The smaller positive wealth effects from rising real estate values were offset, however, by marked financial asset price gains in 2006. At –1%, US households' saving ratio reached a new low in 2006. US economic activity was also buoyed significantly by the sharp expansion of industrial investment (+7¼%) and of exports (+9%). Real export growth exceeded the rise in imports for the first time in a long while, although, owing to the difference in the respective levels, the external sector's net negative contribution to growth remained practically unchanged. Although the US current account deficit was likewise marginally higher than in 2005, it was still at around 6½ % of GDP.

Economic signals from the US economy have been mixed in recent months. It is generally expected to grow in 2007 at a rate below potential. The dampening effects arising from the real estate market are likely to be accompanied by relief as a result of the oil price-related easing of consumer price inflation, which will support private consumption in real terms. The rate of inflation slowed a little in 2006, averaging 3.2%. By contrast, the core personal consumption expenditure deflator (excluding energy and food), which is the US Federal Reserve's preferred instrument for analysing price developments, nudged up from 2.1% in 2005 to 2.2% last year.

Macroeconomic benchmark figures of selected industrialised countries

Table 1

	Real GDP		Consumer prices		Current account balance		Unemployment rate 1	
	2005	2006 pe	2005	2006 pe	2005	2006 pe	2005	2006 pe
Countries	Annual percentage change				As % of GDP		in %	
OECD	2.6	2 3.2	2.6	2.6	– 1.7	– 2.0	6.6	6.0
of which								
Euro area	1.4	2.6	2.2	2.2	– 0.1	– 0.2	8.6	7.8
United Kingdom	1.9	2.7	2.0	2.3	– 2.4	– 2.9	4.8	2 5.3
United States	3.2	3.3	3.4	3.2	– 6.4	– 6.5	5.1	4.6
Japan	1.9	2.2	– 0.3	0.3	3.7	3.9	4.4	4.1
Canada	2.9	2.7	2.2	2.0	2.3	1.7	6.8	6.3

Sources: ECB, OECD, BIS, national statistics. — **1** Standardised unemployment rate, based on OECD and Eurostat calculations. — **2** OECD forecasts (Economic Outlook, December 2006).

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Japanese economy growing markedly

The pace of growth in the Japanese economy increased noticeably at the end of 2006, having slowed markedly in the second and third quarters. Real GDP went up by 2¼% in 2006 on an annual average, owing partly to the substantial overhang from the previous year and buoyant expansion in the first few months of 2006. In the wake of a data revision, the growth rate for 2005 was lowered from 2¾% to 2% at the end of last year. Private consumption made a noticeably smaller contribution to macroeconomic growth in 2006 than in the previous year. This was linked to weak income growth. In addition, government investment was again curtailed as a result of greater efforts to consolidate public finances. However, business investment continued to rise sharply (+7¼%). The same was true of real exports which, lifted not least by the yen's depreciation, expanded by 9¾%. On average, consumer prices went up in 2006 for the first time since 1998, increasing by 0.3%. Excluding food and energy, however, they decreased again (-0.4%). The GDP deflator likewise fell further. Yet in view of the high degree of aggregate capacity utilisation, the chances of lastingly overcoming the deflationary tendencies in the Japanese economy have now increased perceptibly.

Emerging market economies still on steep expansionary path

The majority of the south and east Asian emerging market economies continued to grow rapidly in 2006. This was particularly true of China, whose GDP grew by 10¾%. India's aggregate output rose almost as sharply. Despite the renewed oil price hike, the inflation rates of the region's emerging market economies showed a comparatively small increase on average in 2006. The economies of the oil-producing countries in the Middle East and of the Commonwealth of Independent States (CIS) continued to expand dynamically in 2006. In Latin America the oil-producing countries Venezuela and Mexico, in particular, profited from the renewed average annual rise in energy prices. Other countries, such as Brazil, Argentina and Chile, benefited from the higher market prices of industrial raw materials as well as the considerable increases in the price of cereals. Overall, however, the majority of Latin American economies were unable to keep pace with the rapid expansion of the south and east Asian emerging market economies, owing above all to the existing structural obstacles to growth, which, in some cases, have magnified further.

New EU member states with persistently high growth

The upswing in the ten new EU member states (from the 2004 enlargement round) strengthened further in 2006. Real GDP in this group of countries grew by 5½%, compared with 4¾% in 2005. This rapid growth was supported firstly by sharply rising exports, which benefited particularly from the marked cyclical acceleration in the euro area, and secondly by a noticeable increase in private consumption and investment in the new member states. Together with the ongoing migration of workers to old EU member states without immigration restrictions, the buoyant economic growth led to a marked fall in unemployment. At an estimated 12¼%, the annual unemployment rate was just over 1 percentage point lower than in 2005. Consumer prices went up by 2.4% and thus slightly less than in 2005. However, inflation rates ranged between 1.3% in Poland and 6.6% in Latvia. The new member states again ran up large current account deficits in 2006, most of which widened further. However, these continued to be accompanied by extensive foreign direct investment.

2 Exchange rate gains for the euro

Exchange rate shifts in forex markets

Developments in the foreign exchange market in the past year were shaped by changed cyclical and inflation expectations and – related to this – different interest rate scenarios of the market participants in the main currency areas. Whereas the Federal Reserve (Fed), despite constantly emphasising the inflation risks, left the Federal Funds target rate unchanged at 5.25% from the end of June 2006 onwards and the Bank of Japan, after pursuing a zero interest rate policy for several years, raised its overnight rate for the first time in July 2006 to merely 0.25%, the ECB and the Bank of England raised their key interest rates further in the second half of the year. Thus, from the point of view of international investors, the euro and the pound sterling became more attractive and consequently appreciated in trade-weighted terms by 4½% and 7½, respectively, over the course of 2006. By contrast, the US dollar and the yen lost 4% and 5½% of their value, respectively.

Strong gains for the euro against the US dollar...

Against the US dollar, the euro fluctuated within a narrow band around US$1.20 at the beginning of 2006, before positive economic numbers for the euro area accumulated in early April while the US economic outlook concurrently appeared to be becoming more uncertain. The euro initially appreciated amid expectations that the interest rate differential between the two currency areas would narrow. The euro-dollar exchange rate subsequently remained between US$1.25 and US$1.29 without any clearly discernible trend until mid-November. The publication of a number of favourable economic data for the euro area and market expectations of a possible interest rate cut in the USA then sparked a further marked appreciation of the euro at the end of November to around US$1.33. In 2006 as a whole, the euro gained 11½% against the US dollar to US$1.32. As this article went to press, the euro was largerly unchanged, at US$1.31.

... and the yen

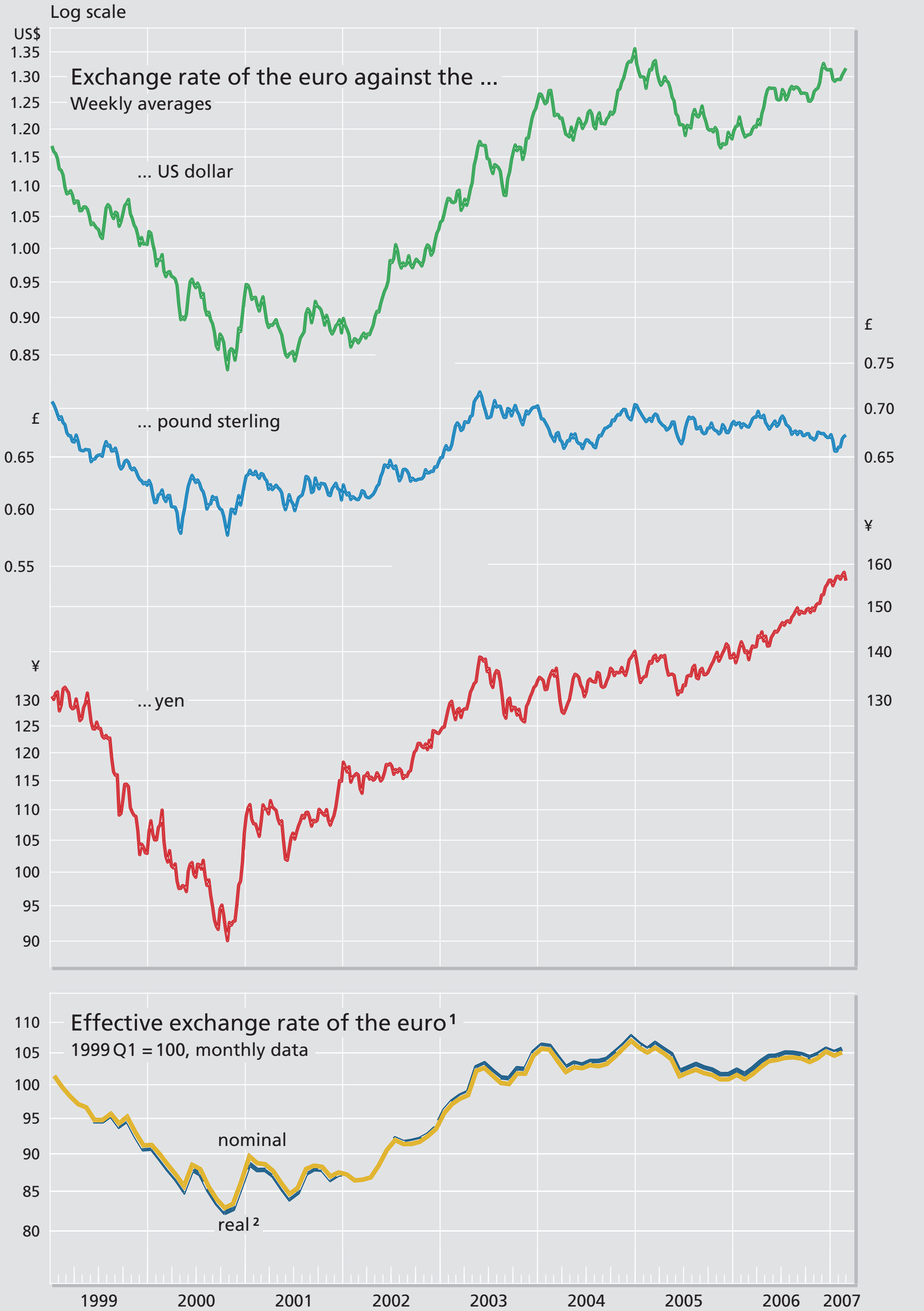
Under the influence of a growing interest rate differential, the euro appreciated against the yen continuously in 2006 except for brief interruptions. At the end of November, downward revisions of the GDP growth rates in Japan and positive news of the economic developments in the euro area caused the euro-yen exchange rate to hit several new peaks. At the end of 2006, it stood at ¥157. The euro's exchange rate gains over the year amounted to a remarkable 13%. In early 2007, the euro was still fairly strong against the yen, but dipped somewhat to ¥153 as this article went to press, amid worldwide financial market corrections.

Slight depreciation against the pound sterling

The euro's external value vis-à-vis the pound sterling was almost unchanged in the first half of 2006. During July, however, the pound was strengthened by anticipation of faster growth in the British economy and a tightening of monetary policy to combat increasing inflation expectations. It is likely that the pound was additionally strengthened by portfolio shifts of some central banks in favour of the British currency. The euro lost around 2% of its value against the pound sterling over the course of 2006. Following the surprise decision by the Bank of England to raise interest rates to 5.25% in January 2007, the euro declined further, but recently recovered, and was trading at £0.68 as this article went to press.

Exchange rate of the euro

Chart 2



1 According to ECB calculations against the currencies of 24 countries. — 2 Based on consumer prices.

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Price competitiveness dulled by euro's appreciation

The euro's exchange rate gains led to the currency's real appreciation as well. In the course of 2006 it appreciated by just under 4% in real terms against 24 major trading partners, leaving it 3% above its level at the launch of monetary union. Although the price competitiveness of euro-area suppliers thus worsened somewhat, this placed little strain on the region's exports on balance given the favourable state of the world economy.

More favourable conditions for adjusting the high current account imbalances

In the medium term, the shifts in exchange rate parities could also make the international adjustment processes easier. In any case, the conditions for adjusting the global current account imbalances without causing major tensions in the foreign exchange markets have improved (see page 70ff) as a result of the US dollar's depreciation, the relative shifts in the matrix of expansionary forces in the major industrialised economic areas and the fall in oil prices in the second half of 2006.

3 Favourable capital market developments

Positive global financial market setting

The international financial markets coped quite well with the strains resulting from the oil price rises, which continued well into the third quarter of 2006, the slowdown in US growth and the monetary policy tightening of some major central banks. Only in the early part of the year was there increased volatility for a time in some market segments. The overall robust state of the global economy and, towards the end of the third quarter, the first declines in oil prices for three years had a stabilising effect. Against this backdrop, the equity markets, in particular, were exceptionally buoyant and the conditions for borrowers in the capital market remained rather favourable, which, in turn, supported the upturn from the financing side.

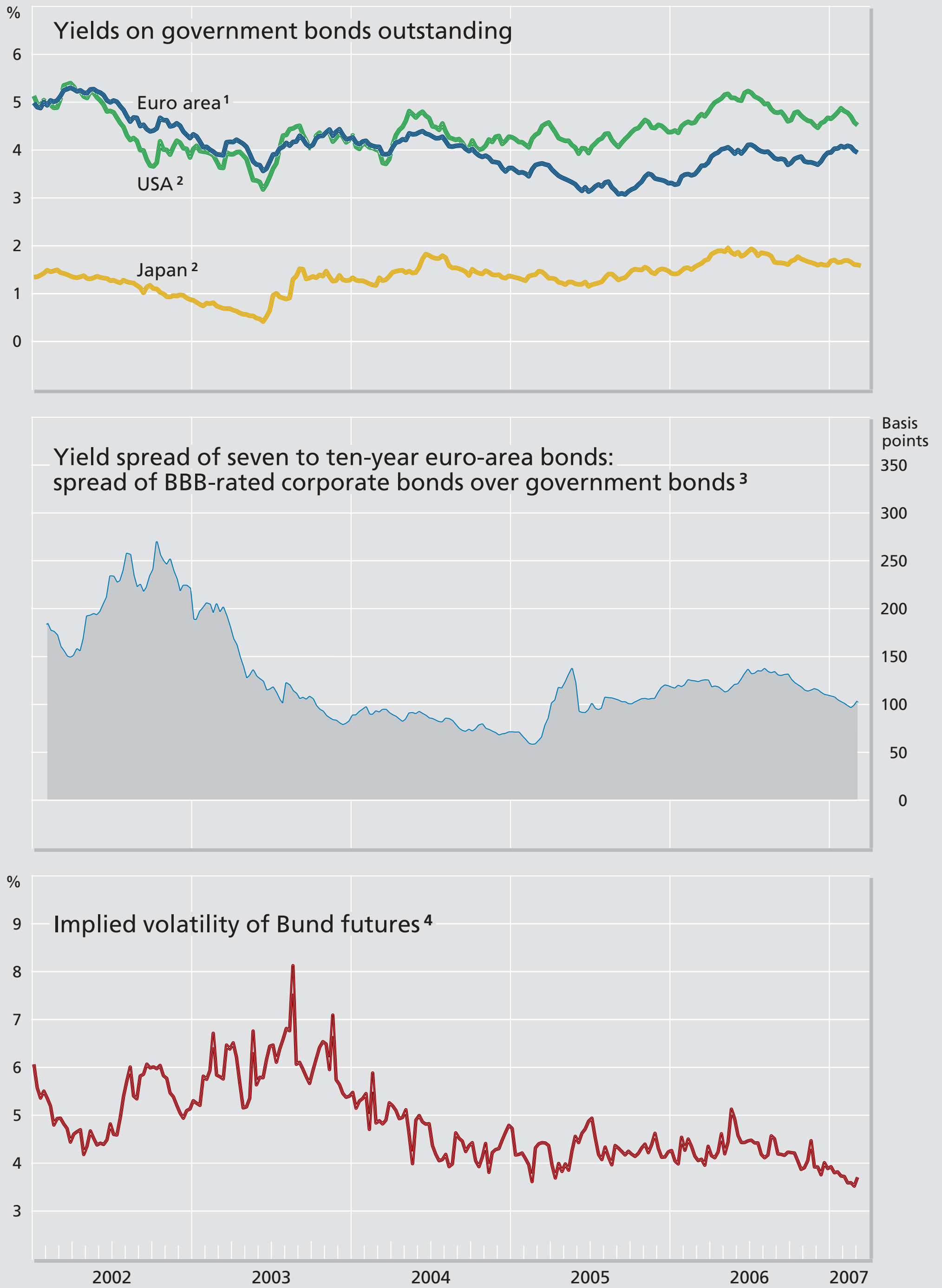
Higher long-term interest rates in the euro area

Over the course of the year, however, yields in the international bond markets increased slightly overall amid some fairly extensive fluctuations. Thus ten-year government bond yields in the euro area stood at around 4% at the end of 2006, which was ⅔ percentage point higher than at the beginning of the year. However, this was below the year's highs reached in early July. In other major currency areas yields rose well into the third quarter of 2006, mostly in unison. This was caused mainly by market participants' widespread optimism in the first few months of 2006 concerning the economic outlook and expectations of further monetary policy moves in major economies. Not until the second half of the year – when the prospects for growth in the United States clouded and the

Bond market

Chart 3

Bank 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, calculated from prices of options on Bund futures. Source: Bloomberg, and Bundesbank calculations.

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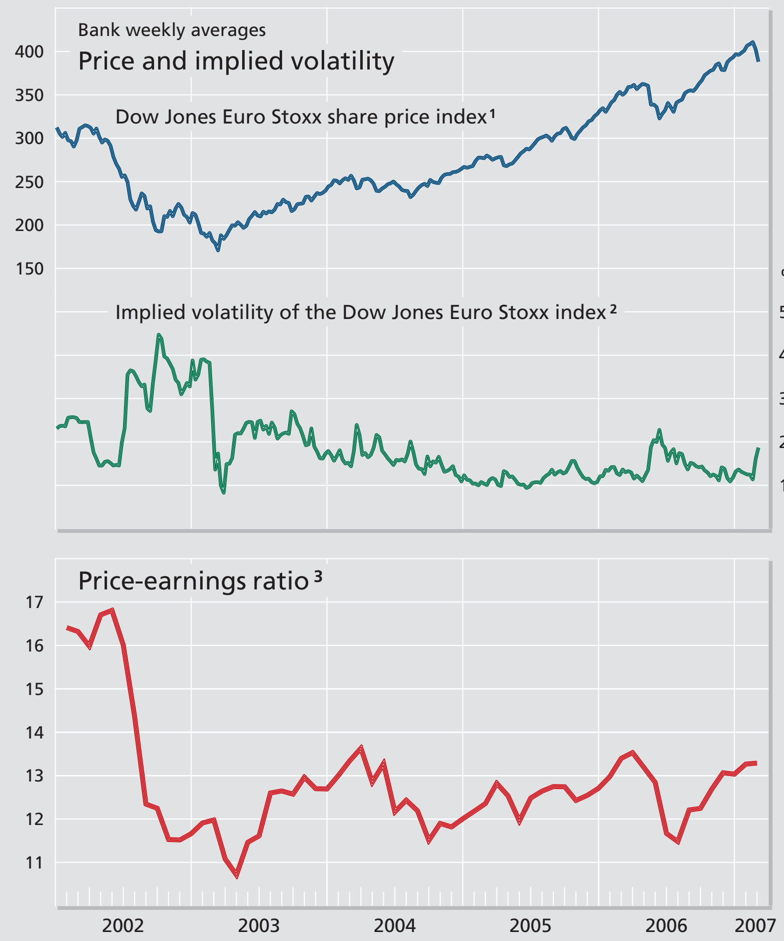
Equity market

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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Fed suspended its phase of monetary policy tightening – did the respective interest rate paths start to diverge, and the interest rate spread of long-term US bonds over comparable euro-area government bonds contracted to ¾ percentage point.

Favourable financing terms for enterprises

The fluctuations in the bond markets were mirrored only partly in the interest rate spreads for non-investment grade corporate bonds. Over the course of last year the interest rate spreads on BBB-rated bonds issued by European non-financial corporations remained within a comparatively narrow band. At the end of 2006, the spread amounted to 110 basis points, the lowest it had been all year, and close to the level at which it had stood immediately before the market turbulence in May and June, which expressed market participants' temporary uncertainty regarding the further course of cyclical development – particularly in the USA – and keener risk awareness. Subsequently, however, investors evidently again assessed the risk of investing in corporate bonds as fairly low. This assessment presumably owes much to the positive economic situation and corporate profit prospects, which are reflected, for example, in the expected earnings per share 12 months ahead. This outlook was continually revised upwards during 2006. Overall, the financing conditions for enterprises in the capital market thus remain favourable.

Equity markets in bullish mood

Firms' improved profitability and the ongoing upturn in the global economy also boosted the share prices of listed companies in many countries. Share prices were additionally buoyed by resurgent merger and acquisition activity. At the same time, uncertainty, which is frequently reflected in the equity markets in price mark-downs, was a significant factor only in May and June. For example, the measures of volatility, which had been driven significantly upwards as a result of the market turbulence towards the middle of the year, were again at an unusually low level at the end of the year. Overall, equity markets throughout the world were in very good shape in 2006, recording positive returns for the fourth year in a row. The German CDAX and the European Euro Stoxx were up 21½% and 20½%, respectively, close to their five-year highs, and the US S&P 500 index recorded its highest levels since November 2000 (+13½% in 2006). Only Japan's Nikkei index progressed more modestly, with a year-on-year rise of 7%, after making large gains in 2005. Share prices continued to rise at the beginning of 2007, although a sharp correction occurred at the end of February/beginning of March. All in all, however, capital market conditions are likely to continue providing positive stimuli for the global economic upturn.

II Economic and monetary developments and monetary policy decisions in the euro area

1 Fast pace of growth in the euro area

Stronger growth in euro area ...

The pace of growth in the euro-area growth picked up again noticeably in 2006. At 2½%, the increase in real GDP was the greatest since 2000. It was also the first time in this period that the expansion rate of potential output (which is probably between 2% and 2½%) was clearly overshot, resulting in a reduction in the negative output gap. Over the course of the year, economic activity in the euro area remained robust. The faster pace of expansion at the end of the year was, however, driven by various special factors, such as the anticipatory effects of the VAT increase in Germany and the positive impact of the mild winter weather on construction output. Growth differentials between the euro-area countries narrowed again somewhat in the year under review. The weighted standard deviation, for example, stood at 1 percentage point, having risen to 1¼ percentage points in 2005.

... and broader foundation of growth

In 2006, overall output growth in the euro area was driven primarily by domestic demand, which increased by 2¼%. The main reason for this was the significant rise in investment growth to 4½%, from 2½% in 2005. This, in turn, was due to both noticeably higher commercial investment and an acceleration in housing construction. Similarly, households' real consumption expenditure increased more sharply than in the previous year; at 1¾%, however, the increase was below that of GDP growth. As in previous years, foreign demand also generated major stimuli in 2006. Real exports, which in the euro-area national accounts include exports to other euro-area countries, rose by 8½% compared with 4¼% in 2005. However, the pace of growth in imports also picked up owing to the strong increase in exports and the marked upturn in domestic economic activity. The contribution to growth from foreign trade amounted to ¼ percentage point in 2006, having been slightly negative in the previous year.

Underlying cyclical trend still on clear upward course

All in all, the euro-area economies have made a positive start to 2007. The dip in growth emerging in the first quarter of 2007 can be attributed mainly to the dampening effect of the VAT increase in Germany and is likely to be rapidly overcome in the next few months. The ongoing favourable findings in surveys of enterprises and consumers are one indication of this. Furthermore, orders re-

Economic performance in the euro area Table 2

Country	Real GDP		Consumer prices 1		Unemployment rate 2	
	2005	2006	2005	2006	2005	2006
	Annual percentage change				As %	
Euro area	1.4	2.6	2.2	2.2	8.6	7.8
Germany	0.9	2.7	1.9	1.8	9.5	8.4
France	1.2	2.0	1.9	1.9	9.6	9.0
Italy	0.1	1.9	2.2	2.2	7.7	3 7.1
Spain	3.5	3.9	3.4	3.6	9.2	8.6
Netherlands	1.5	2.9	1.5	1.7	4.7	3.9
Belgium	1.1	3.1	2.5	2.3	8.4	8.3
Austria	2.0	3.2	2.1	1.7	5.2	4.8
Finland	2.9	5.5	0.8	1.3	8.4	7.7
Portugal	0.4	3 1.2	2.1	3.0	7.6	7.4
Greece	3.7	3 3.8	3.5	3.3	9.8	3 9.3
Ireland	5.5	3 5.3	2.1	2.7	4.3	4.4
Luxembourg	4.0	3 5.5	3.8	3.0	4.5	4.8

1 Harmonised Index of Consumer Prices (HICP) — **2** Standardised unemployment rate according to calculations by Eurostat (ILO definition). — **3** European Commission projections (Economic Forecasts, autumn 2006).

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ceived by industry were clearly still on an upward trend up to the end of the period under review.

Easing in labour market continues

The situation in the euro-area labour markets eased further in 2006. The number of unemployed persons declined steadily over the course of the year and, at a seasonally adjusted 11.1 million at the end of 2006, was around 1.3 million down on the year. On an annual average, the fall amounted to 1.1 million. In line with this, the standardised unemployment rate fell by 0.8 percentage point to 7.8%, which was scarcely any higher than at its last cyclical low in 2001. In the first three quarters of 2006, the number of persons in work in the euro area went up more sharply (1¼%) than in the previous four years. As well as the favourable macroeconomic situation, the continuing moderate trend in labour costs is also likely to have played a part in the sharp increase in employment. Euro-area labour-costs per hour worked rose by no more than 2¼% in 2006, compared with 2½% in the previous year.

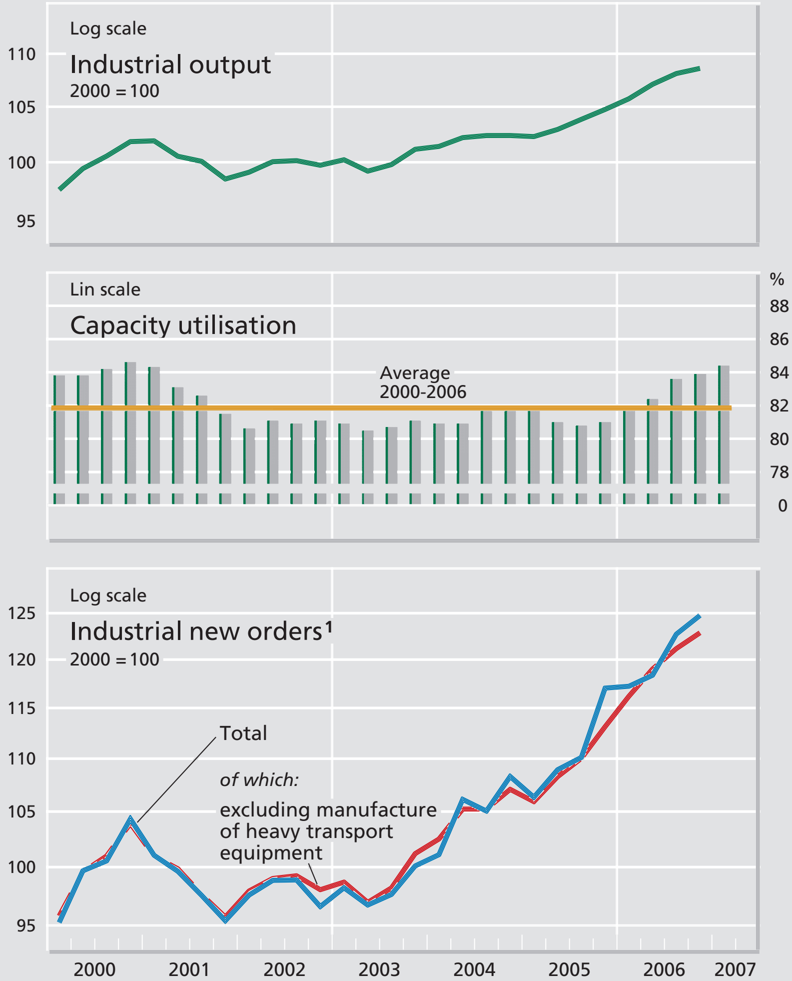
Inflation rate affected by volatile components

Nevertheless, consumer price inflation – measured by the Harmonised Index of Consumer Prices (HICP) – was somewhat higher than 2% for the seventh year in succession. A major contributory factor to this in the year under review was

Selected indicators of
industrial activity in the euro area

Chart 5

Seasonally adjusted, quarterly



1 Total manufacturing working on orders.

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the sharp rise in the prices of volatile components. Energy prices rose by an annual average of 7.7%, while unprocessed food prices went up by 2.8%. Among the other categories of goods, processed food prices showed the most significant increase (2.1%). In terms of the overall rate, the moderate decline in the year-on-year rate for services to 2.0% was offset by a slight increase in the inflation rate for industrial goods (excluding energy) to 0.6%. The sub-index excluding energy and unprocessed food went up by 1.5%, which was much the same as in 2005. In January and February 2007, the energy-price-related pressure on the HICP in the euro area eased as a result of the appreciation of the euro and thanks to markedly lower oil prices. Thus, despite the VAT increase in Germany, Consumer prices in the euro area

Chart 6

Year-on-year change, quarterly

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the year-on-year rate of increase in the HICP remained almost unchanged at 1.8%

Regional divergences in price developments unchanged

Measured by the weighted dispersion indicators, the regional pattern of price developments in the euro area in 2006 was almost unchanged from 2005. The divergence in national price trends remained moderate but did not narrow any further, although price developments in all the euro-area countries were affected in a similar way by the energy price shock, which continued into 2006. A striking factor was the almost unchanged ranking order of the national inflation rates. Certain countries, such as Germany, the Netherlands and Finland, have long been at the lower end of the range with rates below 2%. By contrast, the rate for Greece has been above 3% since 2001. Excluding the volatile components, the divergence in inflation rates was similar to what it had been at the launch of monetary union although greater than in the immediately preceding convergence period.

2 Monetary policy in the face of persistent price risks

Multiple interest rate increases ...

In the year under review, the Governing Council of the ECB pursued the tighter monetary policy stance which it had embarked on in December 2005 and raised the central bank rates six times by March 2007 by a total of 1½ percentage points. In the upshot, these measures led to a tightening of monetary policy last year with the expansionary stance gradually being reined in. However, a restrictive stance has not been adopted yet. The Eurosystem's key interest rates remained at a relatively low level. From 14 March 2007, the main refinancing operations will be conducted as variable rate tenders with a minimum bid rate of 3¾%; the interest rates for the marginal lending facility and the deposit facility will be 4¾% and 2¾%, respectively.

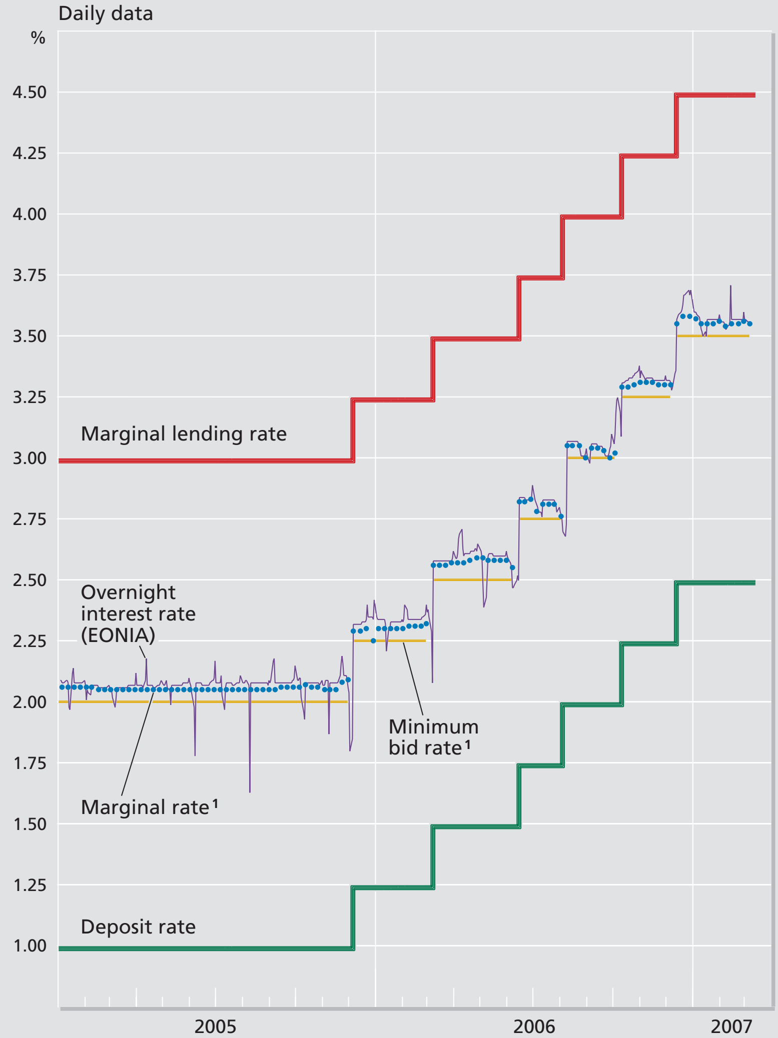
... in line with economic analysis ...

One factor implying the need to tighten the monetary policy stance was the economic analysis, which increasingly pointed to risks to price stability stemming from the growing momentum of economic activity and the positive development in the labour markets. This was all the more the case as the earlier oil price increases were passing through to consumer prices, and the price effects of the German VAT increase, which came into force at the start of 2007, were threatening to generate second-round effects.

Official interest rates and overnight interest rate

Chart 7

Daily data



1 Interest rate for main refinancing operations.

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... and the monetary analysis

Irrespective of this, after the protracted strong monetary growth in the last few years the monetary analysis was also indicating longer-term inflation risks. Driven by a broad-based and rising demand for credit in the private sector and owing to increasing inflows of funds from non-euro-area countries, the pace of monetary growth accelerated even further during 2006 and, at the end of the period under review, had reached a record rate of increase on the year (9.8%).

Further interest rate rises expected by the money market

To a large extent, the market had anticipated both the timing and the scale of the Eurosystem's interest rate steps. In the first half of the year, the three-month forward rates – which also reflect interest rate expectations – had incorporated

Money market operations

As in earlier years, most of the refinancing needs in the euro area in 2006 were covered by the weekly main refinancing operations (73% compared with 77% in 2005). Despite the fact that this instrument's share of total refinancing was somewhat down on the year, the amount outstanding still showed an increase (€307 billion on an annual average compared with €290 billion in 2005). In order to counter an undesirable widening of the spread between the minimum bid rate and the allotment rates of the operations, the benchmark volume was exceeded in the allotment in 43 out of 52 operations. The German share of the operations, which were conducted as American-style variable-rate tenders with a minimum bid rate, was around 51% on an annual average. Of the 377 bidders who participated in the main refinancing operations on average in 2006, roughly two-thirds were counterparties of the Bundesbank.

The money market was provided with the remaining 27% of the refinancing volume (amounting to €115 billion on an annual average) by means of 12 longer-term refinancing operations – conducted as American-style variable-rate tenders with no minimum bid rate. The German share averaged around 64%. In these operations, too, two-thirds of the bidders were German credit institutions, although the overall number of participants – 162 – was much lower in this case.

For 2007, the Governing Council of the ECB has decided to increase the envisaged allotment volume from €40 billion to €50 billion per longer-term refinancing operation in order to take account of the higher need for liquidity and to slightly increase the share of longer-term refinancing operations in the total volume.

Besides these regular open market operations, as before, fine-tuning operations were used in 2006 to offset liquidity imbalances at the end of reserve maintenance periods. A total of 11 fine-tuning operations were conducted, six of which withdrew liquidity from the market through the collection of fixed-term deposits and five of which provided liquidity through reverse transactions.

Owing to a precise assessment of future liquidity needs and assisted by the fine-tuning operations, use of the standing facilities in 2006 on an annual average (marginal lending facility: €126 million – of which Germany €82 million, deposit facility €157 million – of which Germany €80 million) remained low.

The counterparties may use both marketable and non-marketable assets as collateral for refinancing needs (and intraday credit in the context of settling payments). At the end of 2006, the outstanding volume of marketable eligible assets in the Eurosystem amounted to some €9,000 billion. Just under 30% of that sum was accounted for by assets listed or held in Germany.

The value of the eligible assets which counterparties deposited in collateral accounts at the Bundesbank showed a further year-on-year increase from €498 billion to €553 billion. That figure included €326 billion of assets held in other Eurosystem member states and used cross-border for refinancing purposes at the Bundesbank.

At the end of 2006, 44% of the eligible assets submitted to the Bundesbank as collateral were uncovered bank debt securities, 25% were covered bank debt securities (Pfandbriefe), and 17% were government bonds. Other marketable assets and lending to the private sector accounted for just over 14% of the collateral assets deposited at the Bundesbank.

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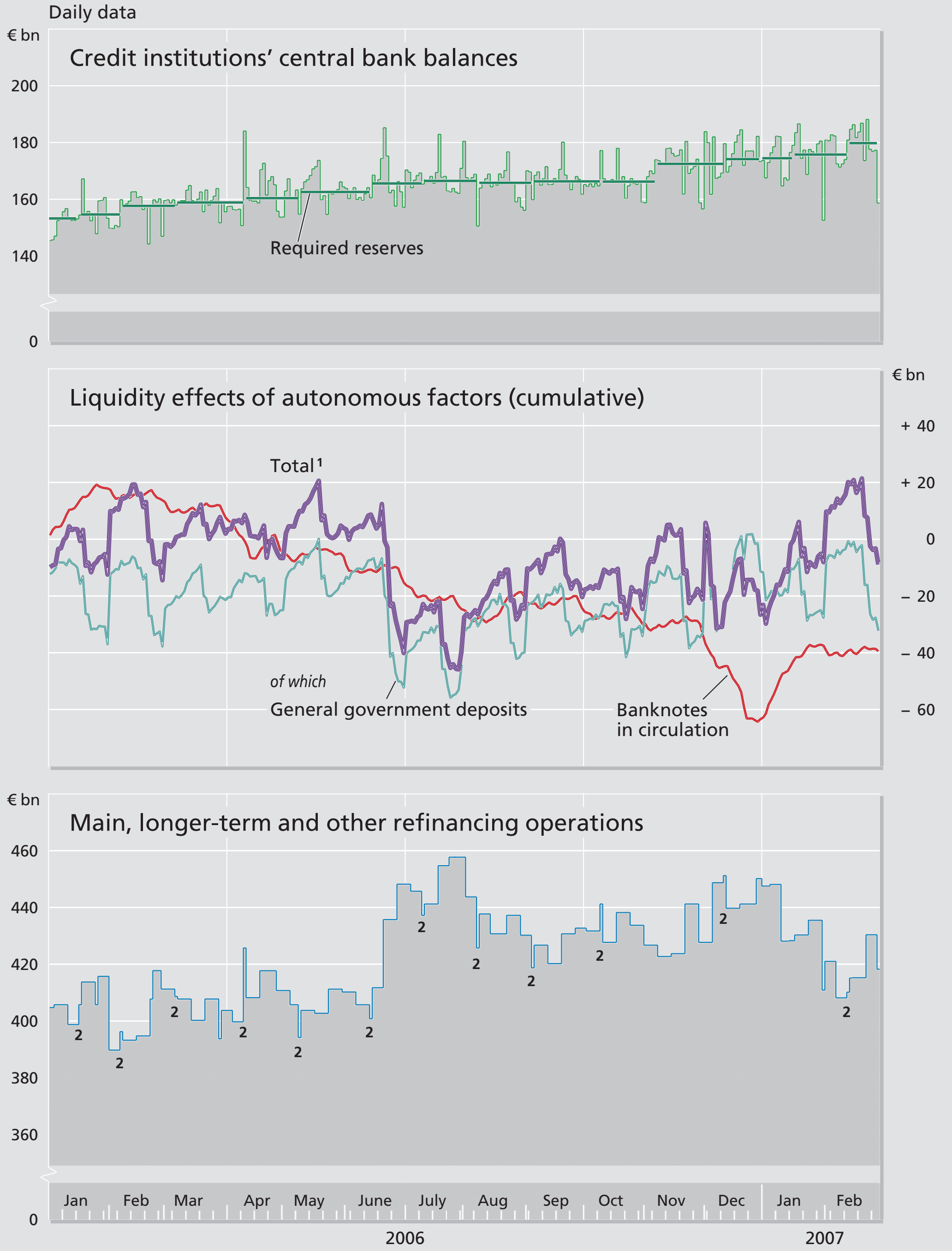
Liquidity management in the Eurosystem

Chart 8



1 Banknotes in circulation, general government deposits with the Eurosystem, net reserve assets of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances. — **2** Fine-tuning operations: liquidity-providing reverse transactions (RT) 17 January 2006: €7.0 billion; RT 7 February 2006: €6.5 billion; liquidity-absorbing collection of fixed-term deposits (FD) 7 March 2006: €2.6 billion; RT 11 April 2006: €26.0 billion; FD 9 May 2006: €11.5 billion; FD 14 June 2006: €4.9 billion; FD 11 July 2006: €8.5 billion; FD 8 August 2006: €18.0 billion; FD 5 September 2006: €11.5 billion; RT 10 October 2006: €9.5 billion; RT 12 December 2006: €2.5 billion; RT 13 February 2007: €2.0 billion.

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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 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.

Development of the factors determining bank liquidity

In 2006, money market management was faced with the task of refinancing a 12% increase in the credit institutions' liquidity needs stemming from the autonomous factors and the minimum reserve requirement, to an annual average of €421.6 billion. The autonomous factors went up by €27.8 billion (see table on page 35) largely owing to a €58.4 billion increase in the volume of euro banknotes in circulation. On 28 December 2006, the volume of euro banknotes in circulation reached a record high of €629.2 billion. At 11.3%, the growth rate remained strong in 2006, but was 4 percentage points lower than in the previous year. Liquidity needs arising from general government deposits with the Eurosystem declined slightly by €2.6 billion. In 2006, government deposits fluctuated within the usual broad band, ranging from €32.0 billion on 26 December to €89.7 billion on 25 July. At €12.1 billion, the volatility of government deposits measured in terms of the intraday standard deviation was almost the same as in the previous year. In 2006, the volatility of the autonomous factors as a whole was only somewhat higher at €14.2 billion. Once again, this emphasised the particular significance of government deposits for the Eurosystem's liquidity forecasts, on the basis of which the volume of the monetary policy operations is set. 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 (see chart on page 32). The development of the remaining autonomous factors, via which €28.0 billion flowed into the market, noticeably dampened the net rise in liquidity needs. This was largely the result of the Eurosystem significantly increasing its stock of euro-denominated securities on a market price basis by €46.6 billion.

In order to meet the increased demand for liquidity, the Eurosystem expanded its monetary policy operations by €45.0 billion. While 38% of this increase was achieved through larger main refinancing operations, 62% resulted from topping up the longer-term refinancing operations with a three-month maturity from €30.0 billion to €40.0 billion in the first few months of 2006. The average volume of the main refinancing operations in 2006 was €307.0 billion, which was €17.0 billion higher than in 2005. The increase of €10.0 billion per longer-term operation instead of €5.0 billion as in the previous year led to a shift in favour of longer-term refinancing operations: the average share of the longer-term refinancing operations in refinancing as a whole increased from about 23% in 2005 to 27% in 2006. Given that liquidity needs are expected to rise again in 2007 and with the intention of slightly raising the percentage of longer-term refinancing operations in the overall refinancing volume, the longer-term refinancing operations were each topped up from €40.0 billion to €50.0 billion starting with the operation of 1 February 2007. Thus, as of 29 March 2007, a total of €150.0 billion will be supplied via longer-term refinancing operations.

On an annual average, the credit institutions' central bank balances in 2006 were €17.2 billion up on the year, roughly reflecting the increase in the minimum reserve requirement. Owing to the substantial monetary expansion in the euro area, the reserve requirement grew at a faster rate from 7% in 2005 to 12% in 2006. The data available so far for the minimum reserve requirement in 2007 point towards a continuation of this expansion. In the January-February period, the reserve requirement, at €175.8 billion, was 14% above the previous year's figure.

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Money market management and liquidity needs (cont'd)

Fine-tuning policy

In the case of larger liquidity imbalances, the Eurosystem conducted fine-tuning operations on the last day of the respective reserve maintenance period. In 2006, 11 fine-tuning operations were conducted: five liquidity-providing operations and six liquidity-absorbing operations. The target liquidity adjustment volume ranged from €2.5 billion to €26.0 billion. On two occasions in the financial year 2006 (7 March and 14 June), the target volume for liquidity-absorbing fine-tuning operations was not achieved owing to insufficient bids. Market participants cited the allegedly insufficient remuneration at the minimum bid rate as one of the reasons for not participating in the absorbing fine-tuning operations. This came about on 7 March because the market rated the liquidity surplus lower than the Eurosystem did and the market interest rates exceeded the minimum bid rate at the time the fine-tuning operation was announced. However, it subsequently turned out that the interest rate of the fine-tuning operations would have been quite attractive, since EONIA at 2.08% was below the minimum bid rate of 2.25%. (See chart on page 30.) In the other liquidity-absorbing fine-tuning operations on 9 May, 11 July, 8 August and 5 September 2006, the target volume was fully allotted.

Last year's fine-tuning operations were successful in helping to create balanced liquidity conditions at the end of the reserve maintenance period and in stabilising the money market rates. This is documented, first, by the decline in the net recourse to the facilities at the end of the maintenance period from €1.6 billion in absolute terms in 2005 to €0.8 billion in the reporting year. Second, the occasional larger spikes in the EONIA spread (defined as the differential between EONIA and the minimum bid rate for main refinancing operations) declined significantly on the last day of the reserve maintenance period. In 2006, the differential vis-à-vis the minimum bid rate on the last day of the reserve maintenance period exceeded ten basis points only on three days, whereas this had occurred on seven days in 2005. The evolution of the standard deviation of daily changes in EONIA gives a similar picture. Compared with 2005, the average EONIA spread on the last day of the maintenance period had halved.[1]

Development of the EONIA spread

The EONIA spread fell from an average of seven basis points in 2005 to an average of six basis points in 2006. This development is likely to be also due to the ECB's generous liquidity policy. The ECB has been providing allotment amounts above the arithmetical benchmark[2] in main refinancing operations since as early as October 2005. The purpose was to contain the creeping increase of the EONIA spread. The increase in the allotment generally amounted to €1.0 billion, but was also €2.0 billion at times and up to €5.0 billion in the Christmas period and before the end of the year. A key factor in the perceptible reduction of the EONIA spread was that, from May 2006, the ECB also extended its generous allotment policy to the last main refinancing operation of the maintenance period. Between May and September, the EONIA spread was only four basis points. However, when the ECB switched back to the benchmark allotment between the end of September and the end of October 2006, the spread widened to as much as eight basis points in the following maintenance periods. At 19 basis points, the traditionally higher EONIA spread at the end of the year was comparatively low in 2006.

1 Comparison of the last day of the respective reserve maintenance period from 18 January to 5 December 2005 and 17 January to 12 December 2006. The standard deviation between EONIA and the minimum bid rate went down from 16 to 8 basis points. — **2** A benchmark allotment amount of a main refinancing operation (MRO) is the amount which ensures that the credit institutions will prospectively be able 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)

Impact of interest rate expectations on money market management

In the financial year 2006, market participants' expectations of impending interest rate moves by the Governing Council of the ECB had no noticeable effects on the overnight money market conditions within the maintenance period. Thus, the monetary policy framework in place since March 2004, which requires a strict separation of the conditions in the overnight money market in different maintenance periods, has proven to be effective, even against the backdrop of five interest rate hikes, each of 25 basis points, in 2006. Owing to the generous allotment policy, which, in May 2006, was also extended to the last main refinancing operation, the overnight interest rates were, in fact, often declining in the period from when the interest rate decision was taken to the time it came into effect, and they sometimes stood below the minimum bid rate. The rise in the overnight interest rates in early October 2006 up to 3.25%, and thus 25 basis points above the minimum bid rate, is unlikely to be due to expectations of higher interest rates, but rather to the ECB having temporarily halted its generous allotment policy and to the autonomous factors having been greater than expected.

All in all, the Eurosystem's money market management in 2006 once again proved reliable in implementing the ECB Governing Council's monetary policy stance in an eventful environment and ensured balanced conditions in the euro money market of the euro area. Slovenia's accession to the euro area went smoothly from the perspective of money market management.

Factors determining bank liquidity

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

Item	2005	2006
I Provision (+) or absorption (–) of central bank balances owing to changes in autonomous factors		
1 Banknotes in circulation (increase: –)	– 69.0	– 58.4
2 Government deposits with the Eurosystem (increase: –)	– 4.8	+ 2.6
3 Net foreign assets[1]	– 6.2	+ 32.4
4 Other factors[1]	+ 24.0	– 4.3
Total	– 56.0	– 27.8
II Monetary policy operations of the Eurosystem		
1 Open market operations		
(a) Main refinancing operations	+ 48.2	+ 17.2
(b) Longer-term refinancing operations	+ 17.4	+ 27.8
(c) Other operations	+ 0.0	+ 0.0
2 Standing facilities		
(a) Marginal lending facility	– 0.1	+ 0.0
(b) Deposit facility (increase: –)	+ 0.1	– 0.0
Total	+ 65.6	+ 45.0
III Change in credit institutions' credit balances (I + II)	+ 9.7	+ 17.2
IV Change in the minimum reserve requirement (increase: –)	– 9.9	– 17.3

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

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an increase in the overnight rate of up to ¾ percentage point (for transactions with a maturity of nine to 12 months). Between mid-September and early December, however, there was a marked temporary decline in interest rate expectations, probably owing to a brief period of economic pessimism. Since then, however, the market players have again been proceeding on the assumption that the Governing Council of the ECB will continue to tighten its monetary policy stance. On balance, the overnight interest rate (EONIA) last year remained close to the minimum bid rate on the main refinancing operations, partly thanks to the fine tuning operations conducted at the end of the reserve maintenance periods. Slovenia's accession to European monetary union at the start of 2007 has not had any significant impact on the overnight rate.

3 Acceleration in monetary growth accompanied by persistently strong lending

Strong demand for components remunerated at market rates

Among the components of the money stock, 2006 saw a sharp rise, above all, in the M3 components remunerated close to market rates. Alongside marketable instruments (repurchase agreements, money market fund shares and short-term bank debt securities), these included, in particular, short-term time deposits, which grew by more than one-quarter over the course of the year. Mainly households, but also non-financial corporations, other financial intermediaries and general government (excluding central government) made extensive deposits of this kind.

Moderate rise in liquid components

By contrast, growth in the most liquid components was comparatively moderate owing to the gradual increase in opportunity costs in the shape of rising market interest rates, especially in the short-term maturities range. Although there was a further double-digit rate of increase in cash holdings of 11.1% in 2006, the annual growth rate of overnight deposits declined to 5.8%, having been twice as high one year previously. As in the last episode of rising interest rates in 1999-2000, the interest rate hikes led relatively quickly to a marked deceleration in highly liquid money components, which in many cases yield only a low rate of remuneration. At the end of the period under review, there was also a perceptible slowdown in the growth of deposits redeemable with an agreed period of notice of up to three months, much as in the preceding interest rate cycle. On balance, short-term savings deposits increased by only 0.7%.

M3 growth in the euro area

Chart 9

Seasonally adjusted, year-on-year change

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Overall, further significant rise in loans to the private sector ...

Among the counterparts of M3, loans to the domestic private sector were once again by far the most significant source of money creation in the euro area. Unsecuritised lending to enterprises and households rose by 10.7% in the reporting year. Non-financial corporations, in particular, borrowed heavily from banks in the euro area, probably using a large amount of the funds to finance mergers and acquisitions. As in past years, there was strong demand from households for housing loans. At the end of the period under review, such loans from euro-area banks had risen at an annual rate of 9.5%, compared with 11.6% at the end of 2005. This was undoubtedly due, in part, to the persistently low level of interest rates, particularly in the case of longer maturities.

Net increase in banks' stocks of securities

As well as expanding their direct lending to enterprises and individuals, banks in the euro area also increased their investments in the securities markets in 2006. After adjustment for market prices, their holdings of domestic shares and other equities rose by 13.8%, compared with 7.6% in 2005. The banks also acquired large volumes of fixed-interest securities issued by domestic enterprises, with the result that their investment in this segment of the bond market alone rose by 19.5%. At the same time, however, they significantly scaled back their extensive holdings of government bonds. In net terms, the banks' direct and indirect

Monetary developments in the euro area

Table 3

Changes in the course of the year

Item	2005	2006
	as %	
I Growth of the monetary aggregates [1]		
M1 [2]	11.4	7.5
M2 [3]	8.5	9.4
M3 [4]	7.3	9.8
	€ bn	
II Money stock and its counterparts		
M3 (= 1 + 2 – 3 – 4 – 5)	495.5	702.6
Currency in circulation and overnight deposits	352.3	271.9
Other shorter-term bank deposits	137.8	312.1
Marketable instruments	5.4	118.6
Balance sheet counterparts		
1 Total credit to non-MFIs in the euro area	920.6	980.0
Credit to general government	89.0	– 114.0
Credit to private-sector non-MFIs in the euro area	831.5	1,094.0
2 Net claims on non-euro-area residents	0.5	195.2
3 Central government deposits	10.9	– 16.2
4 Longer-term financial liabilities to other non-MFIs in the euro area	404.2	419.4
5 Other counterparts of M3 [5]	10.5	69.4

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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provision of funds for the non-bank sector in the euro area rose by 8.2% last year.

Large inflows of funds from countries outside of the euro area

In 2006, foreign payment transactions also generated significant expansionary impulses for monetary growth. The banking system's net external assets position, which reflects the transactions of resident non-banks with non-euro-area counterparties, increased by €195.2 billion last year, following an increase of just €0.5 billion in 2005. In the light of rising interest rates in the euro area and a slight appreciation in the euro, demand for investments in the euro area was clearly stronger among non-residents, too.

Persistently high level of monetary capital formation

The sharp expansion in the lending business of euro-area banks in 2006 was, however, juxtaposed not only by a sharp rise in M3 but also by extensive monetary capital formation. The longer-term liabilities of domestic banks went up by 8.4%. As usual, bank debt securities accounted for the greatest part of this. Once again, however, there was also a sharp increase in longer-term time deposits (with an agreed maturity of more than two years). Even savings deposits with an agreed notice period of more than three months – which are not so significant in quantitative terms – rose sharply at an annual rate of 17.8% in the year under review after they had been scaled back in 2005.

III Economic trends in Germany

1 Economy stronger and more broadly based

Fastest growth since 2000

In cyclical terms, the German economy improved and gained momentum in 2006. Real GDP in 2006 was up by an average of 2.7% on the year. After adjustment for the varying number of working days, this represents an increase of just under 3%. Not only was this the most substantial growth in overall output since the year 2000, actual output also grew much more strongly than potential, with the result that capacity utilisation increased significantly. Against the backdrop of a vigorously expanding global economy, the external sector again made an important contribution to economic growth at just over 1 percentage point. Final domestic demand, however, made an even greater contribution to growth (1¾ percentage points) in 2006. This was attributable primarily to gross fixed capital formation, which has now become the second mainstay of economic activity.

Cyclical upturn increases in momentum

All in all, the economic upswing acquired increasing momentum. This was also reflected in the noticeable recovery in the labour market, which was the catalyst of the cyclical turnaround in 2006. At the same time, Germany cast off its international status as the economic straggler. Now, it is even generating considerable growth stimuli for the euro area. The price climate remained essentially favourable in 2006. Although during much of last year energy and raw materials put strong external upward pressure on prices, inflationary pressures from the domestic market remained relatively weak. Germany therefore remains one of the euro-area countries with the highest degree of price stability.

Key economic variables in Germany

Table 4

Annual percentage change

Item	2003	2004	2005	2006
Growth (real) 1				
Private consumption	– 0.1	+ 0.1	+ 0.1	+ 0.8
Government consumption	+ 0.4	– 1.3	+ 0.6	+ 1.8
Machinery and equipment	– 0.1	+ 4.2	+ 6.1	+ 7.3
Premises	– 1.6	– 3.8	– 3.6	+ 4.2
Other investment	+ 2.5	+ 1.2	+ 4.7	+ 5.9
Domestic use	+ 0.6	+ 0.0	+ 0.5	+ 1.6
Exports 2	+ 2.4	+ 9.6	+ 6.9	+ 12.5
Imports 2	+ 5.4	+ 6.9	+ 6.5	+ 11.1
Gross domestic product	– 0.2	+ 1.2	+ 0.9	+ 2.7
Contribution to GDP growth in percentage points				
Domestic use (excluding stocks)	– 0.1	– 0.3	+ 0.3	+ 1.7
Changes in inventories	+ 0.7	+ 0.3	+ 0.2	– 0.2
Net exports	– 0.8	+ 1.2	+ 0.4	+ 1.1
Employment				
Employed 3	– 1.0	+ 0.4	– 0.1	+ 0.7
Average working time per employed person	– 0.4	+ 0.2	– 0.3	– 0.1
Total number of hours worked	– 1.4	+ 0.6	– 0.4	+ 0.6
Unemployed (in thousands) 4	4,377	4,381	4,861	4,487
Western Germany	2,753	2,783	3,247	3,007
Eastern Germany	1,624	1,599	1,614	1,480
as a percentage of the civilian labour force	10.5	10.5	11.7	10.8
Western Germany	8.4	8.5	9.9	9.1
Eastern Germany	18.5	18.4	18.7	17.3
Prices				
Consumer prices	+ 1.1	+ 1.6	+ 2.0	+ 1.7
Producer prices of industrial products 5	+ 1.7	+ 1.6	+ 4.6	+ 5.5
Construction prices 6	+ 0.1	+ 1.1	+ 1.3	+ 2.5
Import prices	– 2.2	+ 1.0	+ 4.3	+ 5.2
Export prices	– 0.2	+ 0.5	+ 1.3	+ 2.3
Terms of Trade	+ 2.0	– 0.6	– 2.9	– 2.7
GDP deflator	+ 1.0	+ 0.9	+ 0.6	+ 0.3
Productivity and labour costs				
GDP per hour worked by employed persons 1	+ 1.2	+ 0.7	+ 1.3	+ 2.0
Compensation per hour worked by employees 3	+ 2.0	+ 0.2	+ 0.4	+ 0.8
Labour costs per unit of value added in real terms in the economy as a whole 7	+ 0.7	– 0.5	– 0.9	– 1.2

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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More balanced demand profile

Now that the buoyant momentum that has been characterising exports has clearly spread to domestic demand, Germany is once again in its traditional business cycle pattern. In line with this pattern, the expansionary impulses tend to be generated by exports at the beginning of an upswing, before being translated into a sharp rise in investment at a later stage. There tends to be a shift in investment motives as well. Nevertheless, a continued transmission of expansionary impulses to private consumption is required if a sustained upswing is to be achieved. Although private consumption emerged from its period of stagnation of the past few years, it was still rather subdued in 2006 on the whole.

Strong growth in exports

German exports of goods and services made a significant contribution to overall economic growth in 2006 as well. In real terms, they grew by 12½% and thus even more sharply than in the previous two years. The sharp rise in exports in 2006 was attributable primarily to growth in the export markets. Furthermore, Germany's cost and price situation again showed a year-on-year improvement over that of its most important trading partners on average in 2006. All in all, German exporters significantly improved their market position both within the euro area and elsewhere.

Positive stimuli from FIFA World Cup

Furthermore, the additional revenue generated from cross-border travel in the second and third quarters of 2006 owing to the FIFA World Cup contributed to the growth in exports of services. This resulted, in particular, from spending on overnight stays and other consumption by foreign visitors to the World Cup in Germany and included purchases of tickets for the individual football matches and expenditure on journeys within Germany.[1] The overall effect of the 2006 World Cup on Germany's revenue from cross-border services, which was essentially spread between May and July, totalled just under €1½ billion. In total, however, the World Cup effect made only a marginal contribution to overall GDP growth in 2006.

Imports driven by domestic demand

In 2006, the year-on-year increase of 11% in real imports of goods and services was almost as strong as that of exports. This is due, firstly, to the fact that the proportion of imported intermediate goods used in the production of export goods is relatively high and this trend tends to be on the increase. Secondly, foreign manufacturers benefited from the stronger growth in German domestic demand in 2006. Despite the sharp rise in domestic output, Germany's net energy imports were down only slightly on the year in 2006 in quantative terms.

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1 See also Deutsche Bundesbank, The World Cup effect on travel receipts in Germany, Monthly Report, November 2006, p 43.

At current prices, the annual increase amounted to just under one-quarter, which was due to a significant average annual rise in energy costs. The overall decline in purchasing power associated with the price increase for energy imports amounted to €12 billion in 2006 and thus ½% of GDP.

Incentive to expand capacity for machinery and equipment more significant

Alongside foreign trade, domestic demand gained considerable momentum in 2006. Against the backdrop of very buoyant exports and the positive sentiment in many sectors of the economy, gross fixed capital formation, in particular, was clearly on an upward path. At 5½% for the year 2006, it recorded its strongest level of growth since German reunification. Real investment in machinery and equipment has tended to be on the increase since the second quarter of 2004. It grew by 7¼% in the year under review and thus faster than at any time since 2000. The restructuring in the area of output and sales that has been underway over the past few years also paved the way for this; so did the generally positive development in corporate earnings, the consistently favourable financing terms and the abundant supply of liquidity. The need for replacement investment also remained high, although, according to the Ifo Investment Test, not quite as high as in 2004. Rationalisation has diminished in significance over the past few years as well. Furthermore, according to the survey carried out by the German Chamber of Industry and Commerce in the fourth quarter of 2006, replacement purchases still remain the most significant investment motive in absolute terms. There was a particularly sharp increase in the number of enterprises wishing to expand their capacities. This applies, in particular, to industrial and construction enterprises. Investment in other products, which primarily includes bought-in software and software produced in-house, also remained on an upward trend.

Turnaround in construction investment

The upturn in investment in non-financial assets was boosted by the turnaround in construction activity, which showed an increase for the first time since 1999. It went up by 4¼% after decreasing by 3½% in 2005. There are several factors to suggest that the downward trend in construction investment, which had persisted for several years, has now come to an end. The increasingly important role of investment in capacity extensions for machinery and equipment contributed to the marked improvement in commercial construction in 2006. Residential construction grew for the first time since 1999, a development which was attributable to several factors. First, there was a shortage of housing in some conurbations in Germany. Second, interest rates were comparatively low. Third, residential construction received stimuli from the CO_2 Building Renovation Programme. The construction industry also benefited from the tax deductions for handicraft services for renovation, maintenance and modernisation measures in

2006. The abolition of grants to homebuyers at the start of 2006 also had an impact on residential construction. For example, there was a sharp rise in the number of construction permits at the end of 2005, which were then translated into construction orders and output during 2006. There was also a rise in demand for construction services in an effort to avoid the rise in VAT as of 1 January 2007. These residential construction projects that were brought forward are also likely to be missing from the figures in 2007.

Slight growth in private consumption but still no momentum

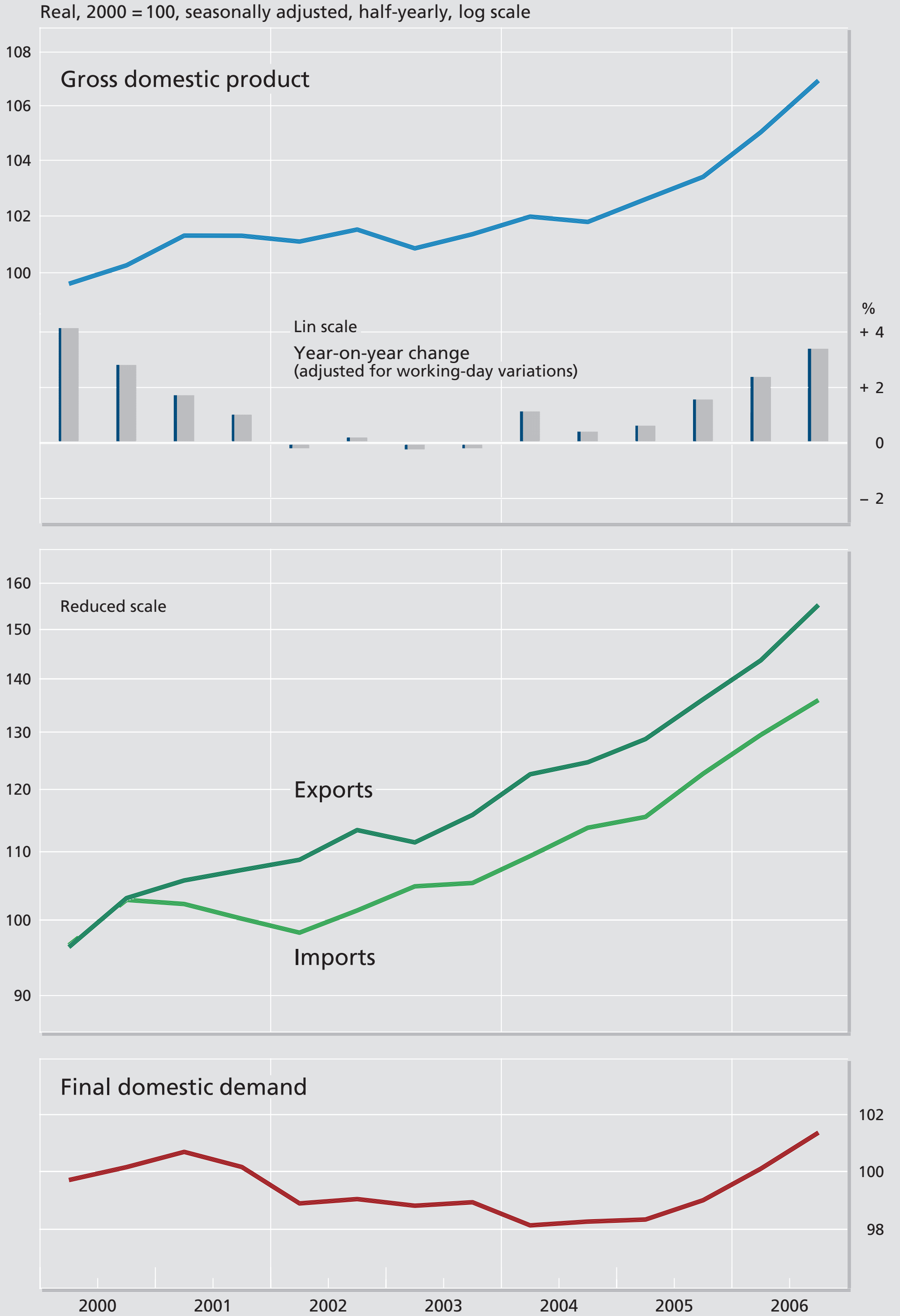
Private consumption expenditure broke away somewhat from the sideways movement experienced over the previous few years. On average in 2006, it was ¾% up on the average of 2005. Quarter-on-quarter volatility was fairly high. This slightly improved picture is consistent with the fact that the households' saving ratio, which had increased by almost 1½ percentage points to 10.6% between 2000 and 2005, was marginally down on 2005 during the year under review. Given the improved labour market conditions, the motive of insecurity could have become less significant. Anticipatory effects in connection with the rise in VAT also played a role. This was particularly the case for purchases of consumer durables. In 2006, they were 3½% higher than the average for 2005. Retail sales of furniture and household articles grew significantly in the fourth quarter in seasonally adjusted terms. Sales of electrical household appliances and of radios and television sets have been showing an upward trend since the third quarter of 2005. New car registrations by households recorded a very sharp rise in November and December.

Rise in employment

The economic recovery reached the labour market last year. Both employment and unemployment were increasingly influenced by the improving macroeconomic situation. By contrast, labour market policy measures became less significant. According to the calculations of the Federal Statistical Office, 39.11 million persons were in gainful employment in Germany on average in 2006. This was 280,000, or 0.7%, more than in the previous year. This growth was supported essentially by the greater number of employees subject to social security contributions (+0.5%). Along with the favourable economic climate, the increase in the flat-rate charges for mini jobs which entered into force in the middle of the year is also likely to have contributed to this growth as this form of employment is likely to have become less attractive when compared with jobs that are subject to full social security contributions. The average number of hours worked by both full-time and part-time employees went up last year. This was due partly to the fact that there was a cyclically induced increase in the number of overtime hours and working time accounts were also replenished. There was also a fur-

Gross domestic product and
selected expenditure components

Chart 10



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ther decline in the sickness ratio. However, as the employment structure continued to shift towards part-time employment, despite the partial containment of low-paid part-time employment, there was virtually no change in the average number of working hours across all occupations. The total number of hours worked, at +0.6%, therefore grew at a similar pace to that of employment. The sharp rise in the number of vacancies registered at the labour exchanges for jobs not promoted by labour market policy measures (+25.3%) is also an indication of the cyclical improvement in the labour market. With just under 600,000 vacancies on an average for 2006, labour shortages were already beginning to show in certain areas. At sectoral level, it was the services sector that contributed most to the growth in employment (+1.3%). The reduction in the number of employees in the production sector (excluding construction) slowed down considerably (-1.0%), and it more or less came to a standstill in the construction sector (-0.4%). As there was particularly strong growth in employment in the area of labour leasing, which is allocated entirely to the services sector, employment developments in the tertiary sector are being somewhat overstated and therefore understated in the secondary sector. The number of persons working in positions promoted by the Federal Employment Agency fell slightly in 2006. There was a shift away from job creation measures and the promotion of self-employment towards reintegration grants and employment opportunities (one-euro jobs).

Decline in unemployment

The decline in the number of persons officially registered as unemployed accelerated in the course of 2006. Whereas the decline in the number of unemployed persons following the inclusion of persons receiving social assistance although able to work in the statistics at the beginning of 2005 was initially due largely to labour market policy measures, it was the rising demand for labour that was the predominant factor in 2006. There was an average of 4.49 million persons registered as looking for work in 2006. This was 375,000 fewer than in the previous year. The official unemployment rate went down from 11.7% to 10.8%. This decline in unemployment was attributable to the increase in employment and to demographic effects. The average size of the labour force declined by 180,000 on the year. The decline in unemployment continued at a rapid rate at the beginning of 2007, a development which was supported by the favourable economic situation and the mild weather, as well as by the new seasonal short-time working benefits in the construction sector.

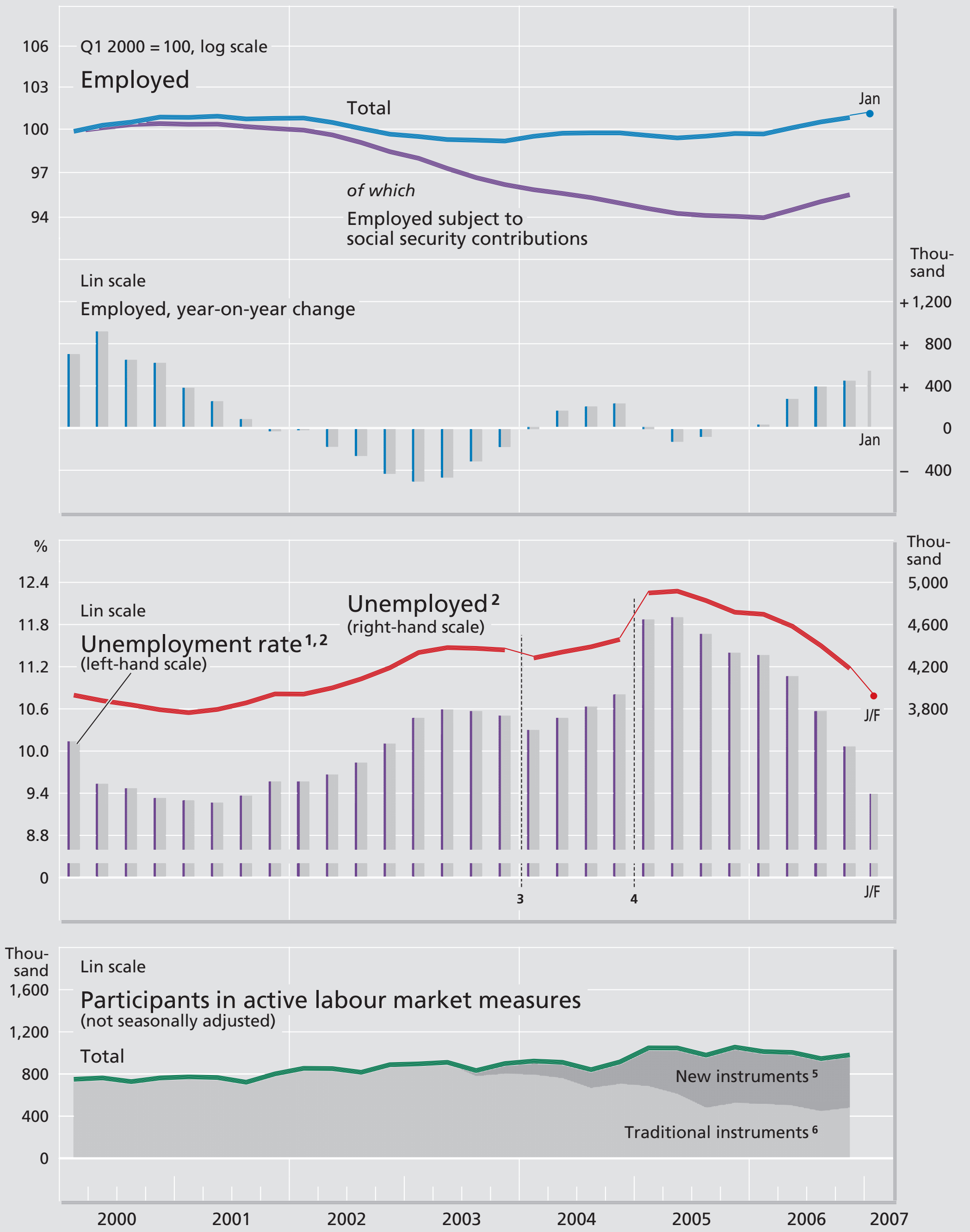
Labour market policy put to test

Despite the recovery in economic activity, the unemployment rate in Germany is still unacceptably high, and it is unlikely that economic growth alone will be

Labour market

Chart 11

Quarterly, seasonally adjusted



1 Unemployed as a percentage of the civil labour force. — 2 As defined by the Federal Employment Agency. — 3 From January 2004, unemployed excluding participants in aptitude testing and training schemes. — 4 Increase influenced by inclusion of persons receiving social assistance who are able to work. — 5 Personal Service Agencies (PSAs), government-assisted one-person businesses, business start-up grants, employment opportunities (one-euro jobs). — 6 Job creation measures and structural adjustment measures, promotion of further vocational training excluding the intergration of disabled persons, reintegration grants, bridging payments for self-employed persons, short-time workers.

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able to resolve the problems of the German labour market. Although the reforms of the past few years have made a significant step towards reducing the structural problems (deregulation of subcontracted work, reduction in the maximum period of entitlement to unemployment benefit I, transformation of income-related unemployment assistance into the new standardised unemployment benefit II), further labour market reforms are still required to improve the incentive structures and to strengthen the flexibility of labour utilisation.[1]

Wage developments moderate overall

On the whole, the modest wage developments witnessed over the past few years continued in 2006. On an annual average, negotiated rates of pay went up by 1.3% on a monthly basis and by 1.1% on an hourly basis. The discontinuation of special payments and the extension of weekly working hours *inter alia* contributed to this moderate increase, especially in the public sector. Given the primary objective of securing jobs and ensuring the future viability of production sites, however, even standard monthly wages had to be carefully adjusted in most sectors as well. One-off payments were also offered in addition to regular remuneration – the amount of these payments being dependent on the economic situation of the individual enterprises. Pay agreements in the metal, steel and chemical industries, which benefited particularly well from the economic developments, were above average. Whereas wage agreements in recent years were often made on a longer-term basis, the duration of new wage agreements concluded in 2006 declined considerably. The increase in effective wages was again lower than that of negotiated wage agreements. Firstly, there was a continued reduction in non-core payments. Secondly, liberalisation clauses were used. Actual earnings per employee and company-relevant labour costs increased by ¾%. Combined with the further improvement in labour productivity, this led to a further 1¼% fall in unit labour costs.

Strong external upward pressure on prices

Price developments in Germany were driven largely by external factors in 2006. Despite the appreciation of the euro, the sharp rise in crude oil prices was reflected in higher import prices, producer prices and consumer prices of energy. As a result, there was also a rise in the cost of production of energy-intensive goods and services. The price of metals and metal ores continued to rise in the international commodity markets. Overall, import prices rose by 5.2% last year, and the price of domestic industrial products went up by 5.5%. If energy and metals are excluded, the price of imports rose by 0.4%, and by 1.5% in the case of domestic products (excluding tobacco products). The sharp rise in com-

1 See also Deutsche Bundesbank, The labour market in Germany: general developments seen in an international context, Monthly Report, January 2007, pp 31-51.

modity prices also affected construction prices, the rise in which was twice as high as in the previous year (2.5%). However, the more favourable sectoral conditions are likely to have played a role in this. The price of German agricultural products went up by just over 8%, which was due primarily to weather-related factors.

Consumer price rises subdued on the whole

At +1.7%, according to the national consumer price index (CPI), consumer prices in Germany, however, did not rise quite as sharply as on an average of the previous year when they had increased by 2.0%.[1] The reason why the loss of purchasing power was not higher on an annual average was due largely to the reversal in oil price developments in August. If the volatile components of energy and unprocessed food are excluded, the price increase accelerated somewhat during the rest of the year. Anticipatory effects in connection with the rise in VAT which came into effect on 1 January 2007 also played a role in this. The price of tobacco products, in particular, had been increased by almost 5% as early as 1 October.

Perceptible VAT effect at beginning of 2007

At the beginning of 2007, seasonally adjusted consumer prices in Germany rose quite sharply on the whole (+0.5%) despite the considerable fall in oil prices. The prices of industrial products did not fall as they had done in the previous two years, and the decline in the prices of services was weaker. The year-on-year increase in the national consumer price index went up from 1.4% to 1.6%, and the HICP, which is more heavily affected by the rise in VAT owing to the lower weighting of tax-exempt housing, went up from 1.4% to 1.8%. Preliminary estimates suggest that the rise in VAT could have contributed just under 0.7 percentage point to the change in HICP from the previous month and up to as much as 1 percentage point to its increase on the year. The tax change had somewhat less effect in the case of the national CPI. The effects of the increase in VAT were therefore rather perceptible for consumers in January 2007, although they would have been much greater if the VAT increase had been passed on to customers in full from 1 January 2007. Additional price adjustments are expected in the course of 2007.

Little change in house prices

According to Bundesbank calculations, which are based on data provided by BulwienGesa AG, there was a slight rise in prices for new residential property. The relatively sharp rise in construction prices in the past year is likely to have

1 The Harmonised Index of Consumer Prices (HICP) indicates only a slight decline in consumer price inflation to +1.8%, compared with +1.9 % in the previous year.

Prices at various levels of the economy

Table 5

Annual percentage change

Item	2005 Q4	2006 Q1	Q2	Q3	Q4
Import prices	5.5	6.2	6.7	5.2	2.7
Energy	41.0	41.1	34.4	15.6	2.1
Metal ores	54.6	40.8	20.3	20.7	13.4
Basic metals and semi-finished products	8.5	11.9	22.1	28.9	27.3
Other	– 0.2	0.3	0.4	0.7	0.2
Industrial producer prices	5.0	5.8	6.1	5.7	4.6
Tobacco	14.9	7.2	7.2	4.7	2.7
Energy	17.7	22.1	19.2	14.1	9.6
Basic metals and semi-finished products	4.6	4.6	11.6	17.7	16.3
Other	0.8	0.7	1.4	1.9	2.1
Construction prices	1.0	1.2	1.9	3.1	4.0
Residential buildings	0.6	0.9	1.5	2.7	3.6
Industrial and office buildings	1.4	1.2	1.7	3.0	3.9
Road construction	1.2	2.3	3.4	5.0	4.9
Agricultural producer prices	2.0	4.3	8.0	10.4	10.0
Vegetable products	6.0	9.5	14.3	18.8	23.0
Animal products	– 0.6	0.9	3.8	5.0	1.4
Consumer prices	2.2	2.0	2.0	1.6	1.3
Energy	12.9	14.0	12.8	6.2	1.8
of which					
Refined petroleum products	14.3	15.5	13.8	3.0	– 4.1
Gas	15.2	19.1	19.7	17.5	14.6
Electricity	4.2	4.0	3.8	3.9	4.0
Tobacco	13.4	6.0	6.0	3.9	4.8
Meat	0.1	0.3	0.6	1.4	2.1
Vegetables	– 0.1	1.8	6.3	12.7	12.9
Fruit	4.5	2.9	– 1.2	4.0	4.0
Other	0.9	0.6	0.7	0.8	1.0
of which					
Services	1.5	1.0	1.0	1.0	1.0
Housing rents	0.9	1.0	1.0	1.0	1.1

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played a role in this. Residential construction prices increased by 2.2%. The cost of older housing remained virtually unchanged.

2 Public finance situation and outlook brightens

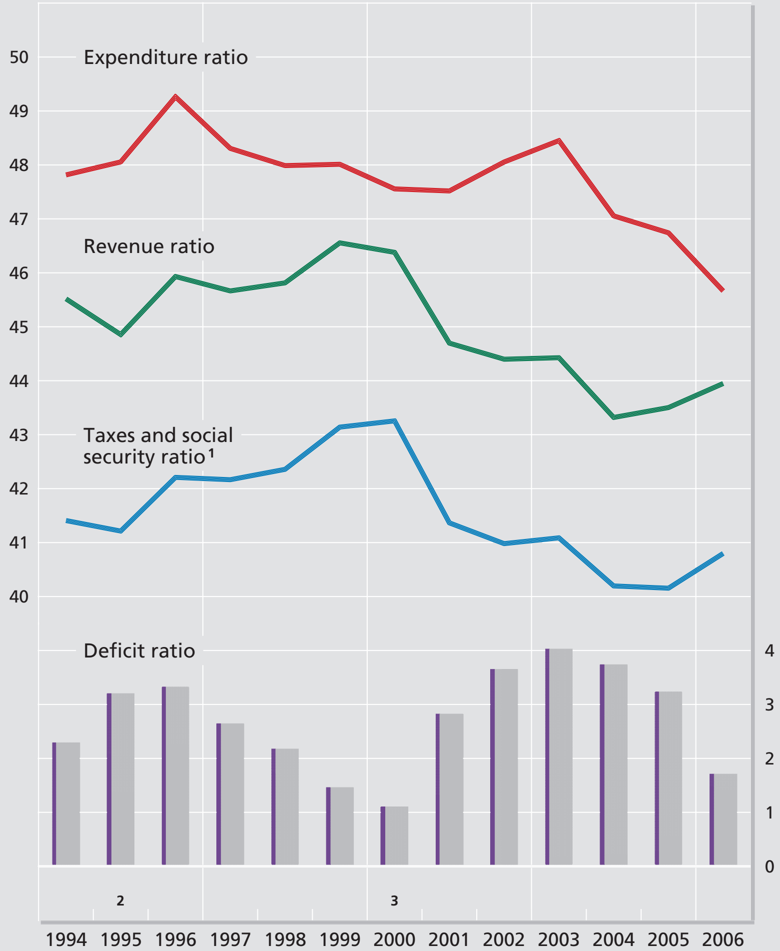
Maastricht deficit ceiling met for the first time since 2001

The public finance situation in Germany improved last year and turned out far better than had been expected at the start of 2006. The general government deficit ratio declined to 1.7%, thus staying below the 3% ceiling laid down by the EC Treaty for the first time since 2001. Alongside the fact that expenditure

General government fiscal ratios*

Chart 12

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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growth was, on balance, moderate, this was due mainly to the unexpectedly strong economic recovery and the exceptionally large jump in revenue from the highly volatile profit-related taxes. Revenue from taxes was more than €30 billion – or almost 1½% of GDP – greater than had been predicted in the tax estimate in the fourth quarter of 2005, with 1% of GDP being attributable to profit-related taxes alone.

Debt ratio unchanged

In 2006, government debt rose to roughly €1.57 trillion. Thus, despite the significant decline in the deficit ratio and the relatively sharp nominal economic growth, the debt-to-GDP ratio merely stabilised at just under 68%. This means

General government as defined in the national accounts * Table 6

Item	2004	2005	2006 pe	2004	2005	2006 pe
				Year-on-year change		
	€ billion			as %		
Expenditure	1,039.6	1,048.5	1,054.6	– 0.8	0.9	0.6
of which						
Social benefits	592.8	597.7	600.9	– 0.2	0.8	0.5
Compensation of employees	169.4	167.5	167.5	0.3	– 1.1	– 0.0
Interest	62.5	62.0	64.9	– 2.5	– 0.8	4.7
Gross capital formation	31.4	30.2	32.5	– 7.0	– 3.8	7.4
Memo item						
Old-age provision 1	288.7	288.7	290.3	0.5	0.0	0.5
Healthcare 2	143.4	147.6	151.5	– 3.5	2.9	2.6
Revenue	957.1	975.9	1,015.0	– 0.4	2.0	4.0
of which						
Taxes	481.2	493.0	530.2	– 0.1	2.4	7.5
Social contributions	396.7	397.0	401.0	0.2	0.1	1.0
				€ billion		
Balance	– 82.5	– 72.6	– 39.5	4.5	9.9	33.1
Memo item						
As defined in the Maastricht Treaty				as %		
Debt level	1,451.1	1,521.6	1,567	5.1	4.9	3.0
	as % of GDP			in percentage points		
Debt ratio	65.7	67.9	67.9	1.8	2.2	0.0
Deficit 3	3.7	3.2	1,7	– 0.3	– 0.5	– 1.5

***** 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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that Germany is still failing to achieve the reference value for indebtedness. The EC Treaty provides for an exception only in the event that the debt ratio is diminishing sufficiently and approaching the reference value at a satisfactory pace.

Only moderate rise in revenue ratio despite steep rise in tax receipts

Last year saw a modest rise in government revenue to 44% of GDP. As the growth in gross wages and salaries was only moderate and accompanied by unchanged contribution rates, social contributions increased far less than nominal GDP.[1] Moreover, other revenue actually declined. However, at 7½%, growth in tax receipts had not been so strong since 1999 and 1992. The main reason for this was the sharp increase (+26%) in profit-related taxes, which are by nature highly volatile and which benefited from the positive trend in earnings. There was also a significant rise of 5% in VAT receipts. This is probably related, in part, to certain anticipatory effects in connection with the increase in the standard rate of VAT at the start of 2007 and to the decline in insolvency-related tax

1 Excluding one-off receipts in connection with bringing forward the transfer deadlines that are not recorded as additional revenue in the national accounts owing to the application of the accruals principle of accounting.

Chronology of general economic and fiscal policy measures

1 January 2006
Several new economic and fiscal policy regulations enter into force: in particular, the grant to new homebuyers, the tax-free status of settlements as well as the special allowance for private tax consultancy fees are abolished and the offsetting of losses in connection with tax deferral models is limited. Most employers are now obliged to transfer social security contributions for their employees just over two weeks earlier than before. Also, the regulation allowing people over the age of 58 to draw employment substitution benefits without being available for work is extended again to the end of 2007.

25 January 2006
In its Annual Economic Report, the Federal Government forecasts real GDP growth of 1.4% in 2006 following 0.9% last year. Domestic demand, in particular, is expected to increase, on the assumption of stronger impulses from investment in machinery and equipment and a halt in the downward trend in the construction industry. Owing to more favourable economic developments, the situation on the labour market is expected to improve, leading to an average annual reduction in the unemployment level of around 350,000. The number of people in employment may pick up somewhat during the year.

16 February 2006
Following a decision in the Financial Planning Council, central, state and local government will endeavour to curb the rise in expenditure to an annual average of 1% from 2007 to 2009.

20 February 2006
As a precautionary measure against possible cash supply shortages, the Bundesbank extends its counters' opening hours temporarily and also opens its branches and operating units on Saturday, 25 February 2006, after embezzlement at a cash-in-transit company comes to light.

22 February 2006
The Federal Cabinet adopts the draft Federal budget for 2006 and medium-term financial plan until 2009. Net borrowing in 2006, at €38½ billion, is expected to exceed total investment expenditure by €15 billion. A return to compliance

with the borrowing limit stipulated in Article 115 of the Basic Law is planned for the following years, not, however, without the help of the realisation of central government assets. In addition, the updated stability programme is adopted. It envisages a deficit ratio of 3.3% in 2006. The 3% reference value is not to be undershot before 2007, when the ratio is to be 2½%.

3 March 2006
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by 0.25 percentage point to 2.50%, starting from the operation to be settled on 8 March. The interest rates on the marginal lending facility and the deposit facility are likewise raised by 0.25 percentage point to 3.50% and 1.50%, respectively, both with effect from 8 March.

10 March 2006
The Act Amending the Second Book of the Social Security Code and other Acts is passed by the Bundesrat. The standard rate of unemployment benefit II in eastern Germany is raised to the western level of €345 per month. Furthermore, contributions to the statutory pension insurance scheme for recipients of unemployment benefit II will be nearly halved from 2007.

14 March 2006
The European Council of Economic and Finance Ministers (Ecofin) decides to intensify the excessive deficit procedure with regard to Germany and gives notice to Germany under Article 104(9) of the EC Treaty with an extension of the deadline until 2007.

21 March 2006
The Bundesbank presents its annual accounts for 2005 and transfers a profit of €2,860 million to the Federal Government (compared with €676 million in the previous year).

7 April 2006
The Bundesrat approves the Act to Promote Growth and Employment through Tax Incentives (*Gesetz zur steuerlichen Förderung von Wachstum und Beschäftigung*). Limited term improved depreciation allowances, a tax reduction for craftsmen's invoices and higher turnover thresholds for the actual taxation of turnover tax are introduced.

1 May 2006
The Act Improving Cost Efficiency in Pharmaceuticals Supply (*Gesetz zur Verbesserung der Wirtschaftlichkeit in der Arzneimittelversorgung*) enters into force. The increase in pharmaceuticals expenditure is to be curbed by a two-year price moratorium on the price of all pharmaceuticals, and an additional 10% discount on the price of generic drugs, manufacturers being prohibited from providing pharmacists with additional pharmaceuticals for sale purposes at no extra cost, a reorganisation of the fixed-price system, and a bonus-malus system for prescribing physicians.

11 May 2006
The Working Group on Tax Estimates expects tax revenue to rise by 3% in 2006. In the light of the envisaged increase in the standard rate of turnover tax, additional revenue is expected in the ensuing years. Overall economic development until 2010 is estimated as somewhat less favourable than in May 2005. In 2006 there was a net increase in revenue of €8 billion on the November 2005 estimate, and of approximately €20 billion for the following years on

Chronology of general economic and fiscal policy measures

(cont'd)

the medium-term estimate in May 2005.

19 May 2006
The *Länder* (excluding Hesse and Berlin) and employee representatives conclude a pay settlement, which rises by 2.9% from 2008. Additional one-off payments graduated according to pay grade are to be made in the years prior to this increase. The average working week is to be increased by a maximum of 0.4 hours throughout Germany.

8 June 2006
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by 0.25 percentage point to 2.75%, with effect from 15 June. The interest rates on the marginal lending facility and the deposit facility are likewise raised by 0.25 percentage point to 3.75% and 1.75% respectively, both with effect from 15 June.

For the first time ever, the ECB publishes growth and inflation forecasts taking market expectations on short-term interest rates into account.

16 June 2006
The Bundesrat adopts the Act Accompanying the 2006 Budget (*Haushaltsbegleitgesetz 2006*). In particular, the standard rates of VAT and insurance tax are raised by 3 percentage points to 19% with effect from 1 January 2007 and the unemployment insurance contribution rate is lowered from 6.5% to 4.5%. In addition, only premiums for working on Sundays, bank holidays and during the night at hourly wages of up to €25 are not subject to social security contributions, the fixed contribution rate for low-paid part-time workers is raised from 25% to 30% and, to offset this, the general Federal grant to the statutory pension insurance scheme is cut by a lump sum and health insurance contributions for recipients of unemployment benefit II are reduced. The general Federal grant to the statutory health insurance scheme is to be lowered from €4.2 billion to €1.5 billion in 2007 and then eliminated altogether.

23 June 2006
Following its third reading, the Bundestag adopts the Federal budget for 2006, in which the borrowing author-

isation is marginally less than the February draft.

29 June 2006
Following a unanimous decision in the Financial Planning Council, central, state and local government will endeavour to curb the average annual expenditure growth to 1% between 2007 and 2010. The commitment to continued deficit reduction of 0.5% of GDP from 2008 onwards in accordance with the revised Stability and Growth Pact is confirmed.

5 July 2006
The Federal Cabinet approves the draft Federal budget for 2007 and medium-term financial plan until 2010. Decreased net borrowing amounting to €22 billion and investment expenditure amounting to €23½ billion are envisaged for 2007. This is made possible by additional revenue from tax increases, an across-the-board correction of €2 billion in the May tax estimate, extensive asset disposals and shifts in burdens to other parts of the public sector. Until 2010, only a reduction in net borrowing to €20½ billion is planned. The Implementation Report on measures to reduce the excessive deficit, which was sent to the European Commission on the same day, predicts a general government deficit ratio of 3.1% in 2006 and 2½% in 2007. An annual structural consolidation of at least 1% of GDP by 2007 is to be achieved through revenue-boosting as well as expenditure-reducing measures.

7 July 2006
The Bundesrat approves the first stage of the reform of the federal structure. In particular, areas of responsibility are to be assigned more clearly and mixed financing arrangements are to be eliminated. The fact that the *Länder* will, in future, be responsible for the pay and service regulations of their civil servants creates room for manoeuvre. In addition, the Bundesrat approved the 2007 Tax Amendment Act, which, among other things, limits the flat-rate commuter allowance on distances greater than 20 km, nearly halves the savers' tax-free allowance, lowers the maximum age of a child qualifying for child benefit and introduces a higher top rate of taxation for non-commercial income.

12 July 2006
The Federal Cabinet adopts the cornerstones of a corporate tax reform planned for 2008. This would entail limiting the overall tax burden on the profits of corporations to below 30% as well as easing the burden on non-incorporated firms. Furthermore, a withholding tax on capital income is also planned. In the medium term, counterfinancing measures are to contain shortfalls in tax revenue to €5 billion per year.

1 August 2006
The core components of the Act for the Further Development of the Basic Allowance for Job Seekers come into effect. Workfare placements (one-euro jobs) are expanded, screening for benefit abuse is more careful, sanctions are more targeted, and bridging payments and business start-up grants are combined into start-up grants.

3 August 2006
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by 0.25 percentage point to 3.0%, starting from the operation to be settled on 9 August. The interest rates on the marginal

Chronology of general economic and fiscal policy measures

(cont'd)

lending facility and the deposit facility are likewise raised by 0.25 percentage point to 4.0% and 2.0%, respectively, both with effect from 9 August.

28 September 2006
The Federal Government's autumn notification announces a deficit ratio of 2.6% for 2006, thus meeting the Maastricht Treaty reference value.

5 October 2006
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by 0.25 percentage point to 3.25%, starting from the operation to be settled on 11 October. The interest rates on the marginal lending facility and the deposit facility are likewise raised by 0.25 percentage point to 4.25% and 2.25%, respectively, both with effect from 11 October.

19 October 2006
The Federal Constitutional Court issues a judgement rejecting the action filed by the state of Berlin with the aim of securing the right to Federal aid in overcoming alleged extreme budgetary hardship. According to the judgement, Berlin neither suffers from such hardship nor has undertaken all possible efforts of its own to overcome its difficult financial position.

3 November 2006
The official tax estimate revises the revenue forecast for 2006 and 2007 upwards by around €20 billion each, especially because of the surprisingly positive development of profit-related taxes as well as a somewhat more favourable macroeconomic environment.

The Bundesrat approves the Act Introducing Parental Benefit (*Gesetz zur Einführung des Elterngeldes*). For a period of up to 14 months after a child is born, the Federal Government pays a benefit of up to €1,800 per month amounting to 67% of the monthly net income over the 12 months prior to the birth in order to compensate for the limited availability for work.

8 November 2006
In its 2006-07 annual report, the German Council of Economic Experts forecasts real GDP growth of 1.8% in 2007. The Council believes foreign trade will be the driv-

ing factor. By contrast, domestic consumption is expected to weaken. A drop in the unemployment rate from 10.9% to 10.2% is predicted. The increase in the VAT rate will sap household purchasing power, thus household expenditure is set to rise by just 0.3%. In real terms, investment in machinery and equipment is predicted to rise by 6.0%. As a result, industrial construction investment will also grow, but not as strongly as in 2006.

10 November 2006
The Financial Planning Council reaffirms the expenditure targets set in June and the continued European commitment to annual deficit reduction by 0.5% of GDP beyond 2007.

24 November 2006
The Bundestag adopts the 2007 Budget Act. In the light of the more favourable tax estimate outcome, net borrowing is now lower at just €19½ billion. Additional burdens arise from higher contributions to accommodation costs for unemployment benefit II recipients, and the smaller than estimated compensatory amount paid by the Federal Employment Agency. The increase in the Federal grant to statutory health insurance institutions of €1 billion compared to the summer Draft is offset in formal terms within the Budget.

The law changing the legal framework for contract doctors (*Vertragsarztrechtsänderungsgesetz*) is passed by the Bundesrat. This postpones the introduction of a morbidity-oriented risk structure compensation scheme to the beginning of 2009 and also allows, in exceptional cases, health insurance institutions to delay their debt relief until the end of 2008.

29 November 2006
The Federal Cabinet endorses the updated stability programme for Germany. In 2006, the deficit ratio is to drop to 2.1% of GDP, remaining well below the 3% reference value. A further drop to 1½% is expected in 2007, owing, in large part, to the increase in VAT. The Ecofin Council's requirement that the structural deficit should be reduced by a total at least 1% of GDP in both years will be met by a drop in the ratio of 1¼ percentage points because the rise in revenue from profit-related taxes is primarily viewed as not being cyclically induced. Despite the favourable macroeconomic scenario assumed here, no efforts will be made after 2007 to reduce the structural deficit by 0.5% of GDP each year, and a structural deficit of 1% of GDP in 2010 will still not be able to meet the aim set down in the Stability and Growth Pact of achieving at least a reasonably balanced budget.

7 December 2006
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by 0.25 percentage point to 3.50%, starting from the operation to be settled on 13 December. The interest rates on the marginal lending facility and the deposit facility are likewise raised by 0.25 percentage point to 4.50% and 2.50%, respectively, both with effect from 13 December.

14 December 2006
The Bundestag debates, in its first reading, the Act increasing the retirement age for the pension insurance scheme (*Rentenversicherungs-Altersgrenzenanpassungsgesetz*), designed to raise the statutory retirement age incrementally from 65 to

Chronology of general economic and fiscal policy measures

(cont'd)

67 between 2012 and 2029. An exception is to be made for persons who have paid in compulsory contributions for 45 years (including especially periods spent raising children). They will continue to be allowed to draw a pension without reductions upon reaching 65 years of age.

15 December 2006
The Bundesrat passes the Act to increase the 2007 contribution rate to the statutory pension insurance scheme by 0.4 percentage point to 19.9%. According to the statistics, a slight increase would have been sufficient to provide for the minimum required reserves in the amount of 20% of a month's expenditure by the end of 2007. The larger increase is designed to help stabilise contribution rates at below 20% in the medium term. Also, owing to the favourable financial development in unemployment insurance contributions, the Act lowers this rate from 4.5% to 4.2% from 2007 on.

The Bundesrat adopts the Act Amending the Second Book of the Social Security Code (*Gesetz zur Änderung des SGB II*) and the Revenue-sharing Act (*Finanzausgleichsgesetz*). From 2007 on, the Federal Government will contribute 41.2% of the accommodation costs for unemployment benefit II recipients in Rhineland-Palatinate, 35.2% in Baden-Württemberg and 31.2% in the rest of the Länder.

1 January 2007
Numerous new economic and fiscal policy regulations enter into force in Germany: the standard rate of VAT is raised by 3 percentage points to 19%. The rate of income tax for non-commercial income above €250,000 for unmarried persons and €500,000 for married persons is also, among others, raised to 45%. The savers' tax-free allowance is nearly halved, dropping to €750 for single persons and €1,500 for married couples. Commuters can only make use of the standard travel allowance from the 21st kilometre. In addition to the regulations on social contributions passed by the Bundesrat on 15 December, a number of health insurance institutions raise their contribution rates, in part markedly. The Federal Government's child-raising benefit is replaced by the parental benefit for new cases.

Subject to conditions, Bulgaria and Romania join the European Union.

Slovenia is the 13th member of the European Union to introduce the euro.

12 January 2007
According to the provisional figures, the Federal Government records a deficit of €28 billion in 2006. This is €10½ billion less than the amount budgeted.

24 January 2007
In its Annual Economic Report, the Federal Government expects an increase in real GDP of 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. The additional employment and sharper wage increases than in the previous year will strengthen private consumption. However, growth in domestic demand will be only half as strong as in 2006. The external contribution to GDP growth remains unchanged.

16 February 2007
The Act Strengthening Competition of Statutory Health Insurance Institutions (*GKV-Wettbewerbstärkungsgesetz*) is passed by the Bundesrat. The aim is to convert the financing of the statutory health insurance institutions by 2009 to a health fund into which employee and employer contributions as well as a tax grant all flow. Health insurance institutions are to receive risk-adjusted insurance premiums from the fund. If the resources from the fund are insufficient, health insurance institutions may demand an additional contribution which, if it is no more than €8 per month, may not exceed 1% of income subject to compulsory insurance contributions from their members. Private health insurance providers must offer a base 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 highest contribution rate. In the future, a change from statutory to private health insurance is to be possible only if the individual's income is above the threshold for opting out of the statutory health insurance scheme (currently €3,975 per month) for three consecutive years.

8 March 2007
The Governing Council of the ECB raised the minimum bid rate on the main refinancing operations by 0.25 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 0.25 percentage point to 4.75% and 2.75%, respectively both with effect from 14 March.

13 March 2007
The Bundesbank's profit, amounting to €4,205 million, is distributed to the Federal Government.

losses – although more successful fraud prevention may well have played a part, too. Wage tax revenue, which had fallen in the two preceding years as a result of income tax cuts, also experienced a marked increase of almost 3½%. The main factors behind this were higher average remuneration and the rising employment level.

Expenditure ratio declined

Government expenditure grew by a moderate ½% last year, which meant that in relation to GDP it went down perceptibly to just over 45½%. Labour market-related spending fell significantly, mostly thanks to the favourable employment trend. However, the weak growth in spending on state and civil service pensions, the stabilisation of personnel expenditure and, not least, the relatively sharp rise in nominal GDP also contributed to the decline in the expenditure ratio.

Sharp fall in general government fiscal deficit

In 2006, the combined fiscal deficit of central, state and local government (in accordance with the budgetary definition) is likely to have fallen significantly from €53½ billion to €36 billion. According to the preliminary outturn, there was only a moderate decline in central government's fiscal deficit to €28 billion as the sharp increase in tax revenue was accompanied by a decline in proceeds from asset realisations. Nevertheless, the result was still €10 billion more favourable than had been envisaged in the budget. State government managed to reduce its combined budgetary deficit by more than half from €23½ billion to less than €10 billion, largely thanks to the increases in tax revenue. Consequently, its result was also far better than originally expected. Local government may actually have run up a distinct surplus at the end of last year owing to the strong growth in local business tax receipts and to proceeds from asset disposals. By contrast, the Federal special funds recorded a slight deficit as the volume of new loans granted by the ERP Special Fund outweighed loan repayments to this fund for the first time since 2001.

Improvement in social security funds' financial situation overstated because of special effect

The social security funds' fiscal balance improved significantly. However, this was largely due to the fact that the deadlines for transferring social contributions to the funds were brought forward. This effectively meant that almost 13 monthly contributions were received in 2006. This one-off effect was particularly noticeable in the financial statistics of the statutory pension insurance scheme and the Federal Employment Agency. In the statutory health insurance scheme, however, the financial statistics are accruals-based, which meant that the one-off additional contribution receipts were not reflected there. The Federal Employment Agency recorded a positive balance of €11 billion. This was

General government finances *

Table 7

Item	2004 pe	2005 pe	2006 pe	2004 pe	2005 pe	2006 pe
	€ billion			Year-on-year change		
Central, state and local government				as %		
Expenditure	610.7	622.6	627.5	– 0.6	1.9	1
of which						
Central government	273.6	281.5	283	– 1.9	2.9	0.5
State government	257.1	260.3	259.5	– 1.0	1.2	– 0
Revenue	545.9	569.3	592	– 0.2	4.3	4
of which						
Taxes	442.8	452.1	489.5	0.1	2.1	8.5
				€ billion		
Balance	– 64.8	– 53.3	– 36	2.5	11.5	17.5
of which						
Central government	– 39.7	– 31.4	– 28.5	– 0.5	8.3	3
State government	– 23.6	– 23.5	– 9.5	6.9	0.0	14
Social security funds				as %		
Expenditure	468.8	471.6	467	– 1.2	0.6	– 1
Revenue	470.3	468.8	486.5	0.5	– 0.3	4
				€ billion		
Balance	1.5	– 2.8	19.5	8.1	– 4.3	22.5
of which						
Statutory pension insurance scheme	– 1.7	– 4.2	7	0.7	– 2.6	11.5
Statutory health insurance scheme	3.9	1.7	1.5	7.5	– 2.2	0

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

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largely due to the favourable labour market developments but also includes €3½ billion from the one-off effect. By contrast, the statutory pension insurance scheme's surplus of just over €7 billion conceals an adjusted deficit of roughly €3 billion. Despite a significant reduction in expenditure growth and increased central government funding of €1.7 billion, the health insurance institutions' surplus remained almost unchanged at just over €1½ billion.

Further deficit reduction in 2007

The general government deficit will continue to decline in 2007. This will be due mainly to tax increases such as the rise in the standard rate of VAT from 16% to 19%. The net cut in the social contribution rates of just under 1½ percentage points will have less of an impact. Furthermore, in key sectors, namely pensions, personnel expenditure and labour market policy, a restrained expenditure course has been embarked upon. As in recent years, moderate wage developments across the economy will automatically be reflected in low growth in both revenue and expenditure, without this being in any way related to active fiscal policy measures. Greater nominal GDP growth – caused in part by the effect of the higher excise duties on prices – will lead to a further decline in the corresponding ratios. While the increases in taxes and social contributions will offset the ratio-reducing effect on the revenue side, the expenditure ratio is expected to decline. For the first time since 2001, there is likely to be a perceptible decline in the debt ratio.

Structurally balanced budget should be achieved rapidly

The latest German stability programme, which was published at the end of 2006, envisages a decline in the deficit ratio to 1½% in 2007. Given that the deficit recorded in 2006 was distinctly lower than predicted and in view of the far more favourable macroeconomic expectations for the current year, it should be possible to bring the ratio down to 1% or even less provided that the fiscal stance is not relaxed. In keeping with the reformed Stability and Growth Pact, in the following years the expected positive macroeconomic development should be exploited and the target of a structurally close-to-balance budget should be achieved by 2009. If the requirement – specified in the 2005 reform of the Pact – of increased consolidation during good times does not occur, there is an increased risk that in the event of a downturn in macroeconomic momentum high deficits will rapidly reappear.

3 Investment and financing

The financial mirror image of the activity in the real economy and fiscal developments described in the previous sections are the market players' investment and financing operations which, in the German financial system, are channelled mainly through banks and, increasingly, the financial markets.

Marked increase in financial asset formation

Overall, the German non-financial sectors' financial asset formation rose significantly in 2006. According to the Bundesbank's financial accounts data that are available so far – covering the first three quarters of the reporting year – it amounted to roughly €160 billion, compared with not quite €110 billion in the same period of 2005. This was fuelled mainly by the strong accumulation of financial assets in the corporate sector driven by a buoyant level of equity acquisitions. General government likewise increased its financial assets in 2006, albeit to a lesser extent. Households presented a different picture: up to and including September 2006, they had built up savings on a somewhat smaller scale than in the comparable period of 2005. Even so, households accounted for two-thirds of the total financial assets accumulated by the non-financial sectors.

A closer inspection of the investment streams reveals that bank deposits increased by 5.3%, or €118½ billion, in 2006, compared with 3.5%, or €75½ billion, in 2005. German non-banks again largely stepped up their liquid bank bal-

Overall somewhat sharper growth in deposits at banks

ances. Households and non-financial corporations, in particular, favoured short-term time deposits, which – in the wake of the rise in the key lending rate in the euro area – were remunerated at a distinctly higher level at the end of 2006 than a year earlier. Given its favourable cash balance, domestic government, too, strongly increased its short-term time deposits. In contrast to 2005, however, longer-term deposits were also in demand in the year under review. Besides domestic insurance corporations, which traditionally invest substantial resources in the longer-term deposit segment (especially in the form of time deposits), households also showed an appetite for longer-term savings deposits – probably mainly to the detriment of deposits redeemable at short notice. In the course of the year, they thus took increasing advantage of the interest rate mark-up which savings deposits with a longer period of notice have over savings deposits with an agreed period of notice of three months.

Acquisition of securities

Furthermore, German non-banks acquired foreign, albeit predominantly euro-denominated debt securities on a major scale last year. They also invested in foreign equities, while acting as sellers in the domestic stock market. In the case of mutual fund shares, too, demand for the products of foreign investment companies was considerably more buoyant, at €19 billion, than the acquisition of similar domestic products.

Demand for external financing

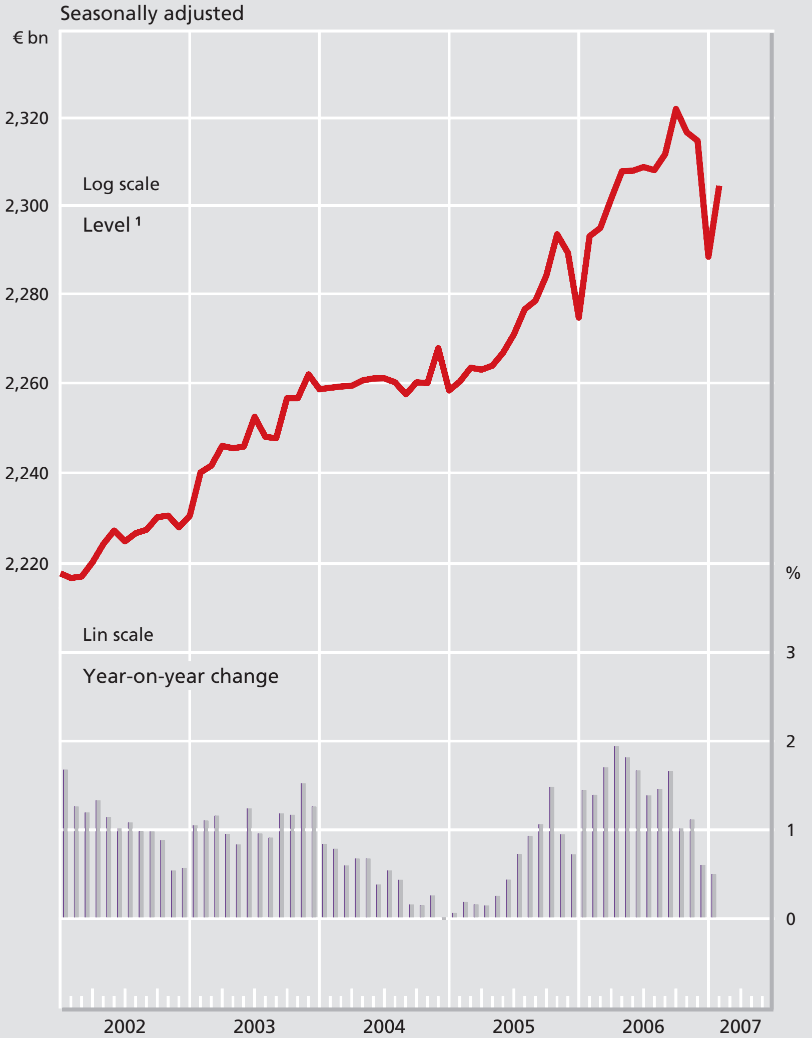
On the financing side, the non-financial sectors borrowed considerably more heavily than in 2005, drawing more than €80 billion over the first three quarters of 2006. In this case, too, enterprises were to the fore as they started once again to absorb debt and equity capital on a more sizeable scale (€37 billion). This was reflected not so much in a higher demand for credit from banks and other institutions as in the sale of short and longer-term debt securities and of equity. By contrast, general government clearly reduced its credit demand, although it still took up more external resources than any other sector.

Stagnant bank lending

German banks' lending to domestic customers stagnated last year following no more than a slight rise in 2005. The decline of €31 billion, or 5.3%, in lending to general government had a dampening impact on the overall result. By contrast, lending to the domestic private sector increased somewhat with a rise of €13 billion, or 0.6%. There were, however, clear differences in the credit demand of the individual sectors. Loans to non-financial corporations picked up noticeably in the course of the year, while monetary financial institutions' borrowing slowed markedly. At the end of 2006, German banks' unsecuritised lending to non-financial corporations was €11 billion, or 1.5%, up on the year.

Loans to enterprises and households in Germany

Chart 13



1 End of month; statistical changes eliminated.

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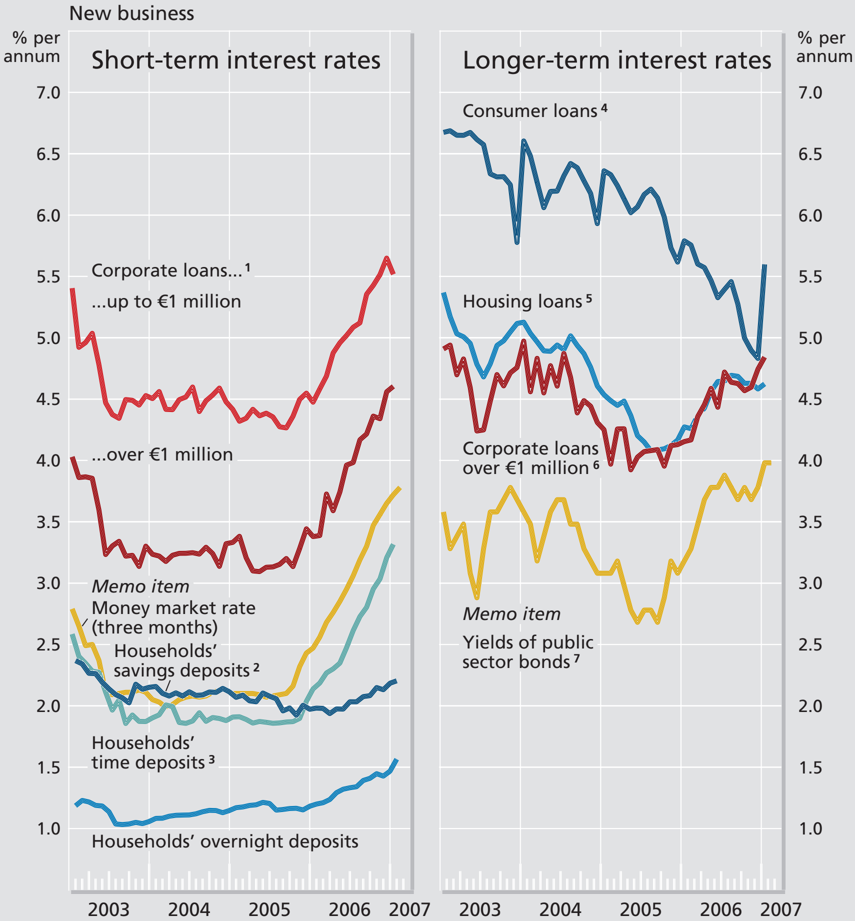
Given that German enterprises were investing more, longer-term loans were in particular demand. At the same time, consumer loans and other lending, taken together, were again repaid in net terms by households. In contrast to developments in construction activity, households' housing loans also showed a somewhat smaller increase than in 2005. This may owe something to the abolition of the grant to homebuyers, which became effective from the beginning of 2006, and to the associated advancement of construction projects to beat the changeover deadline.

Bank interest rates in Germany

Chart 14



1 To non-financial corporations with an initial rate fixation of up to one year. — **2** 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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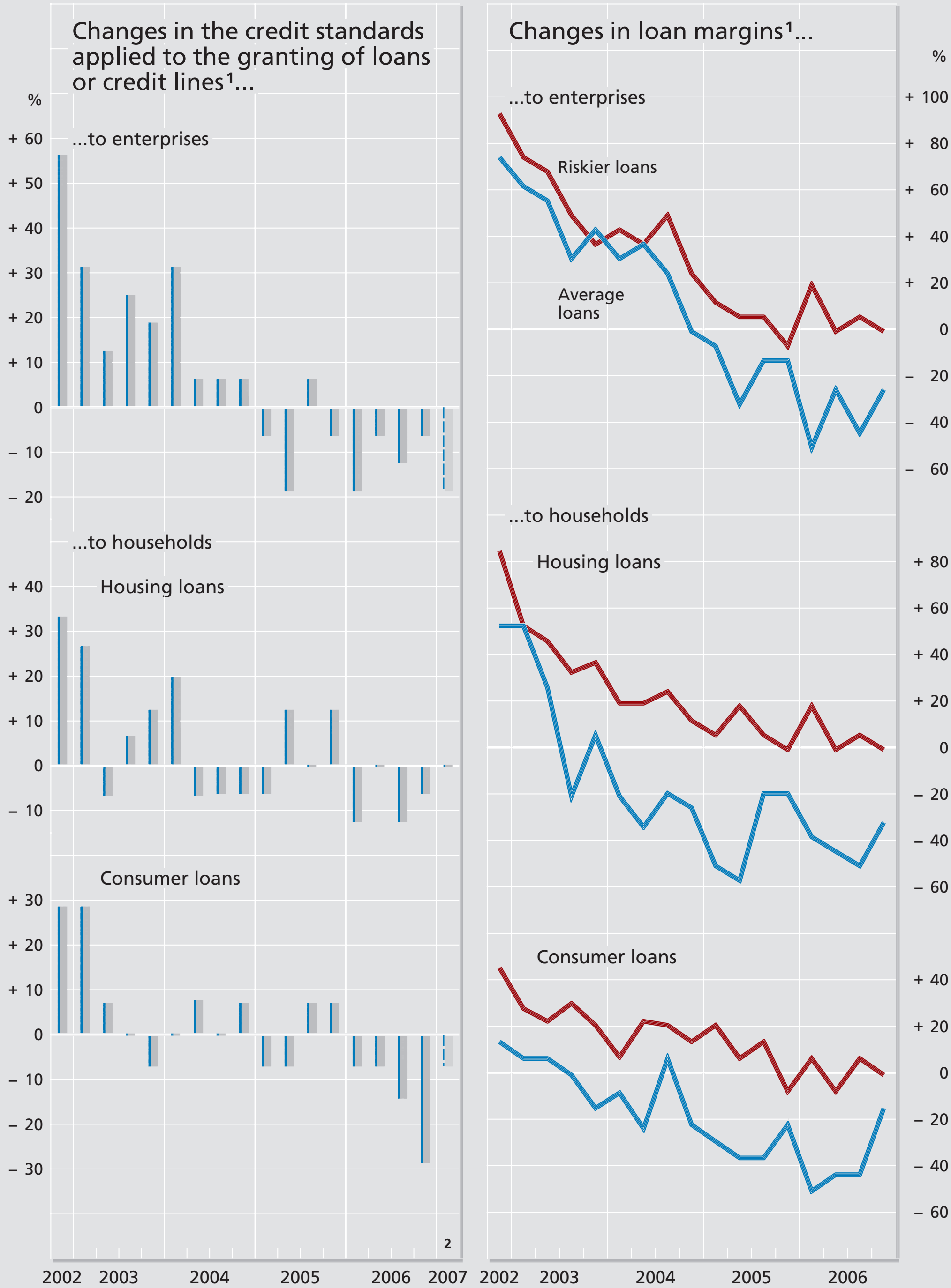
Higher bank lending rates mainly for short-term loans

Financing costs, especially at the long end, showed hardly any rise, however. In December 2006, the banks were demanding 4.6% for housing loans with an initial interest rate fixation of over ten years compared with 4.3% at the end of 2005. Longer-term corporate lending rates also showed a comparatively small rise during the course of 2006 in line with capital market movements. Only short-term bank lending rates showed a somewhat sharper increase. A multi-year comparison reveals that the financing conditions offered by German banks were still rather favourable, however. This becomes even more clearly apparent if the banks' other credit standards are also taken into consideration alongside the bank interest rates in question. At all events, according to the Eurosystem's

Bank lending survey
Results for Germany

Chart 15



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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Bank Lending Survey, the responding German institutions relaxed their lending standards in 2006. Furthermore, they narrowed their margins for average-risk loans – in some cases, considerably. Only the margins for riskier loans were raised in isolated cases.

Decline in borrowing in the German bond market

Despite the fact that financing conditions remained favourable, the domestic sectors' borrowing in the bond market in 2006 was weaker than in earlier years. Net sales of German debt securities, at €102½ billion, were €8 billion down on the year. This was due, not least, to the activities of general government, which, given its favourable cash balance, took less recourse to the bond market than in earlier years. Notwithstanding their sound profitability in 2006, German enterprises' external financing requirement covered by the bond market increased, not least as a result of the resurgence in merger and acquisition activity. Non-financial corporations expanded their capital market debt by €9 billion.

Muted issuing activity in the German stock market

Despite the benign financial market setting, issuing activity in the German stock market failed to pick up in 2006. Domestic enterprises placed new shares to a market value of €9 billion, which was €4½ billion less than in 2005: €5½ billion of this was raised by listed enterprises.

Declining sales of domestic mutual fund shares

Portfolio investment mediated by investment companies presented a similar picture. Despite the strong price gains in the stock markets, the inflow of resources to domestic investment companies halved to €19½ billion in the reporting year. On balance, resources amounting to €34 billion flowed only into specialised funds reserved for institutional investors, while mutual funds open to the general public redeemed shares on balance (€14½ billion). This mainly affected equity-based funds and open-end real estate funds. The latter were burdened by the temporary suspension of share unit redemption at the start of the year.

Sharp overall rise in German net foreign assets

The fact that domestic financial asset formation was far greater than domestic borrowing meant that, on balance, a considerable part of domestic financial asset acquisition in 2006 took place outside Germany. This is revealed in a sharp €112 billion rise in German net foreign assets in the first three quarters of 2006. Ultimately, this growth reflects, amongst other things, the further increase in the current account surplus last year, which amounted to €116½ billion, or 5% of GDP.

Monetary and financial system

The international monetary and financial system once again coped well with the pronounced global current account imbalances in the past year. At the same time, the chances for an orderly unwinding of imbalances have improved, despite the risks that still remain. The emergence of protectionist sentiment is increasingly providing cause for concern.

In the area of international financial organisations, an ad hoc quota increase for four significantly underrepresented countries represented a first step towards reforming the IMF. Further reforms are to follow until 2008, including a review of the quota formula, increased surveillance and measures to secure the IMF's income base. The idea of establishing an "insurance facility", which has likewise been discussed, would pose a variety of problems.

In Europe, economic and monetary integration is making continued progress. The accession of Bulgaria and Romania to the EU and the negotiations being conducted with Croatia and Turkey have increased the urgency of the need to strengthen the EU's constitutional and institutional base. The fact that Slovenia has cleared the final hurdle for introducing the euro, however, must not detract from the need for sustained progress in convergence and for further structural reforms in many EU member states.

In Germany, banks' earnings underwent a welcome period of stabilisation in 2006. The stability of the German financial system continued to improve.

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

1 International monetary and financial system

(a) Continued large external imbalances and sharp rise in foreign reserve assets

Continued pronounced current account imbalances

The global current account structure was once again marked by pronounced imbalances in 2006. With global demand for energy vigorous and oil prices high, the oil-exporting countries' surpluses once again grew strongly, reaching an estimated figure of around US$500 billion. China (in the area of US$200 billion or around 8% of GDP) and Japan (US$170 billion or just under 4% of GDP) also continued to run large surpluses. At the same time, the US current account deficit rose to an estimated US$860 billion or around 6½% of GDP over the reporting year. The current account of the euro area as a whole remained virtually balanced.

Renewed sharp rise in global foreign exchange reserves

In the past year, global foreign exchange reserves went up by US$845 billion to around US$5 trillion. The US dollar remained the most important reserve currency, accounting for an estimated two-thirds of global reserves, followed by the euro with a share of around one-quarter. Just over half of the growth in reserves in 2006 was concentrated among Asian countries, and once again particularly China (US$247 billion). In October, Chinese foreign exchange reserves surpassed the US$1 trillion mark. Reasons include not only the large current account surplus but also copious private capital inflows, both of which were boosted by the low external value of the renminbi. Since the introduction of limited exchange rate flexibility in July 2005, the renminbi appreciated by only 6% against the US dollar until the end of 2006 and depreciated against the euro by just over 3%.

Improved prospects for a gradual unwinding of external imbalances

The overall outlook for a gradual unwinding of current account imbalances improved over the course of the past year. This development was facilitated by a more balanced pattern of global growth, falling energy prices in the second half and a depreciating US dollar. However, the fall in the US dollar showed up only insufficiently – or not at all – in an appreciation of the currencies of key surplus countries. In addition, there is still the danger of a disorderly adjustment, which would have a correspondingly adverse effect on the world economy and the international financial system. It is therefore important for all countries and re-

Foreign currency reserves * of selected countries — Table 8

Country/ group of countries 1	Year-end holdings		Year-on-year change					
	1998	2006 pe	2004	2005	2006	2004	2005	2006 pe
	US$ bn					in %		
Japan	203.2	874.9	171.5	4.5	46.1	26.3	0.6	5.6
Asian developing countries 2	575.3	2,260.2	365.9	254.0	401.6	29.5	15.8	21.6
of which								
China 3	145.0	1,066.3	206.7	208.9	247.5	51.3	34.3	30.2
Hong Kong	89.6	133.2	5.2	0.7	8.9	4.4	0.6	7.2
India	27.0	170.2	27.5	5.9	39.2	28.2	4.7	29.9
Indonesia	22.4	40.7	0.0	– 1.9	7.9	– 0.1	– 5.6	24.2
Malaysia	24.7	81.7	22.1	4.5	12.3	51.7	6.9	17.8
Philippines	9.1	19.9	– 0.5	2.8	4.1	– 4.0	21.7	25.9
Singapore	74.4	136.3	16.5	3.8	20.9	17.4	3.4	18.2
South Korea	52.0	233.2	43.7	11.8	23.2	28.3	6.0	11.1
Taiwan	90.3	266.1	35.1	11.6	12.9	17.0	4.8	5.1
Thailand	28.4	65.1	7.5	2.0	14.6	18.4	4.1	29.0
Asia, total	778.5	3,135.1	537.4	258.6	447.7	28.4	10.6	16.7
Industrial countries excluding Japan	471.0	520.0	25.8	– 27.8	53.8	5.5	– 5.6	11.5
of which								
USA	36.0	40.9	3.0	– 4.9	3.1	7.5	– 11.4	8.2
Euro area 4	284.4	184.0	– 7.0	– 14.0	16.9	– 3.7	– 7.8	10.1
Other developing countries	394.4	1,365.0	159.8	195.7	344.0	24.0	23.7	33.7
Africa	40.7	220.3	35.7	34.2	60.1	39.6	27.1	37.5
Europe 5	97.4	604.8	80.7	96.5	183.8	33.1	29.7	43.6
Latin America and Caribbean	158.4	307.8	25.1	32.1	59.6	13.2	14.8	24.0
Middle East	97.9	232.2	18.3	32.9	40.6	13.0	20.8	21.2
Memo item								
Oil-exporting countries 6	89.6	667.9	98.0	115.9	213.6	40.8	34.2	47.0
All countries	1,643.8	5,020.1	723.0	426.4	845.5	23.9	11.4	20.3

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** Excluding the Middle East. — **3** Excluding the US$45 billion and US$15 billion worth of foreign exchange reserves that were used to recapitalise state banks in 2003 and 2005 respectively. — **4** Foreign exchange reserves of the twelve member states (until end-2006) for the period prior to the beginning of monetary union. — **5** Including Turkey and the countries of the former Soviet Union. — **6** Twenty-one countries, excluding Iran, Iraq, Syria and Turkmenistan.

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gions to do their share to unwind global external imbalances. This requires, in particular, increased domestic saving in the United States, a continuation of growth-enhancing structural reforms in Europe and Japan and greater exchange rate flexibility among some Asian emerging market economies. At the same time, protectionist sentiment – often under the pretext of countering the undesired distributional effects of globalisation – must be rejected resoundingly. To obtain the undisputed benefits of globalisation and to limit the unavoidable costs of adjustment, it is necessary to be ready for reform and structural change. Protectionism is the wrong answer to the challenges of globalisation.

(b) Initial steps towards IMF reform

Introduction of reforms in quota and voting power

The *ad hoc* quota increase for four significantly underrepresented countries agreed by the IMF Board of Governors at their Annual Meeting in Singapore in September 2006 represents a first step towards reforming the IMF. Governors also decided to adopt additional, more comprehensive reforms by the 2008 Annual Meetings at the latest. These includes a review of the quota formula, an increase in the number of basic votes and an adjustment of members' quotas based on a new formula that has yet to be adopted (see box on pages 74 to 76). Strengthening the surveillance of members' economic and monetary policies and the possible creation of a new credit facility ("insurance facility") are also under discussion in the context of the IMF's strategic reorientation.

Stronger focus on multilateral surveillance and exchange rate policy intended

Surveillance of economic and monetary policy is the IMF's primary task. In future, it should figure much more prominently in the Fund's activities and be made more effective, especially through a stronger focus on financial market issues, exchange rate analyses and increased attention to the spill-over of national or supranational economic and monetary policies to other countries and regions. In the Bundesbank's view, the IMF should continue act as a trusted advisor yet not become an order-issuing "umpire". Exchange rate analysis is an essential element of increasingly multilateral surveillance activities. However, in this context, it would cause problems if the IMF were to officially calculate and publish equilibrium rates of exchange. The high level of uncertainty and the variety of methodological approaches for estimating equilibrium exchange rates argue in favour of prudence.

Insurance facility hardly compatible with IMF principles

For some time now, the possible establishment of a new precautionary liquidity facility – a sort of "insurance facility" – has been the subject of intense discussion. This facility is intended to give countries with sound policies and access to international capital markets automatic exceptional access to IMF funds in a financial crisis even if there is no acute need at the time these funds are committed. Its proponents claim that this instrument will close a gap in the IMF's toolkit of lending instruments and satisfy a corresponding demand among emerging market economies. In the opinion of the Bundesbank, however, many key questions have yet to be resolved. As things now stand, the envisaged automaticity of drawings and the full disbursement of funds in a single tranche ("frontloading") would raise doubts about how an appropriate degree of conditionality could be achieved. As a matter of fact, conditionality is the indispensible counterpart of the uniformly low IMF lending rates for which all members are eligible irrespective of their credit rating. There is the added risk that denying or revoking a country's access to this facility could send negative signals to the markets. Guaranteed *a priori* access to IMF resources, moreover, would cause the moral hazard problem to burgeon well beyond the usual level in the case of normal IMF assistance, by tying up a considerable amount of IMF resources which would then be unavailable to other countries in times of need.

Regular IMF lending business continuing to fall

The number of regular IMF lending programmes continued to fall over the course of 2006. Six credit arrangements were still outstanding at the end of the year. The largest single exposure, worth a total of just under SDR 7 billion (US$10 billion), was a three-year stand-by arrangement with Turkey. The trend towards early repayment of IMF loans (by members including Brazil, Argentina, Uruguay and Indonesia) continued. The volume of credit outstanding fell last year by a total of around SDR 20 billion (US$30 billion) to around SDR 10 billion (US$15 billion), its lowest level in 25 years. However, concessional lending to low-income countries, which is not within the IMF's core mandate, remained high. The Policy Support Instrument, a non-borrowing programme which was specially created for these countries in October 2005, has since been applied for and implemented by several members.

Seeking a sustainable income mechanism for the IMF

The sharp decline in regular IMF lending has led to a significant reduction in interest income and thus to considerable income shortfalls. As income is currently insufficient to cover administrative expenditures, the IMF is compelled to tap its reserves in order to balance its budget over the short term. In order to create a long-term income base that is independent of lending volume, early in 2007 a "committee of eminent persons" appointed by the Managing Director of the IMF submitted to the Executive Board a report proposing measures for the long-term financing of the IMF. The Bundesbank will study these proposals carefully and play an active role in discussing them in international organisations and fora. It believes that the future income mechanism should be closely linked to those tasks that arise from the Fund's core mandate. A future financing package also needs to include additional expediture cuts.

Initial debt relief under MDRI

In 2006 the IMF, the African Development Fund (AfDF) and the International Development Association (IDA) of the World Bank began to implement the Multilateral Debt Relief Initiative (MDRI), based on a July 2005 proposal from the G8, by completely cancelling debts with an end-2004 cut-off date owed to them by highly indebted low-income countries meeting certain eligibility requirements. The debt relief brought about a considerable improvement in the financial situ-

Quota and voice reform in the IMF

Quotas and voting power are at the centre of the discussion on IMF reform. Quotas help determine the amount of financial resources member countries are obliged to provide; they also determine the amount of financing each member may obtain from the Fund, as well as its voting power. A fair representation of members is without question. Quotas should therefore reflect a country's position in the world economy; this would also strengthen the legitimacy of the IMF. In the past decade, many emerging market economies, but also some individual EU countries, have seen strong growth and now account for an increased share of global GDP and current account and capital account transactions. As the quota distribution (see table on page 75) no longer reflects these economic developments, it needs to be realigned.

A number of options for quota realignment are being debated among the IMF's members. In a first step, the IMF governors, at their Annual Meeting in Singapore in September 2006, approved an *ad hoc* quota increase for four significantly underrepresented countries (China, Korea, Mexico and Turkey). With the total quota increase amounting to 1.8 %, the gap between the calculated and actual quotas for each of these countries was closed by one-third. Germany's quota share was thus reduced by 0.1 percentage point to 5.98 %.

The IMF governors also approved more comprehensive reform projects, which should take place in a second stage. The number of basic votes, the percentage share of which in the number of overall votes had been falling continuously in the past few decades, is thus to be at least doubled; this would benefit small countries, in particular. A second round of *ad hoc* quota increases for underrepresented countries based on a new formula is linked to the increase in the number of basic votes.

With regard to the revision of the quota formula, there is a broad consensus that the current complex system, consisting of five quota formulas, should be simplified and made more transparent. However, it is not clear yet which variables – gross domestic product (GDP), degree of economic openness, foreign reserves and/or variability of current receipts – should be included in the formula, or how they should be weighted.

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Quota and voice reform in the IMF (cont'd)

The Bundesbank is of the opinion that GDP at current market prices is a key indicator of a country's weight in the global economy and of its ability to provide resources to the IMF. In line with current practice, local currency GDP should be converted, at the respective exchange rate, to a uniform benchmark – the IMF's benchmark is the Special Drawing Right (SDR). By contrast, converting GDP to purchasing power

Quotas and voting power in the IMF

Percentages

Country/group of countries	Existing quota (including 2006 increase)	Calculated quota[1]	Voting power[2]	Economic indicators[3] GDP[4] 2002-2004	Openness[5] 2000-2004	Reserves[6] 2004	Variability of current receipts[7] 1992-2004
EU countries	32.36	37.93	32.00	30.49	43.34	13.17	33.08
of which							
Germany	5.98	6.95	5.87	6.57	8.64	1.73	4.81
France	4.94	4.33	4.85	4.82	5.09	1.17	3.81
United Kingdom	4.94	5.18	4.85	5.02	6.27	1.34	3.65
Italy	3.24	3.44	3.19	3.94	4.08	1.05	2.18
Spain	1.40	2.25	1.38	2.37	2.66	0.45	1.57
Memo item							
Euro area	22.89	27.81	22.56	22.54	31.91	6.34	24.07
Asia	17.64	22.81	17.65	22.11	19.47	58.46	22.20
of which							
Japan	6.12	7.53	6.00	11.82	5.62	25.27	7.05
China	3.72	5.20	3.65	4.54	5.06	15.48	3.53
India	1.91	1.20	1.88	1.59	1.02	3.60	0.84
Korea	1.35	2.51	1.33	1.67	2.33	5.38	3.05
Indonesia	0.96	0.77	0.95	0.63	0.73	1.09	1.18
Malaysia	0.68	1.40	0.68	0.29	1.17	1.72	1.56
Thailand	0.50	0.91	0.50	0.39	0.92	1.36	1.03
Philippines	0.40	0.50	0.41	0.22	0.48	0.42	0.74
Singapore	0.40	1.92	0.40	0.26	1.29	3.21	2.11
The Americas	27.59	25.08	27.40	37.69	24.40	10.32	21.58
of which							
USA	17.08	16.79	16.73	30.35	15.80	2.71	11.83
Mexico	1.45	1.93	1.43	1.80	2.07	1.93	2.03
Brazil	1.40	1.00	1.38	1.43	0.90	1.59	0.87
Venezuela	1.22	0.42	1.21	0.26	0.30	0.57	1.03
Argentina	0.97	0.40	0.96	0.35	0.38	0.52	0.61
Africa	5.40	2.42	5.86	1.56	2.03	3.27	4.42
Other countries	17.01	11.76	17.09	8.15	10.77	14.78	18.72
of which							
Saudi Arabia	3.21	1.06	3.16	0.60	0.86	0.74	2.38
Russia	2.73	1.52	2.69	1.23	1.37	2.85	2.72
Turkey	0.55	0.74	0.55	0.66	0.72	1.08	1.01

Source: IMF. — **1** Calculated on the basis of the five existing quota formulas. — **2** Each member has 250 basic votes plus one additional vote for every SDR 100,000 in its quota. — **3** The IMF uses these data to produce the calculated quota shares. — **4** Three-year average. — **5** Five-year average of the sum of current receipts and current payments. — **6** Twelve-month average of gold and foreign exchange reserves. — **7** Variability of current receipts, defined as one standard deviation from the centred three-year moving average, within a 13-year period.

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Quota and voice reform in the IMF (cont'd)

parities, the preferred measure particularly among some emerging market economies and developing countries, would miss the mark.

Although GDP is an important variable and, under the September 2006 decision taken by the Board of Governors of the IMF, is slated to receive a higher weight in a new quota formula, the Bundesbank does not believe it should play a dominant role in a new formula. The degree of openness of a country should continue to be of major importance, in view of the IMF's international orientation and its focus on balance of payments issues. Countries promoting the liberalisation and opening of their trade in products and services increase their impact on the global economy and thus bear greater responsibility for promoting global economic and financial stability, which should be reflected in a larger quota.

With international capital markets integrating at a rapid pace and their ever growing global economic significance, it is also important to reflect not only trade openness in the quota formula – as is currently the case – but to include financial openness as well. The use of a variable that measures a country's international financial market integration, in addition to current receipts and current payments, is also the subject of debate – and rightly so. Including a financial openness indicator, however, is not without problems, since the quality and availability of national data vary widely across countries.

With the inadequacies of the current quota formulas having been known for a long time, the most recent attempt at quota reform dates back to the late 1990s.[1] A group of experts established in 1999 and chaired by Richard Cooper presented a report on the adequacy of quota formulas and proposals for revising the formula. Although the Executive Board of the IMF regarded the report and its proposals as a valuable stimulus to the debate, an agreement on a new quota formula was prevented by major differences of opinion. Given increasing globalisation and the continued shift among member countries in terms of their position in the world economy, one may hope that more countries are now willing to adopt a better – meaning, in particular, a simplified and more transparent – quota formula.

1 See Deutsche Bundesbank, Quotas and voting shares in the IMF, Monthly Report, September 2002, pp 63-77.

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ation of many of these countries. However, debt relief by itself cannot ensure the long-term sustainability of their debt. It is worrying to note that some countries that obtained debt relief under this initiative have already seen a renewed increase in their debt. A legitimate concern is that countries might be tempted to use the regained scope for incurring debt to once again borrow excessively at commercial terms; moreover, many of those countries lack sufficient debt management capacity. It is therefore very important to rigorously apply the debt sustainability framework developed by the World Bank and the IMF, the main objective of which is to put formerly heavily indebted countries back on the path of debt sustainability.

Development of a strategy to strengthen good governance and fight corruption important

Moreover, in the light of extensive debt relief and rising development assistance, it is important that multilateral development banks also contribute to improving the institutional framework of developing countries. The World Bank's increased attention to strengthening good governance and fighting corruption is therefore a welcome step.

(c) Recent developments in informal cooperation

Bretton Woods institution reform also at centre of G7 and G20 discussions

Reforming the Bretton Woods institutions was also one of the focal points of discussions within informal groups last year. Such talks were held not only within the G7 but also, and in particular, the G20, which has served as an informal forum for discussion between industrial countries and emerging markets since 1999. The decision by the G10 to discontinue its meetings of deputies represented a step towards streamlining international forum activity in 2006. The G10, however, continues to meet annually at the level of finance ministers and central bank governors. In the past, the G10 deputies presented important studies on international finance issues. In future, this function will be assumed to a greater extent by the Financial Stability Forum (FSF). Switzerland, as an important financial centre, became a new member of the FSF.

2 European integration

(a) New members of the EU and euro area

Accession of Bulgaria and Romania to the EU

Bulgaria and Romania joined the European Union on 1 January 2007. In its progress reports in autumn 2006, however, the European Commission had determined that key measures had not yet been sufficiently implemented in some areas. To avoid a potential one-year delay in accession, corresponding accompanying measures in the justice system and the fight against corruption and crime were agreed; Bulgaria and Romania are obligated to report annually on their implementation. In addition, both countries are lagging behind severely in terms of real convergence. In terms of per-capita GDP, which in Romania is 35%, and in Bulgaria, 32% of the EU average, the disparity in economic performance between these accession countries and the EU is even greater than in 2004, when 10 new nations joined the EU, or in the 1980s, when Spain, Portugal and Greece acceded.

Commencement of accession talks with Croatia and Turkey

The accession of Bulgaria and Romania now gives the EU 27 members. In December 2004, the European Council, in a political decision, gave two more states the prospect of EU membership. Open-ended accession negotiations were accordingly launched in October 2005 with Croatia and Turkey. In addition, the European Council has opened a window to the west Balkan countries for possible accession.

Constitutional process in Europe still sputtering

For the EU to maintain its effectiveness even with 27 members or more, it appears necessary to strengthen the institutional foundations, as is envisaged in the Constitution for Europe. However, the ratification process, which ground to a halt following the rejection of the Constitutional Treaty by France and the Netherlands in 2005, did not advance much further in 2006. Only two additional countries – Finland and Estonia – ratified the Treaty last year. In Germany, the ratification procedure, which was already completed at parliamentary level in May 2005, has been put on hold owing to a pending lawsuit against the Treaty before the Federal Constitutional Court.

Introduction of the euro in Slovenia

Slovenia joined the euro area on 1 January 2007. Early in 2006, Slovenia and Lithuania applied for a convergence assessment. The convergence reports of the ECB and the Commission in May 2006 determined that only Slovenia sustainably meets the convergence criteria.

Further progress in convergence necessary

The convergence level of the remaining member states – with the exception of the United Kingdom and Denmark, for which opt-out clauses for joining the euro area had been agreed in the Maastricht Treaty – was assessed in the December 2006 convergence reports. These reports showed clearly that additional long-term progress in price stability and budget consolidation is necessary. Prematurely introducing the euro without sustainable convergence would benefit neither these countries nor the euro area. The convergence assessment should therefore place special emphasis on sustainability. Strict compliance with the rules of the Treaty and, in particular, meeting the obligation to be a member of ERM II for at least two years without any tensions or depreciations remain indispensable.

(b) Economic policy coordination in the EU reveals continued problems in member states

Public finances not yet completely on solid ground

Accelerating economic growth over 2006, along with the increase in government revenue that this engendered, contributed to a better-than-expected average development of public finances. Net borrowing in the euro area and the EU in 2006 is assumed to have fallen each by just under 0.5 percentage point to 2% of GDP. The Ecofin Council has since concluded the excessive deficit procedures against Cyprus and France; Germany – which was given "notice" as recently as March 2006 – may expect to see its excessive deficit procedure concluded in the first half of 2007. This is a likely prospect for several other countries, too, including Greece, Malta and the United Kingdom. By contrast, there has been hardly any reduction in the debt ratios, which are averaging around 70% of GDP in the euro area and are slightly above the reference level of 60% of GDP for the EU as a whole. Therefore, there is no cause to believe that the long-term sustainability of public finances is on solid ground yet.

Use favourable economic situation for structural reform

Within the framework of the recast Lisbon strategy, the EU member states presented national reform programmes at the end of 2006; for the first time, they reported on the implementation of their economic policies. In its progress report, however, the European Commission noted that more ambitious measures were necessary with regard to ensuring the long-term viability of public finances, reforming labour markets, promoting research and development, creating functioning energy markets and improving competition. In the Bundesbank's view, the favourable economic situation is making it easier to carry out the necessary structural reforms.

II Current issues relating to the German financial system

1 Profitability of German banks

Further stabilisation of profitability

Following a recovery in 2005, there is evidence that German credit institutions' profitability stabilised further in 2006. On the income side, interest business in particular was supported by the improved general economic setting. At the same time, however, the comparatively flat yield curve limited the earnings opportunities from maturity transformation. Given this constellation, in 2006, the perceptible rise in the operating result was presumably again fuelled mainly by the growth in net commissions received and in the trading result. On the cost side, a decline in the number of corporate insolvencies limited the need for risk provisioning in domestic lending business. As this was already at quite a low level in 2005 compared with the longer-term average, however, it is unlikely that risk provisions were significantly curbed last year.

Further consolidation among retail banks

The process of consolidation in the German banking sector continued to advance slowly in 2006. It again concerned those categories of banks which are predominantly active in retail business. Thus credit cooperatives and savings banks recorded the sharpest declines (37 and 6 institutions respectively) as a result of mergers while, by contrast, the number of branches of foreign banks operating in Germany increased by 6 in the reporting year. All in all, the number of credit institutions recorded in the banking statistics fell by 41 last year to 2,048.

2 Stability of the German financial system

Stabilisation process continued

The stability of the German financial system showed another improvement in 2006. The stabilisation process which started in 2003 thus continued. The credit institutions' risk situation eased while their risk-bearing capacity increased significantly. The associated robust state of the German banking system is borne out by the results of stress tests. The insurance sector likewise strengthened its financial base. The German financial system can continue to rely on a dependable and robust payment and settlement systems infrastructure.

Buoyed by cyclical upturn

The German banking industry benefited substantially from the strong cyclical upturn and persistently favourable financing conditions. Earnings were bol-

The Deutsche Bundesbank's involvement in the Initiative Finanzstandort Deutschland

In the Initiative Finanzstandort Deutschland (IFD), institutions from the German banking and insurance industries, the central associations representing the German financial industry, Deutsche Börse, the Deutsche Bundesbank and the Federal Ministry of Finance have joined forces to enhance the growth, innovativeness and competitiveness of Germany as a financial centre. To this end, 12 working groups were formed to define specific measures and adopt strategies for implementation. The Bundesbank is active in several of these working groups.

The "Economists Group", of which the Bank is a member, produces an annual financial centre report. This report analyses the strengths and challenges of the financial centre and presents the IFD's activities to the general public.

The Bank chairs the "Modern Financial Education" working group, which in 2006 focused on financial education at secondary schools and played an active role in teacher training. The Bank also supported the establishment of the "House of Finance" at the Johann Wolfgang Goethe University of Frankfurt am Main, where the German financial industry has combined and focused its activities in the field of financial research and education.

In addition, the Bundesbank is a member of the "EU Financial Market Integration" working group, which formulated an IFD position paper on Germany's EU presidency in the first half of 2007, the "Better Governance/Bureaucracy Reduction" working group, and the "Fund Industry Deregulation" working group, which has presented concrete proposals for enhancing Germany's attractiveness to potential investors. Lastly, the Bundesbank is a member of the newly established "Retail Derivatives Markets" working group.

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stered by the improved credit quality in the corporate portfolio as well as by the strong performance in commission business and proprietary trading; the German banking system still falls short of international profit benchmarks, however. The ongoing positive momentum of economic activity in 2007 is likely to contribute to a benign risk situation. In turn, this should further strengthen the resilience of financial institutions, too.

Potential strains for German credit institutions

Despite the current favourable environment, three main risks to the stability of the German banking system remain. First, a turnaround in the national and international credit quality cycle – for which there are several indications – could puncture or terminate the income-bolstering trend towards declining value adjustments. Second, a considerable part of the banks' improved performance has resulted from volatile sources of income, which would wane should the current financial market dynamics weaken. Third, the banks' net interest result is likely to remain under pressure in 2007.

Macroeconomic risks and financial market risks

The buoyant macroeconomic situation is not only contributing to the banks' favourable position but is also boosting the international financial markets in which the German financial system is firmly integrated. The markets are, for the most part, expecting the global economy to carry on expanding, albeit at a somewhat more muted pace, and to become more regionally balanced. The globally low level of risk premiums by historical standards for a large number of financial market products is also likely to reflect to a certain degree greater risk propensity on the part of market participants. Against this background, the broad countermovement observed on the international financial markets at the end of February and in early March 2007 should be seen predominantly as a correction of several earlier exaggerations. A general revision of favourable expectations could, however, trigger challenging adjustments in the international financial markets. Three potential macroeconomic risks should be highlighted in this context: a renewed surge in oil prices, a sharper economic downturn in the United States and an abrupt correction of global imbalances.

The impact of a financial market disruption would depend crucially on the resilience and reactions of the major market players. Banks with a merely regional reach might then also be sucked into the maelstrom owing to their business connections with these internationally active financial institutions. However, the currently high robustness of large internationally active financial institutions suggests that such a scenario is improbable.

Banking supervision

The year 2006 placed high demands on banking regulators and supervisors. For instance, the transposition of Basel II into European and national law had to be completed so that the new capital standards framework could enter into force on schedule on 1 January 2007. In addition, considerable progress was made with regard to the convergence of supervisory practices in Europe. These activities will be continued and further intensified in the coming years in the interests of both banks and supervisors. In 2007, the Inter-Institutional Monitoring Group will also comment on the subject of supervisory convergence as part of its assessment of the Lamfalussy process.

I International harmonisation of banking supervision

1 Activities in the Basel Committee on Banking Supervision

Implementation of Basel II completed

The Basel Committee on Banking Supervision confirmed the calibration of Basel II (specification of the risk weight functions) based on the results of the Fifth Quantitative Impact Study (QIS 5). Working groups chaired by the Bundesbank were set up at both the G10 level and in Europe in order to monitor the effects of the new capital standard in banking practice and, in particular, to be able to better assess the possible fluctuations in capital requirements over the business cycle.

New projects as of 2007

Despite the announced regulatory lull, it is expected that the Basel Committee will examine the existing regulatory framework in search of potential improvements and discuss possible new projects with the banking industry. The redefinition of the concept of regulatory capital and the examination of liquidity risk at the institutions are likely to be particularly important aspects in this respect. Moreover, the initial results of the survey on the state of play with regard to internal credit risk modelling which was launched two years ago will be presented.

Close cooperation on implementation issues

In the year under review, the Basel Committee published a recommendation regarding the exchange of information between home and host supervisors for the implementation of Basel II.[1] It also published papers on special implementation issues (supervisory expectations for the rating systems of third-party vendors in Internal Ratings-Based (IRB) processes,[2] the IRB use test[3] and the range of bank practices relating to the Advanced Measurement Approaches (AMA)[4]) prepared by three subgroups of the Accord Implementation Group (AIG).

In 2006, the Bundesbank and BaFin (the Federal Financial Supervisory Authority) worked together with foreign supervisors on eleven approval procedures for the

1 Basel Committee on Banking Supervision, Home-host information sharing for effective Basel II implementation, June 2006 (http://www.bis.org/publ/bcbs125.htm).
2 Basel Committee on Banking Supervision, Use of vendor products in the Basel II IRB framework, March 2006 (http://www.bis.org/publ/bcbs_nl8.htm).
3 Basel Committee on Banking Supervision, The IRB Use Test: Background and Implementation, September 2006 (http://www.bis.org/publ/bcbs_nl9.htm).
4 Basel Committee on Banking Supervision, Observed range of practice in key elements of Advanced Measurement Approaches (AMA), October 2006 (http://www.bis.org/publ/bcbs131.htm).

internal methodologies of banking groups operating on a cross-border basis and, in this respect, took into account the guidelines developed by the AIG.

Revision of the Core Principles

In October 2006, the Basel Committee published a revised version of its Core Principles for Effective Banking Supervision[1] and Core Principles Methodology.

Use of the fair value option and dealing with credit risk

In the area of accounting, the Basel Committee issued a paper in June 2006 on the proper application of the fair value option set forth in International Accounting Standard (IAS) 39. At the same time, it presented its redrafted principles on sound credit risk assessment and adequate risk provisioning in lending business.

2 Activities in connection with the Committee of European Banking Supervisors

Promoting the convergence of supervisory rules and practices, and intensified cooperation

The focus of the work performed by the Committee of European Banking Supervisors (CEBS) is shifting increasingly towards the promotion of supervisory convergence and cooperation. The Committee thereby supports the supervisory networks for cross-border banking groups created by supervisors. Direct cooperation among supervisory authorities is being further enhanced in a pilot project involving ten cross-border banking groups. A newly established Expert Group is looking into the introduction of a mediation mechanism to reconcile discrepancies between national supervisory authorities and is coordinating staff exchanges and joint training programmes. Important convergence stimuli are also expected to come from the supervisory disclosure framework, which will make national implementation, the exercising of options and the supervisory practices applied in the different EU member states transparent and easily comparable.

Progress regarding supervisory convergence and cooperation among European supervisory authorities will also be a key issue in the review of the Lamfalussy process scheduled to be performed by the Inter-Institutional Monitoring Group on behalf of the European Council, Parliament and Commission in June 2007. CEBS' input to this review will be the results of a public survey launched in 2006 as part of which interested parties can assess CEBS' work.

1 Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, October 2006 (http://www.bis.org/publ/bcbs129.htm).

Ongoing banking supervision operations

At the end of 2006, 2,306 domestic credit institutions had been registered as being subject to the German Banking Act (*Kreditwesengesetz*) (the figure had been 2,349 at the end of 2005).[1] The net decrease of 43 credit institutions indicates a slowdown in the streamlining of the German banking network for the seventh year in succession (decrease of 257 institutions in 2000, 213 in 2001, 164 in 2002, 146 in 2003, 71 in 2004 and 54 in 2005). A total of 73 credit institutions closed down, owing predominantly to mergers; 36 of these institutions were credit cooperatives and 7 were savings banks. The decrease was partly offset by 30 new institutions, mainly branches of foreign banks (European Economic Area), securities trading banks and institutions in a new banking category, namely branches of foreign management companies.

The number of supervised financial services institutions increased slightly to 811 (there were 906 institutions in 2002, 831 in 2003, 827 in 2004 and 800 in 2005).

Prudential discussions with the institutions have developed into a key instrument of banking supervision through which primarily the areas of risk management and bank-wide management can be addressed. In this connection, particular emphasis

Ongoing monitoring of institutions

Number of operations conducted

Item	2004	2005	2006
1 Reports, monthly and other returns			
Individual reports pursuant to sections 13 to 14 of the Banking Act	186,754	165,477	153,653
Single borrowers listed in the summary reports submitted pursuant to sections 13 to 14 of the Banking Act	2,126,336	2,035,187	2,104,412
Reports pursuant to sections 24 and 24a of the Banking Act	47,002	34,951	27,589
Monthly returns and other data pursuant to sections 25 and 25a of the Banking Act	39,470	30,086	34,486
Reports under Principle I	28,907	28,452	27,572
Reports under Principle II	27,789	27,140	26,467
2 Audit reports and reports on activities (new definition as from 2006)	12,181	12,331	10,734
3 Prudential discussions	–	2,047	2,400
4 Audits of banking operations	99	106	186

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)

was placed on the subject of "interest rate risks in the banking book" in the prudential discussions conducted in the year under review.

In 2006, the Bundesbank performed 91 audits on the basis of the "Minimum requirements for risk management" (*Mindestanforderungen an das Risikomanagement*, MaRisk) pursuant to section 44 (1) sentence 2 of the Banking Act. The audits took the form of risk and process-oriented system audits, which focused on the organisation of risk management practices. Most of these audits related, above all, to the requirements for an adequate business organisation of credit business and trading activities. In addition to these audits, three audits concerning the arrangements for the management, monitoring and control of interest rate risks in overall business were performed.

The first suitability examinations as part of the licensing of Advanced Measurement Approaches for operational risk were also performed in 2006. Furthermore, the Bundesbank conducted initial approval, model extension and follow-up examinations with regard to the use of own market risk models at nine institutions. The model extensions centred on the modelling of credit spread risks.

Activities in connection with the licensing of internal ratings-based systems were stepped up significantly in 2006. At the end of the year, 38 institutions had submitted applications for approval to use an Internal Ratings-Based (IRB) Approach, 15 of them

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	Change (%)	Number	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	2,277	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

1 Credit institutions and financial services institutions.

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Ongoing banking supervision operations (cont'd)

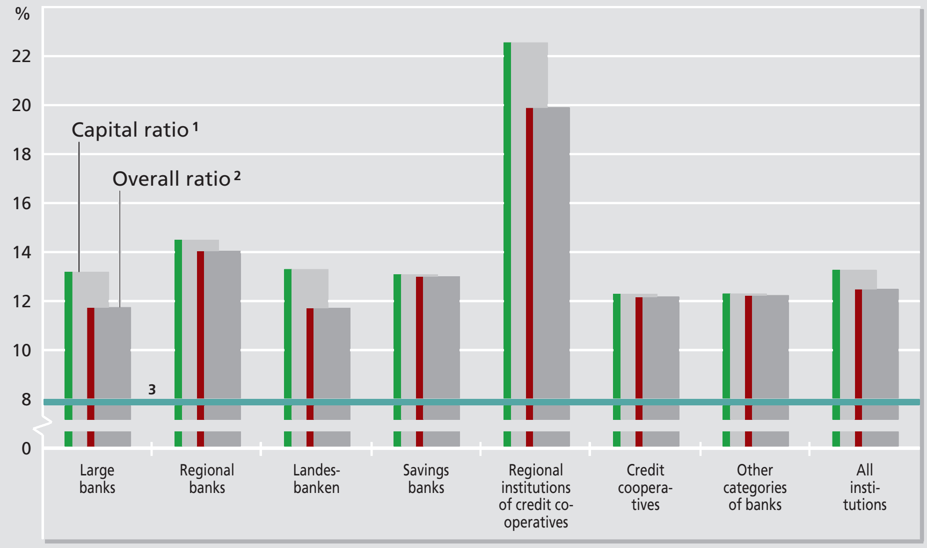
to use the Advanced IRB Approach. The IRB banks concerned were large banks, public sector and cooperative central institutions, and medium-sized private banks. In 2006, the Bundesbank examined around 180 rating systems in 78 examination blocks at these institutions.

As for the central credit register, there was an increase in both the number of loans of €1.5 million or more to be reported quarterly pursuant to section 14 of the Banking Act and the total volume of reported loans of €1.5 million or more.

The revision of the Regulation governing large exposures and loans of €1.5 million or more (*Grosskredit- und Millionenkreditverordnung*) included changes regarding the data to be reported. These related principally to the integration of risk-relevant information about the borrower to be reported, such as probabilities of default, risk-weighted assets and specific provisions. The new data are to be reported from 2008 onwards.

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

End-2006 levels



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

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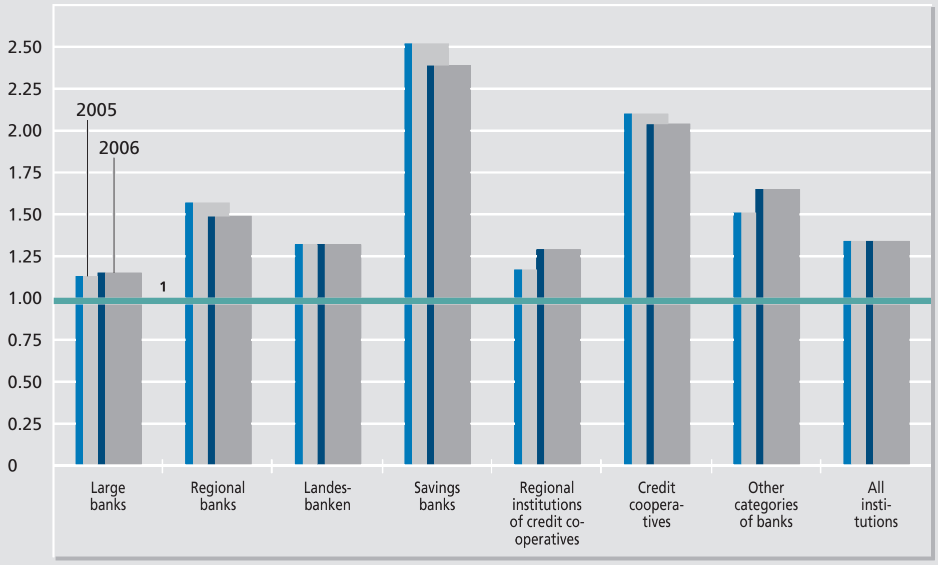
Ongoing banking supervision operations (cont'd)

The capital ratio under Principle I pursuant to section 10 of the Banking Act (defined as the ratio of risk-weighted assets to liable capital) of institutions reporting on a non-consolidated basis was 13.3% on average on 31 December 2006. Groups of institutions/financial holding groups submitting Principle I reports on a consolidated basis pursuant to section 10a of the Banking Act had an average capital ratio of 12.1%. The average overall ratio, which gives the ratio of all risk positions that have to be backed by capital to eligible own funds, was 12.5%. Groups of institutions/financial holding groups had an average overall ratio of 10.9%.

On 31 December 2006, the average liquidity ratio of German banking institutions – bearing in mind the minimum liquidity ratio of 1.0 laid down by the regulatory liquidity standard Principle II – was 1.34. Differences in the liquidity ratio level could be the result of special structural features in the refinancing operations of the individual banking sectors.

Liquidity ratio of individual institutions submitting Principle II reports *

End-of-year levels



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

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3 Cooperation within the European System of Central Banks

Macroprudential analyses

In 2006, the ECB's Banking Supervision Committee (BSC) published reports on the stability of and structural developments in the European banking system.[1] Moreover, analyses were produced concerning the effects which regulatory requirements have on the financial sector, issues relating to cross-border supervision and – together with CEBS – the exchange of information, as well as of cooperation between central banks and supervisory authorities in the event of critical developments in the European financial system.

II Development of the national prudential supervisory standards

Amendments to the Banking Act

The new Basel II capital rules began to be applied in Germany on 1 January 2007. The amendments to the German Banking Act (*Kreditwesengesetz*)[2] which came into force on that date have implemented the prudential requirements of the relevant EC directives[3] and created the legal basis for both the Solvency Regulation (*Solvabilitätsverordnung*) and the Regulation governing large exposures and loans of €1.5 million or more (*Grosskredit- und Millionenkreditverordnung*). This means that all three pillars of the Basel II capital framework (minimum capital requirements, the supervisory review process and disclosure) are now enshrined in the Banking Act. The transposition of Pillar 1 is effected, in particular, in section 10 of the Banking Act, Pillar 2 in section 25a (1) of the Banking Act and Pillar 3 (disclosure) in section 26a of the Banking Act. New directive-induced additions to the Banking Act also include "group provisions" as the EU regulations are geared more towards groups of institutions or financial holding groups than was previously the case. These include the "waiver" rule within a group (section 2a of the Banking Act), the provisions for cooperation among supervisory agencies, especially in relation to cross-border groups (section 8 et seq of the Banking Act) and the possibility of zero weighting intra-group exposures (section 10c of the Banking Act). These rules repre-

1 ECB, EU banking sector stability, November 2006, and ECB, EU banking structures, October 2006.
2 Federal Law Gazette I No 53 of 22 November 2006, p 2606.
3 Banking Directive 2006/48/EC and Capital Adequacy Directive 2006/49/EC.

sent a partial departure from the previous practice of viewing institutions on a (predominantly) stand-alone basis.[1]

Solvency Regulation replaces Principle I

The Solvency Regulation supplements the Banking Act and transposes the bulk of the two amended EC directives into German law. The institutions can, however, still choose to calculate their minimum capital requirements on the basis of the former Principle I during a one-year transition period up to the end of 2007. The new Solvency Regulation will lead to a fundamental reorientation of the capital adequacy provisions. For instance, the Credit Risk Standardised Approach (CRSA) and the institutions' own Internal Ratings-Based (IRB) Approaches will lead to the introduction of more risk-sensitive calculation methods for the minimum capital requirements for credit risk. Furthermore, the supervisory treatment of credit risk mitigation techniques will be more differentiated and risk-sensitive than has hitherto been the case. Not least, comprehensive rules for the treatment of securitisation exposures and a capital requirement for operational risk will be introduced for the first time, and the disclosure requirements under the Banking Directive will be transposed into German law.

Revised Regulation governing large exposures and loans of €1.5 million or more

Finally, the Regulation governing large exposures and loans of €1.5 million or more has also been revised. The provision regarding the concept of large exposures in the Banking Directive is based on the solvency rules. However, the risk weights are generally not to be used. In order to limit the maximum loss risk of a credit institution with respect to a single customer or a group of affiliated customers, the nominal value of the exposures is to be used as the basis for defining large exposures. However, the effects of credit risk mitigation techniques can be recognised in a similar way to those relating to solvency.

Liquidity Regulation replaces Principle II

The Liquidity Regulation (*Liquiditätsverordnung*) likewise entered into force on 1 January 2007 and supersedes Principle II. It constitutes an autonomous national rule as there are currently no internationally harmonised standards for regulating liquidity. The Liquidity Regulation has modernised the quantitative liquidity rules in the sense of creating a more risk-oriented supervisory regime and has geared them more precisely to the institutions' specific risk profiles. To this end, it is now possible – subject to prior approval – to use internal liquidity risk measurement and management procedures for prudential liquidity risk mitigation

1 For more information on the amendments to the Banking Act as well as on the new Solvency Regulation and Regulation governing large exposures and loans of €1.5 million or more, see Deutsche Bundesbank, Transposing the new Basel capital rules into German law, Monthly Report, December 2006, pp 67-88.

purposes. Germany is practically at the forefront worldwide in authorising banks to use their own liquidity models. The Liquidity Regulation has not brought about any significant changes for institutions which do not exercise this option, which means that the existing rules of the former Principle II continue to apply largely unchanged.

Cash management

The year 2006 was marked by the Bundesbank's involvement in the development of the second series of euro banknotes, the upgrade of its cash processing machinery and the development of new procedures for the electronic exchange of cash payment data. A further important task was the preparation of a draft agreement for the banking industry on the national implementation of the Eurosystem's framework for the detection of counterfeits and fitness sorting of euro banknotes by credit institutions and other professional cash handlers. Finally, the insolvency of a number of cash-in-transit companies posed major challenges for the Bundesbank in terms of its cash logistics.

Euro currency in circulation in the Eurosystem

During 2006, the volume of euro banknotes in circulation issued by the Eurosystem increased again sharply by 11.2% to €628.2 billion. The volume of coins in circulation rose by 7.4% to €17.9 billion.

Euro currency in circulation in the Eurosystem — Table 9

Trend
€ million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation 1
2004	516,613	501,259	15,354
2005	581,860	565,217	16,643
2006	646,119	628,242	17,877

Breakdown at year-end 2006

Banknotes in circulation			Coins in circulation		
Notes of €	€ million	Percentage of total	Coins of €	€ million	Percentage of total
500	209,692	33.4	2.00	7,004	39.2
200	30,565	4.9	1.00	5,301	29.7
100	111,641	17.8	0.50	2,220	12.4
50	203,880	32.4	0.20	1,461	8.2
20	46,731	7.4	0.10	915	5.1
10	19,005	3.0	0.05	561	3.1
5	6,728	1.1	0.02	258	1.4
			0.01	157	0.9
Total	628,242	100.0	Total	17,877	100.0

1 Circulation of euro coins excluding commemorative coins.

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In the financial year 2006, the Bundesbank paid out 14.8 billion euro banknotes with a value of €453.9 billion and 12.6 billion euro coins with a value of €6.3 billion. During the same period, the Bundesbank received lodgements from its customers of 14.1 billion euro banknotes with a value of €427.6 billion and 10.9 billion euro coins with a value of €6.0 billion. Besides the coins in circulation, euro collector coins were issued in all the participating countries; these are legal tender only in their country of issue. In Germany, issues of German euro collector coins in 2006 had a total value of €155 million.

Deutsche Mark currency in circulation

The volume of Deutsche Mark currency in circulation was reduced to DEM14.4 billion by the end of 2006. Banknotes and coins each accounted for around

Development of Deutsche Mark currency in circulation — Table 10

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
2004	15,178	7,876	7,302
2005	14,725	7,497	7,228
2006	14,380	7,218	7,162

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DEM7.2 billion of this amount (this included commemorative coins for collector purposes with a value of around DEM2.3 billion).

Euro counterfeits

The number of counterfeit euro banknotes detained in German payments and recorded by the Bundesbank was significantly lower than the number of counterfeits in the previous year. By contrast, the number of counterfeit euro coins was up on the year.

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

Table 11

Year	Banknotes Number (thousand)	Banknotes € thousand	Coins Number (thousand)	Coins € thousand
2004	81	6,070	51	98
2005	74	4,896	46	90
2006	46	3,233	77	150

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The marked reduction in counterfeit banknotes is largely due to a series of raids on counterfeit print shops outside Germany in which mainly counterfeit €50 banknotes were produced. Nevertheless, the €50 banknote was still the most frequently counterfeited denomination in Germany in 2006, accounting for 50% of the total volume of counterfeits. In relative terms, the number of counterfeit banknotes detected in Germany is comparatively low at around six counterfeits per 10,000 inhabitants per year. There was a very sharp rise in the number of counterfeit coins compared with the previous year. The €2 denomination was most heavily affected, accounting for 95% of all counterfeit coins.

Counterfeit prevention

The training courses offered free of charge by the Bundesbank as part of its counterfeit prevention programme were again very popular in 2006 among representatives from the banking and retail sectors and other interested parties. In total, around 550 training courses were organised across Germany, attracting some 11,000 participants. These prevention measures – as well as the close cooperation with the police authorities and the involvement of the Bundesbank in the cash cycle via its network of branches – helped to contain the number of counterfeits in circulation.

Damaged and mutilated banknotes and coins

In the financial year 2006, the National Analysis Centre for Damaged Banknotes and Coins received around 22,500 applications (2005: 21,500). The table below

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

Table 12

Year	Banknotes		Coins	
	Number (thousand)	€ million	Number (thousand)	€ million
2004	389	12.9	206	0.07
2005	367	13.7	264	0.06
2006	428	17.2	242	0.07

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shows the amount of Deutsche Mark and euro coins and notes that were submitted for reimbursement.

Involvement in the development of euro series II banknotes

The Bundesbank is involved in the preparations for the second series of euro banknotes, particularly in the development of security features which are designed to be easily recognisable by the general public without the aid of counterfeit detection devices. Besides the enhanced level of security, another stated objective, at least for the smaller denominations €5 and €10, is improved banknote durability.

New common side for euro coins

Owing to the enlargement of the European Union, the design of the common side of the €1 and €2 euro coins, as well as the 10, 20 and 50 cent coins, is going to be redesigned accordingly. From 2007 onwards, or at the latest from 2008, Europe will be shown without national borders instead of the previous 15 EU member states. German euro coins will be minted with the new common side starting 2007. The existing coins showing the 15 EU member states will remain legal tender throughout the euro area. The common sides of the smallest denominations (1, 2 and 5 cent coins) will continue to feature the "Europe in the world" motif.

Recommendation by the European Commission for authenticity checking of euro coins

In line with a recommendation by the European Commission dated 27 May 2005, at least 10% of the 50 cent, €1 and €2 coins in circulation nationally are to be checked every year for authenticity by the public authorities, credit institutions or other professional cash handlers. Germany met this requirement in 2006.

Eurosystem framework for the detection of counterfeits and fitness sorting of euro banknotes

The national implementation of the ECB Governing Council's adopted framework for the detection of counterfeits and fitness sorting of euro banknotes by credit institutions and other professional cash handlers was discussed with their representatives in 2006. After agreeing a model contract with the Central Credit

Committee, the Bundesbank intends to conclude individual contracts with the credit institutions to implement the framework.

Simplified requirements for banknote lodgements

In 2006, the Bundesbank continued the upgrading of its cash processing machinery which it had already started in the previous year. By the end of 2006, 19 branches had switched to multi-denomination processing. In tandem with this, the requirements concerning the preparation of banknotes prior to lodgement have also been simplified. At these branches, both standard lodgements and multi-denomination lodgements, the latter being subject to a fee, are now settled on a lodgement basis. The possibility of making lodgements using multi-denomination packages – with banknotes of any combination of denominations and in any position – has been well received, without there being any shifts of lodgements to these branches. A further 16 branches will be equipped with multi-denomination processing systems in 2007.

Electronic exchange of cash payment data

To make the cash processes more transparent and secure, the Bundesbank will, in future, be offering professional cash handlers the possibility of exchanging cash payment data electronically, especially for lodgements and cash orders. Reports by the Bundesbank on cash transactions that have been carried out will allow the participants to track their cash containers at any time. Furthermore, labelling the cash containers with barcodes will permit an efficient scanner-based cash hand-over.

Cashless payment and securities settlement systems

The objective of the Bundesbank's activities concerning cashless payment and securities settlement is to increase the security and efficiency of processing payment and securities transactions. In the case of payment transactions and systems, this is based on a legal mandate. The Bundesbank's interest in this field, however, also embraces securities settlement owing to the latter's close interaction with payments and its relevance for financial stability in Germany. The Bank's activities are based on three pillars: operating its own systems, influencing general developments (catalyst function) and overseeing payment operations and – together with other responsible authorities – securities settlement. In 2006, the Bank focused its activities on further developing its own range of services, carrying out tasks in connection with the TARGET2 and TARGET2-Securities (T2S) projects as well as preparing for the Single Euro Payments Area (SEPA). In addition, the Bank is currently modernising its IT infrastructure for securities trading and safe custody account business and preparing for the implementation of a self-collateralisation process.

TARGET2 project

In the year under review, the activities connected with setting up the technical side of the new TARGET2 single shared platform, which in Germany is to replace the Bundesbank's RTGS^{plus} system in 2007, continued as planned. The Bundesbank had a special responsibility here as it, together with Banca d'Italia and Banque de France, is developing and operating the single shared platform for the Eurosystem. The joint work within the Eurosystem also focused on the legal framework and business organisation issues.

Decision on prices and possible forms of participation

In July 2006, the ECB Governing Council approved and published the final pricing scheme for TARGET2 payments as well as price information for ancillary systems (such as securities settlement systems) that settle in TARGET2. The transaction pricing scheme has been revised in recent years due to the positive development of TARGET business and an additional value band has been included. Participants with more than 100,000 payments now have to pay a fee of only €0.125. In addition, the functionality of liquidity pooling, which makes it possible to pool several RTGS participant accounts, has been made much more attractive by, *inter alia*, considerably reducing the additional fee charged for this service. The Governing Council also provided information about the various ways that banks can connect to TARGET2, including the associated fees, with the focus on ensuring maximum flexibility. The third TARGET2 progress report published in November 2006 contains supplementary legal information and details the pricing scheme for the use of TARGET2 by ancillary systems.[1]

Testing activities

Germany is to switch to the single shared platform with the first group of countries on 19 November 2007. The required customer test activities are to start in May 2007. The Eurosystem has published a test handbook to support participants and to ensure that the procedure is harmonised across Europe. Transparency and operational security for the project phase has been improved for end-users by publishing a detailed project plan.

Eurosystem examines TARGET2-Securities…

The Eurosystem, together with central securities depositories and market participants, has been investigating options for a new way of settling securities held in central bank money centrally (TARGET2-Securities: T2S) since summer 2006. T2S is intended to increase the efficiency of European securities settlement by simultaneously posting the cash and securities legs of a transaction on a single platform (integrated model). T2S is based on the same basic concept as TARGET2. While TARGET2 enables the liquidity of central bank money to be

1 See ECB, Third progress report on TARGET2, November 2006, (http://www.ecb.int/pub/pdf/other/3rd-progress-report-target2en.pdf).

… as central securities settlement system …

concentrated throughout Europe, T2S would additionally centralise the liquidity of securities, which is currently held decentrally, on one platform. The Eurosystem would merely provide an integrated technical platform. The safe custody accounts themselves would remain the responsibility of the central security depository in question. National and cross-border securities transactions could then be settled in a highly efficient way on a single platform. A crucial consideration in this respect is that the Eurosystem itself owns and operates such a platform so that the core functions of account management and granting central bank loans against securities collateral are still under full control of the Eurosystem.

… to promote capital market integration

The T2S initiative can make a contribution to harmonising and consolidating European securities settlement and thus to integrating the European capital market. T2S would remove some of the Giovannini barriers overnight and could act as a catalyst in eliminating others. Consequently, the European Commission, the European Parliament and the governments of the member states are watching the T2S initiative with interest.

Feasibility study by Eurosystem

On 8 March 2007, the Governing Council of the ECB reaffirmed both the general economic, legal, operational and technical feasibility as well as the use of the single shared platform constructed for TARGET2. Together with central securities depositories and market participants, user requirements are to be surveyed in the next project phase up to the end of 2007 that, from the Eurosystem's perspective, can be implemented within an appropriate cost and time framework.

Bundesbank's role

To maximise synergies, the T2S is to be developed within the Eurosystem and operated on the TARGET2 platform. The Deutsche Bundesbank, Banque de France and Banca d'Italia (3CB), which are already responsible for developing and operating TARGET2, are prepared to develop the new service jointly with the Banco de España (3CBplus) on behalf of the Eurosystem and to run it on the single shared platform. By operating TARGET2 and TARGET2-Securities together considerable savings can be made when providing and operating these services and banks can improve their liquidity and information management.

SEPA

In the field of European retail payments, the reporting period was dominated by the preparations for the Single Euro Payments Area (SEPA). From 1 January 2008 onwards, citizens, enterprises and public authorities across Europe should be able to make euro payments using SEPA credit transfers, SEPA direct debits

Cashless payment and securities settlement systems

The Bundesbank's $RTGS^{plus}$ system – a real-time gross system for processing urgent payments – accounts for approximately 30% of total European individual payment transactions. $RTGS^{plus}$ is concurrently the national component of the EU central banks' TARGET system with the largest payment volume. In addition, via its RPS system (Retail Payment System), the Bundesbank provides the private banking sector with a complementary option for processing interbank payments. The business volume of the systems operated by the Bundesbank evolved as follows.

Cashless payments of the Deutsche Bundesbank

Item	2005		2006			
	Number (million)	€ billion	Number (million)	Percentage change	€ billion	Percentage change
Individual payments	36.8	140,442	38.8	5.5	162,629	15.8
$RTGS^{plus}$	35.8	138,497	37.9	5.9	150,776	8.9
National	30.8	97,203	32.7	6.5	104,025	7.0
Cross-border	5.0	41,295	5.1	2.5	46,751	13.2
Other[1]	1.0	1,945	0.9	– 9.0	11,853	509.3
Retail payments	2,178.3	2,103.1	2,301.3	5.6	2,196.3	4.4
RPS	2,174.7	2,101	2,297.9	5.7	2,195	4.4
National	2,172.2	2,099	2,294.5	5.6	2,189	4.3
Cross-border	2.5	2	3.4	35.5	5	137.6
Other[2]	3.6	2	3.4	– 6.0	2	– 8.1
Total	2,215.1	142,546	2,340.1	5.6	164,825	15.6

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

Moreover, through its Electronic Securities Settlements (ESS) procedure, the Bundesbank performs an important function in the German financial market in the monetary settlement of securities and derivatives transactions in central bank money. The German central securities depository Clearstream Banking AG Frankfurt (CBF) and Eurex Clearing AG use ESS as the central counterparty for forward and spot transactions and the European Energy Exchange (EEX) uses it to process payments.

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Cashless payment and securities settlement systems (cont'd)

In addition to pursuing its payment policy, which is aimed at influencing national, European and international developments in payment and securities settlement, the Bundesbank also conducted a number of ongoing oversight activities in 2006. The Bank focused its activities on systems that are of particular relevance for financial stability. In Germany, this especially includes the Bundesbank's RTGS^{plus} individual payment system, which is independently monitored on the basis of internationally recognised standards. In the year under review, this included monitoring the new TARGET2 system, which will replace the current RTGS systems linked in the TARGET system in EU countries in November 2007. This should ensure that the new system is compliant with the core principles for systemically relevant payment systems before it is launched. The Bundesbank, along with other central banks, was involved in the cooperative oversight of the Continuous Linked Settlement (CLS), a global system for settling foreign exchange transactions; this included analysing the implications of a possible extension of CLS business activities. In 2006, the G10 countries' activities to monitor SWIFT, the largest global provider of communication services to the financial sector, focused mainly on SWIFT's use of effective risk control mechanisms and processes to eliminate risks to financial stability as far as possible. In addition, the Bundesbank took part in a survey on correspondent banking in the euro area. The results of this survey demonstrated that this line of business is still very important – also for German participants – and that, for some providers, correspondent banking even exceeds the transaction volume of some payment systems in the euro area. The oversight activities for payment instruments and electronic access procedures are being gradually extended. In 2006, the Bundesbank thus also supported the activities of the Eurosystem within the framework of the "electronic Payment Systems Observatory" (ePSO), a freely accessible online platform for monitoring developments in electronic payments.

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and SEPA-enabled card systems on the basis of uniform standards and rules. There should then be no difference between national and cross-border payments.

Intensive involvement at European and national level

As well as participating in Eurosystem SEPA tasks, the Bundesbank has been involved nationally in the mirror working groups of the Central Credit Committee (CCC), which support the activities of the European banking industry at a national level. In addition, together with the CCC it continued the political dialogue with SEPA end-users that was started in 2005 with a view to improving the transparency of current activities and increasing the general public's level of awareness. Following the initial focus of planning activities in Germany on implementation, the emphasis now needs to be shifted towards dissemination in order to promote active use of the new instruments.

German SEPA Committee established

In September 2006 the central associations of the CCC and the Bundesbank established the German SEPA Committee. The committee's brief is to promote and strategically underpin the swift implementation of SEPA in Germany. To this end the committee monitors and assesses the underlying political and economic situation as well as possible risks and seeks to trigger action whenever a perceived need arises.

Participation in G10 Committee on Payment and Securities Settlement Systems

At international level, the Bundesbank was very active in the G10 central banks' Committee on Payment and Settlement Systems (CPSS) at the Bank for International Settlements (BIS) in Basel. The work focused on completing a report on the settlement principles for migrants' remittances, which was drawn up together with the World Bank and was published at the beginning of 2007. Work began on a study to examine the existing dependencies between settlement systems – for example owing to joint participation – as well as the resulting implications for risks and efficiency. Another working group analysed existing agreements and risk management practices in over-the-counter derivatives markets to see whether and how existing risks can be mitigated. A particularly important initiative was a survey of institutions active on the foreign exchange markets to discover whether efforts made to date by the banking industry and central banks have led to an appropriate handling of or reduction in foreign exchange settlement risks. A report presenting the results of this survey is expected during the course of 2007.

The Bundesbank continued to develop its own range of services in 2006. For example, after introducing the SWIFTNet File Act function into its Retail Payment

System (RPS) on 9 January 2006, the Bank now provides an international communication standard for accepting and delivering payments. It has also continued to develop an image-based cheque collection procedure. This procedure is designed to replace the current large-value cheque collection procedure featuring the separate presentation of the original cheques (GSE procedure) on 3 September 2007 with the aim of rationalising cheque collection, which has been contracting greatly for years. With the Bundesbank acting as the clearing house pursuant to Article 31 of the Cheque Act (*Scheckgesetz*), cheques no longer have to be physically presented at the drawee bank because an electronic image of the cheques is sent instead.

Further development of own range of services

Following the insolvency of a number of cash-in-transit (CIT) companies and extensive consultation with the associations representing the banking sector, the retail trade and CIT service providers, the Bundesbank has decided to redesign the operational system for cash payments via Bundesbank accounts and in non-account-based payment procedures with effect from 1 April 2007. Own accounts held by CIT companies will be restricted to providing customers with coins and collecting coins from them. In the medium-term, banknotes are to be collected from trading enterprises exclusively by means of an automated non-account-based procedure; collective trustee accounts can be used as an interim measure. For banks, cash is to be provided and collected, as is already generally the practice, using their own accounts. This increases the transparency and the security of settlement in cash payments for all parties.

New procedure for settling cash payments for cash-in-transit companies

From autumn 2007, the Bundesbank will provide a self-collateralisation procedure for clearing securities settlement transactions that are processed by the German central securities depository Clearstream Banking AG Frankfurt (CBF). Purchases of securities that are eligible for this procedure (government securities and Pfandbrief bonds) can – after deducting an appropriate haircut – finance themselves without corresponding liquidity having to be kept on the purchaser's money account. In adopting this procedure, the Bundesbank is making an additional contribution to ensuring efficient securities settlement in the German financial market. This procedure will be implemented together with the current, extensive modernisation of the Bundesbank's IT infrastructure for securities trading and safe custody account business (WPneu project).

Enhanced efficiency owing to self-collateralisation procedure

Organisation and staff

I Structural reform

Structural reform has progressed considerably and will be concluded in 2007

The structural reform which began in 2002 and is due for completion by the end of 2007 has progressed considerably and will be concluded in the financial year 2007 on schedule. The Bundesbank has become more efficient and is now better placed to tackle the new challenges faced in Europe since the introduction of the euro. Previous *Annual Reports* contained a detailed account of the individual measures adopted.

Streamlining of branch network continued according to schedule

As scheduled, the Bundesbank's branch network was streamlined down to 71 locations (61 branches, ten operating units) by the end of 2006. In 2006, a further seven operating units were closed. After the round of closures in 2007, the number of branches will be reduced to 47.

Clear improvement in efficiency achieved

The targeted annual cut in the cost of providing services by around €280 million set for 2008 was already close to being achieved in the reporting year.

Outlook: strategic cycle from 2008 to 2012

The current strategic cycle focused on structural reform will be followed by the strategic cycle for the period from 2008 to 2012 based on the objective "Raising the Bank's profile – continuing the consolidation process". The aim is to raise the Bundesbank's profile as a stability-oriented, independent institution both in Germany and within the European System of Central Banks.

II Staff

Further reduction in staff numbers

The number of core staff continued to fall, decreasing by 535 (about 4%) to 11,773. As in previous years, the branch network bore the brunt of this development. If part-time and full-time employees are taken together on the basis of their contractual working hours, the Bundesbank had a weighted core headcount of around 10,972 full-time equivalent (FTE) employees (in 2005, the number was 11,502 FTEs; ie staff figures decreased by approximately 5%). Part-time employment accounted for a share of around 16%, as in 2005.

Take-up of downsizing instruments

298 salaried staff took advantage of the option of early retirement on reaching 55 years of age in the year under review.

Regional Offices and branches of the Deutsche Bundesbank on 1 April 2007

Locality number	Bank location	Regional Office [1]	Locality number	Bank location	Regional Office [1]
390	Aachen	D	520	Kassel	F
720	Augsburg	M	210	Kiel	HH
773	Bayreuth	M	860	Leipzig	L
100	Berlin	B	545	Ludwigshafen	MZ
480	Bielefeld	D	230	Lübeck	HH
430	Bochum	D			
380	Bonn	D	810	Magdeburg	H
290	Bremen	H	550	Mainz	MZ
			670	Mannheim	S
870	Chemnitz	L	840	Meiningen	L
570	Coblenz	MZ	310	Mönchengladbach	D
370	Cologne	D	700	Munich	M
180	Cottbus	B	400	Münster	D
440	Dortmund	D	150	Neubrandenburg	HH
850	Dresden	L	760	Nuremberg	M
300	Düsseldorf	D			
350	Duisburg	D	280	Oldenburg	H
			265	Osnabrück	H
820	Erfurt	L			
360	Essen	D	160	Potsdam	B
215	Flensburg	HH	750	Regensburg	M
500	Frankfurt/M	F	640	Reutlingen	S
170	Frankfurt/O	B	130	Rostock	HH
680	Freiburg	S			
	Lörrach [2]		590	Saarbrücken	MZ
			140	Schwerin	HH
513	Giessen	F	600	Stuttgart	S
260	Göttingen	H			
			585	Trier	MZ
450	Hagen	D			
800	Halle	H	630	Ulm	S
200	Hamburg	HH			
410	Hamm	D	694	Villingen-	
250	Hanover	H		Schwenningen	S
620	Heilbronn	S			
			790	Würzburg	M
660	Karlsruhe	S			

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.

Deutsche Bundesbank

Bundesbank staff on 31 December 2006 * Table 13

Item	Staff numbers 1				Year-on-year changes			
	Total	Regional Offices	Branches	Central Office	Total	Regional Offices	Branches	Central Office
Civil servants	5,828	1,678	2,131	2,019	– 100	30	– 199	69
Salaried staff	6,425	1,628	2,908	1,889	– 423	– 62	– 289	– 70
Total	12,253	3,306	5,039	3,908	– 521	– 32	– 488	– 1
of which Trainees	480	152	77	251	14	6	– 17	25
Remainder Core staff	11,773	3,154	4,962	3,657	– 535	– 38	– 471	– 26
of which Staff with permanent contracts	11,690	3,144	4,935	3,611	– 517	– 39	– 469	– 9
Staff with temporary contracts	83	10	27	46	– 18	1	– 2	– 17
Memo item Core staff *pro rata* (Full-time equivalent)	10,972.1	2,923.6	4,583.3	3,465.2	– 529.4	– 49.4	– 434.0	– 46.0

	End-2006	End-2005
* Not included:		
Members of staff on secondment	146	126
Members of staff on unpaid leave	472	544
Members of staff in the second phase of the partial retirement scheme	425	425
1 *Of which* part-time employees	1,964	1,953

Deutsche Bundesbank

On 31 December 2006, 915 members of staff had been admitted to the partial retirement 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 previous phase. There are now 425 employees in the second pre-retirement phase.

Great demands on the mobility of staff

The ongoing organisational restructuring of the Bundesbank continues to place great demands on the professional and geographical mobility of many members of staff. Employees working in areas where there is a staff surplus are therefore being retrained to work in other fields by means of tailored measures. These efforts are being accompanied as part of the comprehensive human resources management strategy by instruments aimed at promoting local mobility; these include the possibility of placing staff with other employers.

Number of trainee places remains stable

The number of trainee civil servants and of other salaried trainees changed very little from the previous year. In total, 480 members of staff (466 in 2005) 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 (277). 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, 76 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 professional 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]

– Professor Franz-Christoph Zeitler, Vice-President:
  Alternate, Administrative Council, Liko-Bank;[2]
  Alternate, Credit Committee, Liko-Bank;[2]
  Member of the Board of Trustees, Monetary Stability Foundation

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1 Ex officio.
2 Partnership agreement.

- Professor Jürgen Stark, Vice-president until 31 May 2006:[1]
  Alternate, Board of Directors, BIS[2] (until 31 May 2006);
  Deputy Chairman of the Executive Board and Board of Trustees, Ifo Institute, Munich;
  Chairman of the Board of Trustees, University of Hildesheim Foundation

- Dr Hans Georg Fabritius:
  Member of the Administrative Council, Rhineland-Westphalian Institute for Economic Research

- Professor Hans-Helmut Kotz:
  Member of the Administrative Council, Liko-Bank;[3]
  Member of the Credit Committee, Liko-Bank;[3]
  Standing guest on the Central Capital Market Committee;
  Member of the Stock Exchange Expert Commission

- Dr Edgar Meister:
  Member of the Administrative Council, Liko-Bank;[3]
  Member of the Administrative Council, BaFin;
  Member of the Auditor Oversight Commission in Germany

- Dr Hans Reckers:
  Alternate, Administrative Council, Liko-Bank[3]

- Professor Hermann Remsperger:
  Alternate, Board of Directors, BIS[2] (from 1 June 2006);
  Chairman of the Board of Trustees, Monetary Stability Foundation

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1 Offices held at the time he stepped down from the Executive Board on 31 May 2006.
2 Ex officio.
3 Partnership agreement.

Other activities

I Conferences and workshops

Dialogue with academics and practitioners

The Bundesbank hosted several conferences and smaller workshops in the past year. Such events are one way of holding a public dialogue with interested parties on issues that are of particular interest to the Bundesbank. This enables the Bundesbank to present its own research and viewpoints; in addition, conferences involving leading academics and practitioners can help to harness their knowledge and experiences for the Bundesbank's work. A number of conferences and workshops were staged by the Bundesbank in collaboration with other institutions, such as the European Central Bank (ECB), the Center for Financial Studies (CFS) at the University of Frankfurt or the Centre for European Economic Research (ZEW) in Mannheim. In the "Bundesbank lecture" series, Italian finance minister Tommaso Padoa-Schioppa delivered a keynote speech in Berlin on the topic of "Public Money and Public Expenditure".

Array of topics

The Eighth Bundesbank Spring Conference looked at the topic of "New developments in economic forecasting". Forecasting is one of the key tasks of economists at central banks. At the same time, academic researchers have developed many new methods in the past few years that can help to improve the accuracy of forecasts. Globally renowned theoreticians presented and discussed such new approaches at the conference. A symposium on "Banking supervision in dialogue" focused on concentration risk in credit portfolios and banks' interest rate risk as well as issues relating to the implementation of Basel II. At a conference on TARGET2, aspects of this future payment system were presented. Other events covered issues such as the modernisation of European financial systems and its implications for growth as well as the influence of ownership on the functioning of the banking system. The role of public banks in Germany and other countries, in particular, met with avid interest. Finally, at another conference, the interplay between monetary policy and financial markets was discussed intensively.

II Research Centre

Projects were executed and published in all four core areas of the Research Centre's programme. Part of this work was carried out in the context of internation-

Various research projects and collaborative ventures

al and national cooperation with other central banks, universities and other academic institutions. In the past year, the "Inflation Persistence Network", in which the Bundesbank was involved along with the ECB and other central banks, completed its work. This project yielded important new findings about the character of the inflation process in Europe; these findings were presented in a series of papers and at conferences. A subsequent newly created international network has, since last year, been addressing the issue of wage developments and their implications for prices in more detail. Another project, conducted jointly with the central banks of Italy and France, dealt with the question of whether, and how strongly, these three major countries' economies have been converging since joining monetary union.

Improving the understanding of the monetary transmission process is a continuing point of interest in our research programme. In this connection, in particular, several papers on the determinants of long-run interest rates, which are important for understanding the transmission channel of monetary policy, were published in the reporting year. Several papers discussed the progress of Germany's integration into the world economy and its consequences. In this context, the Research Centre also established a network of national and international scholars to research the determinants and effects of German enterprises' outward foreign direct investment (FDI) as well as foreign enterprises' FDI in Germany. The backbone of this network is a Bundesbank data pool on foreign investment activities. The German financial system and its ongoing evolution formed another focal point of research. Several studies in this field measured the efficiency of the German banking system and the potential implications for economic developments.

Publishing activity at a high level

All in all, in 2006 the Research Centre published 60 discussion papers, 48 of which were in Series 1 (Economic Studies) and 12 in Series 2 (Banking and Financial Studies). Last year the Centre's researchers published their results in over 70 articles in academic journals and books. In addition, they held lectures at numerous academic conferences.

Scientific Advisory Council

Professor Richard Clarida of Columbia University in New York City and Professor William Perraudin of Imperial College in London were named as new members of the Bundesbank's Scientific Advisory Council. Professor Clarida is an expert in monetary theory and monetary policy, while Professor Perraudin's speciality is financial stability. Professor Bernd Rudolph of the Ludwig Maximilian University of

Munich left the council at the end of the year. Lastly, several visiting scholars came to the Research Centre to carry out research.

III Technical central bank cooperation

Wide range of training and advisory activities

In the first year following the establishment of the Centre for Technical Central Bank Cooperation, demand for the Bundesbank's training and advisory services for foreign central banks remained virtually unchanged from the previous year's high level: in all, around 300 measures conducted in Germany and abroad were attended by more than 2,800 central bank staff members from over 60 central banks. In addition, the past year was marked by a further adjustment to structural changes pertaining to international central bank cooperation. Alongside ongoing alterations to content, the teaching strategy behind the international central banking seminars held by the Deutsche Bundesbank since the mid-1990s was broadened further to meet participants' requirements. The Bundesbank's programme now ranges from seminars for junior central bank staff to expert forums for high-level central bank officials. Furthermore, the number of events is also set to increase by around 15 % for the calendar year 2007. In terms of its bilateral activities, the Bundesbank is continuing to focus on tried-and-tested individually tailored projects with partner central banks across the globe.

Increased central bank cooperation on a European level

Central bank cooperation on a European level has also progressed further in the year under review. Alongside EU twinning projects, the Bundesbank's cooperation with other national central banks within the ESCB has also continued to play a prominent role. After eighteen months, the EU twinning project with the Czech National Bank has come to a successful conclusion. The primary objective of bringing the Czech monetary authority's reports on the financial stability of the country into line with ESCB standards has been fully met. Since the beginning of 2006, the Bundesbank, in conjunction with the Federal Ministry of Finance and the Federal Financial Supervisory Authority, has been advising the Turkish Capital Markets Board on matters pertaining to capital market legislation as part of a joint EU twinning project. EU twinning projects with the central banks of South-Eastern Europe are planned for this year. Within the framework of the ESCB, the Bundesbank has been involved in a MEDA (EuroMediterranean Partnership) project with the Central Bank of Egypt since the end of 2005.

MEDA funds promote economic and social reforms in Mediterranean partner countries. In the current project, a total of five central banks in the Eurosystem are providing support in reforming local banking supervision. This year, the Bundesbank will also be involved in a comprehensive Eurosystem demand analysis for the Central Bank of Bosnia and Herzegovina using CARDS (Community Assistance for Reconstruction, Development and Stabilisation) funds.

"Partnership with Africa"

Over the past year, the Federal President's "Partnership with Africa" initiative has played a special role in the Bundesbank's technical central bank cooperation programme. As the conceptual preparatory work is now largely complete, the Bundesbank is aiming to support this initiative in 2007 in conjunction with other central banks by establishing regional focal points on the African continent. The long-term secondment of one Bundesbank staff member as an advisor to the Bank of Botswana has already been confirmed.

IV Services the Deutsche Bundesbank provides for the Federal Government

Involvement in the issuance of Federal securities

As the Federal Government's fiscal agent, 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 GmbH. One-off issues of Federal securities are sold by auction via the electronic "Bund Bidding System" (BBS) developed by the Bundesbank. In 2006, there were 34 auctions with a total allotment volume of €180.4 billion (2005: €184.9 billion, also in 34 auctions). In the reporting year the Bundesbank continued to be involved, through credit institutions, in selling Federal savings notes and Federal Treasury financing paper issued on tap.

Asset management

The Deutsche Bundesbank's portfolio mandate for the pension provisions of Federal civil servants was, by law, expanded to over 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 issuers 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. The investment horizon for fixed-income securities is oriented to the expected pension reserve or pension fund payout dates.

The funded pension provisions for the Federal Financial Supervisory Authority and the Deutsche Bundesbank are regulated outside the scope of the "Act on a Federal Government Pension Reserve" *(Versorgungsrücklagegesetz des Bundes).* The Bundesbank manages both portfolios passively, one of which is mostly and the other exclusively in bonds. The Bundesbank's own-account portfolio is an asset counterpart to the pension reserves for Bundesbank civil servants. The Bundesbank also provides varying levels of securities management services in managing several types of state government pension reserves. In addition, it manages the assets of the Monetary Stability Foundation.

V Managing foreign exchange reserves

The framework for managing the foreign exchange reserves of the Bundesbank and the ECB is defined by benchmarks for each currency (US dollar and yen) that reflect the desired long-term level of risk and act as a guideline for asset management. Decisions may deviate from the benchmark within a narrow margin in order to achieve the most favourable result possible by managing duration and yield curve positions and selecting instruments.

In addition to US and Japanese government bonds, a very limited volume of fixed-interest securities of other issuers of top credit quality are recognised as 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 different types of transactions are regulated by a differentiated limit system.

Whereas the benchmark for the Bundesbank's own reserve assets is set by the Executive Board on an annual basis, the Bundesbank manages the ECB reserves for which it is responsible using two-tier benchmarks fixed by the ECB Governing Council and ECB Executive Board.

Annual accounts of the Deutsche Bundesbank for 2006

I Balance sheet of the Deutsche Bundesbank as at December 2006

Assets

				31.12.2005
			€ million	€ million
1	Gold and gold receivables		53,114	47,924
2	Claims on non-euro-area residents denominated in foreign currency			
	2.1 Receivables from the IMF	3,011		(4,549)
	2.2 Balances with banks, portfolio investment, external loans and other external assets	28,640		(33,708)
			31,651	38,257
3	Claims on euro-area residents denominated in foreign currency		—	—
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	173,940		(146,529)
	5.2 Longer-term refinancing operations	82,329		(56,448)
	5.3 Fine-tuning reverse operations	—		(—)
	5.4 Structural reverse operations	—		(—)
	5.5 Marginal lending facility	79		(949)
			256,348	203,927
6	Other claims on euro-area credit institutions denominated in euro		3,049	116
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	1,183		(1,183)
	9.2 Claims arising from the transfer of foreign reserves to the ECB	11,762		(11,762)
	9.3 Claims related to the allocation of euro banknotes within the Eurosystem (net)	—		(—)
	9.4 Other claims within the Eurosystem (net)	5,328		(29,834)
			18,273	42,779
10	Items in course of settlement		1	1
11	Other assets			
	11.1 Coins	599		(555)
	11.2 Tangible and intangible fixed assets	1,613		(1,722)
	11.3 Other financial assets	2,813		(2,809)
	11.4 Off-balance-sheet instruments revaluation differences	—		(—)
	11.5 Accruals and prepaid expenses	1,034		(775)
	11.6 Sundry items	301		(314)
			6,360	6,174
			373,535	343,919

Liabilities

				31.12.2005
			€ million	€ million
1	Banknotes in circulation		170,881	153,739
2	Liabilities to euro-area credit institutions related to monetary policy operations denominated in euro			
	2.1 Current accounts	47,913		(46,301)
	2.2 Deposit facility	43		(12)
	2.3 Fixed-term deposits	—		(—)
	2.4 Fine-tuning reverse operations	—		(—)
			47,956	46,314
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	36		(28)
	4.2 Other liabilities	369		(374)
			404	402
5	Liabilities to non-euro-area residents denominated in euro		3,746	3,438
6	Liabilities to euro-area residents denominated in foreign currency		3	4
7	Liabilities to non-euro-area residents denominated in foreign currency		1,061	2,834
8	Conterpart of special drawing rights allocated by the IMF		1,382	1,465
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)	84,334		(75,134)
	9.3 Other liabilities within the Eurosystem (net)	—		(—)
			84,334	75,134
10	Items in course of settlement		4	6
11	Other liabilities			
	11.1 Off-balance-sheet instruments revaluation differences	0		(—)
	11.2 Accruals and income collected in advance	736		(414)
	11.3 Sundry items	2,519		(2,678)
			3,255	3,092
12	Provisions		5,370	5,359
13	Revaluation accounts		45,933	44,274
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		4,205	2,860
			373,535	343,919

II Profit and loss account of the Deutsche Bundesbank for the year 2006

				2005
			€ million	€ million
	– Interest income	8,859		(6,001)
	– Interest expense	– 3,423		(– 2,168)
1	Net interest income		5,436	3,833
	– Realised gains/losses arising from financial operations	163		(335)
	– Write-downs on financial assets and positions	– 201		(– 230)
	– Transfers to/from provisions for general risks, foreign exchange risks and price risks	78		(188)
2	Net result of financial operations, write-downs and risk provisions		41	293
	– Income from fees and commissions	50		(50)
	– Expense relating to fees and commissions	– 13		(– 12)
3	Net income from fees and commissions		37	38
4	Income from participating interests		16	21
5	Net result arising from allocation of monetary income		– 71	– 51
6	Other income		174	187
7	**Total net income**		5,633	4,321
8	Staff costs		902	970
9	Other administrative expenses		234	223
10	Depreciation on tangible and intangible fixed assets		162	154
11	Banknote printing		110	93
12	Other expenses		19	21
13	**Profit for the year**		4,205	2,860

Frankfurt am Main, 20 February 2007

DEUTSCHE BUNDESBANK
Executive Board

Professor Axel A Weber
Professor Franz-Christoph Zeitler

Dr Hans Georg Fabritius
Professor Hans-Helmut Kotz
Dr Edgar Meister
Dr Hans Reckers
Professor Hermann Remsperger

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

We have audited the 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 2006 to 31 December 2006. 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, 6 March 2007

PricewaterhouseCoopers
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Borgel	Theobald
Wirtschaftsprüfer	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 shall be taken into the profit and loss account. 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 revaluation gains registered in the corresponding revaluation account.

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

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

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.

Realised gains and losses in foreign currencies can arise only in the case of transactions which result in a change in a foreign currency position.

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.

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 plant in buildings: 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 continue to 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 remains unaffected.

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 29.6% 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 decision of 19 May 2006 (ECB/2006/7).

value of the euro banknotes actually issued is greater than the value according to the 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 (net)". If the value of the euro banknotes actually issued is less than the value according to the allocation key, the difference is recorded in asset sub-item 9.3 "Claims related to the allocation of euro banknotes within the Eurosystem (net)". 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 is to be made between 2002 and 2007. The period between July 1999 and June 2001 is being 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 2006 all of the ECB's income from the banknotes allocated to it will be required to increase 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 increases 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 are that the Bundesbank's participating interest in the ECB (see asset sub-item 9.1 "Participating interest in the ECB") increase 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 increase from €11,762 million to €11,821 million (asset sub-item 9.2). The increases in the contribution to the capital of the ECB and in the claims arising from the transfer of foreign reserves were settled with the ECB as TARGET payments at the beginning of January.

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 declined from 29.6% to 29.5% on 1 January 2007.

Preparation and auditing of financial statements

The Executive Board drew up the Bundesbank's financial statements for the financial year 2006 on 20 February 2007. The financial statements were audited by PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Frankfurt am Main. The Executive Board had appointed the firm as external auditors on 17 January 2006 in accordance with section 26 (3) of the Bundesbank Act. The auditors confirmed without qualification on 6 March 2007 that the Bundesbank's financial statements for 2006 – 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 13 March 2007.

V Notes on the individual balance sheet items

1 Assets

Gold and gold receivables

At the end of 2006 the Bundesbank's holdings of fine gold (ozf) amounted to 3,422,542 kg or 110 million ounces. The gold was valued at market prices (1 kg = €15,518.78 or 1 ozf = €482.688). In the year under review the gold holdings declined by 5,274 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 €3,011 million (SDR 2,637 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 (€14,850 million) and the euro balances amounting to €13,364 million (SDR 11,707 million) at the disposal of the IMF at the end of the year. In 2006 there was a net decline of SDR 1,135 million (€1,462 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 2006 amounted to €1,525 million (SDR 1,336 million) compared with €1,601 million (SDR 1,324 million) on 31 December 2005.

Receivables from the IMF

Table 14

Item	31.12.2006		31.12.2005		Change from previous year			
	SDR million	€ million	SDR million	€ million	SDR million	%	€ million	%
Drawing rights within the reserve tranche (net)	1,302	1,486	2,437	2,948	– 1,135	– 46.6	– 1,462	– 49.6
Special drawing rights	1,336	1,525	1,324	1,601	12	0.9	– 76	– 4.8
Total	2,637	3,011	3,760	4,549	– 1,123	– 29.9	– 1,539	– 33.8

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No loans were granted to the IMF as a result of special credit arrangements under either the General Arrangements to Borrow or the New Arrangements to Borrow in 2006.

The drawing rights in the reserve tranche, special drawing rights and the counterpart of special drawing rights allocated by the IMF are shown in the balance sheet on the basis of the market rate of SDR 1 = €1.1416 (2005: SDR 1 = €1.2099) 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 €28,640 million at the end of 2006 compared with €33,708 million on 31 December 2005. These are almost exclusively US dollar holdings amounting to US$37,027 million (= €28,115 million), representing a decline of US$2,041 million from the previous year. This sub-item also contains holdings in yen (¥81,369 million = €519 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 market prices amounted to US$35,957 million compared with US$35,753 million in 2005. 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$1.3170 (compared with €1 = US$1.1797 at the end of the previous year).

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 in-

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

Item	31.12.2006 € million	31.12.2005 € million	Change from previous year € million	 %
Current account holdings and overnight deposits	513	837	– 324	– 38.7
Claims arising from reverse repurchase agreements (reverse repos, held in US dollars)	1,538	4,105	– 2,567	– 62.5
Fixed-term deposits and deposits at notice (held in US dollars)	4,161	4,942	– 781	– 15.8
Marketable securities	22,305	23,695	– 1,390	– 5.9
of which: amount held in US dollars	21,816	23,394	– 1,577	– 6.7
Other	124	130	– 6	– 4.4
Total	28,640	33,708	– 5,068	– 15.0

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come 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 pattern 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 €52,421 million higher than on 31 December 2005.

The main refinancing operations undertaken as part of money market management account for the bulk of the monetary policy operations. These operations 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 €173,940 million, which was €27,411 million more than the level on 31 December 2005. On a daily average the main refinancing operations amounted to €155,578 million (2005: €144,559 million).

The longer-term, and in terms of value smaller, refinancing operations held at monthly intervals and with a maturity of three months are used to provide additional longer-term liquidity. In the year under review they were held as variable-rate tenders. The volume of longer-term refinancing operations amounted to €82,329 million at the end of 2006 and was therefore €25,881 million above that of the previous year. On a daily average the volume of longer-term refinancing operations amounted to €73,192 million (2005: €53,000 million).

The marginal lending facility (overnight liquidity) is permanently available at a predetermined interest rate (standing facility). By 31 December 2006, recourse to the marginal lending facility had declined by €871 million on the year to €79 million. The extent to which it was being used on a daily average amounted to €80 million (2005: €81 million).

Other claims on euro-area credit institutions denominated in euro

This item, amounting to €3,049 million (2005: €116 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 2006 the Bundesbank had a 21.1% share of the ECB's capital. This share amounts to €1,176 million excluding the net increase in the Bundesbank's share of the accumulated net profits of the ECB (also referred to as net equity) in connection with the last capital key change on 1 May 2004, which – as at that time – amount to €7 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 exchange) 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 2006 these claims amounted to €11,762 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 (net)" shows the claims which arise from applying the euro banknote allocation key. As at the end of 2005, the Bundesbank again had no claims at the end of 2006 but, instead, liabilities, which are shown in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)".

A daily netting-by-novation procedure produces either a net assets balance or a net liabilities balance vis-à-vis the ECB from the TARGET settlement balances between the central banks of the ESCB. Sub-item 9.4 "Other claims within the Eurosystem (net)" contains a net assets balance together with the very small settlement balances arising from the traditional correspondent banking operations within the Eurosystem. The balances are 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 €5,399 million (2005: €30,073 million) arising from its assets and liabilities. This item also contains the liabilities amounting to €71 million in 2006 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.

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 €1,613 million compared with €1,722 million in 2005; it comprises land and buildings, furniture and equipment and computer software.

Tangible and intangible fixed assets

Table 16

€ million

Item	Purchase/ production costs 31.12.2005	Additions	Disposals	Accumulated depreciations	Book value 31.12.2006	Book value 31.12.2005	Depreciation in 2006
Land and buildings	3,031	20	– 113	– 1,512	1,425	1,546	– 103
Furniture and equipment	787	79	– 91	– 593	181	168	– 51
Computer software	102	7	– 1	– 101	8	8	– 7
Total	3,920	106	– 206	– 2,206	1,613	1,722	– 162

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Sub-item 11.3 "Other financial assets" amounting to €2,813 million contains the Bundesbank's fixed-interest euro assets (€2,723 million) as a counterpart to the pension and healthcare assistance provisions as well as its participating interests (€90 million). The participating interests are in the Bank for International Settlements (BIS), Basel, the Liquiditäts-Konsortialbank GmbH, Frankfurt am Main, and the cooperative society SWIFT, La Hulpe (Belgium).

At the end of 2006 the participating interest in the BIS was unchanged at €50 million. The Bundesbank holds 50,100 shares.

As in the previous year, the balance sheet value of the participating interest in the Liquiditäts-Konsortialbank GmbH amounted to €38 million. The 30% interest continues to entail a maximum additional commitment of €300 million for the Bundesbank.

Owing to the statutory redistribution of shares, the participating interest in the cooperative society SWIFT declined in the year under review and amounted to €2 million at the end of 2006.

Sub-item 11.5 "Accruals and prepaid expenses" contains the accrued and prepaid expenditure identified at 31 December 2006. 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 denominated in US dollars 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 2006, 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 banknotes in circulation within the Eurosystem rose from €565,216 million to €628,240 million. In accordance with the allocation key, the Bundesbank shows holdings of euro banknotes worth €170,881 million at the end of the year compared with €153,739 million at the end of 2005. The value of the euro banknotes actually issued by the Bundesbank in the year under review increased from €228,873 million to €255,216 million. As this was more than the allocated amount, the difference of €84,334 million (2005: €75,134 million) is shown in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)".

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 €47,913 million (31 December 2005: €46,301 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. On a daily average the current account deposits amounted to €40,469 million (2005: €38,524 million).

Sub-item 2.2 "Deposit facility" amounting to €43 million (31 December 2005: €12 million) contains overnight deposits at a predetermined interest rate (standing facility). On a daily average the deposit facility amounted to €82 million (2005: €53 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 2006 general government deposits amounted to €36 million in all (31 December 2005: €28 million).

Sub-item 4.2 "Other liabilities" amounted to €369 million compared with €374 million on 31 December 2005. 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 €3,746 million (31 December 2005: €3,438 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 almost exclusively liabilities in US dollars, amounting to US$1,395 million (€1,059 million) compared with US$3,341 million (€2,832 million) in 2005, 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 (net)" contains the liabilities arising from the application of the banknote allocation key (see liability item 1 "Banknotes in circulation"). At the end of 2006 these liabilities amounted to €84,334 million (2005: €75,134 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 (net)". At the end of 2006 the Bundesbank had a net claim, and this is shown on the asset side under sub-item 9.4 "Other claims within the Eurosystem (net)" 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 2006. These consist 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 2006 amounted to a total of €3,690 million. The banknote series BBk I/Ia accounted for €1,322 million of this sum (2005: €1,341 million) and the banknote series BBk III/IIIa for €2,368 million (2005: €2,492 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 of the total amount involved were taken off the books and transferred to profit and loss item 6 "Other 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 2006 amounted to €2,453 million.

Provisions

The provisions for general risks, pursuant to the regulations governing the Bundesbank's annual accounts contained in section 26 (2) of the Bundesbank Act, are created in view of the foreign currency risks, especially in the case of the Bundesbank's US dollar and SDR positions. The €78 million decline in the provi-

Provisions Table 17

Provisions for	31.12.2006 € million	31.12.2005 € million	Change from previous year € million	 %
General risk	2,000	2,078	– 78	– 3.8
Direct pension commitments	1,991	1,874	117	6.2
Indirect pension commitments (supplementary pension funds)	352	327	25	7.5
Healthcare subsidy commitments to civil servants	366	342	23	6.8
Pre-retirement part-time work	84	96	– 12	– 12.1
Staff restructuring schemes	308	352	– 44	– 12.4
Other	269	289	– 20	– 6.9
Total	5,370	5,359	12	0.2

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sions is due mainly to the year-on-year reduction in the SDR position (see asset item 2.1 “Receivables from the IMF”).

The provisions for direct pension commitments were increased by €117 million and now amount to €1,991 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 €352 million on 31 December 2006 (2005: €327 million). The provision for healthcare subsidy commitments to civil servants was increased by €23 million to €366 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 5.6% was applied in the year under review (2005: 6%).

After a reduction of €12 million a provision of €84 million for pre-retirement part-time work was shown in the balance sheet as of 31 December 2006. The provision for payment commitments arising from staff restructuring schemes that had already been carried out by the balance sheet date was reduced by €44 million to €308 million. €40 million of the reduction in these provisions is included in the profit and loss item 8 “Staff costs” and €16 million in the profit and loss item 6 “Other income”.

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

Table 18

Item	Revaluation items "old" € million	Revaluation items "new" € million	Total 31.12.2006 € million	Total 31.12.2005 € million	Change from previous year € million	%
Gold	19,019	26,004	45,023	39,821	5,202	13.1
US dollars	–	738	738	3,961	– 3,223	– 81.4
SDRs	–	–	–	168	– 168	– 100.0
Yen	–	–	–	3	– 3	– 100.0
Securities	–	172	172	321	– 148	– 46.3
Total	19,019	26,914	45,933	44,274	1,659	3.7

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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 2006 (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 the gold on 1 January 1999 and the lower value of the gold prior to that date. In the balance sheet on 31 December 1998 the value for gold was 1 ozf = DEM 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 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 shown in the profit and loss item 2/subitem "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 2006 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 costs are 1 ozf = €246.370. At the end of 2006 the market price for a fine ounce of gold was €482.688, with the result that the market value of the gold position exceeded its acquisition value and a revaluation item amounting to €26,004 million arose (2005: €20,773 million). As in 2005, the market value at the end of 2006 in the case of the US dollar position was above the acquisition value, with the result that there was a revaluation gain of €738 million. In the case of the yen and SDR positions, the market values at the end of the year were below the respective acquisition values, resulting in revaluation loses (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 €159 million arose from the valuation of US-dollar-denominated assets and €13 million from the valuation of the euro portfolio and marginal gains 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 2006 closed with an annual surplus of €4,205 million. Pursuant to section 27 of the Bundesbank Act, it will be transferred in full to the Federal Government as the statutory reserves are at their maximum level of €2.5 billion.

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 €1,604 million to €5,436 million. Of this total amount, €1,393 million was in foreign currency (primarily foreign reserves) while the euro holdings amounted to €4,043 million (primarily from the use of monetary policy instruments).

Interest income

Interest income in foreign currency increased year on year by €257 million to €1,480 million. This was due primarily to the higher annual average rate of interest on US dollar assets. The interest income from gold is derived from gold leasing transactions, which are remunerated in US dollars.

Interest income

Table 19

Item	2006	2005	Change from previous year	
	€ million	€ million	€ million	%
Interest income in foreign currency				
Gold	0	6	– 5	– 94.3
IMF	57	92	– 35	– 38.3
Current account holdings and overnight deposits	5	4	2	41.6
Reverse repo transactions	163	155	7	4.6
Fixed-term deposits and deposits at notice	213	147	66	44.7
Marketable securities	1,036	815	221	27.2
Other	6	4	2	44.8
Total	1,480	1,223	257	21.0
Interest income in euro				
Main refinancing operations	4,477	3,049	1,428	46.8
Longer-term refinancing operations	2,155	1,136	1,019	89.6
Other refinancing operations	5	3	2	70.9
Claims arising from central bank services	37	1	36	.
TARGET balances in the ESCB	264	225	39	17.3
Claims arising from the transfer of foreign reserves to the ECB	285	210	75	35.9
Financial assets	104	100	3	3.3
Other	52	53	– 1	– 2.7
Total	7,379	4,778	2,601	54.4
Grand total	8,859	6,001	2,858	47.6

Deutsche Bundesbank

Interest income in euro increased year on year by €2,601 million to €7,379 million. Income from the refinancing of credit institutions rose by €2,449 million to €6,637 million. This was due primarily to the higher interest rate level on an annual average as well as to the increases in the average volumes of the main refinancing operations and the longer-term refinancing operations (see asset item 5 "Lending to euro-area credit institutions related to monetary policy operations denominated in euro").

Interest expense

Interest expenditure increased by €1,254 million to €3,423 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 €848 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 (net)"). The €346 million year-on-year rise in expenditure on remunerating the minimum reserve balances was due mainly to the increase in the average interest rate.

Interest expenditure

Table 20

Item	2006 € million	2005 € million	Change from previous year € million	%
Interest expenditure in foreign currency				
Repo transactions	87	79	8	10.4
Other	0	0	– 0	.
Total	87	79	8	10.1
Interest expenditure in euro				
Minimum reserves	1,149	803	346	43.1
Time deposits/deposit facility	4	2	2	132.5
Liabilities arising from central bank services	95	61	34	56.6
TARGET balances in the ESCB	30	14	16	113.4
Net liabilities related to the allocation of banknotes	2,056	1,208	848	70.3
Other	2	2	– 0	– 4.6
Total	3,336	2,089	1,246	59.7
Grand total	3,423	2,168	1,254	57.9

Deutsche Bundesbank

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 €163 million compared with €335 million in 2005. In the case of foreign currency there were realised gains which arose almost exclusively from the disposal of US dollar holdings (€77 million) and SDR holdings (€56 million). The realised gains from gold also include the partial dissolution (€29 million) of the revaluation item "old" created on 1 January 1999 (see liability item 13 "Revaluation accounts").

The valuation losses of €201 million recorded in the sub-item "Write-downs on financial assets and positions" occurred in US-dollar-denominated securities (€92 million) and euro paper (€31 million) as well as in the yen position (€64 million) and SDR position (€14 million).

The sub-item "Transfers to/from provisions for general risks, foreign exchange risks and price risks" contains the reduction of €78 million in the provision for general risks (see liability item 12 "Provisions").

Net income from fees and commissions

There was a year-on-year decline of €1 million to €37 million in net income from fees and commissions.

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

Table 21

Item	2006	2005	Change from previous year	
	€ million	€ million	€ million	%
Realised gains/losses				
Gold	69	47	22	47.4
Foreign currency	134	255	– 121	– 47.5
Securities	– 39	34	– 73	– 215.1
Total	163	335	– 172	– 51.3
Write-downs				
Foreign currency	– 78	0	78	.
Securities	– 123	– 230	– 108	– 46.8
Total	– 201	– 230	– 30	– 12.8
Transfers to/from provisions for general risks, foreign exchange risks and price risks	78	188	– 110	– 58.5
Grand total	41	293	– 253	– 86.1

Deutsche Bundesbank

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 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 (net)"; and the net liabilities arising from TARGET accounts contained in liability sub-item 9.3 "Other liabilities within the Eurosystem (net)". 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.

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) as amended by the Decision of the European Central Bank of 19 May 2006 (ECB/2006/7).

Net income from fees and commissions

Table 22

Item	2006 € million	2005 € million	Change from previous year € million	 %
Income				
Cashless payments	29	30	– 1	– 2.7
Cash payments	5	5	0	7.1
Securities trading and safe custody account business	10	9	1	8.9
Other	6	7	– 0	– 6.0
Total	50	50	0	– 0.1
Expenditure				
Securities trading and safe custody account business	8	7	1	10.0
Other	5	5	0	7.9
Total	13	12	1	9.2
Grand total	37	38	– 1	– 3.1

Deutsche Bundesbank

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 (net)", the net assets arising from TARGET accounts contained in asset sub-item 9.4 "Other claims within the Eurosystem (net)" 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.

In the year under review the allocation of monetary income resulted in a net liability of €71 million for the Bundesbank. This net liability represents the difference between the €4,490 million in monetary income paid by the Bundesbank into the common pool and the Bundesbank's claim of €4,419 million – corresponding to the Bundesbank's share of the ECB's paid-up capital – on the common pool. In 2005 the distribution of monetary income among the national central banks resulted in net expenditure of €51 million.

Other income

The remaining income amounted to €174 million compared with €187 million in 2005. In the financial year 2006 profits from the sale of buildings and land accounted for €106 million of this income.

Staff costs

Total expenditure on staff declined year on year by €68 million (7%) to €902 million.

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 to be published. In 2006 the President of the Bundesbank received a pensionable salary of €280,583.00, 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 €369,391.82. On 1 June 2006 there was a change of Vice-President. Up to the date on which he relinquished office (31 May 2006), the then incumbent Vice-President had received a pensionable salary of €93,361.00, a special non-pensionable remuneration of €25,564.60, a special payment of €4,668.05 in accordance with the *Bundessonderzahlungsgesetz* and a standard expenses allowance of €1,278.25, amounting to a total of €124,871.90. His successor, who was already a member of the Executive Board before 1 June 2006, drew for the year a pensionably salary of €201,226.20, a special non-pensionable remuneration of €54,963.88, a special payment of €5,018.16 in accordance with the *Bundessonderzahlungsgesetz* and a standard expenses allowance of €2,854.75, amounting to a total of €264,062.99. In 2006 each of the five other members of the Executive Board received €221,323.92; €168,549.92 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 €11,831,492.95 in 2006.

In the year under review, expenditure on retirement pensions, including transfers to the provisions for pension and healthcare subsidy commitments to civil servants, rose by €161 million to €299 million. If the transfer of funds to provisions is excluded, the year-on-year increase in expenditure amounted to €2 million.

The main staff-related provisions, other than the provisions for pension and healthcare subsidy commitments to civil servants, are those for commitments under pre-retirement part-time working agreements and staff restructuring schemes (see liability item 12 "Provisions").

Other administrative expenses

The other (non-staff) operating expenditure increased year on year by €11 million (5.1%) to €234 million.

Depreciation on tangible and intangible fixed assets

The depreciation of land and buildings, of furniture and equipment and of computer software amounted to €162 million compared with €154 million in 2005 (see asset sub-item 11.2 "Tangible and intangible fixed assets").

Banknote printing

Expenditure on banknote printing increased by €17 million to €110 million because the Bundesbank procured a much greater number of banknotes than in 2005. 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 on the year by €2 million to €19 million.

The Deutsche Bundesbank: key figures

	2005	2006
Staff[1]		
Core staff (full-time equivalents)	11,501	10,972
– Contraction since 31 December 2001[2]	-3,299 (= 22.3%)	-3,828 (= 25.9%)
Projected core staff (full-time equivalents)		
– End-2007 = 10,500		
– End-2012 = 9,000		
Locations/core staff (full-time equivalents)[1]		
Central Office	1 / 3,511	1 / 3,465
Regional Offices	9 / 2,973	9 / 2,924
Branches and operating units	78 / 5,017	71 / 4,583
Projected number of branches		
– End-2007 = 47		
Annual accounts[1]		
Profit for the year	€2,860 million	€4,205 million
Net interest income	€3,833 million	€5,436 million
Balance sheet total	€343,919 million	€373,535 million
Foreign reserve assets (total)	€86.2 billion	€84.8 billion
– *of which* foreign currency	€33.7 billion	€28.6 billion
– *of which* gold	(3,428 t) €47.9 billion	(3,423 t) €53.1 billion
– *of which* receivables from the IMF	€4.5 billion	€3.0 billion
ECB capital key[3]		
Share of subscribed capital		20.5211%
Share of paid-up capital		29.5229%
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)	351	377
– *of which* using the Bundesbank as an intermediary	227	254
Amount outstanding for main refinancing operations in the euro area[4]	€290 billion	€307 billion
– *of which* counterparties of the Bundesbank	€145 billion	€156 billion
Cash payments		
Volume of euro banknotes in circulation (Eurosystem)[1]	€565.2 billion	€628.2 billion
Volume of euro coins in circulation (Eurosystem)[1]	€16.6 billion	€17.9 billion
Value of DM/euro exchange transactions	DM288.6 million	DM240.4 million

1 On 31 December.
2 Core staff (full-time equivalents) on 31 December 2001 (year before the structural reform): 14,800.
3 Since 1 January 2007.
4 Daily average.

	2005	2006
Incidence of counterfeit money in Germany		
Euro banknotes	74,000 banknotes	46,000 banknotes
Euro coins	46,300 coins	77,000 coins
Cashless payments		
Payments via the Bundesbank (number of transactions)	2,215.1 million	2,340.1 million
– *of which* via RPS (Germany)	2,172.2 million	2,294.5 million
– *of which* via RPS (cross-border)	2.5 million	3.4 million
– *of which* via RTGS^{plus} (Germany)	30.8 million	32.7 million
– *of which* via RTGS^{plus} (cross-border)	5.0 million	5.1 million
Payments via the Bundesbank (value)	€143 trillion	€165 trillion
– *of which* via RPS (Germany)	€2,099 billion	€2,189 billion
– *of which* via RPS (cross-border)	€2 billion	€5 billion
– *of which* via RTGS^{plus} (Germany)	€97 trillion	€104 trillion
– *of which* via RTGS^{plus} (cross-border)	€41 trillion	€47 trillion
Banking supervision		
Number of institutions to be supervised	3,149	3,117
Audits of banking operations	106	186
Monthly returns processed	30,086	34,486
Audit reports processed	12,331	10,734
Own Funds Principle (Principle I) reports	28,452	27,572
Liquidity Principle (Principle II) reports	27,140	26,467
Prudential discussions	2,047	2,400
Cooperation with foreign central banks		
Training and advisory events	345	311
– Number of participants (total)	3,294	3,066
– Number of participating countries (total)	78	85
Selected publications (number per year/average number of copies)		
Annual Report	1 / 25,600	1 / 23,600
Financial Stability Review	1 / 23,000	1 / 22,000
Monthly Report	12 / 22,200	12 / 19,300
Statistical Supplements	52 / 4,000	52 / 3,400
Research Centre Discussion Papers	58 / 800	60 / 800
Publications in academic journals/books	43 / no data available	73 / no data available
External communication/public relations		
Visitors to the Money Museum	38,600	36,600
Written answers to queries	18,000	13,200
Press releases	215	217
Visits to the website (www.bundesbank.de)	82,000,000	90,000,000
Total number of copies of educational material for schools	800,000	900,000
Training sessions on counterfeit prevention	2,100	550
– Number of participants	45,000	11,000