DEUTSCHE
BUNDESBANK

ANNUAL REPORT

2004 2005 2006 2007 2008

We mourn the death in 2004

of the former Member of the Directorate of the Deutsche Bundesbank

Dr Günter Storch

† 3 August 2004

and of the following members of our staff

Klaus-Heinrich Beckmannshagen	7 January 2004
Hermann-Josef Gerhards	11 January 2004
Gerd Kornmann	17 January 2004
Günter Görtz	18 January 2004
Wilfried Grassmann	20 January 2004
Gerd Patze	15 March 2004
Peter Müller	20 March 2004
Bernhard Sutter	27 March 2004
Edda Schülbe	29 April 2004
Claus Otto	13 May 2004
Waltraud Baumgart	29 May 2004
Dagmar Felber	19 June 2004
Helmut Brust	19 June 2004
Gerda Hippler	26 June 2004
Angelika Barreneche Arias	30 June 2004
Horst Kälz	4 August 2004
Armin Müller	3 September 2004
Heinz Baden	10 September 2004
Klaus Schober	22 September 2004
Dagmar Balkow	24 October 2004
Hans Vorholzer	13 November 2004
Rolf Loock	29 November 2004
Ruth Chorvas	30 November 2004
Arno Langner	6 December 2004
Reiner Güth	18 December 2004

We also remember the retired staff members of the Bank who died in 2004.

We will honour their memory.

DEUTSCHE BUNDESBANK

Members of the Executive Board of the Deutsche Bundesbank

Professor Axel A Weber
President of the Deutsche Bundesbank
(from 30 April 2004)

Ernst Welteke
President of the Deutsche Bundesbank
(up to 27 April 2004)

Dr Jürgen Stark
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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	Figure unknown, not to be published or not meaningful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

For the German economy, 2004 was a year of rather mixed fortunes. A positive aspect is that the price climate in Germany and in the euro area as a whole remained essentially favourable despite major burdens from administered prices and the oil price surge. In addition, the economy pulled out of the period of persistent weakness that had lasted from mid-2000 to mid-2003. In the third and fourth quarter of 2004, however, the macroeconomic momentum slackened again. The unbalanced demand structure was a characteristic feature of the year as a whole. The dynamic performance of the external sector continued to contrast with weak domestic demand.

Overall economic growth in the past year was not sufficiently strong to bring about a turnaround on the labour market. At the beginning of 2005, there was even a sharp rise in the number of persons officially registered as unemployed, although this increase was of a statistical nature largely attributable to the fact that former recipients of social assistance who are able to work are now included in the jobless figures. In the public debate, these figures have recently threatened to eclipse the progress made in the area of structural reforms. At all events, the ball has now been set rolling on the labour market. For example, considerable advances have been made in terms of the flexibility of working hours and rates of pay. Management and unions demonstrated a keen awareness of the need to safeguard jobs and production sites. Furthermore, the entry into force of the "Hartz IV" social welfare changes laid key foundations for a structural improvement in the labour market situation.

In the context of the cyclical improvement, German credit institutions enjoyed a more stable position in 2004 after experiencing difficult years in 2002 and 2003. The restructuring measures which they set in train and their efforts to reduce their portfolios of risk assets made an important contribution in this respect. The Deutsche Bundesbank described these developments in detail in its report on the stability of the German financial system published in October 2004.

The situation of public finances remained very strained. With the general government deficit amounting to 3.7% of GDP in 2004, the 3% ceiling laid down by the Maastricht Treaty was exceeded for the third year in succession. Although the Ecofin Council initially decided not to pursue the excessive deficit procedures against Germany and France in the autumn of 2003, both countries – in return – pledged to reduce their deficits to below 3% of GDP in 2005. However, it is by no means assured that this target will be achieved; in view of further revenue shortfalls ensuing from the final stage of the income tax reform, strict expenditure restraint will be required at all levels of government. These efforts are crucially required not only to honour Germany's European commitments, but also to comply with its national budgetary regulations; moreover, they are in the country's own self-interest given the pressing demographic problems facing its social security systems.

Numerous other EU member states also had extreme difficulties complying with the provisions of the Stability and Growth Pact. In September 2004, the European Commission presented a set of proposals aimed at reforming the Pact in which it heeded the deficit countries' calls to take greater account of country-specific circumstances. The Deutsche Bundesbank has clearly voiced its opposition to the reform proposals as they would reduce the Pact's binding effect and thus weaken the commitment to fiscal discipline. The Stability and Growth Pact was an important precondition for the public acceptance of monetary union, especially in Germany. A further cause for concern is not least that a move towards relaxing the rules could also spread to the convergence criteria. This would give rise to the risk of the euro being introduced in countries which have not yet achieved the necessary degree of convergence.

The European Union gained ten new members on 1 May 2004. In June 2004, Estonia, Lithuania and Slovenia became the first new EU countries to join the European Exchange Rate Mechanism. In October 2004, the Heads of State or Government of the now 25 EU member states signed the Treaty establishing a Constitution for Europe. In contrast to the original draft, the Constitutional Treaty expressly lays down not only balanced economic growth, but also price stability as an EU objective. The fact that price stability has been included in the Union's objectives is due above all to the insistent urging of the central banks, in particular the ECB and the Bundesbank.

For the Deutsche Bundesbank, 2004 ushered in a number of changes. Following the appointment of a new president, the Executive Board adopted a series of measures to strengthen the Bank's corporate governance. At the same time, the Bundesbank pushed ahead with its internal structural reform. As decided in 2002 and 2003, the Bank will close around 60% of its locations and employ around 30% fewer staff (compared with the figures at the end of 2002) by the end of 2007. In 2004, the Bundesbank made good progress towards the goal of optimising its organisational structure. The central concentration of various activities within dedicated service centres has almost been completed. The streamlining of the branch network is running to plan. Considerable savings have been made with regard to staff costs and other administrative expenses for the provision of in-house services.

The *Annual Report* also contains the Bundesbank's annual accounts for 2004, which were drawn up by the Executive Board and have been independently audited.

My fellow members of the Executive Board join me in taking this opportunity to express our gratitude to all members of the Bank's staff for their work in 2004. Besides thanking them for their past efforts, I call on them to continue to play an active role in ensuring the fulfilment of the Bank's many and varied functions. My thanks also go to the staff representative bodies for their committed and constructive contribution.

Frankfurt am Main, March 2005

Professor Axel A Weber
President of the Deutsche Bundesbank

Currency and economy

I The international and European setting

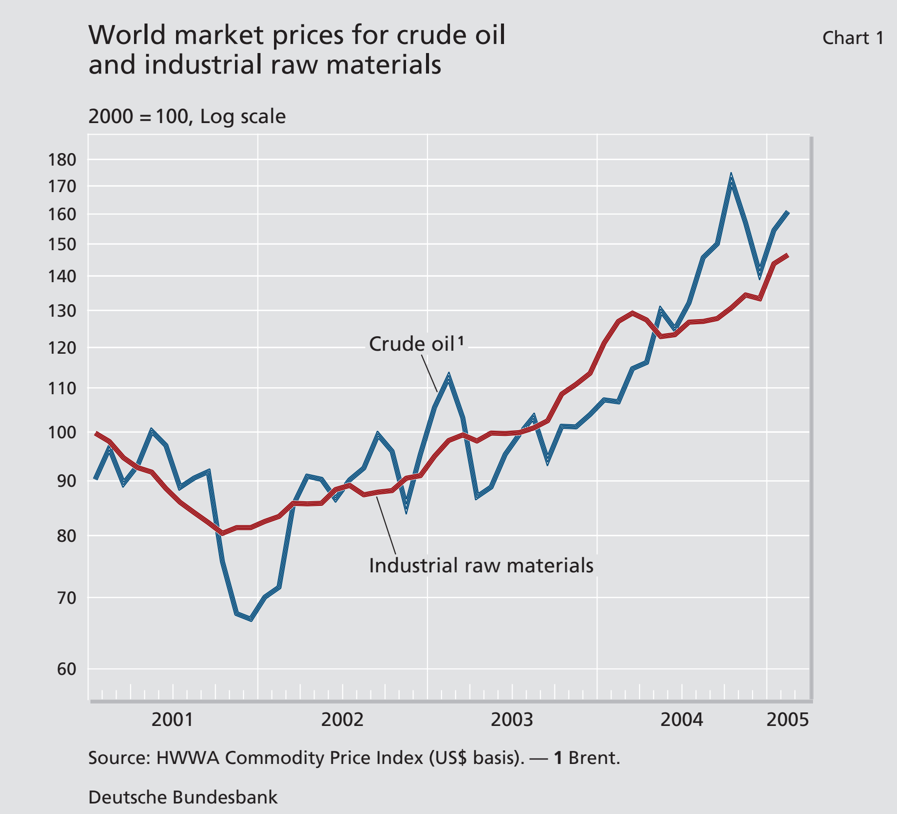
1 Global economic upturn

Strong growth of world economy amid slackening momentum in second half of 2004

The global upturn which began in 2003 continued at a robust pace in the first half of 2004. In the second half of the year the momentum of worldwide economic activity slackened, however. On an annual average global output grew by an estimated 5%. Such a high rate was last recorded in the mid-1970s. Compared with the multi-year average (+3½%), too, global economic growth in 2004 was exceptionally strong. The marked increase in output went hand in hand with very buoyant cross-border trading of goods. Real world trade, which had already picked up noticeably in 2003, expanded by nearly 9% according to IMF calculations. At the same time, however, the imbalances in the world economy became more pronounced. They were reflected towards the end of 2004, in particular, in sizeable exchange rate movements. These entailed further adjustment burdens for the euro area. At the global level the changes in cross-currency parities to date have not caused any serious disruptions of the economic recovery process.

Global economy driven by USA and China

The worldwide upturn in 2004 was again fuelled by the dynamic economy in the USA and the east Asian newly emerging markets, especially China. The higher demand for imported manufactures and intermediate goods in the two regions provided strong expansionary impulses to Japan and the euro area in particular. Countries that export crude oil and raw materials benefited not only from the vigorous volume growth but also from the in some cases substantial price increases for energy and industrial commodities, with the result that their terms of trade improved. A salient feature of the current upturn is that it is being co-driven for the first time by an emerging-market economy, namely China. The large weight of industrial production that is typical of emerging-market economies also explains the current commodity and energy bias of global growth, which to some extent may be characterised as a resurgence of the "old economy". The process of global economic expansion was additionally supported by the persistently favourable financing terms for both enterprises and households as well as the marked share price rally on the stock markets. In addition, the risk premia charged for emerging-market government securities on the international bond markets were exceedingly low.



World economy handicapped by higher oil prices

The main factor dampening the momentum of the world economy after the middle of 2004 was the steep rise in crude oil prices, which occurred from the start of 2004 in several stages. At the end of October the quotations for Brent crude oil reached a new high of US$51½ per barrel.[1] While crude oil prices receded distinctly during the final two months of 2004, at the end of the year they were still 33% up over twelve months. On an annual average, too, the US dollar price of Brent was one-third higher than in 2003. Calculated in euro, the year-on-year increase was significantly smaller (+21½%) on account of the euro's appreciation. From the turn of 2004/2005 oil prices began to nudge back up again; in early March they reached a new historical peak of US$53½. The market prices of industrial raw materials likewise increased substantially in 2004. On an annual average they exceeded the corresponding level in 2003 by 25% in US dollar terms and by 13½% in euro terms. The boom on the oil and commodity markets was fuelled principally by the cyclical upswing in demand and as such is of an endogenous nature. However, the oil price spike reached in the fourth quarter of 2004 was also partly caused by supply disruptions connected *inter alia* with reduced production in the wake of the hurricane damage

1 In real terms, ie taking account of the increase in consumer prices in the industrial countries, crude oil prices were, however, still noticeably lower than in the late 1970s and early 1980s.

on the US Gulf coast. Oil prices were additionally driven for a time by speculative influences in connection with the geopolitical tensions in the Middle East. A growing share of the additional revenue of the oil-exporting countries appears meanwhile to be flowing back to the oil-consuming countries in the form of rising demand for goods. Nevertheless, on a global scale this is still being outweighed at present by the retarding effects of the erosion of purchasing power in the importing countries.

Relatively favourable price climate in industrial countries despite rise in energy prices

Despite the rise in crude oil prices, which led directly to higher prices for mineral oil products, consumer price inflation increased comparatively little in most industrial countries. The main reason for this was that their energy intensity has declined and that so far there have been discernibly fewer second-round effects in the form of higher pay increases than was the case during the oil price crises of the 1970s and early 1980s. This helped to limit the need for monetary policy action in 2004.

Global growth conditions still good, but considerable risks remain

The somewhat slower pace of global economic activity of late also has some positive aspects. For much of 2004 world output expanded at a pace that in part was distinctly higher than the rise in the production potential and would sooner or later have led to tensions. A certain deceleration in world economic activity was inevitable anyway because the previously very strong fiscal policy impulses were on the wane and monetary policy switched to a less accommodating stance. Apart from that, the high oil prices have merely dampened global growth; the underlying conditions for a sustained upturn are still in place. All in all, the world economy has got off to a sound start in 2005. The prospects for a continuation of global growth remain favourable. Global risks may be perceived in the continuing high volatility of the oil markets and the persisting external imbalances. Another factor that is difficult to gauge is whether there is a need for price adjustment, particularly on the Anglo-Saxon real estate markets and on the international bond markets.

Sharp expansion in USA amid growing imbalances

The US economy picked up speed in the second half of 2004 after the pace of expansion had slowed a little in the second quarter. On an annual average GDP grew by 4½%. Given potential growth of 3¼% (according to IMF estimates), aggregate utilisation also increased. The output gap looks set to narrow further in 2005, even though real GDP will probably not expand as strongly as it did last year. The main drivers of US economic activity last year were once again private consumption and gross fixed capital formation. Whereas in the first half of 2004 private consumption had been stimulated predominantly by tax rebates and

Macroeconomic benchmark figures of selected industrialised countries Table 1

	Real GDP		Consumer prices 1		Current account balance		Unemployment rate 2	
	2003	2004 pe	2003	2004 pe	2003	2004 pe	2003	2004 pe
Countries	Annual percentage change				As % of GDP		In %	
OECD	2.2	3.6	1.5	1.5	– 1.1	– 1.2	7.1	6.9
of which								
Euro area	0.5	2.0	2.1	2.1	0.3	0.5	8.7	8.8
United Kingdom	2.2	3.1	1.4	1.3	– 1.7	– 2.2	4.9	4.6
United States	3.0	4.4	2.3	2.7	– 4.8	– 5.5	6.0	5.5
Japan	1.4	2.6	– 0.3	0.0	3.2	3.5	5.3	4.7
Canada	2.0	2.8	2.8	1.9	2.0	3.0	7.6	7.2

Sources: IMF, ECB, OECD, national statistics. — **1** Consumer price index; OECD: deflator of private consumption (excluding high-inflation countries). — **2** Standardised unemployment rate, based on OECD and Eurostat calculations.

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mortgage refinancing, in the second half of the year the main stimulus came from a further fall in saving by US consumers for a time in response to the loss of purchasing power caused by the rising oil prices. Although the private saving ratio rose again distinctly at the end of 2004 when households benefited from exceptionally large dividend payouts, on an annual average it dropped to a new low (1%). Industrial investment and expenditure on new residential construction grew by 10½ and 9½%, respectively. The real external balance of goods and services went further into the red in 2004 and per se slowed GDP growth by ¾ percentage point. The US current account deficit reached a new estimated high of 5½% of GDP. Despite the buoyant macroeconomic situation the US administration was unable to reduce the budget deficit; according to an estimate made by the OECD, the general government deficit in 2004 remained around 4½% of GDP. The rate of consumer inflation rose markedly in the course of the year owing chiefly to the oil price surge. On an annual average it stood at 2.7%, compared with 2.3% in 2003. The headline rate (excluding energy and food) rose in 2004 by less than ½ percentage point to 1.8%.

In Japan the cyclical momentum weakened considerably during the course of 2004. Following a sharp upswing at the beginning of the year, seasonally adjust-

Marked slowdown in Japan in the course of 2004

ed national output contracted by a total of ½% in the next three quarters. Among the causes of this were the strains on domestic demand from the oil price hike, the appreciation of the yen and the slowing pace of growth of world trade in the second half of the year. On an annual average GDP increased by 2½% thanks to the strong growth overhang from 2003 and the dynamic pace of expansion at the start of 2004.[1] This led to a further narrowing of the output gap. Domestic demand accounted for about three-quarters of the rise in real GDP and net exports for one-quarter. The decline in consumer prices was halted in the third quarter, and on an annual average the level remained unchanged. Although the budget deficit was lowered distinctly in 2004, it was still very high at 6½% (according to OECD estimates). The central bank continued its policy of providing massive liquidity at zero interest rates. Not least on account of the healthy corporate earnings trend, the Japanese banks and production enterprises made good headway in overcoming their structural problems.

South and east Asian emerging economies still on growth path despite significant burdens

At 7½%, the emerging-market countries in south and east Asia again achieved the highest growth rates of the world's main economic regions in 2004 (according to IMF estimates). Although the surge in oil prices was keenly felt in this area owing to the relatively high energy intensity in these countries, this did not lastingly impede the upswing. Even the tsunami disaster at the end of 2004, which caused a high toll of human casualties and wrought massive damage in a number of south Asian states, will probably slow the high growth tempo only a little. In most of the countries affected the relative weight of the hardest hit sectors – coastal fishing and tourism – is fairly small. Two exceptions to this are the Maldives and Sri Lanka, which have an above-average dependency on tourism. At 9½%, China's aggregate output expanded even faster than in 2003. After clear signs of overheating had become evident at the start of 2004, the Chinese government initially took administrative measures to dampen domestic demand. In addition, in October the central bank raised interest rates for the first time in a long while. The economic policy measures, together with the curbing effect of higher oil prices, appears to have slowed the rate of expansion somewhat.

High rate of expansion in the new EU states, but still large prosperity gap

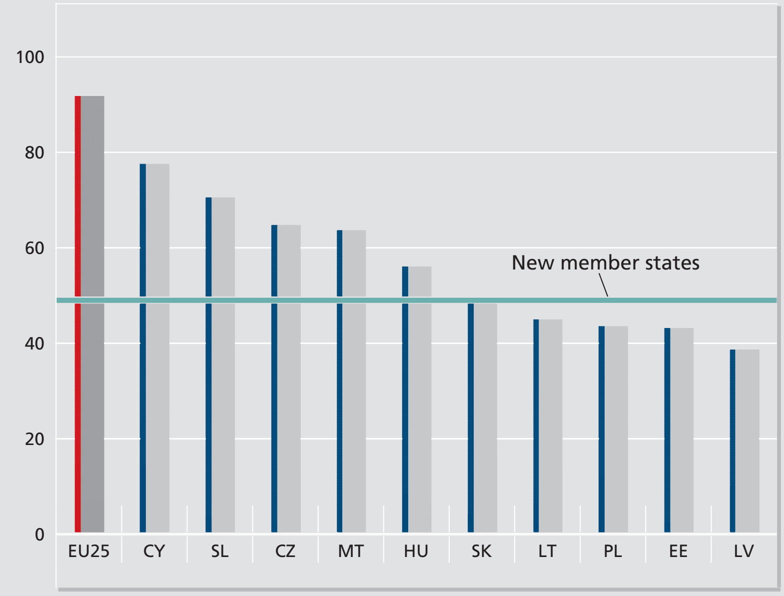
In 2004 the new EU member countries further narrowed the real economic gap vis-à-vis the older EU states. According to the IMF's estimate, their aggregate output grew by 5% compared with 2¼% in the old member countries. Al-

1 GDP thus grew far more slowly than many observers had anticipated. This was due firstly to the cyclical slowdown and secondly to the methodological changeover in the national accounts to a chain index at the end of 2004. According to the new method of calculation the decline in the Japanese price level – measured by the GDP deflator – was much more moderate than previously reported.

Per capita income in the new EU member states and in the EU as a whole

Chart 2

Per capita GDP in purchasing power standards in 2004, EU15 = 100



Source: European Commission.

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though the prosperity gap between the new and old EU states has narrowed significantly in recent years on account of the new member states' strong growth lead, it has remained quite large. Per capita GDP – calculated on the basis of purchasing power parities – in the new EU member countries in 2004 was about half the average level of the EU15. The spread ranged from 39% of the EU15 median in Latvia to 78% for Cyprus. The macroeconomic picture in the new member countries was clouded again in 2004 by the difficult situation of public finances. Moreover, the rate of price increases in the group of new countries strengthened perceptibly. This was caused principally by cyclical developments, the rise in food and energy prices and (in some cases sharp) increases in indirect taxes in connection with accession to the EU. While the average current account deficit, estimated at 4½% of GDP, was quite high, it should be remembered that this was accompanied by high foreign direct investment.

Latin America and CIS buoyed by booming crude oil and commodity markets

The majority of the Latin American countries and of the Community of Independent States (CIS) profited very greatly in 2004 from the boom on the commodity and crude oil markets. In addition, these countries enjoyed very favourable funding terms on the financial markets. The overall balance for Latin America was more propitious in 2004 than it has been for many years. For 2005, too, an ongoing favourable course of development is apparent. The region's real GDP grew last year – based on IMF estimates – by 4½% following 2% in 2003. The rate of inflation eased from 10½% in 2003 to 6½%, while the region's aggregated current account surplus has edged up further. Argentina and Venezuela achieved especially high growth rates, although this was at least partly due to exceptional factors. In the case of Argentina this notably includes the payment moratorium, while the Venezuelan economy has been given a massive uplift by the higher oil revenues. In Brazil the macroeconomic framework for a sustained vigorous expansion improved further. Mexico also made relatively good headway in the slipstream of the US upturn, although the competitive pressure from China is making itself increasingly felt. The risks for the Latin American countries stem principally from the possibility of marked interest rate rises in the USA and corresponding shifts in capital movements. The aggregate output of the CIS again expanded very sharply last year. Within this group of states Russia has developed into a growth pole that has also pulled along those countries whose terms of trade have deteriorated as they are net importers of oil. Russia's continuing heavy reliance on the energy and raw materials sector could prove a problem in the medium term, however. The climate for private domestic and foreign investment in industry still leaves something to be desired.

Strongest growth in euro area since boom year 2000

The euro-area economy, which had started to recover in the second half of 2003, picked up speed noticeably in the first half of 2004. From the middle of the year, however, the pace of expansion slowed distinctly. On average in 2004 real GDP grew by 2%, which was the largest rise in output since the boom year 2000. At the same time economic growth came much nearer to its potential rate, which according to the ECB's estimate is just over 2%. In contrast to the two previous years, therefore, the underutilisation of production capacity increased only marginally. The euro area's economy again lagged behind those of the other two members of the triad last year. Its growth gap vis-à-vis the USA was virtually unchanged but narrowed perceptibly vis-à-vis Japan.

Strong impulses from external demand and ...

The main impulse for the accelerating rate of expansion in 2004 came from external demand, which had moved onto a steep upward curve back in the second half of 2003. Real exports – which include exports within the euro area according to the definition used in the national accounts – increased last year by 6% and contributed 2¼ percentage points to GDP growth. Real imports likewise rose sharply from the second quarter. Over 2004 as a whole they grew almost in parallel with exports, so that the real balance of net exports barely changed.

Economic performance in the euro area

Table 2

Country	Real GDP		Consumer prices 1		Unemployment rate 2	
	2003	2004 pe	2003	2004 pe	2003	2004 pe
	Annual percentage change				in %	
Euro area	0.5	2.0	2.1	2.1	8.7	8.8
Germany	– 0.1	1.6	1.1	1.7	9.0	9.5
France	0.5	2.5	2.2	2.3	9.5	9.6
Italy	0.3	1.2	2.8	2.3	8.4	8.0
Spain	2.5	2.7	3.2	3.0	11.3	10.8
Netherlands	– 0.9	1.3	2.2	1.4	3.8	4.7
Belgium	1.3	2.7	1.4	1.9	8.0	7.8
Austria	0.7	...	1.3	1.9	4.3	4.5
Finland	2.4	3.7	1.3	0.2	9.0	8.8
Portugal	– 1.1	...	3.3	2.5	6.3	6.7
Greece	4.5	3.9	3.4	3.1	9.7	...
Ireland	3.7	...	4.0	2.3	4.6	4.5
Luxembourg	2.9	...	2.6	3.2	3.7	4.2

1 Harmonised Index of Consumer Prices (HICP). — **2** Standardised unemployment rate according to calculations by Eurostat (ILO definition).

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... revival of domestic demand

The vigorous export growth was accompanied by a revival of domestic activity. Domestic demand expanded on an annual average by 2% (following 1¼% in 2003). Stockbuilding contributed ¾ percentage point to this and final domestic demand 1¼ percentage points. Of the individual components of final demand, real government consumption expenditure registered the largest growth at just over 1½%. Following a cumulative decrease of 3½% between 2001 and 2003, gross fixed capital formation increased again by 1¼%. Real private consumption likewise grew by 1¼% and hence only a little faster than in 2003. Consumers' restrained propensity to purchase was due chiefly to the difficult overall situation on the labour market and the small growth of incomes. This was compounded in the fourth quarter by the oil price surge which eroded households' purchasing power.

Smaller growth differentials among member states

The growth differentials within the euro area narrowed perceptibly during the year under review. In calendar-month terms, ie not adjusted for the variations in the number of working days, the rates of expansion ranged from Ireland's estimated GDP growth of 5½% down to Portugal's output rise of 4½ percentage points, whereas in 2003 growth rates had shown a top-bottom spread of 5½ percentage points between Greece and Portugal. The unweighted standard deviation fell by ½ percentage point in 2004 to 1¼ percentage points. The standard deviation weighted by the share in GDP declined from 1¼ percentage points to ¾ percentage point. With respect to the growth forces, however, the euro area still presented a very mixed picture.

Turning point reached on labour market

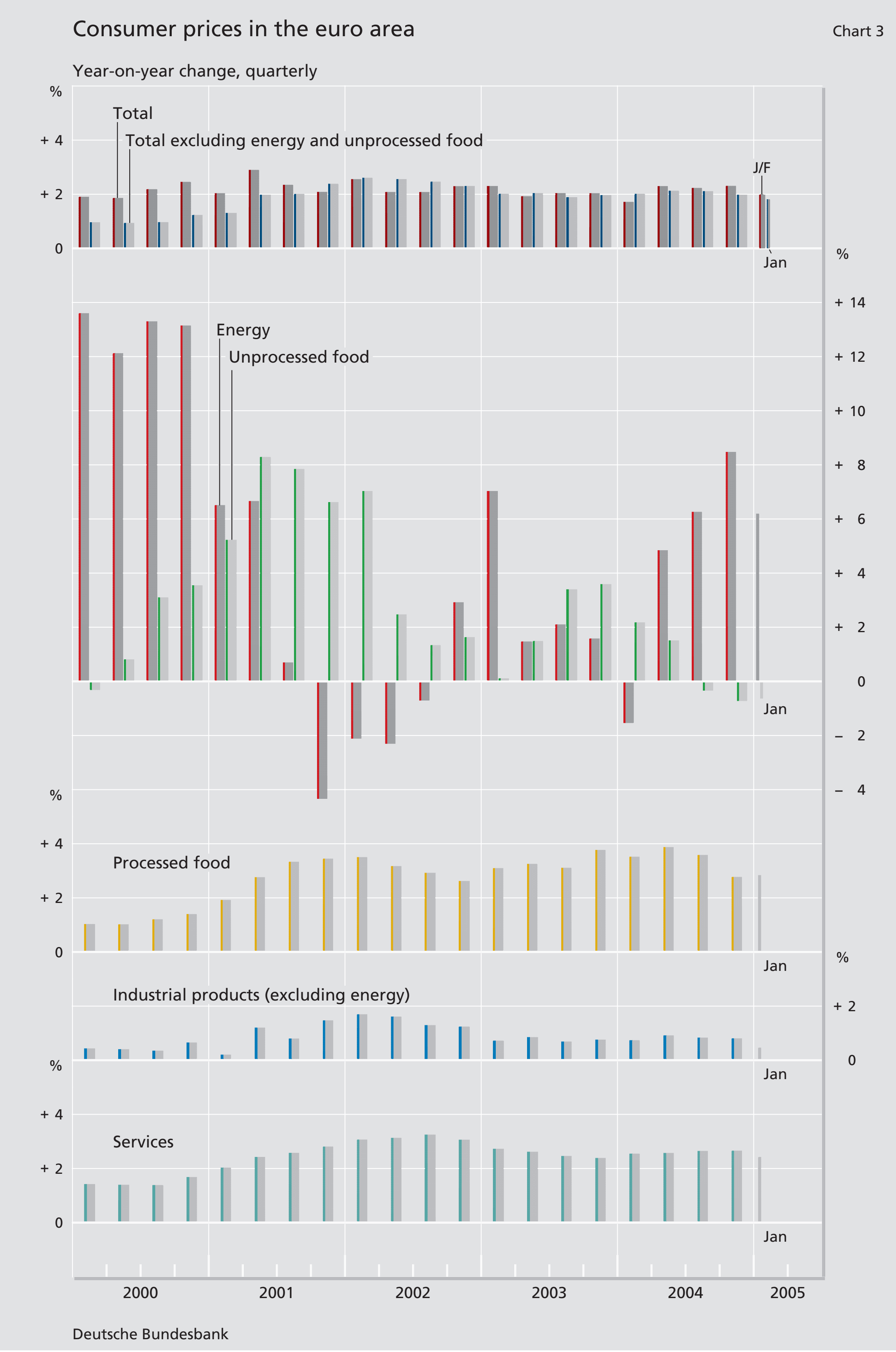
The moderate cyclical recovery of production activity in the euro area implies that the cyclical turning point was reached on the labour market in the course of last year. At any rate, the standardised number of unemployed showed no further rise from the second quarter onwards. On an annual average, however, 12.7 million persons were unemployed, which was around 275,000 more than in 2003. The unemployment rate exceeded the 2003 level slightly at 8.8%. According to the figures available (which are partly estimated), the rise in the number of employed persons in 2004 probably amounted to ½%.

Muted start to 2005, but favourable economic outlook on balance

The momentum of business activity in the euro area remained muted at the turn of 2004/2005. New orders received by the manufacturing sector showed a jump in the fourth quarter of 2004, owing in part to large-scale orders in the aviation industry, which it will take some time to process. In addition, the Purchasing Managers' Index moved upwards again in January/February. By contrast, sentiment in industry deteriorated further and latterly dipped below its multi-year average. In addition, consumer confidence remained dulled at the start of 2005. A slight strengthening of cyclical momentum is expected in the course of the year, however.

Inflation rate again above stability zone owing to special factors

The rise in consumer prices in the euro area in 2004 amounted to 2.1% and was slightly above the price stability zone defined by the Eurosystem for the fifth year in succession. The failure to meet the stability target despite a very favourable evolution of domestic cost factors – unit labour costs in the euro area increased last year by less than 1% – was largely due to two reasons. The first was the price effects of additional fiscal burdens. For example, in both Germany and the Netherlands the method of financing the public health system was changed to include greater co-payments by consumers. This was reflected in the Harmonised Index of Consumer Prices (HICP) in the form of higher prices for pharmaceuticals and medical services. Healthcare costs increased by 7.9% altogether. Tobacco tax was also raised – in some cases sharply – in a number of countries. Tobacco products became 12.2% dearer as a result. Excluding the administered price increases for pharmaceuticals and medical services as well as tobacco, the


Consumer prices in the euro area
Chart 3
Year-on-year change, quarterly
%
Total
Total excluding energy and unprocessed food
J/F
Jan
+ 4
+ 2
0
Energy
Unprocessed food
+ 14
+ 12
+ 10
+ 8
+ 6
+ 4
+ 2
0
– 2
– 4
Processed food
Industrial products (excluding energy)
Services
2000
2001
2002
2003
2004
2005
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HICP showed a rise of less than 1¾%.[1] In the second half of the year the price of fuel and heating oil also went up in the wake of the rising crude oil quotations and only receded towards the end of the year. The hike in energy prices contributed approximately ¼ percentage point to the annual inflation rate. If the aforementioned special burdens are disregarded, the underlying tendency of general price movements was moderate at around 1½%. In January 2005 the year-on-year rate of increase of consumer prices fell to 1.9%. This was largely attributable to the baseline dropout effect of the earlier rise in healthcare costs. In February the year-on-year rate increased again to 2.0%.

Regional price developments more even

Measured by the weighted dispersion indicators, which take account of the member states' varying sizes, inflation rates in the euro area converged further in 2004. One factor in this was the fiscal burdens described above which made themselves felt above all in countries with otherwise low inflationary pressures. The regional pattern of inflation rates showed little change last year, however. Only the Netherlands recorded a below-average rate of consumer price increases for the first time since the start of the third stage of EMU at the beginning of 1999.

2 Growing global imbalances and pronounced swings for a time on the foreign exchange markets

Widening of external imbalances

The external imbalances widened further in 2004. The US current account deficit reached a new record high estimated at US$650 billion or 5½% of GDP. This contrasts with large surpluses in Japan, the emerging-market economies of Asia and the OPEC states. In addition, some of these countries concurrently purchased US dollars on a large scale and thus further increased their foreign reserve assets. The current account of the euro area, by contrast, recorded only a small surplus in 2004 (€ 41½ billion or ½% of GDP).

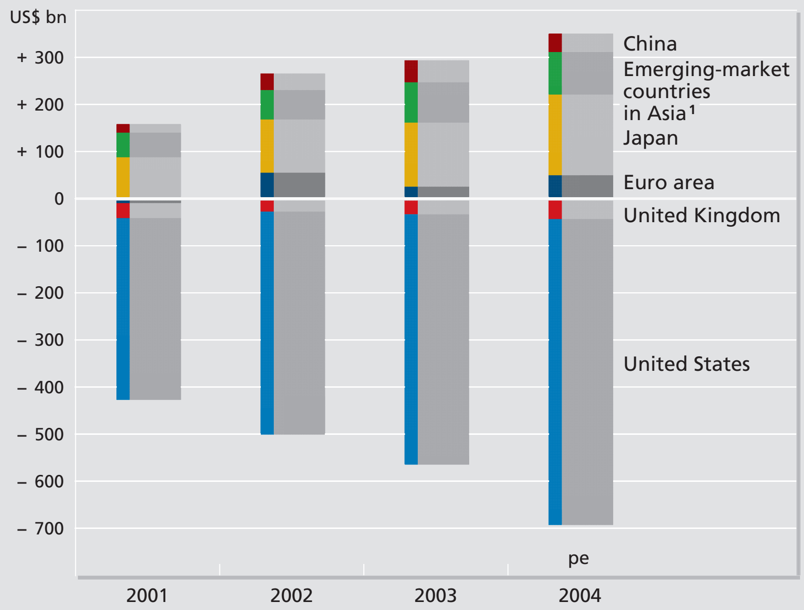
Causes of the imbalances

Among the causes of the growing imbalances are the persisting growth differentials between the leading industrial nations, which in the United States were magnified by continuing monetary and fiscal policy stimuli – along with US households' low saving ratio. The USA's high import elasticity led to rising bilateral current account deficits even vis-à-vis other rapidly growing economies

1 The reduction of taxes on alcohol in Finland had no noticeable effect on the overall index.

Current account positions of selected countries and regions

Chart 4



Source: IMF, ECB, national statistics. — **1** Hong Kong, Korea, Singapore, Taiwan.

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such as China. The lack of exchange rate flexibility of some Asian countries also contributed to the increasing imbalances.

Exchange rate losses of the US dollar ...

In this context of rising global imbalances the weakness of the US dollar on the international foreign exchange markets continued in 2004. Following a temporary recovery in the second quarter, the US currency lost value heavily, especially in the final third of the year. This affected its parities not only against other industrial nations but also vis-à-vis some emerging-market economies with flexible exchange rates, but not its external value against currencies that are actually or effectively pegged to the dollar. On a weighted average the US currency's losses in the course of 2004 added up to 6% (2003: 14½%).[1]

... corresponded to the euro's exchange rate gains

One of the exchange rates which has been subject to marked changes is the euro-dollar rate, which in the first two months of 2004 climbed to new highs approaching US$1.30 for 1 euro. Growing concerns about the strains which this might place on the burgeoning recovery in the euro area slowed this rising trend in the further course of the year, however. This was underpinned by surprisingly

1 This is based on the nominal external value of the US dollar against the currencies of 19 industrial countries, which the Bundesbank calculates regularly.

positive economic data from the other side of the Atlantic. Substantial net capital inflows into the United States, which were caused to a significant extent by large dollar purchases by Asian central banks, along with the reversal of the yield spread in favour of dollar bonds, strengthened the US currency in the second quarter, with the result that the euro's external value fell below US$1.20 by mid-May. The euro exchange rate subsequently moved within a band of US$1.20 to US$1.24. It was only in the course of the fourth quarter, when the growth-boosting effects of US monetary and fiscal policies subsided and new oil price surges clouded the global economic outlook, that the US dollar again started to weaken against the euro. The USA's large budget deficit, together with the record US current account deficit, came under particularly close scrutiny from market participants at this time and were seen as weighing on the US economy's prospects, whereas the moderate recovery process in the euro area appeared to be essentially intact. Against this background the euro temporarily reached a record peak of US$1.36 at the turn of 2004/2005. This was 8% above its value at the end of 2003. Since the beginning of 2005 the euro-dollar rate has receded again somewhat, however. Latterly it stood at US$1.34.

Euro's exchange rate against yen and pound sterling virtually unchanged

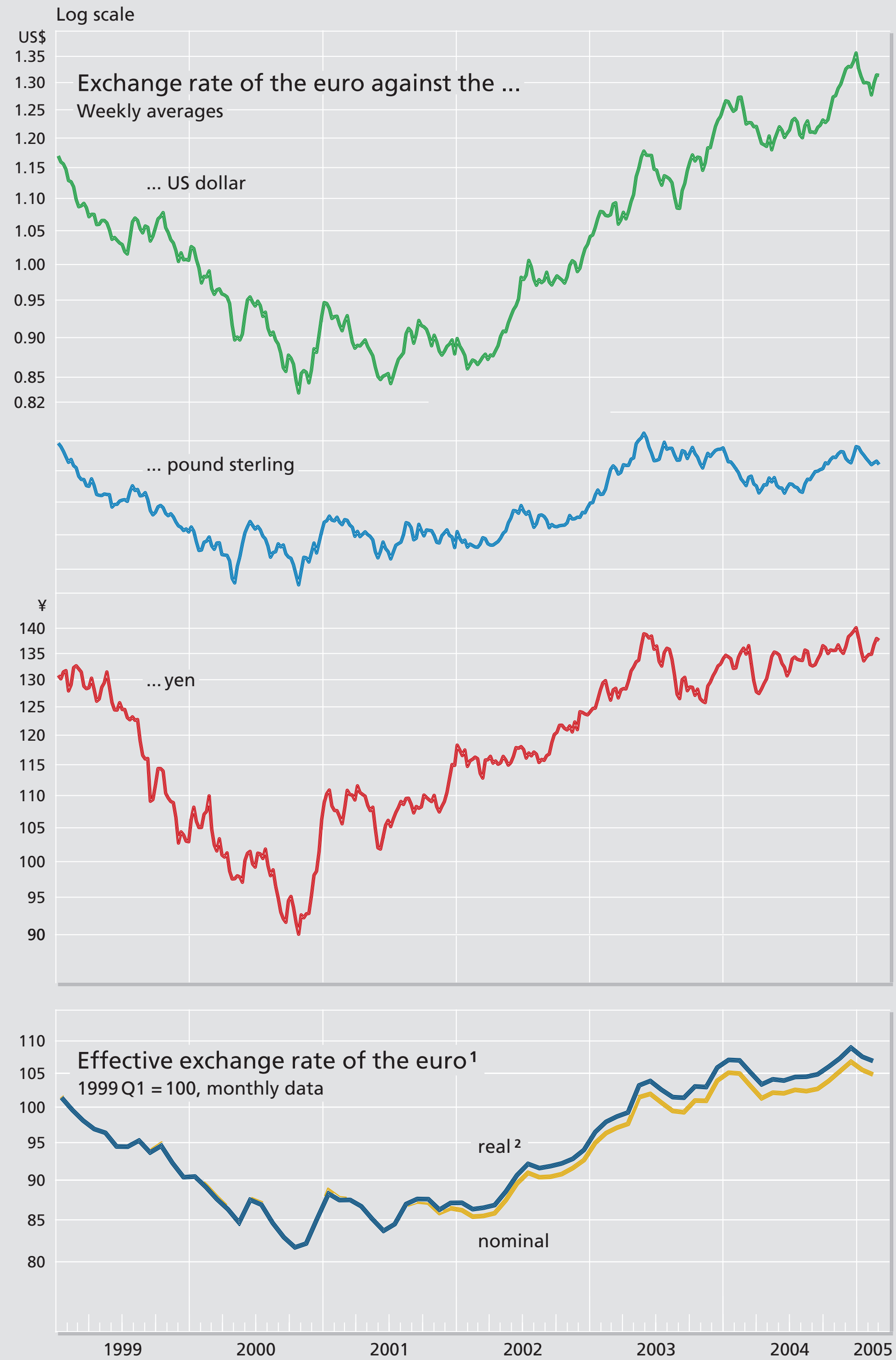
The euro's exchange rate gains last year against the US dollar and the currencies pegged to it contrasted, especially after the enlargement of the EU, with exchange rate losses vis-à-vis some central and east European currencies. The euro also lost ground perceptibly on balance against the South Korean won. By contrast, the euro's exchange rate against the pound sterling showed no net change. At 3½%, the euro's appreciation against the yen during the course of the year kept within comparatively narrow bounds.

Euro appreciation eases pressure on monetary policy

On a weighted average vis-à-vis 23 major trading partners, the euro increased in value last year by only 2% despite the marked shift in the euro-dollar rate. Towards the end of 2004, however, the euro reached its highest level since its introduction in 1999. It also appreciated slightly last year in real terms, ie after taking account of the inflation differentials between the euro area and its trading partners. Consequently, the euro's exchange rate development lessened the pressure on the monetary policy makers in pursuit of their stability policy mandate in view of the sharp price rises on the energy and raw materials markets.

Exchange rate of the euro

Chart 5



1 According to ECB calculations against the currencies of 23 countries. — **2** Based on consumer prices.

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II Monetary policy and monetary development in the euro area

1 Stability-oriented monetary policy in a difficult environment

(a) Interest rate policy course remained steady as risks to price stability changed

No change in central bank rates

On the basis of its monetary policy strategy, the Governing Council of the ECB geared its monetary policy decisions to the medium-term prospects for price stability in the euro area. In so doing, the Governing Council analysed real economic and financial indicators as well as monetary indicators. As a result, it left the Eurosystem's interest rates unchanged in 2004.

Economic analysis

Indeed, the medium-term outlook for prices remained favourable at first. However, from the second quarter of the year rising oil prices together with a series of fiscal measures, such as the increase in certain excise taxes and patient co-payments for health services, led to marked consumer price increases in the euro area. Particularly in view of the further decline in euro-area economic growth in the second half of the year, the Governing Council of the ECB nonetheless considered that the outlook for prices was still compatible with price stability over the medium term. However, in connection with the uncertainty about future oil price developments and the latent threat posed by second round effects, the risk of prices moving upward over the medium term increased. During the course of 2004 long-term inflation expectations gradually crept up to and beyond the stability ceiling set by the Governing Council of the ECB.

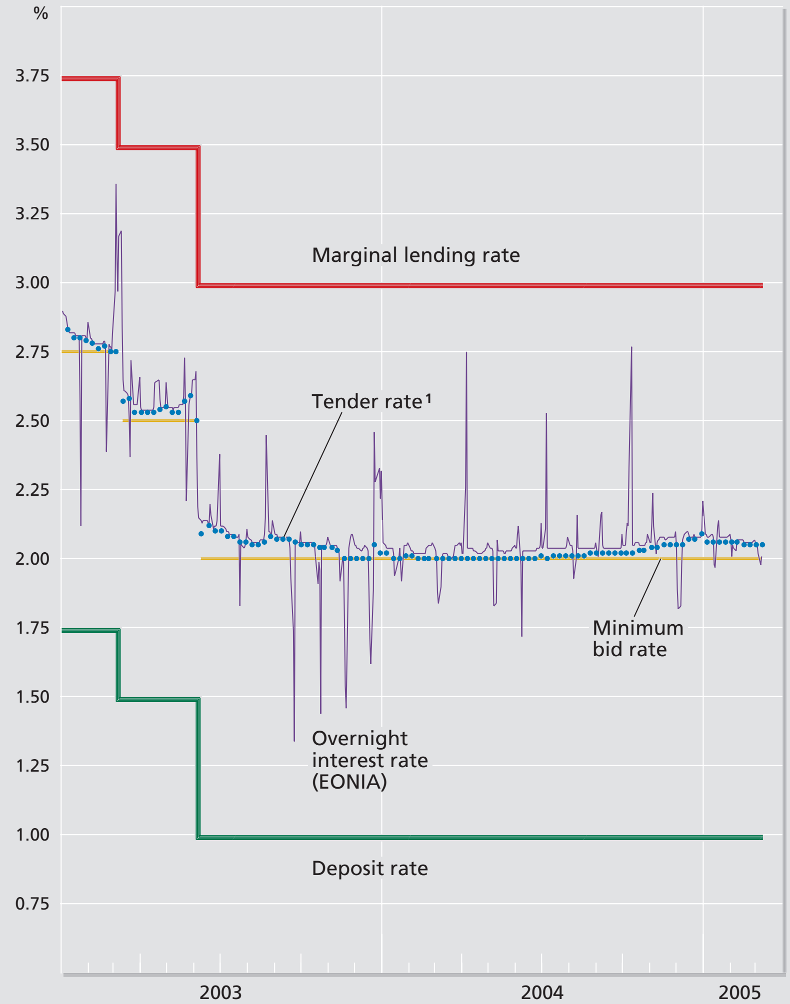
Monetary analysis

The signals for risks to price stability generated by the monetary analysis were not uniform last year, either. Money holding had gradually begun to settle back down in mid-2003 and this continued into the second quarter of 2004. The year-on-year growth rate of the money stock M3 fell from to 7.1% in December 2003 to 4.9% in May 2004. However, from the third quarter onwards, figures indicated that liquidity was again being expanded at a faster pace. Latterly, the money stock M3 was up 6.6% on the year. Monetary expansion was favoured by a noticeable acceleration in the growth of lending to the private sector. As the US dollar tended to weaken, there was also a further clear

Official interest rates and overnight interest rate

Chart 6

Daily data



1 Interest rate for main refinancing operations; marginal rate (variable rate tenders).

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increase in funds flowing in from abroad. All in all, there was a further distinct rise in excess liquidity in the year under review.

(b) Successful money market management and a smooth transition to the new operational framework for monetary policy

Successful liquidity management, ...

Money market management by the Eurosystem was largely trouble-free in the year under review. For instance, a smooth transition to the new operational framework for monetary policy was made in early March. Since 10 March 2004 the main refinancing operations have been conducted with a maturity of one

Monetary developments in the euro area

Table 3

Changes in the course of the year

Item	Euro area 2003	Euro area 2004
	in %	
I Growth of the monetary aggregates 1		
M1 2	10.6	8.4
M2 3	7.6	6.5
M3 4	7.1	6.4
	€ bn	
II Money stock and its counterparts		
M3 (= 1 + 2 – 3 – 4 – 5)	404.6	390.4
Currency in circulation and overnight deposits	254.0	220.1
Other shorter-term bank deposits	117.6	119.6
Marketable instruments	32.9	50.8
Balance sheet counterparts		
1 Total credit to non-MFIs in the euro area	575.7	616.7
Credit to general government	130.0	49.7
Credit to private sector non-MFIs in the euro area	445.7	567.0
2 Net claims on non-euro-area residents	91.7	158.3
3 Deposits of central government	12.9	9.5
4 Longer-term financial liabilities to other non-MFIs in the euro area	239.0	338.6
5 Other counterparts of M3 5	10.9	36.5

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 shorter-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 at agreed notice 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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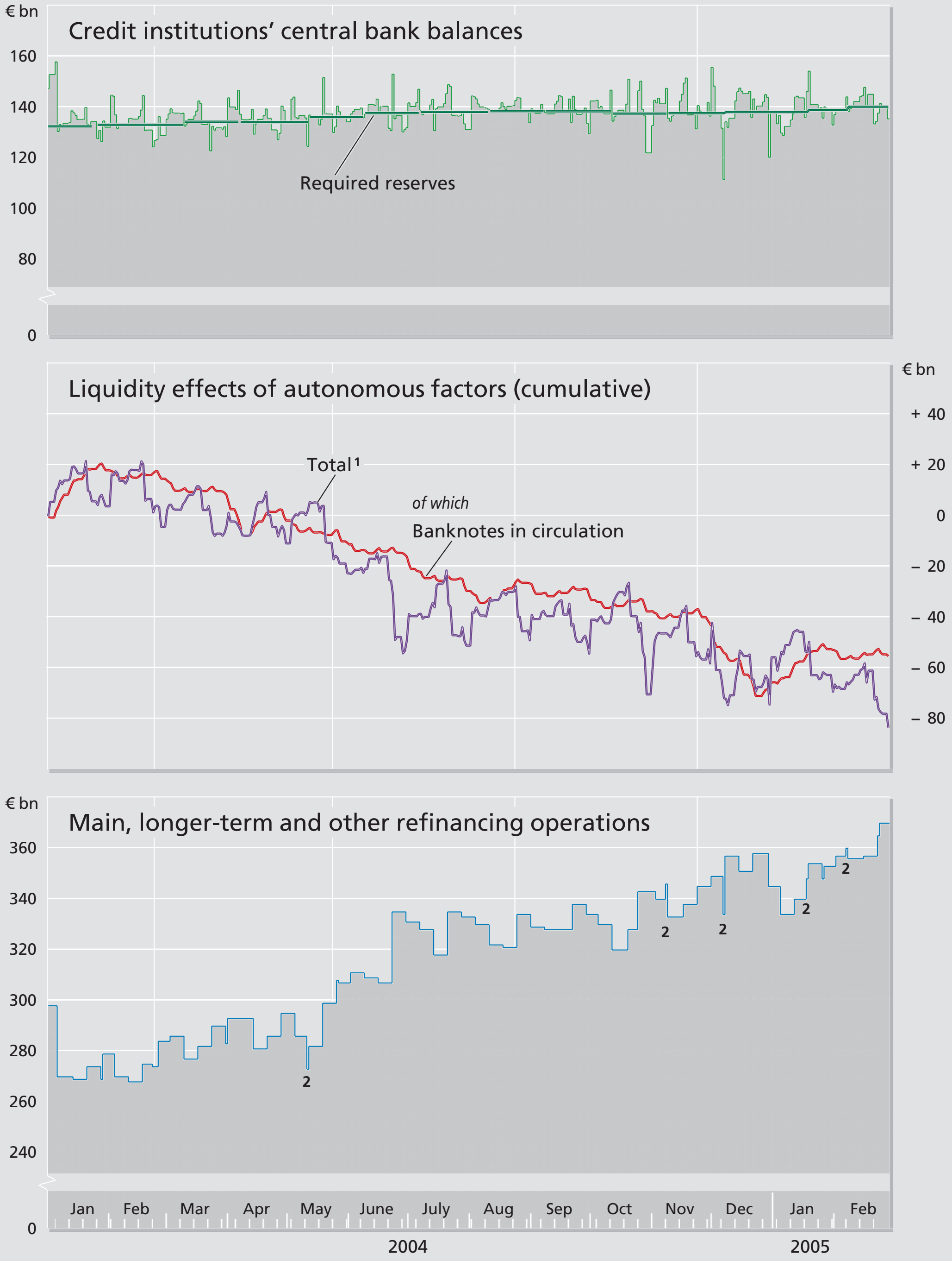
week rather than two, as had previously been the case. This was also the date from which the start of the reserve maintenance periods changed. They now always start on the settlement day of the main refinancing operation following the Governing Council meeting for which the monthly assessment of the monetary policy stance is scheduled. The advantage of this rule is that the interest rates for the whole maintenance period are known, thus potentially eliminating speculative underbidding.

As the year went on, the overnight rate deviated fairly strongly from the marginal rate of allotment at the end of the reserve maintenance periods only. To cush-

Liquidity management in the Eurosystem

Chart 7

Daily data



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: on 11 May 2004 collection of fixed-term deposits amounting to €13.0 billion; on 8 November 2004 reverse transaction amounting to €6.5 billion; on 7 December 2004 collection of fixed-term deposits amounting to €15.0 billion: on 18 January 2005 reverse transaction amounting to €8.0 billion; on 7 February 2005 reverse transaction amounting to €2.5 billion.

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Money market management and liquidity needs

The task of the Eurosystem's money market management is to enable the euro-area credit institutions to fulfil their minimum reserve requirements with as little difficulty as possible and hence to keep the overnight interbank market rate as close as possible to the minimum bid rate applicable to main refinancing operations. Last year the Eurosystem had to deal with two particular challenges. First, the volume of open market operations had to be expanded in such a way that the additional need for central bank money caused by the marked increase in the autonomous liquidity factors again in 2004 was still covered. Second, the new operational framework for monetary policy, which involved a number of changes to the monetary policy instruments and procedures, had to be introduced in March 2004.[1]

In 2004 the credit institutions' liquidity needs deriving from the autonomous liquidity factors went up by €63.0 billion year on year (see table on page 31; for the growth of central bank balances, autonomous factors and open market operations during the year, see chart on page 29). The main cause of this development was the continued marked expansion of banknotes in circulation, which went up by €72.6 billion. At the end of 2004 the €500 billion mark for banknotes in circulation was exceeded for the first time – albeit initially for a short time only. The annual average in 2004 was, at €450.5 billion, some 33% above the annual average in 2001, the last year before the introduction of the euro. Higher government deposits with the Eurosystem led to no more than a small €3.0 billion increase in liquidity needs. However, government deposits were by far the most volatile factor. With an average level of €53.4 billion in 2004, the range of fluctuations was between €29.6 billion on 5 January and €87.5 billion on 28 June. If the changes in the net foreign assets and in other factors are taken together, a move which eliminates valuation effects with no impact on liquidity, €12.6 billion net was provided. Although the Eurosystem's foreign assets decreased, not only because of the appreciation of the euro but also as a result of transactions, this was clearly more than offset, particularly by a topping-up of the holdings of financial assets that are unrelated to monetary policy.

The greater need for liquidity was largely met by increasing the volume of the main refinancing operations by €44.1 billion. In addition, the volume of longer-term refinancing operations was increased by €25.2 billion in that, starting with the operation which took place at the end of January, €25 billion instead of €15 billion was allotted on each occasion. This expansion counterbalanced a decline in the share of longer-term operations in the total refinancing volume. Given the fact that the need for liquidity is likely to continue to grow, the Eurosystem is upping the volume to €30 billion each month in 2005, beginning with the January operation, with the result that at the end of March the total volume will be €90 billion. The standing facilities also continued to fulfil their function of offsetting short-term liquidity fluctuations at individual credit institutions. Overall, the credit institutions' central bank balances were increased in order to ensure that the €5.6 billion increase in the required reserves could be met without difficulty.[2]

The Eurosystem's new operational framework for monetary policy, which consisted, *inter alia*, of shortening the maturity of the main refinancing operations from two weeks to one, synchronising the reserve maintenance period with the monetary policy meeting of the Governing Council of the ECB and expanding the publication of liquidity data, was successfully introduced in March 2004. A slight underbidding of €5 billion in the main refinancing operation on 24 March was due, as in the operation on 23 February, to the fact that overnight rates evolved in the preceding days at a level only just above the minimum bid rate and could be easily offset in the following operation. When a sizeable liquidity surplus emerged on 11 May at the end of the April-May reserve maintenance period, the Eurosystem carried out a fine-tuning operation (collection of fixed-term deposits for one day) amounting to €13 billion and thus created balanced liquidity conditions. In the following reserve maintenance periods it became more and more apparent that synchronising the reserve maintenance periods with the meetings of the Governing Council of the ECB is not completely problem-free from the perspective of money market management; it has advantages when changes in the key interest rates are expected but results in a lengthy period between the allotment of the last main refinancing operation in a period and the end of the period. In the operations since March, the allotment volumes have not been measured in steps of €1 billion but in steps of €½ billion, meaning that it has been possible to translate the liquidity forecasts more precisely into allotment volumes. However, relatively small forecasting errors have already led to perceptible uncertainty in the market, with the result that the EONIA started to deviate from the minimum bid rate shortly after the last operation in each period. Particularly after the September-October reserve maintenance period had ended with the EONIA at 2.77%, the tender rates and the EONIA both crept upwards (see chart on page 27). The Eurosystem has taken decisive steps to stop this development and, since the October-November reserve maintenance period, has carried out a one-day fine-tuning operation on the last day of the reserve maintenance

1 For details of the new monetary policy framework, see Deutsche Bundesbank, Initial experience with the new monetary policy framework and the Bundesbank's contribution to liquidity management by the Eurosystem, *Monthly Report*, July 2004, pp 49-66.
2 The fact that, as an annual average, the credit institutions' balances increased more strongly than the required minimum reserves is due mainly to the relatively low balance at the end of 2003, which was offset at the start of 2004, ie in the same reserve maintenance period.

Factors determining bank liquidity

Year-on-year changes in annual averages, in € billion

Item	2003	2004
I Provision (+) or absorption (-) of central bank balances by		
1 Change in volume of banknotes in circulation (increase: -) 1	– 60.1	– 72.6
2 Change in government deposits with the Eurosystem (increase: -)	– 1.6	– 3.0
3 Change in net foreign assets 2	– 48.1	– 28.1
4 Other factors 2, 3	+ 55.1	+ 40.7
Total	– 54.6	– 63.0
II Monetary policy operations of the Eurosystem		
1 Open market operations		
(a) Main refinancing operations	+ 65.5	+ 44.1
(b) Longer-term refinancing operations	– 9.8	+ 25.2
(c) Other operations	– 0.5	– 0.0
2 Standing facilities		
(a) Marginal lending facility	– 0.0	– 0.1
(b) Deposit facility (increase: -)	+ 0.0	+ 0.1
Total	+ 55.2	+ 69.3
III Change in credit institutions' credit balances (I + II)	+ 0.5	+ 6.3
IV Change in the minimum reserve requirement (increase: -)	– 1.1	– 5.6

1 From January 2003, euro banknotes only. — **2** Including liquidity-neutral valuation adjustments at the end of the quarter. — **3** Including monetary policy operations concluded in stage two and still outstanding in stage three of EMU (outright transactions and the issuance of debt certificates) as well as financial assets not connected with monetary policy.

period. On 8 November 2004, 18 January 2005 and 7 February 2005 reverse transactions supplied the market with additional liquidity; on 7 December 2004 and on 8 March 2005 liquidity was absorbed by means of a collection of fixed-term deposits. Since November the EONIA has consequently not deviated from the minimum bid rate by more than 25 basis points. In addition, with the main refinancing operation on 9 November 2004 the ECB began providing amounts above the benchmark allotment, thus enabling the credit institutions to "frontload" their minimum reserve requirements.[3] At least this successfully stopped the upward trend of the EONIA, which had been going on since October 2004. After the turn of the year, the EONIA gradually normalised again and, with the exception of the last day in the month, was around 2.06% in the second half of February 2005. The Eurosystem subsequently reverted to the benchmark allotment for the main refinancing operations in early March. The new flexible length of the reserve maintenance periods proved its worth particularly at the turn of the year, which on that occasion occurred roughly in the middle of the corresponding reserve maintenance period. An additional allotment of €4.5 billion and of €5 billion above the benchmark in the 22 December and 30 December tenders respectively – to avoid a possible liquidity shortage during the public holiday period – kept the overnight rates at a moderate level. In the second half of December, the EONIA deviated from the minimum bid rate by an average of 9 basis points, whereas the figure had been 24 basis points in the same period in 2003. At 21 basis points on 31 December, the spread between EONIA and the minimum bid rate at the end of the year was at its lowest since the start of EMU.

All this shows that, in a difficult environment in 2004, the Eurosystem's money market management again fulfilled its task of ensuring that monetary policy was appropriately implemented. As an annual average in 2004, at 5 basis points, the spread between the EONIA and the minimum bid rate and, at 9 basis points, the volatility of those spreads, including all the fluctuations – some of which were very large – at the end of the reserve maintenance periods, were both down on 2003.

3 The benchmark allotment is the allotment amount which is intended to enable the Eurosystem's counterparties to plan to meet their minimum reserve requirements without difficulty. See European Central Bank, Publication of the benchmark allotment in the main refinancing operations, *Monthly Bulletin*, April 2004, pp 16-18.

... also owing to various fine-tuning operations

ion sizeable estimation errors when allotting liquidity, the ECB conducted some fine-tuning operations at the end of the maintenance period. Whereas it injected liquidity into the money market to this end in November 2004 as well as in January and February 2005, it withdrew excess funds in May and December 2004 and again in March 2005.

Expectations of interest rate increases predominated

The past year was largely characterised by expectations of interest rate increases, although these were postponed further and further as the year went on. Some market participants expected a drop in central bank rates in March only, when uncertainty about further economic developments increased as a result of the terrorist attacks in Madrid and an expansionary monetary policy stance was therefore anticipated for a while. The steady interest policy course in early April, however, led to a new shift in sentiment in the money market. After a short-lived increase, the interest rate premium for the three-month future rate for funds with a maturity of nine to twelve months shrank back to ¼ percentage point as a result of subdued economic growth in the euro area and the still favourable medium-term outlook. At the end of the period under review, market players were not expecting the Governing Council of the ECB to increase interest rates by ¼ percentage point until the fourth quarter of 2005.

2 Monetary expansion accelerates in the second half of the year

(a) Further strong expansion of liquidity holdings

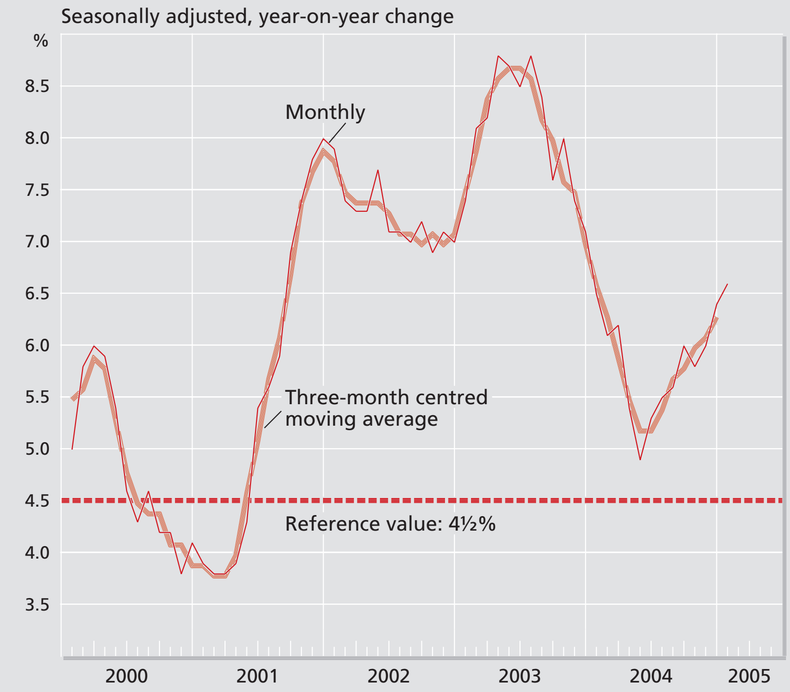
Monetary growth continued to slow at first ...

The slowdown in monetary expansion which had begun in mid-2003 initially continued in the first and second quarters of 2004. The seasonally adjusted six-month growth rate of the money stock M3, which reflects the short-term monetary dynamics, slipped back to just under 4½% in May 2004. For the first time since early 2001 it was therefore back under the reference value for non-inflationary growth of the money stock. In May 2003 the corresponding growth rate had been just over 9%. The year-on-year three-month moving average accordingly went down to 5.2% by mid-2004. It was thus 3½ percentage points lower than one year previously. Against a backdrop of minor uncertainty in the financial markets, residents again invested heavily in forms of investment that are not included in the money stock M3.

Monetary expansion therefore tended to be curbed by the decline in uncertainty-related investment by residents while at the same time being en-

M3 growth in the euro area

Chart 8



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couraged by persistently low euro-area interest rates. This expansionary interest rate effect was the main feature of monetary growth in the euro area from the middle of the year under review onwards. The impact of the robust growth of lending to the domestic private sector was particularly strong. Latterly, the seasonally adjusted six-month rate of change in M3 was 7%.

... but expanded perceptibly again from the third quarter onwards

Of the components of the money stock, cash holdings outside the domestic monetary financial institutions (MFI) sector again showed the greatest increase in terms of growth rates in the year under review. Cash in circulation grew by 17.0%, following 24.9% in 2003. Both low interest rates and the appreciation of the euro against the US dollar are likely to have favoured the expansion of currency hoarding by domestic and foreign residents. Overnight deposits also increased strongly in 2004. This is not surprising given the low opportunity costs of holding money and a slight increase of interest rates in the course of the year to just under 1¼% on average towards the end of the period. Other short-term bank deposits increased by 4.5% last year, following 4.7% in 2003. In the year under review, there was also a further marked expansion in deposits with an agreed period of notice of up to three months. However, the 7.4% growth in these deposits was well down on the previous year. Overall, short-term time de-

Expansion of cash and short-term bank deposits ...

Chronology of monetary policy measures

12 January 2004
The Governing Council of the ECB decides to increase the allotment amount for each of the longer-term refinancing operations to be conducted in 2004 from €15 billion to €25 billion. The Eurosystem will, however, continue to provide the bulk of the liquidity through its main refinancing operations.

8 March 2004
The ECB and 14 European national central banks sign a new gold agreement limiting their gold sales to a maximum of 500 tonnes a year for the next five years. The previous agreement is thus superseded with effect from 27 September 2004.

10 March 2004
The changes to the monetary policy framework approved by the Governing Council of the ECB in 2003 take effect. The maturity of the regular main refinancing operation conducted on 8 March 2004 is, for the first time, just one week. Furthermore, from now on, the reserve maintenance period will always start on the settlement day of the main refinancing operation following the Governing Council meeting for which the monthly assessment of the monetary policy stance is scheduled. In the future, changes in the rates on the standing facilities will generally also take effect on the settlement day of the main refinancing operation.

24 March 2004
The Executive Board of the Deutsche Bundesbank decides that the profit to be distributed to the Federal Government shall amount to €248 million.

16 April 2004
Ernst Welteke resigns early from his position as President of the Bundesbank.

30 April 2004
The President of the Federal Republic of Germany appoints Professor Axel A Weber as President of the Deutsche Bundesbank for a period of eight years.

1 May 2004
The European Union is enlarged by ten new members, taking the number of national central banks that, along with the ECB, comprise the European System of Central Banks to 25. However, the new member states will continue to conduct their own national monetary policies for the time being.

27 June 2004
The currencies of Estonia, Lithuania and Slovenia join the European exchange rate mechanism II (ERM II), which was introduced at the start of the third stage of economic and monetary union. A standard fluctuation band of ±15% applies to all three currencies, based on their central rates as on 28 June 2004. However, Estonia and Lithuania retain their currency boards after joining ERM II. No additional obligations are placed on the ECB as a result.

18 November 2004
The Governing Council of the ECB decides to continue not to issue €1 or €2 banknotes. The main reasons for this decision were insufficient demand as well as the high cost of printing and processing.

20 December 2004
Exercising its option applicable in the first year of the current gold agreement, the Executive Board of the Deutsche Bundesbank decides to sell eight tonnes of gold to the Federal Ministry of Finance for its regular gold coin programme.

14 January 2005
The Governing Council of the ECB decides to increase the allotment amount for each of the longer-term refinancing operations to be conducted in 2005 from €25 billion to €30 billion.

15 March 2005
The Bundesbank's profit of €676 billion is distributed to the Federal Government.

posits (with an agreed maturity of up to two years) increased slightly. After being reduced considerably in the first half of the year, they nonetheless expanded at a seasonally adjusted annual rate of just under 10% in the second half of the year.

... together with a strong increase in marketable instruments

The upward movement of marketable instruments likewise gathered pace last year. Money market fund shares were still in demand, even though their year-on-year growth slowed somewhat. By contrast, repo transactions and investment in short-term bank debt securities were expanded strongly. They had decreased in 2003.

(b) Determinants of monetary growth

Lending to the private sector characterised by a marked increase in housing loans ...

In 2004 growth of the money stock M3 was favoured predominantly by loans to the domestic private sector; they were expanded by 7.0% in the year under review, following 5.5% in 2003. Owing to their low interest rate level, which fell further as the year went on, there was a particularly strong increase in long-term housing loans to households; they expanded by 10.2% in 2004. Consumer credit also grew more rapidly than in the previous year. Here, too, long-term unsecuritised lending was the main expansion area (+6.8%).

... coupled with a weaker expansion of corporate lending

The demand by non-financial enterprises for loans also picked up as the year went on. However, at 5.4%, their growth rate was also noticeably smaller than the rate for loans to households. Investment by euro-area enterprises, which is still comparatively moderate, probably had a particular dampening effect, as did the increase in those enterprises' internal financing potential.

Lending to general government

Lending by domestic MFIs to the euro-area public sector expanded by 2.3% last year. On balance, however, the banks in the euro area only purchased securities issued by the domestic public sector (€55 billion). Loans to domestic general government stagnated.

Net external assets increased

Large amounts of funds from foreign payment transactions accrued to domestic non-banks again in 2004. The net external position of the MFI sector, which reflects such payments, rose by €158½ billion. In addition to a surplus generated from external transactions in goods and services, cross-border securities transactions were again a further contributory factor. With the marked appreciation of the external value of the euro, external borrowing by euro-area residents also declined perceptibly in the year under review. It had gone up noticeably in the previous year.

Strong monetary capital formation

Monetary growth in the euro area was dampened by strong monetary capital formation, which, at an annual rate of 8.1%, again expanded more strongly than in the previous year (6.0%). In particular, bank debt securities with a maturity of more than two years were again sold. The amount outstanding outside the MFI sector rose by 10.5% year on year. Euro-area banks were apparently endeavouring to refinance their extensive long-term lending primarily by issuing long-term securities. With capital market rates low and falling, investors were apparently willing to bear a somewhat greater risk in order to gain a higher return than on government paper. In addition, longer-term time deposits increased markedly (by 8.4%). By contrast, longer-term savings deposits were further decreased. The banks' capital and reserves were topped up only slightly.

III Financial system

1 More funds raised in the securities markets

(a) Bond markets in the light of economic recovery and renewed disillusionment

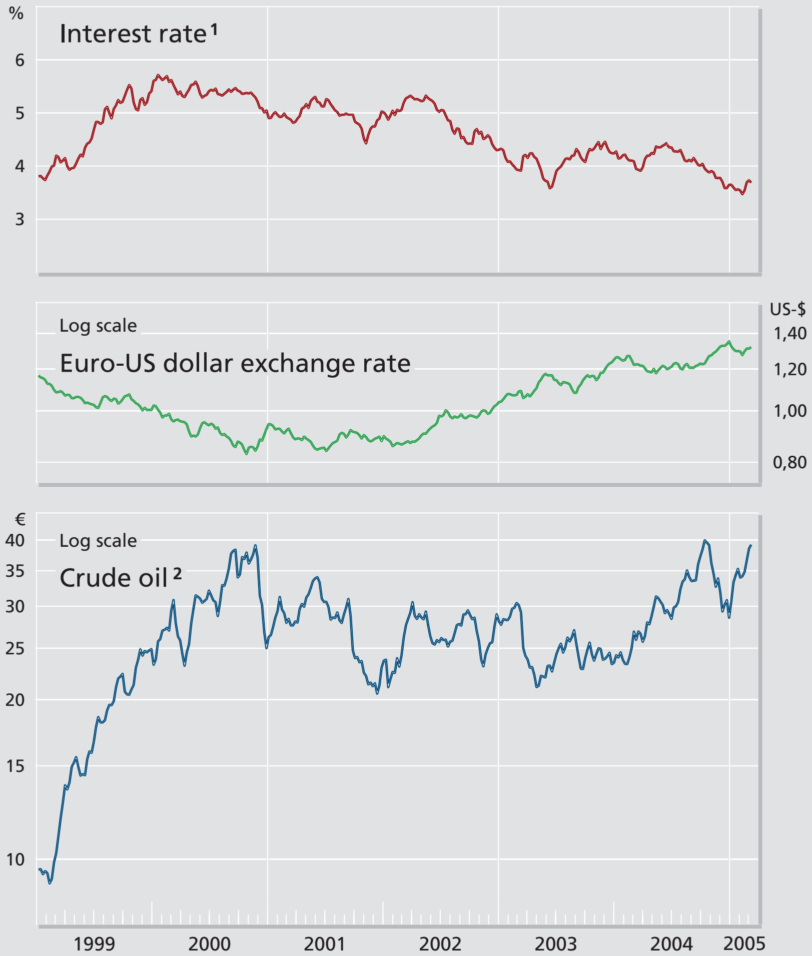
Interest rates decline from mid-year

After several years of low and downward-trending capital market rates in the euro area, there initially appeared to be an upward trend turnaround in spring against a backdrop of increasingly optimistic economic expectations. Within the space of a few months, European bond yields went up ½ half percentage point to just under 4½% in summer. With a slowdown in booming global demand becoming apparent given the sharp increase in oil prices, the development in capital market rates changed direction in the second half of the year. At just under 3½% in February 2005, euro-area yields reached a new low before the interest rate trend reversed upwards. The long-term rates in the dollar zone developed parallel to those in the euro area in the period under review, decoupling only temporarily in the fourth quarter of 2004. On balance, the yield curve in the euro area flattened considerably at the long end in the second half of the year.

Interest rates in the euro area, US dollar movements and oil prices

Chart 9

Weekly averages



1 Weighted average yields of ten-year government bonds of all euro-area countries; GDP-weighted. — 2 Price per barrel of Brent North Sea Oil. Source: Thomson Financial, Bundesbank calculations.

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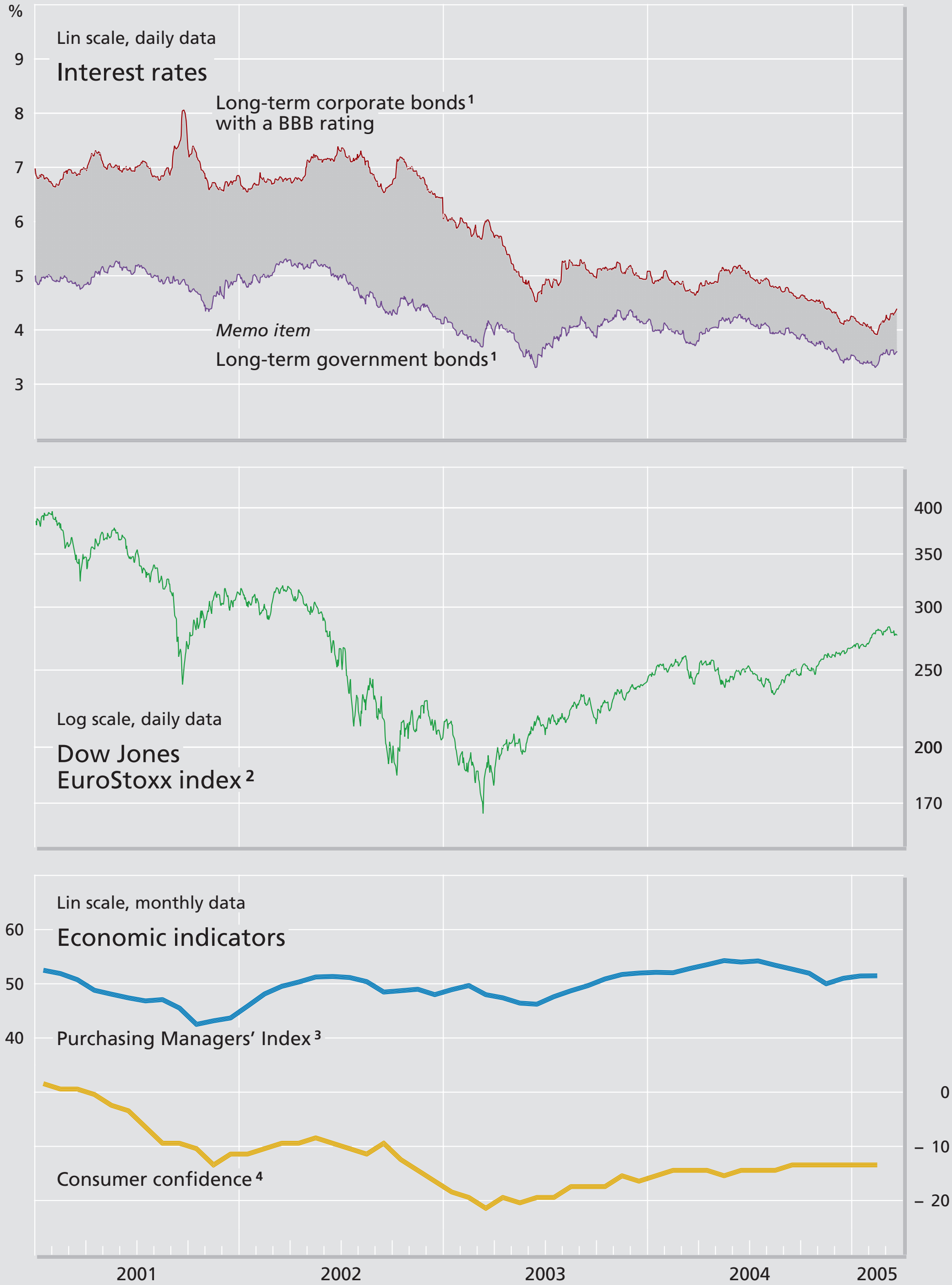
Yield premiums on corporate bonds continue to fall

The somewhat riskier and, by extension, higher yielding corporate bonds benefited especially from this development. As a result of this search for yield, the yield premiums vis-à-vis euro-area government bonds declined to an all-time low, falling at times to ½ percentage point in the BBB rating category, compared with average yield spreads of 2 percentage points and more as recently as two years ago.

Corporate valuations and economic indicators in the euro area

Chart 10



1 Euro-area bonds with a residual maturity of seven to ten years. Source: Merrill Lynch Indices. — 2 31 December 1991 = 100. Source: Thomson Financial Datastream. — 3 Diffusion index (50% represents an equal number of positive and negative assessments of the current situation). Source: NTC Research, London. — 4 According to an EU economic survey for euro-area countries. Balance of the percentages of positive and negative assessments.

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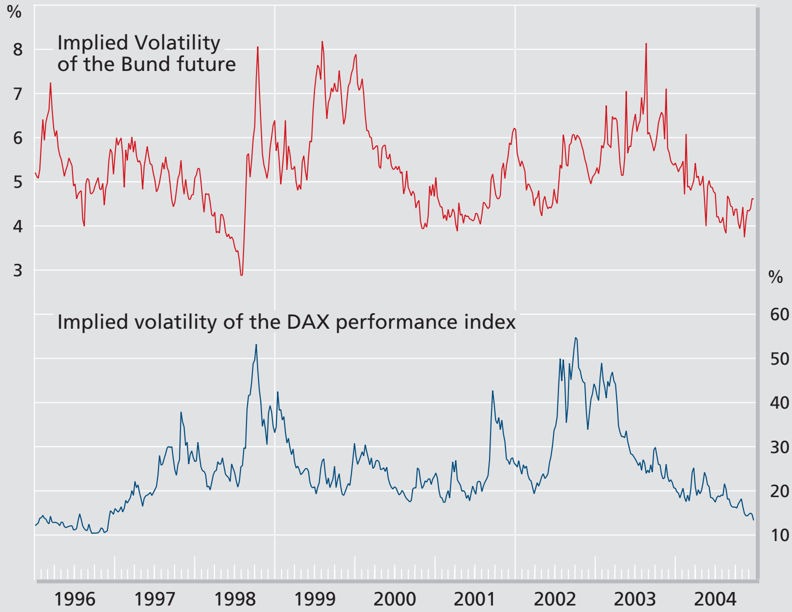
Volatility* in the bond and equity markets

Chart 11

Weekly averages



1 Expected future volatility extracted from option prices on the Bund future and the DAX.

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(b) Tentative stock market price increases despite improved earnings expectations

Marginal price gains in the stock markets

Investors' high propensity for risk, which is reflected in the low yield premia for corporate bonds, did not initially stimulate the equity markets in the same way. It is true that, on balance, share prices rose in the European equity markets in 2004. On average, the shares of listed European enterprises gained just under 15% since January 2004. German equities rose by 9% as measured against the broad CDAX. However, the market was trending weaker until well into the second half of the year before equity prices started to rise again in late summer. Analysts' repeated upward revisions of their earnings forecasts contrasted somewhat with investors' reluctance, which had been noticeable for some time. The price-to-earnings ratio of German and European shares measured on this basis fell from approximately 15 in early 2004 to the comparatively low level of around 14 in February 2005.

Uncertainty in the stock markets

Insofar as these equity evaluations reflect a relatively strong perception of risk by investors with regard to German and European shares, it stands in contrast to the assessment of uncertainty concerning the future outlook for share prices, as

Sales and purchases of securities

Table 4

€ billion

Period	Sales: Bonds: Total	Sales: Bonds: *of which* Foreign bonds	Sales: Equities: Total	Sales: Equities: *of which* Foreign equities	Sales: Mutual fund shares: Total	Sales: Mutual fund shares: *of which* Mutual funds open to the general public
2000	226.4	68.4	140.5	117.7	118.0	39.7
2001	180.2	93.6	82.7	65.1	97.1	35.5
2002	175.2	51.2	37.4	28.2	66.6	25.9
2003	185.2	50.7	14.0	– 2.8	48.0	20.1
2004	240.9	107.2	3.2	– 7.0	13.4	– 4.0
2004 Q1	93.9	27.1	1.5	0.2	12.7	2.8
Q2	81.4	33.4	5.3	0.3	1.4	– 1.3
Q3	61.5	28.5	– 8.7	– 9.5	– 0.8	1.0
Q4	4.1	18.2	5.0	2.1	0.1	– 6.5

Period	Purchases: Non-residents: Domestic bonds	Purchases: Non-residents: Domestic equities	Purchases: Domestic non-banks: Bonds	Purchases: Domestic non-banks: Equities	Purchases: Domestic credit institutions (including Bundesbank): Bonds	Purchases: Domestic credit institutions (including Bundesbank): Equities
2000	74.8	– 24.2	60.1	141.4	91.4	23.3
2001	68.9	84.9	75.4	12.5	35.8	– 14.7
2002	111.5	20.9	50.2	39.7	13.5	– 23.2
2003	89.9	28.7	59.5	– 21.7	35.7	7.1
2004	133.8	– 4.6	– 14.8	2.8	121.8	5.0
2004 Q1	51.2	0.0	– 12.6	– 5.2	55.3	6.7
Q2	22.3	– 11.8	20.9	22.5	38.2	– 5.4
Q3	37.7	6.7	– 2.1	– 8.1	25.9	– 7.3
Q4	22.6	0.5	– 21.0	– 6.4	2.5	11.0

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is revealed, say, in the implied volatilities of options on German and European blue chip stocks. These are now ranging at a low level that has not been seen since 1997 and 1998, before the period of persistent high volatility began.

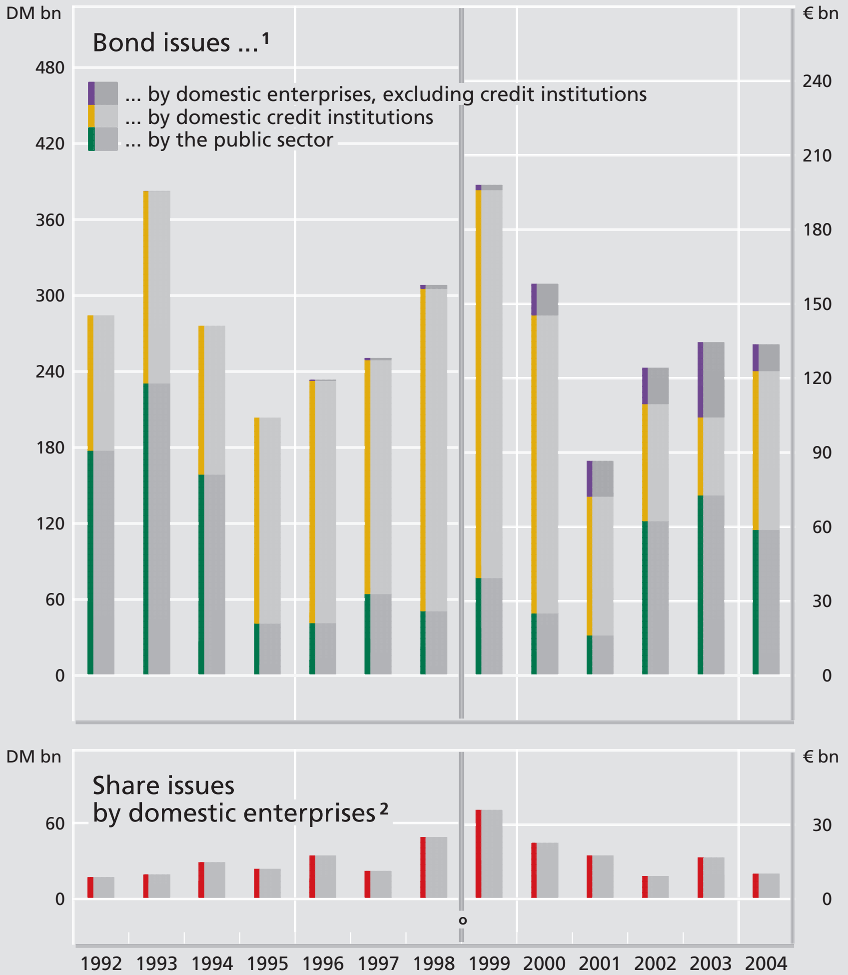
(c) Buoyant issuing activity in the German bond market

Higher level of borrowing on the German bond market

Given the continuing favourable financing conditions in the German bond market, issuing activity became more buoyant, driving gross sales of German debt securities to a new record high of €1,223 billion (market value). After deducting redemptions and changes in issuers' holdings of their own bonds, funds raised through sales of domestic paper reached last year's level of €134 billion. Banks raised €64 billion from the sale of their own bonds. These consisted mainly of uncovered or other bank debt securities for which, as opposed to Pfandbriefe, no separate cover funds have to be created. A large amount of debt securities issued by special purpose credit institutions was also issued, whereas Pfandbriefe were redeemed in net terms. The public sector absorbed €59 billion through the issuance of their own bonds. German enterprises used the favour-

Net borrowing in the German capital markets

Chart 12



1 At market value less redemptions and changes in issuers' holdings of their own bonds. — 2 Sales at market value. — o From 1999, data in euro.

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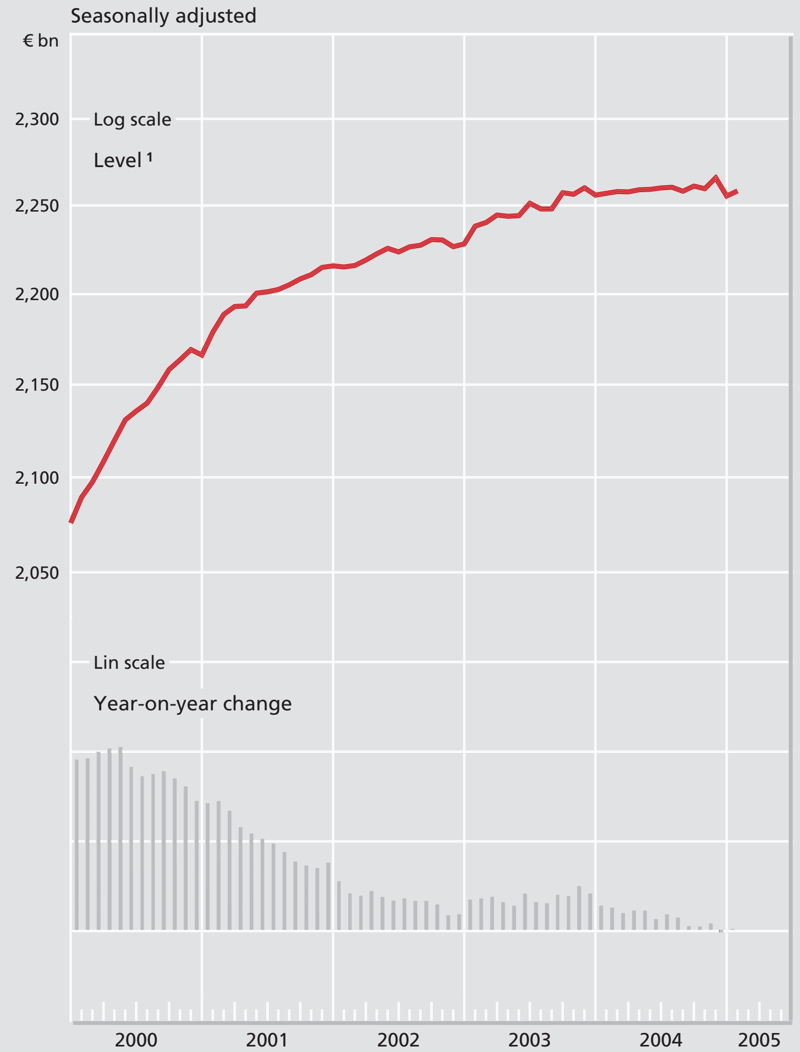
able conditions for corporate bonds, some issuing large-volume longer-term bonds. Non-resident issuers raised €107 billion in the German bond market.

Credit institutions the most important group of investors

The reporting year saw a continuation of the trend towards greater diversification in the bond portfolios, a trend which has been under way since the 1990s. Domestic investors purchased €107 billion in foreign bonds, while foreign investors purchased German bonds for approximately €134 billion. Credit institutions bought debt securities for €122 billion (€73 billion of which from foreign issuers), undoubtedly in part as a substitute for weak lending business. Domestic

Loans to enterprises and households in Germany

Chart 13



1 End of month; statistical changes eliminated.

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non-banks increased their holdings of foreign bonds by €34 billion and sold domestic debt securities worth €49 billion.

(d) Subdued activity in the primary equity market, but vigorous M&A business

Decline in equity sales

Issuing activity in the German market dropped considerably. Domestic enterprises placed new shares to a market value of €10 billion, which was only 60% of the previous year's level (€17 billion). Approximately two-thirds of this accrued to listed enterprises. In contrast to the previous year, several IPOs were also launched. At the same time, however, a number of large private equity transactions in Germany – encouraged by the favourable financing conditions – accelerated the tendency towards "going private". For example, US funds', acquisitions of participating interests in Germany alone exceeded the amount of shares issued in Germany. Of the transaction values published, enterprises from the chemicals industry and real estate sector were the main targets.

(e) Declining sales of domestic mutual fund shares

Further decline in capital accruing to mutual funds

2004 was a difficult year for the German investment fund industry. Sales of shares of domestic mutual funds declined by more than 95% on the year to no more than €1½ billion. Funds open to the general public were particularly affected by this slump. Overvalued real estate of at least one mutual fund and a public investigation led to outflows from open-end real estate funds in the second half of the year. After the Investment Modernisation Act entered into force at the start of 2004, foreign mutual funds, which had previously been at a tax disadvantage, made considerable gains. They sold certificates for €11.9 billion in 2004.

2 Earnings outlook for German banks stabilises

(a) Bank deposits with moderate growth, but German banks' lending business stagnates

Slackening momentum in short-term deposits

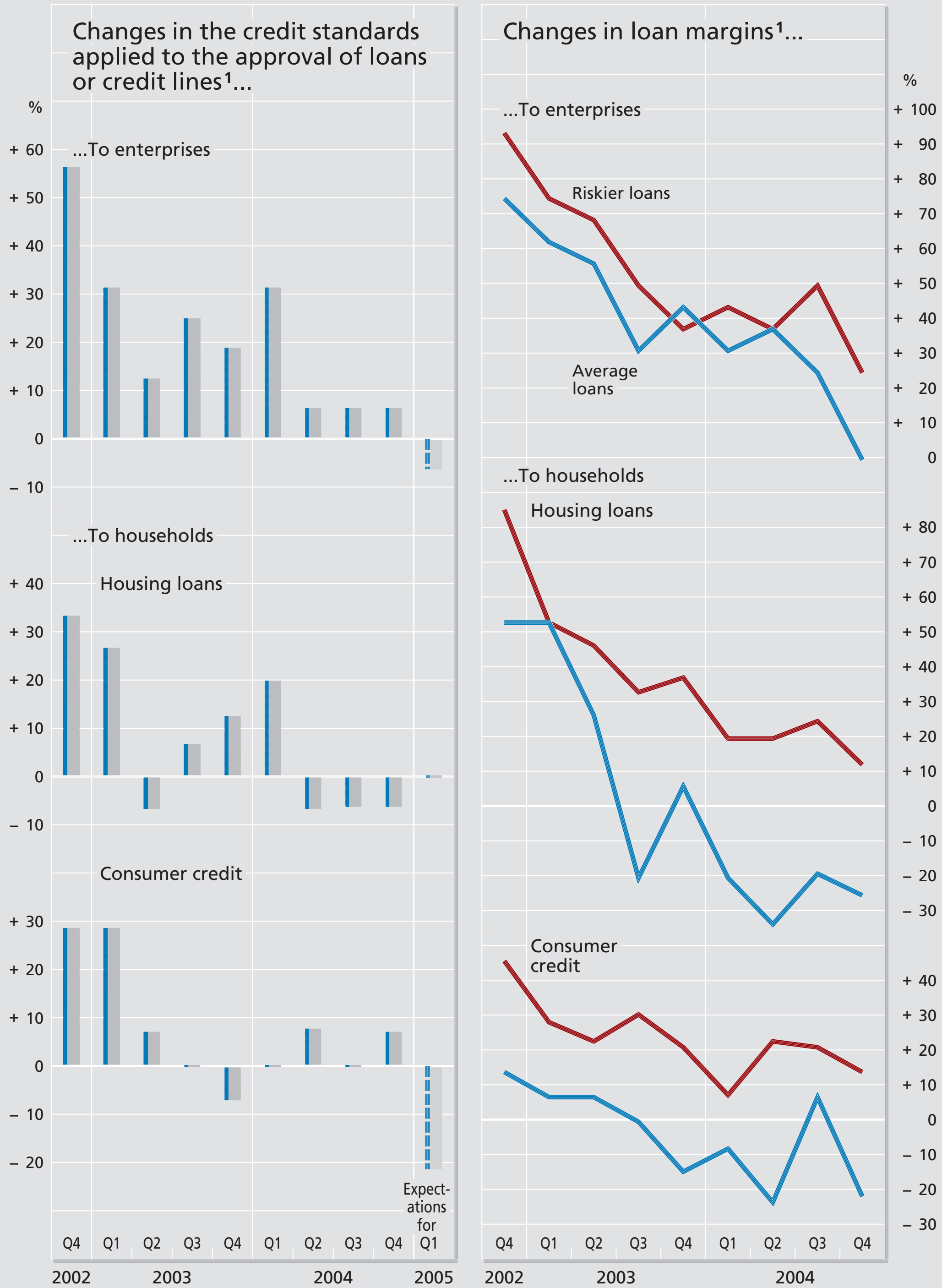
At 3.5%, German banks' deposit business grew somewhat more strongly in the year under review than in 2003 (2.9%). Both in Germany and throughout the euro area, however, short-term bank deposits were topped up to a lesser extent than in the previous year. Above all, overnight deposits in Germany increased by 5.3%, only half the amount of the year before. German investors' deposits with an agreed notice period of three months at domestic banks also posted weaker growth in 2004. There was a further reduction in short-term time deposits (with an agreed period of notice of up to two years), albeit to a considerably lesser extent than in 2003. It was only the longer-term time deposits that showed strong growth.

Lending to the domestic private sector stagnates

German banks' lending to domestic private non-banks stagnated. Given the low long-term interest rates, house purchase loans to households were increased. At the same time, however, other lending to households fell considerably. Over and above that, non-financial enterprises reduced their lending. However, they only cut back on their short-term loans; as in the previous year, they stepped up

Bank lending survey
Results for Germany

Chart 14



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”.

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their longer-term lending again. In the year under review, banks invested considerable amounts in domestic public sector securities, probably also to offset stagnating lending to private borrowers and declining unsecuritised lending to the domestic public sector.

Bank Lending Survey

The results of the Eurosystem's bank lending survey indicate that stagnating lending in Germany remains mostly on the demand side. According to the respondent banks, this was also partly due to the fact that, in many cases, enterprises were initially able to draw on own funds for financing purposes, a quite typical feature of the first stage of an economic upturn. The supply-side tightening of credit standards that was still identifiable in 2003 and in the first quarter of 2004 almost came to a standstill last summer, at least as reported by the surveyed banks.

Long-term bank lending rates in line with market developments

The long-term interest rates which German MFIs charged households and non-financial enterprises on new business were mostly in line with the matching capital market rates in 2004. These were declining throughout the period under review (see chart on page 47). Loans to households for house purchase with an interest rate fixation of more than five and up to ten years declined by approximately ½ percentage point to 4½%. In late 2004, German banks also charged less in year-on-year terms for long-term corporate loans, the most recent figure being 4½%.[1] The long-term rates domestic banks paid households on deposits also declined in the year under review. By contrast, most short-term deposits and lending rates changed only a little, in line with developments in the money market.

(b) Developments in the German banking sector

Heterogenous exposure in new lending business

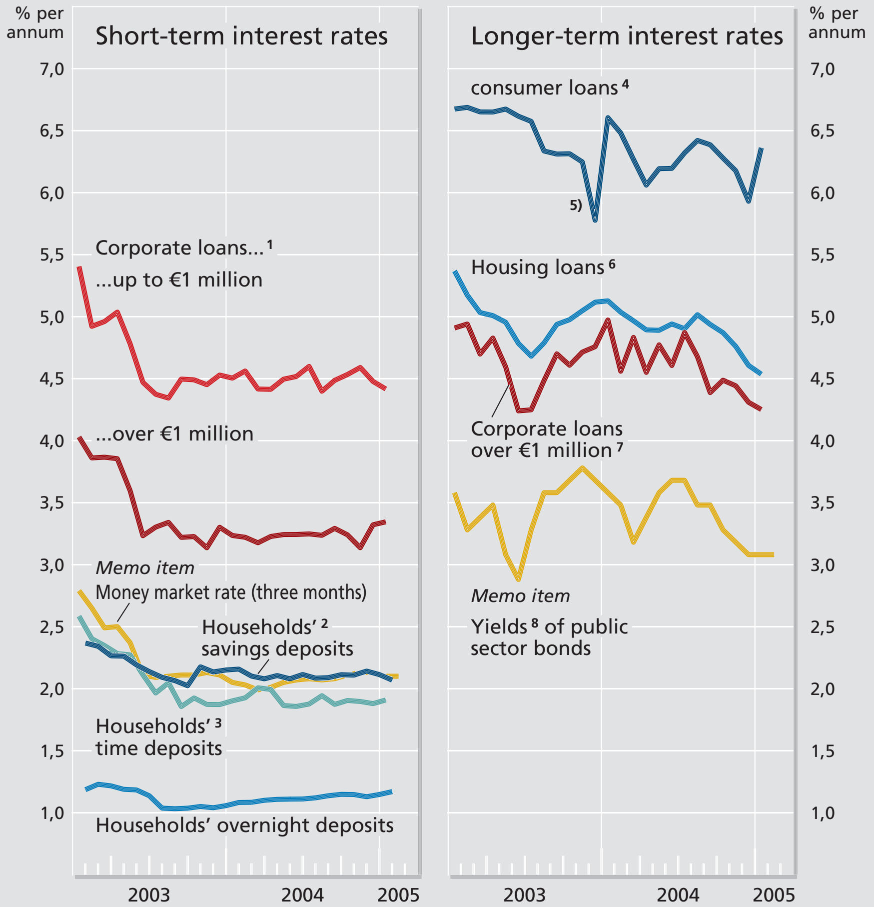
The individual categories of banks conducted their lending operations with domestic private customers on a varying scale. A noticeable share of new lending was accounted for by the commercial banks, of which only the regional banks and other commercial banks sharply increased their lending to the domestic private sector. The big banks, by contrast, again reduced their lending perceptibly, even after eliminating the valuation adjustments.[2] The credit cooperatives and

1 For a comparison of German and European interest rates for loans to enterprises, see box in Deutsche Bundesbank, Lending rates in the euro area and in Germany, *Monthly Report,* February 2004, pp 32-33.
2 The market shares, which were calculated based on stocks of credit, do not reflect this development as reclassifications between the individual categories of banks took place. The *Landesbanken* and special-purpose banks were also affected by this.

Bank interest rates in Germany

Chart 15

New business



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** Decline owing to special effect. — **6** To households with an initial rate fixation of over five years and up to ten years. — **7** To non-financial corporations with an initial rate fixation of over five years. — **8** Residual maturity of over five years and up to six years.

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Landesbanken also posted comparatively high growth rates in domestic private lending. Finally, the regional institutions of credit cooperatives and mortgage banks cut back their respective lending activities in 2004. Lending by the savings banks and special-purpose banks stagnated.

Cost-driven stabilisation of the earnings situation

The earnings situation in the German banking industry had been less than satisfactory in the two preceding years, but the situation eased somewhat in 2004. Developments on the cost side played a very major part in this. First, restructuring measures that were undertaken following one-off payments are likely to have had a greater impact on administrative expenses. Second, in the light of the value adjustments carried out in the preceding years, there is likely to have been a further reduction in the need for risk provisioning in domestic lending business. The accelerated reduction of risk assets, which was reflected not least in extensive sales of distressed loans, also probably contributed to an easing in this respect. The reduction in risk assets, however, does have a negative impact on net interest income. As the trading result is also likely to be down on the year owing to the weaker year-on-year performance of the equity markets, the earnings situation did not yet show a sustained and marked improvement for all banks in 2004.

Further consolidation

Not least in the light of the difficult earnings situation, there was a continuation of the consolidation process in the banking sector in 2004, albeit at a somewhat slower pace. As a result, the number of credit institutions recorded in the banking statistics fell by 79 to 2,147. Again, this affected mainly smaller banks. The largest decline of 57 institutions occurred among the credit cooperatives, followed by the savings banks with a reduction of 14 institutions and the regional banks with a reduction of ten institutions. Given the planned measures to curb costs, the consolidation process is likely to continue in 2005.

3 Stability of the German financial system

German financial system strengthened

Owing to the slight cyclical improvement in Germany and the far-reaching restructuring efforts in the German banking industry, the stability of the German financial system continued to improve in the period under review. However, risks remain. Therefore, progress made should not be a reason for slackening in such efforts. At present, the opportunity exists to achieve structural improvements without the pressure of acute risks to stability.

Global economic imbalances pose a risk to stability

The external imbalances in the global economy, which have been building up for many years and are reflected particularly in the sizeable capital imports into the United States, pose the risk of a realignment of international capital flows, which may be accompanied by marked exchange rate fluctuations and a rise in capital market rates. The financial system would be affected both directly and indirectly through developments in the real economy. The fact that this risk has existed for years now should not lead to carelessness.

Low level of risk aversion

With ample global liquidity, yields and risk premia were compressed further in 2004, especially in the case of corporate bonds and, following a temporary rise in the summer, in the case of emerging countries' government bonds as well. Rising prices in virtually all categories of investment and large inflows to risky hedge funds and private equity funds reflect institutional and private investors' increased willingness to assume higher risks. This does not mean that the low level of risk aversion will persist; it could, for example, increase considerably if global interest rates were to rise faster than expected.

Hedge funds and market concentration

Developments in the rapidly growing hedge fund industry also warrant closer analysis. Hedge funds, which are not subject to any financial supervision, are becoming increasingly important for financial markets, for banks' lending and their commission business as well as for institutional investors. More and more hedge funds are aiming to make profits by investing large inflows of funds into tight niches. Maintaining the customary high yields in this environment is becoming more difficult and/or requires greater risks to be assumed. Over and above that, the high degree of concentration in individual market segments, such as credit derivatives, deserves attention; the withdrawal of a single institution could affect the entire financial system.

Stable capitalisation of German financial intermediaries

The large German banks' return on equity remains well below that of their international competitors. However, it should be borne in mind that some of the large domestic banks operating on an international scale have significantly reduced their interest-bearing assets in response to their generally impaired ability to bear risk owing to the losses incurred in the previous years. With a virtually unchanged capital base over the course of the year, the national and international capital adequacy requirements were met throughout 2004. At an average of 8%, the core capital ratio of the main internationally operating banks is still at a comfortable level. Available market indicators confirm the improved assessment of the risk potential. For example, credit default swap premia of the big banks remained at a low level throughout the year. The rating agencies also took due account of this, with some of them reassessing the outlook as more favourable.

Savings banks and credit cooperatives

For the savings banks and the cooperative banks, which are organised in a network structure, lending and, therefore, net interest income is of major importance, owing to their strong market position in lending to households and to small and medium-sized enterprises. After having improved from a low level in the two preceding years, net interest income stagnated in 2004. However, these institutions are also likely to benefit from the general improvement in credit quality, which should be reflected in lower risk provisioning. Further cost reductions might be achieved by a more consistent division of labour within the network.

Mortgage banks

Last year, in particular mortgage banks suffered from the difficult situation in the commercial real estate markets and in several segments of the residential construction market. Some of these banks had to carry out large valuation adjustments. The current weakness of these markets also poses a higher risk potential for some of the commercial banks and real estate funds; however, this appears to be manageable.

Insurance sector

Apart from credit institutions, insurance companies are also of key importance for the stability of the German financial system. Given the recovery in the major equity markets, solvency and earnings in the insurance sector continued to stabilise in 2004. The life insurance companies succeeded in wiping out nearly all of the hidden losses which had arisen in the preceding years, thereby increasing their ability to bear risk again. In addition, growth in new business had a positive impact on the earnings situation. The non-life insurance companies and reinsurance companies managed to post a satisfactory actuarial result despite higher-than-average damage claims in 2004.

IV Economic trends and economic policy in Germany

1 Cyclical recovery narrowly based

Brighter economic picture with some weaknesses

In 2004, the German economy overcame a period of persistent slow growth that had lasted three years. Once again, the initial boost for this came – apart from stock-cycle influences – from exports, which increased along with extremely dynamic world trade. However, this has so far failed to spark off domestic demand to the degree that was hoped for. Despite successes on the international sales markets, a broadly based and self-sustaining upswing has not yet materialised. The German economy therefore remains susceptible to disruptive influences and external shocks. This is all the more the case as the economic recovery is following a rather flat growth trend. A visible sign of this was the interruption of the cyclical upturn in the later part of 2004 when there was a lull in exports. At the same time, this clearly revealed the weaknesses and structural problems that continue to exist in Germany.

Key economic variables in Germany

Table 5

Annual percentage change

Item	2001	2002	2003	2004
Growth (real) [1]				
Private consumption	+ 1.7	– 0.7	+ 0.0	– 0.4
Government consumption	+ 1.0	+ 1.9	+ 0.1	+ 0.4
Machinery and equipment	– 4.9	– 8.6	– 1.4	+ 1.2
Premises	– 4.8	– 5.8	– 3.2	– 2.6
Other investment	+ 5.5	+ 1.4	+ 1.7	+ 1.4
Changes in inventories				
Change (in € billion)	–19.2	– 8.7	+17.4	+14.6
Domestic use	– 0.8	– 1.9	+ 0.5	+ 0.4
Net exports [2]				
Change (in € billion)	+31.3	+38.6	–11.5	+22.7
Exports	+ 5.7	+ 4.1	+ 1.8	+ 8.6
Imports	+ 1.0	– 1.6	+ 4.0	+ 6.4
Gross domestic product	+ 0.8	+ 0.1	– 0.1	+ 1.6
Contribution to GDP growth in percentage points				
Domestic use (excluding stocks)	+ 0.2	– 1.4	– 0.4	– 0.3
Changes in inventories	– 1.0	– 0.4	+ 0.9	+ 0.7
Net exports	+ 1.6	+ 1.9	– 0.6	+ 1.1
Employment				
Employed [3]	+ 0.4	– 0.6	– 0.9	+ 0.4
Average working time per employed person	– 0.9	– 0.8	+ 0.2	+ 0.1
Total number of hours worked	– 0.5	– 1.4	– 0.8	+ 0.4
Unemployed (in thousands) [4]	3,853	4,061	4,377	4,381
Western Germany	2,321	2,498	2,753	2,781
Eastern Germany	1,532	1,563	1,624	1,600
as percentage of the civilian labour force	9.4	9.8	10.5	10.5
Western Germany	7.2	7.6	8.4	8.5
Eastern Germany	17.3	17.7	18.5	18.4
Prices				
Consumer prices	+ 2.0	+ 1.4	+ 1.1	+ 1.6
Producer prices of industrial products [5]	+ 3.0	– 0.6	+ 1.7	+ 1.6
Construction prices	+ 0.3	– 0.1	+ 0.1	+ 1.1
Import prices	+ 0.6	– 2.2	– 2.2	+ 1.0
Export prices	+ 1.0	– 0.2	– 0.2	+ 0.5
Terms of trade	+ 0.5	+ 2.0	+ 2.0	– 0.6
GDP deflator	+ 1.3	+ 1.5	+ 1.1	+ 0.7
Productivity and labour costs				
GDP per hour worked by employed persons [1]	+ 1.3	+ 1.5	+ 0.7	+ 1.1
Compensation per hour worked by employees [3]	+ 2.4	+ 2.1	+ 1.6	+ 0.2
Labour costs per unit of value added in real terms in the economy as a whole [6]	+ 1.1	+ 0.6	+ 0.9	– 1.0

Sources: Federal Statistical Office; Federal Employment Agency. — **1** At 1995 prices. — **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** Gross compensation generated in Germany per hour worked by employees divided by real GDP per hour worked by employed persons.

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Movement on the labour market

The sideways movement in the second half of 2004 also means that the German economy went into 2005 without any great momentum. Even so, important conditions for a continuation of the economic upturn are still in place. There has not yet been a turnaround on the labour market, which has a key role in terms of the sustainability of the development of the economy in Germany. Although the number of persons in work has been rising since the start of 2004, the increase has been solely in government-assisted jobs. This contrasts with employment subject to social security contributions, which was on a downward trend up to the end of the period under review. Nevertheless, there has now been some movement on the labour market. The reform measures that have been initiated and the greater sense of proportion with which wage bargaining is being conducted means that government as well as both sides of industry have taken important steps to shape the future course of events. If the international setting remains intact, there are grounds for hoping that there will be a turn for the better on the labour market, too, this year.

Exports: driving force and vulnerable flank

In Germany, the cyclical upturn was sustained primarily by strong stimuli to German exports stemming from a buoyant world economy. From the middle of 2003 export orders received by German industry recovered in the wake of the revival in global economic activity. Besides Germany's price competitiveness, which can still be rated as favourable despite the appreciation of the euro, the wide range of high-quality products on offer, especially capital goods, was a significant factor in this. Overall exports of goods and services went up 8½% in real terms compared with a meagre growth of 1¾% in 2003. Despite the fact that imports were also rising, net exports made an arithmetical contribution to growth of 1 percentage point of GDP, whereas the external side had tended to be a negative factor for GDP in 2003. The slowdown in exports in summer 2004, which interrupted the recovery phase, once again clearly revealed the German economy's high (and increasing) degree of integration into the international setting and its growing dependence on it. The sharp increase in net exports in 2004 was partly a reflection of weak domestic demand and, to that extent, mirrors the unbalanced structure of the economic upturn. It is therefore also an indication of the fact that impulses emanating from exports still have a major impact on the pace of growth in Germany. At the same time, the German economy's degree of openness and, therefore, its integration into the international division of labour have increased markedly in the past few years. This is shown, for example, by the ratio of the sum of imports and exports in GDP. This indicator had risen from not quite 50% in the first half of the 1990s to more than 70% at the end of the reporting period.

Expansion in machinery and equipment for the first time since 2000

Given positive export activity, 2004 saw a turnaround in investment in machinery and equipment, which showed an increase for the first time since 2000. Nevertheless, measured in terms of the major need for expenditure on replacement and renovation and given the favourable financing conditions, the increase, at 1¼%, was quite modest. The continuing weakness of domestic final demand and uncertainty about the future outlook were retarding factors which probably led many enterprises to be cautious in allocating resources to non-financial assets. Added to this was greater competition for investment, not least with countries in central and eastern Europe, which have comparative cost and tax advantages over Germany. It is not just large companies that are outsourcing production to these countries. Even so, according to both the Ifo Investment Test and the surveys of the German Chamber of Industry and Commerce (DIHT), there has been a greater propensity to invest in Germany. This is also likely to have something to do with the marked progress that has been achieved on the German labour market in terms of flexibility in working hours and rates of pay, which has meant that Germany has made good some ground as a location for investment.

Still no end to the adjustment crisis in construction

By contrast, the adjustment of the exaggerations that occurred in the construction sector after German reunification has not been concluded. Apart from a brief interruption in 1999, construction investment has been on a downward course for ten years now. Real investment in construction in 2004 was 2½% down on the year, compared with a year-on-year figure of -3¼% in 2003. At the end of the reporting period, the figure was more than one-fifth down on the peak in 1994. In regional terms, the decline was especially marked in eastern Germany at 6%. At the end of the period under review, the level of construction investment in eastern Germany was no more than half that in the mid-1990s. All construction subsectors in both eastern and western Germany were affected by the negative trend. A large number of vacant commercial properties and the low level of demand for capacity expansion continued to place a strain on industrial construction activity. Investment in housebuilding was given a temporary stimulus by anticipatory effects in connection with the reduction and/or abolition of the government grant towards the cost of buying a home. Isolated shortages in west German urban centres as well as the historically low interest rate level are also likely to have had a reinforcing impact. However, this was not enough to offset the retarding factors resulting from the large supply overhangs in eastern Germany and the expected longer-term decline in the resident population, which made itself felt especially in rented-housing construction. The public sector, too, made a perceptible cutback in its construction activity.

Further levelling-off in fixed capital formation

Despite the increase in investment in machinery and equipment and in other plant, which includes bought-in software and software produced in-house, there was a slight fall in gross fixed capital formation in the reporting year. After deduction of appreciation, which represents the amount of fixed assets used up as a result of normal wear and tear and foreseeable obsolescence, fixed investment in relation to national disposable income was no more than 3%, which marks a new all-time low. The capital stock as a major indicator of the future opportunities for growth went up by no more than 1½% in total. If new housing is excluded, the increase at the end of the period under review was only 1%. As a corollary of this, an increasing part of (the already severely depressed) asset formation is being made available to foreign countries in the form of capital exports.

Weak consumption not yet overcome

Households' propensity to consume remained weak. In real terms, households cut back their consumption spending again somewhat compared with 2003. This means that the level of real consumption has fallen by a total of 1% in the past three years. The continuing lull in consumption is due to the tight overall framework for incomes, the higher rate of inflation and the further increase in the saving ratio. Incomes were dampened, in particular, by the weak condition of the labour market, which meant that net wages and salaries went up by only 1¾% despite the relief on income tax. Added to this was a smaller increase in social benefits than in 2003. Including other incomes, among which are mixed income and investment income, nominal disposable income rose by only 1½%. After adjustment for the fall in the purchasing power of money, which was larger than in the year before mainly on account of increases in administrative prices, nominal disposable income was more or less just as high as in 2003.

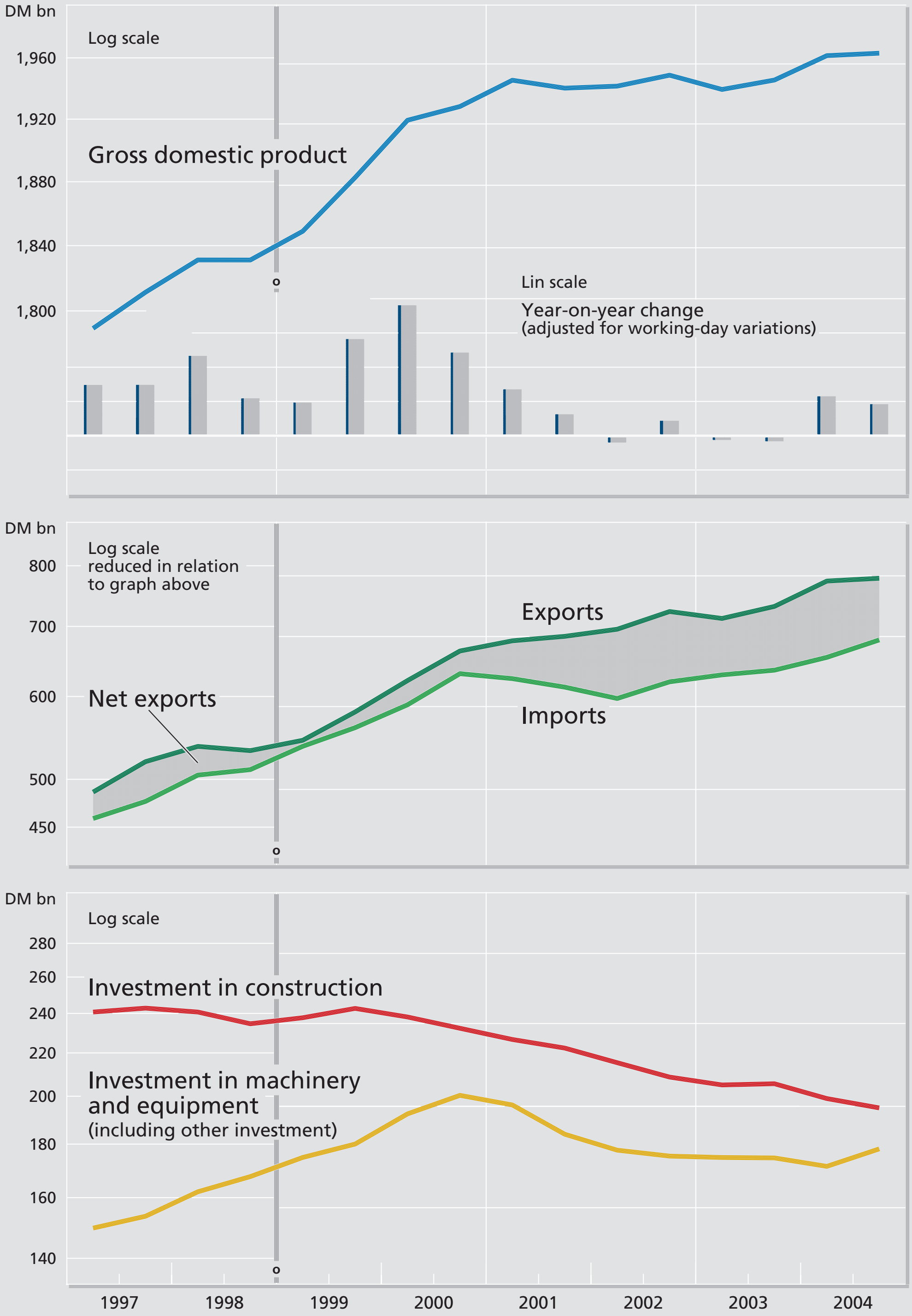
Further increase in the saving ratio

Savings as a ratio of disposable income showed a further increase to just under 11%. This means that households' saving ratio has risen by more than 1 percentage point since 2000. Apart from the general uncertainty about jobs and consumers' uncertainty about the impact of the Federal Government's recent reforms, another likely cause of the increased propensity to save is that the problems of the public health and pension systems have raised awareness of the necessity to make personal provision. In general, the accumulation of private assets for maintaining the standard of living in old age is to be seen positively as a major contribution to coping with demographic strains, even though it represents a cyclical burden in the short term. Furthermore, it is quite possible that households have generally down-revised their assessment of their future income

Gross domestic product and
selected expenditure components

Chart 16

1995 prices, seasonally adjusted, half-yearly



o From 1999, data in euro.

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prospects, which is leading to a generally more cautious attitude to spending on high-quality durable consumer goods.

Rise in employment through labour market policy

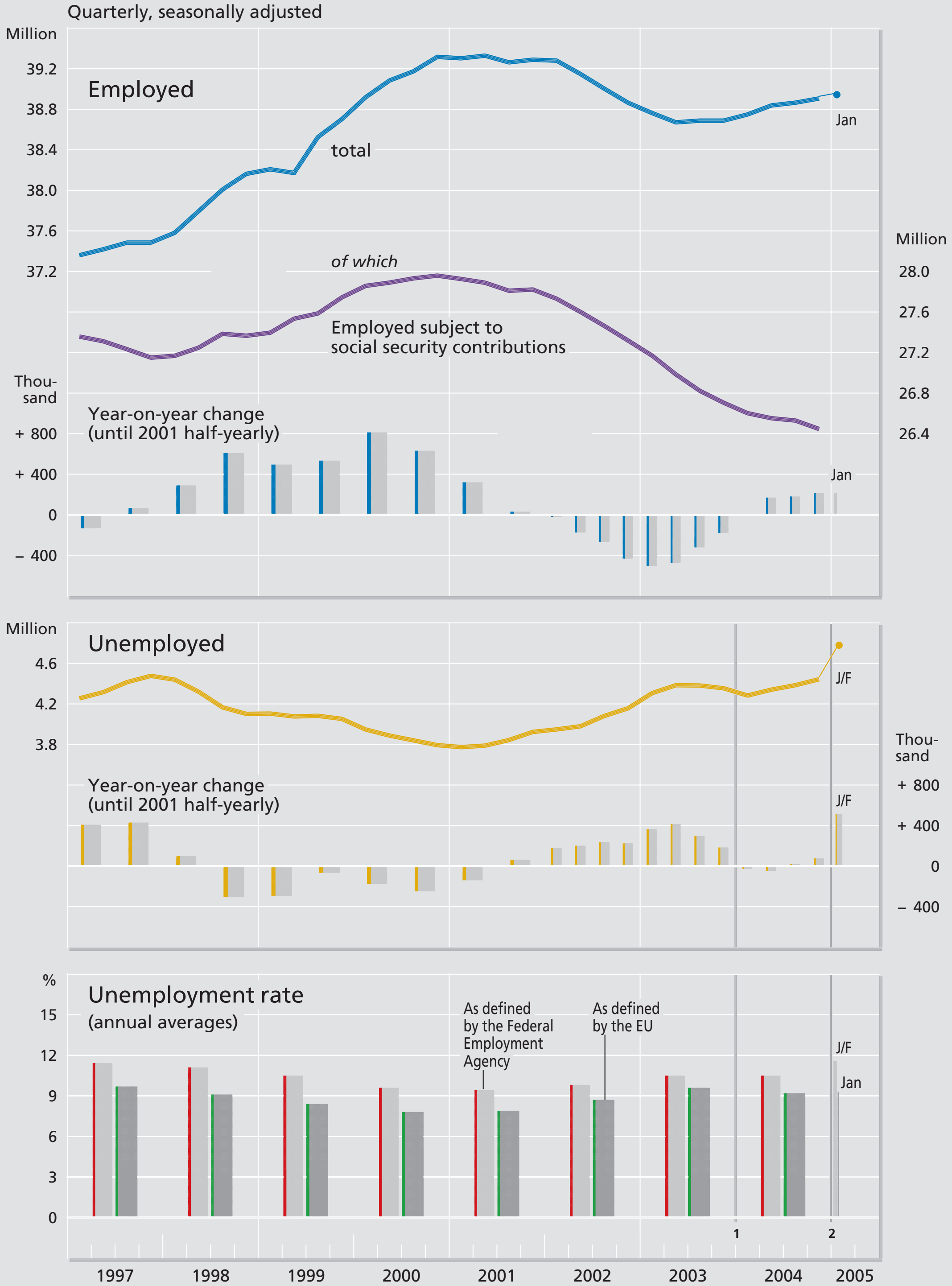
The labour market in 2004 was marked by administrative and labour market policy measures which, to quite a large extent, concealed the cyclical factors. The 137,000, or 0,4%, rise in the number of persons in work, for example, was essentially due to the increase in low-paid part-time workers and self-employed persons. Both types of employment are being vigorously promoted by labour market policy. In taking the step out of unemployment into self-employment, say, as a one-person business, business start-up grants and bridging payments play an important role. According to Federal Employment Agency figures, more than 300,000 persons were receiving such payments at the end of 2004. This played a crucial part in the accelerated increase in the number of self-employed persons last year. For low-paid part-time workers in "mini-jobs" the government had introduced favourable arrangements as early as April 2003. The monthly ceiling for earnings was raised to €400 and, employees have been exempted from social security contributions and taxes on income. The employers pay a flat-rate amount of 25%. Together with the possibility of very flexible working hour arrangements and what is probably quite a large amount of scope with regard to remuneration, jobs like these have become considerably more attractive. In December 2004, an estimated 7 million low-paid part-time workers were registered at the "mini-job head office" of the Miners' Federal Statutory Health Insurance Scheme, the *Bundesknappschaft.* This was around 1 million persons more than in the year before. Even though these cannot all be considered to be additional persons in work, since the figure includes those who also have another job, it still represents a marked increase in employment. The job opportunities increasingly offered since the introduction of "unemployment benefit II" to persons who need financial assistance but who are able to work were not yet so significant last year in quantitative terms. Up to the end of 2004, nearly 80,000 persons had taken up such work, which should be "in the public interest" and which involves a compensation of between €1 bis €2 per hour.

Decline in employment subject to social security contributions

By contrast, many "normal" jobs subject to social security contributions, which have a closer link to cyclical developments in the economy, were lost in 2004. According to data from the Federal Employment Agency, their number was 1% down on the year, which corresponds to the loss of around 250,000 jobs. Measured by developments over the course of last year, when broken down by sector it was mainly construction that was affected by cutbacks in employment levels. Nevertheless, employment was reduced in some branches of the services sector

Labour market

Chart 17



1 Unemployed and unemployment rate as defined by the Federal Employment Agency; from January 2004, excluding participants in aptitude testing and training schemes. — **2** From January 2005, including former recipients of social assistance who are able to work.

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as well. That was the case, not least, for public administration and education. In the case of the wholesale and retail trade and for hotels and restaurants, a sharp reduction in jobs subject to social security contributions contrasted with a distinct growth in low-paid part-time employment. This points to the existence of substitution processes.

Slight increase in total number of hours worked

The decline in full-time employment and the increase in low-paid part-time jobs has also had an impact on the number of hours worked. The resultant trend decline in the average number of hours worked was more than offset, however, by the reduction in time lost through illness and the large number of additional working days in 2004. According to calculations by the *Institut für Arbeitsmarkt- und Berufsforschung* (IAB), the Federal Employment Agency's labour market and employment research institution, the number of hours worked per employee increased on average by 0.1% to 1,440 hours. The total number of hours worked by all employees – whose number, it should be remembered, went up 0.4% – rose 0.5%. If the working-day effects are eliminated, the sum of working hours was more or less just as high as in 2003, in which – as in the years before – there was still a distinct decline in the total number of hours worked.

Continuing rise in unemployment

The unemployment statistics of the Federal Employment Agency underwent a major change in methodology last year. Since January 2004, participants in aptitude testing and training measures have no longer been counted as unemployed, which has affected between 90,000 and 100,000 persons. This played a crucial part in the number of persons officially registered as unemployed last year, at 4.38 million, being scarcely higher than in 2003. In cyclical terms, however, unemployment continued to rise during 2004. In seasonally adjusted terms, in December, it was nearly 220,000 up on the level at the start of the year. The seasonally adjusted unemployment rate as calculated by the Federal Employment Agency, went up from 10.2% to 10.8% in December 2004.

Large number of additions from the hidden reserve

One reason why the number of persons out of work remained high despite the increase in employment is that much of the additional demand for work was met by the "hidden reserve" or by an increase in labour force participation. This group of persons is likely to have had an advantage over the officially registered reserve of labour with regard to regional and working-hours availability as well as in terms of flexibility in remuneration. This is often a factor, especially in the case of low-paid part-time workers who, as mentioned above, accounted for the major part of the increase in employment. It is particularly true of women, who are in a clear majority among low-paid part-time workers. Young persons are also heavily represented, particularly school and university students as well as older persons aged over 60. Changing from registered unemployment into employment is also hindered by the fact that a large part of earned income is offset against unemployment benefit. This considerably reduces the financial attraction of low-paid part-time work in particular. Finally, the regulations allow persons who work fewer than 15 hours a week to continue to be registered as unemployed.

Growing underemployment in eastern Germany

Broken down by region, underemployment in eastern Germany remained depressingly high. The unemployment rate last year was more than twice as high as in western Germany. Moreover, the rise was at an accelerated rate. The rate as calculated by the Federal Employment Agency went up almost 1 percentage point to a seasonally adjusted 18.9% in December 2004. This contrasted with a 0.5 percentage increase in western Germany to 8.7% at the end of the reporting period. The differential is also due to the fact that employment in eastern Germany was reduced more sharply last year than in the western part of the country. Measured in terms of employees subject to social security contributions, employment in eastern Germany in September 2004 was 2½% down on the year, while the year-on-year figure in western Germany was -½%.

Unemployment in early 2005

The seasonally adjusted number of persons officially registered as unemployed showed a perceptible rise in January 2005. The unadjusted figure shows an increase of 573,000 on the month and a year-on-year rise of 440,000. This brought a rise in the level of unemployment in Germany to 5.037 million. The increase, which was clearly higher than the usual rise in unemployment in winter, was due mainly to the re-registration of 220,000 persons – who used to receive social assistance and were are able to work. Since the introduction of "unemployment benefit II", these persons have been in the care of the labour exchanges. In cyclical terms, there was hardly any change in the situation at the beginning of the year. The fact that unemployment in February also increased more sharply than is usual is due, at least partly, to late registrations under the new regulations. The unadjusted figure for unemployment in February was 5.216 million. After seasonally adjustment, unemployment stood at 4.88 million. The unemployment rate, as calculated by the Federal Employment Agency, was 11.7%, compared with 10.8% in December 2004. The unemployment rate as calculated by the Federal Statistical Office, which is based on International Labour Organization (ILO) criteria, was 9.3% in January, against 9.2% in December. One main reason for the clear difference in both the figures and the trend when compared with the statistics of the Federal Employment Agency is that the Federal Statistical Office does not count as unemployed anyone who has done any paid work, even if it has been for, say, only one hour per week. For the Federal Employment Agency, on the other hand, any paid work lasting up to 15 hours has no effect on the unemployment registration. Added to this is the fact that the labour force figure, which is inserted as the denominator of the rate, is adjusted on a monthly basis, while the Federal Employment Agency figure is derived from the findings of the micro-census only once a year in spring. Finally, the Federal Statistical Office calculates the number of unemployed using a representative survey of households. Being officially registered as unemployed, however, requires a personal registration with the labour exchanges.

Change in wages policy

The safeguarding of jobs and production sites was a main factor behind wages policy in 2004. Enterprises made use of potential savings in wage costs on a broad front in order to improve their competitiveness and to help secure Germany as a location for investment. In doing so, there was an identifiably strong tendency to seek company-specific solutions as well as an increasing differentiation of collective pay agreements as a result of creating and/or using "escape clauses". A lowering of hourly wage costs was achieved in many enterprises by extending regular weekly working hours without a corresponding increase in pay. As a supplementary or alternative measure, annual bonus payments were either reduced or linked to corporate performance. Furthermore, there was a continuing trend towards reducing non-core wage components.

Negative wage drift

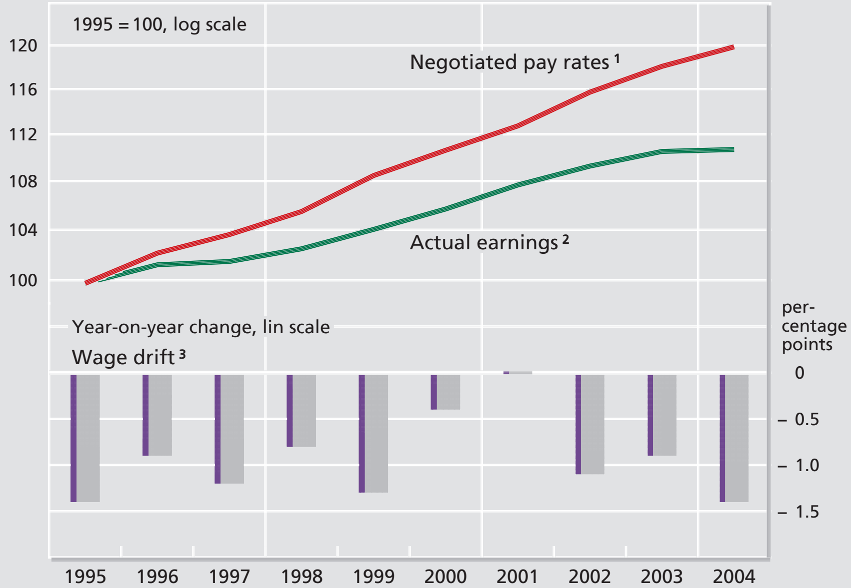
One conspicuous sign of this increasing flexibility in pay bargaining is the pronounced negative wage drift. Evidently, many enterprises felt that the continued moderation in negotiated pay rates – which, at +1½% calculated on a monthly basis, went up ½ percentage point and thus less sharply last year than in 2003 – was not enough to stand up successfully against the fiercer international pressure for investment and jobs. Together with the sharp expansion in low-paid part-time employment, which depresses average earnings in the economy as a whole in purely mathematical terms and therefore likewise contributes to the negative wage drift, this meant that actual earnings per employee in 2004 were scarcely up on the year.

Decline in unit wage costs

The virtual stagnation in the compensation of employees, which includes the employers' social security contributions as well as actual earnings, combined with the cyclical pick-up in labour productivity led to nominal unit labour costs being 1% down on the year. However, enterprises also benefited quite consider-

Wages in Germany

Chart 18



1 Negotiated wage and salary level on a monthly basis. — **2** Wages and salaries per employee. — **3** Difference between negotiated pay rates and actual earnings.

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ably from the exceptional pattern of working days and public holidays, since 2004 was a leap year and many public holidays fell at the weekend. It was therefore possible to use the additional working days for increased value added, while incurring only minor additional wage costs owing to the fact that a large number of employees draw a fixed monthly salary, irrespective of the number of working days. All in all, this meant that the pay policy of both sides of industry also made an important contribution to price stability.

External upward pressure on prices due to raw materials

The international energy and commodity markets and national administrative measures were among the main factors determining general price developments in Germany in 2004. By contrast, cyclical influences remained quite limited. There were no identifiable second-round effects in the wake of the accelerated price inflation. The impact of the world markets was reflected especially in German import prices. Whereas prices had fallen by just under 3% during 2003, imported goods became 3.2% more expensive overall in the course of 2004. One crucial factor in this was that December saw a 20% year-on-year increase in the cost of energy – the main sources being gas and coal alongside oil and refined petroleum products. Added to this were price increases of 43% for non-ferrous ores and 21% for semi-finished metal products. By contrast, all other imported goods cost less on average than they had done one year before. There were especially sharp price reductions of 2.9% in the capital goods sector, with computers and telecommunications equipment, in particular, becoming considerably cheaper. Moreover, many products of the consumer goods industry, such as televisions and radios or furniture and jewellery, cost less in year-on-year terms. Price reductions owing to technical improvements as well as the appreciation of the euro are likely to have played a significant role in this.

Tobacco tax driving industrial producer prices

The international influences and the increases in tobacco tax in March and December were reflected in industrial producer prices. Industrial factory gate prices went up 2.9% in total in the course of the year. That was half as much again as in 2003. Tobacco alone became almost 25% more expensive. Excluding the direct impact of energy, metals and semi-finished products as well as tobacco, the price increase last year was lower at 1.2%. On a breakdown of the consumer goods sector (excluding tobacco), there was hardly any change in prices. Capital goods, too, were no more than 0.6% up on the year in December 2004. Subdued demand combined with favourably priced competing imports are likely to have set clear limits on the scope for raising prices. Such restraint was made much easier by the fall in unit labour costs in 2004.

Strong fiscal component in consumer prices

At the consumer level, both the increase in tobacco tax and the health system reform put upward pressure on prices. Under the reform, some items were taken off the list of services and products previously paid for by the health insurance institutions *(Krankenkassen)* and additional payments, such as a "surgery visit charge" were introduced. Overall, the cost of healthcare went up around 20% in the basket of goods. The two upward steps in tobacco tax last year played a large part in overall tobacco prices going up by somewhat more than 24%. This combined with the impact on prices of the health system reform accounted for just over half of the total rise in the cost of living. Furthermore, there were sharp price movements on the international oil markets, which not only determined the consumer prices of petrol and heating oil but also pushed up gas prices owing to the fact that the price of natural gas is coupled to price of heating oil. In addition, there was a further increase in electricity prices. More than one-fifth of the increase in prices can be attributed to energy sources. As in previous years, the cost of housing was no more than roughly 1% higher. Incidental housing costs were increased more than twice as sharply, whereas pure rents eased back somewhat. Price adjustments in the case of industrial goods (excluding tobacco) were still well below average. Between December 2003 and December 2004, the prices of industrial goods went up by no more than 0.5%.

Prices at various levels of the economy

Table 6

Percentage year-on-year changes

Item	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Jan
Import prices	– 2.5	– 2.6	1.7	2.4	2.9	2.9
Energy	– 3.6	– 12.2	15.3	23.0	27.7	25.7
Non-ferrous metal ores	10.1	25.3	45.6	39.3	41.0	43.3
Basic metals and semi-finished products	3.0	9.4	18.9	22.7	22.8	20.7
Other	– 2.7	– 2.3	– 1.0	– 1.2	– 1.2	– 1.0
Producer prices	1.8	0.2	1.3	2.2	3.0	3.9
Tobacco	7.7	4.0	12.3	12.4	16.4	24.7
Energy	8.1	– 0.4	2.4	3.1	4.8	7.3
Basic metals and semi-finished products	2.4	4.1	10.9	17.1	21.4	22.6
Other	– 0.2	– 0.1	0.1	0.7	1.1	1.4
Consumer prices	1.2	1.0	1.7	1.8	2.0	1.6
Healthcare	0.7	16.7	19.5	20.4	20.3	3.8
Tobacco	8.5	4.4	12.2	12.2	16.2	24.3
Energy	3.3	– 1.6	4.9	6.1	7.1	5.3
of which						
Refined petroleum products	1.4	– 6.3	7.7	10.3	11.2	5.9
Gas	7.3	1.5	0.7	– 0.2	2.1	6.9
Electricity	5.2	4.0	4.2	4.0	3.8	4.1
Other	0.9	0.6	0.5	0.4	0.3	0.6
Construction prices	0.1	0.2	1.1	1.5	1.7	.
Residential buildings	0.1	0.2	1.2	1.6	1.7	.
Industrial and office buildings	0.2	0.3	1.4	2.1	2.4	.
Road construction	– 0.1	0.0	– 0.3	0.0	0.1	.

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Food even became 0.4% cheaper. The year-on-year rate of consumer price inflation in December was 2.1%. On an annual average, the figure was 1.6%, compared with 1.1% in 2003. The Harmonised Index of Consumer Prices (HICP) rate of inflation was 1.7% in 2004, compared with 1.1% in 2003.

Slower rate of price increase

The year-on-year rate of consumer price increase went down to 1.6% in January 2005, which was essentially due to a base effect in the case of healthcare. In cyclical terms, prices remained largely stable. The fact that year-on-year figure went up to +1.8% in February was connected, amongst other things, with the sharp rise in prices for seasonal foodstuffs. These were affected by a marked supply shortage owing to the onset of winter weather in the Mediterranean countries. An easing of the situation can only be expected from mid-March onwards when goods from other growing regions come on to the market. Overall, the price climate this year is still favourable.

2 Exports buoyed by strong foreign demand

Exports driven by brisk global demand

The favourable global economic climate in 2004 created the right conditions to give German exports of goods a substantial boost. After three years of fairly moderate export growth, the German economy benefited from a sharp rise in foreign orders last year. The capital and intermediate goods sectors benefited most from the strong foreign demand, as did the manufacturers of consumer goods, albeit to a lesser extent. However, exports of goods did not increase at the same speed in the second half of the year as they had done in the first two quarters. In the end, exports in 2004 were 10% up on the year in nominal terms and 9½% up in real terms,[1] thereby making an important contribution to growth last year.

Positive export trend despite further appreciation of euro

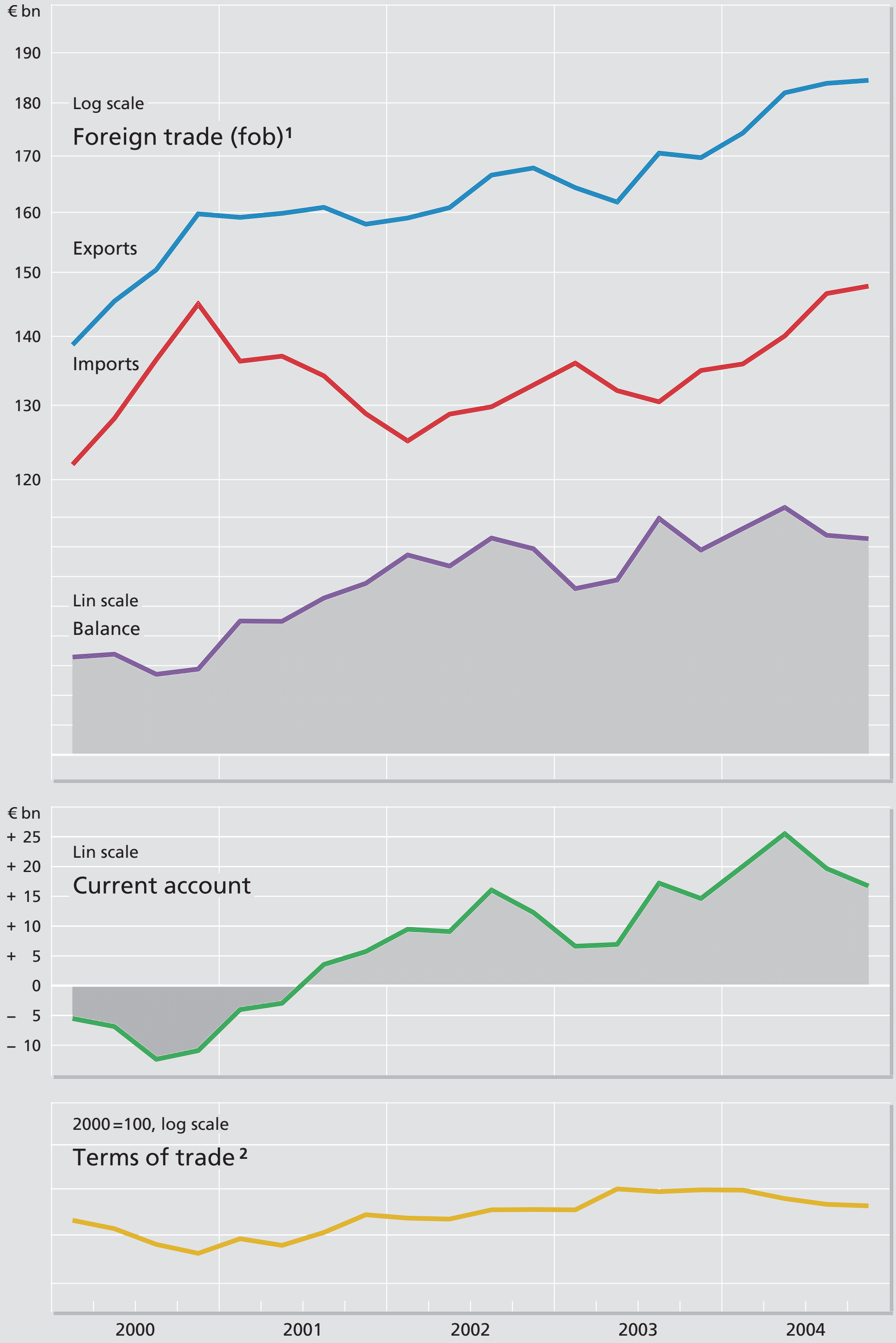
Differences in the economic developments from one country to another and the changes in price competitiveness as a result of exchange rate movements are particularly apparent in the regional breakdown of German foreign trade. The price competitiveness of the German economy, which was fairly strong anyway, continued to improve against that of the euro-area partner countries in 2004. This can be attributed to the relatively moderate price and cost developments in Germany and was reflected in German producers' export turnover with the other euro-area countries; this rose noticeably in 2004 compared with the previous year (+10%). German exporters therefore managed to make slight gains in market share in the euro area. However, German enterprises were not quite able to hold their market position outside the euro area, even though they largely refrained from passing on the worldwide increases in energy and raw material prices, which were handicapping them, too. Their price competitiveness in relation to the dollar area in particular again noticeably worsened as a result of the euro's strong appreciation in the second half of 2004. The increase in export sales to the United States, for example, was therefore comparatively low (6½%). However, it should be viewed in the context of the particular profile

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

Foreign trade and current account

Chart 19

Seasonally adjusted, quarterly



1 Including supplementary trade items. — **2** Export price index in relation to the import price index.

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of German exports to the United States, which, typically, are heavily concentrated on car sales. In 2004, German manufacturers exported 5½% fewer motor vehicles to the United States in terms of value than in the previous year. By contrast, sales of German products to other EU countries as well as to Russia, the OPEC countries and China were much more robust. This reflects, not least, these countries' strong economic growth and the substantial oil revenues generated by the oil-exporting countries.

Sharp increase in imports during the year

At 8%, the value of imports in 2004 grew somewhat less sharply than that of exports. Demand for imports, which was initially still weak, picked up substantially over the course of the year. Imported goods rose almost as sharply in real terms, too, even though energy and raw material imports became considerably more expensive. Overall, however, import prices increased by just 1% on an annual average, owing, not least, to the relatively small proportion of German imports that these goods constitute. The fairly considerable rise in imports in 2004 when measured against domestic demand is partly attributable to stock-cycle adjustments following declining inventories in 2003. Furthermore, the export bias of German production is also likely to have been a factor given the large and in 2004 presumably still rising share of imports in German exports. Foreign manufacturers of intermediate goods, especially chemical products and metal products, were the main beneficiaries of this. Overall, the value of goods imported from the euro area grew by 9% and from non-euro-area countries by 7%. Owing to the fact that the price of imports from the euro area rose somewhat more sharply than from third countries, however, these differences largely cancel out in real terms. Imports from China and the countries of South-East Asia increased particularly sharply. The value of energy imports from the OPEC countries and Russia also went up considerably. By contrast, there was a below-average increase in imports from the United States in nominal terms.

Record foreign trade and current account surpluses

The higher rise in the value of exports than of imports in 2004 led to a €24 billion year-on-year increase in the foreign trade surplus to €156 billion. As invisible current transactions, which comprise services, income and current transfers, likewise developed quite favourably, the overall current account surplus increased by an even bigger margin. The greatest improvement was recorded in income[1] owing to the noticeably higher net investment income from abroad. The income account was in balance at the end of 2004 whereas a year earlier

1 Owing to an ECB guideline, this *Annual Report* has changed over to the accruals principle of accounting for interest received. For more detailed comments on this, see Deutsche Bundesbank, The German balance of payments in 2004, *Monthly Report*, March 2005.

Balance of payments

Table 7

€ billion

Item	2001	2002	2003	2004
I Current account	+ 3.3	+ 48.2	+ 45.2	+ 84.0
1 Foreign trade [1]	+ 100.7	+ 136.5	+ 132.0	+ 156.0
Exports (fob) [1]	636.4	652.6	665.5	731.8
Imports (fob) [1]	535.7	516.1	533.5	575.8
2 Services	– 60.5	– 45.6	– 44.4	– 43.7
of which				
Foreign travel	– 37.8	– 35.2	– 36.8	– 35.8
3 Income	– 9.5	– 14.7	– 13.7	+ 0.1
of which				
Investment income	– 9.1	– 14.7	– 13.6	– 0.1
4 Current transfers	– 27.4	– 28.1	– 28.7	– 28.4
of which				
Net contributions to the EU budget [2]	– 12.3	– 10.9	– 13.2	– 12.2
Other official current transfers to non-residents (net)	– 4.6	– 5.4	– 5.5	– 5.4
II Capital transfers [3]	– 0.4	– 0.2	+ 0.3	+ 0.4
III Financial account (net capital exports: –)	– 17.8	– 42.8	– 46.3	– 99.8
1 Direct investment	– 14.8	+ 37.6	+ 27.3	– 25.2
German investment abroad	– 44.3	– 16.1	+ 3.2	+ 5.9
Foreign investment in Germany	+ 29.5	+ 53.7	+ 24.2	– 31.1
2 Portfolio investment	+ 32.2	+ 63.8	+ 64.9	+ 20.8
German investment abroad	– 124.5	– 62.9	– 47.4	– 112.9
of which Shares	– 10.7	– 4.7	+ 7.4	+ 6.2
Bonds and notes	– 95.1	– 47.5	– 54.0	– 99.9
Foreign investment in Germany	+ 156.7	+ 126.7	+ 112.3	+ 133.7
of which Shares	+ 86.8	+ 15.9	+ 24.2	– 5.2
Bonds and notes	+ 80.3	+ 82.9	+ 67.1	+ 147.7
3 Financial derivatives	+ 6.8	– 0.9	– 0.1	– 4.2
4 Credit transactions	– 40.7	– 141.6	– 135.4	– 87.8
Monetary financial institutions [4]	– 76.3	– 104.1	– 111.6	– 89.0
of which Short-term	– 33.1	– 88.7	– 73.1	– 85.3
Enterprises and individuals	– 7.9	– 7.7	– 31.0	+ 5.6
of which Short-term	– 17.1	– 11.5	– 27.5	+ 5.1
General government	+ 16.9	+ 5.5	+ 4.9	+ 1.0
of which Short-term	+ 16.8	+ 5.5	– 0.6	+ 0.6
Bundesbank	+ 26.6	– 35.4	+ 2.2	– 5.3
5 Other investment	– 1.3	– 1.6	– 3.0	– 3.4
IV Change in the reserve assets at transaction values (increase: –) [5]	+ 6.0	+ 2.1	+ 0.4	+ 1.5
V Balance of unclassifiable transactions	+ 8.9	– 7.2	+ 0.3	+ 13.9

1 Special trade, according to the official foreign trade statistics, including supplementary trade items; imports excluding freight and sea transport insurance costs, which are included under services. — **2** Excluding collection expenses, EAGGF (Guidance Fund) and Regional Fund and other capital transfers, where identifiable. — **3** Including the acquisition/disposal of non-produced non-financial assets. — **4** Excluding the Bundesbank. — **5** Excluding SDR allocation and changes due to valuation adjustments.

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there had been a deficit of €13½ billion. At the same time, the deficit on services, in which foreign travel is the most prominent item, went down by €½ billion to €43½ billion. At €28½ billion, however, net outflows resulting from current transfers remained almost unchanged. Overall, the German current account recorded a record surplus of €84 billion (or almost 4% of GDP) in 2004, €38½ billion higher than the previous year's figure.

Financial transactions shaped by financial market developments and the cyclical situation

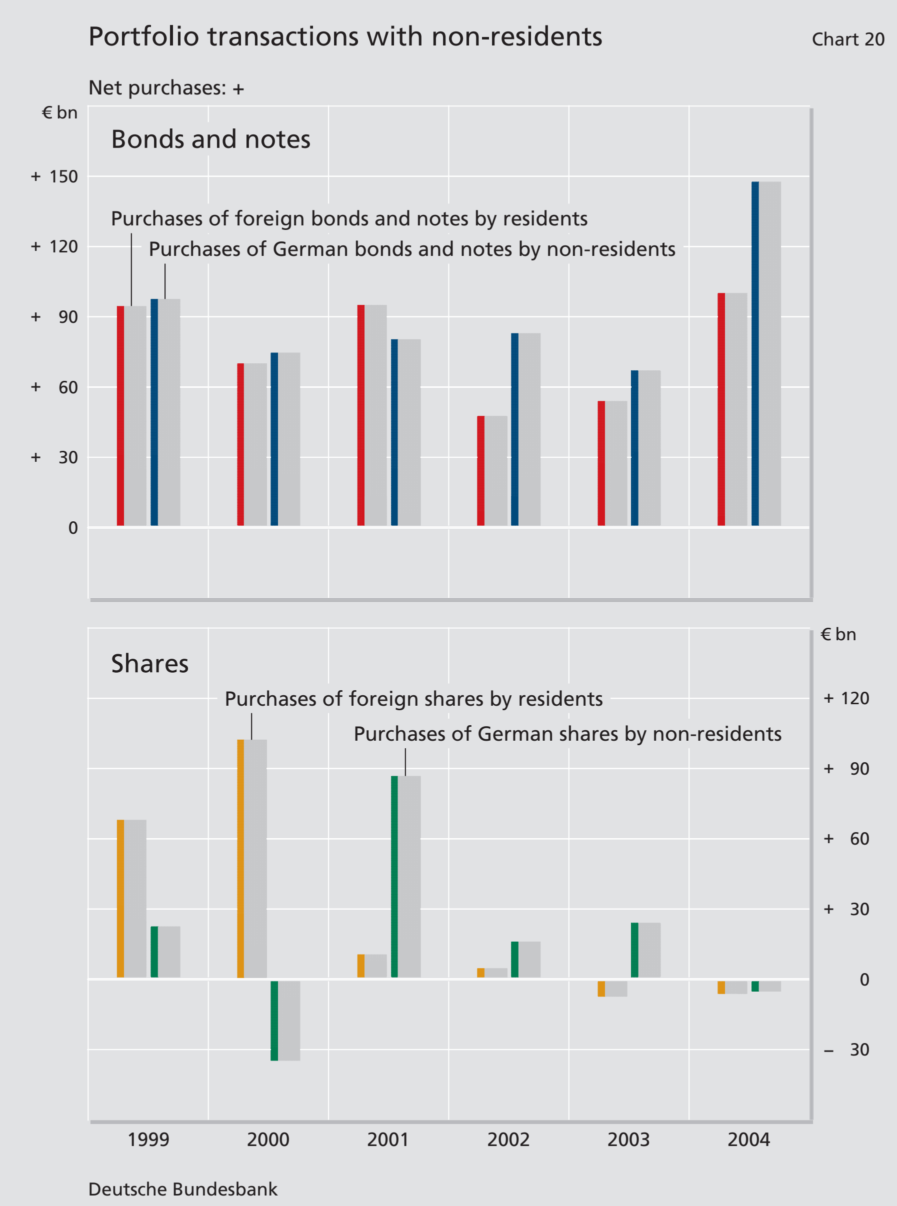
Events on the international financial markets and the favourable cyclical development of the global economy also shaped financial transactions last year. In view of low yields all over the world, investors' risk appetite appears to have increased somewhat; this was partly reflected in higher cross-border investments, with bonds and notes being most in demand. Overall, Germany recorded net capital imports of €21 billion as a result of securities transactions in 2004.

High foreign portfolio investment in Germany

The main reason for the inflows of funds was that non-residents invested large amounts in the German securities markets (€133½ billion). Apart from investing in mutual fund shares, they focused exclusively on German debt securities on balance, mainly those issued by banks. All in all, they purchased the record amount of €147½ billion of domestic bonds and notes. The main reason for the attractiveness of German bonds and notes for foreign investors is likely to have been the appreciation of the euro and temporary price rises on the bond market. Especially at the beginning of the year, though, geopolitical uncertainties are also likely to have favoured sales of German fixed-rate securities to non-residents. By contrast, foreign investors sold German money market paper (€14 billion) and shares (€5 billion) on balance in 2004.

Heavy demand from German investors for foreign securities as well

German investors increased their holdings of foreign securities to a much greater extent in 2004 than in the previous year (€113 billion as opposed to €47½ billion in 2003). The increased interest which they showed in foreign bonds and notes, primarily in euro-denominated paper, was a key factor in this respect. At €100 billion net, they almost doubled their purchases year on year in this market segment. The main buyers were credit institutions, presumably making use of the interest rate advantage of foreign euro bonds over German paper to improve their profitability. German investors also increased their purchases of foreign mutual fund shares (€12 billion) and, to a lesser extent, of money market paper (€7 billion) in 2004. By contrast, they sold foreign equities for the second year in a row (€6 billion).

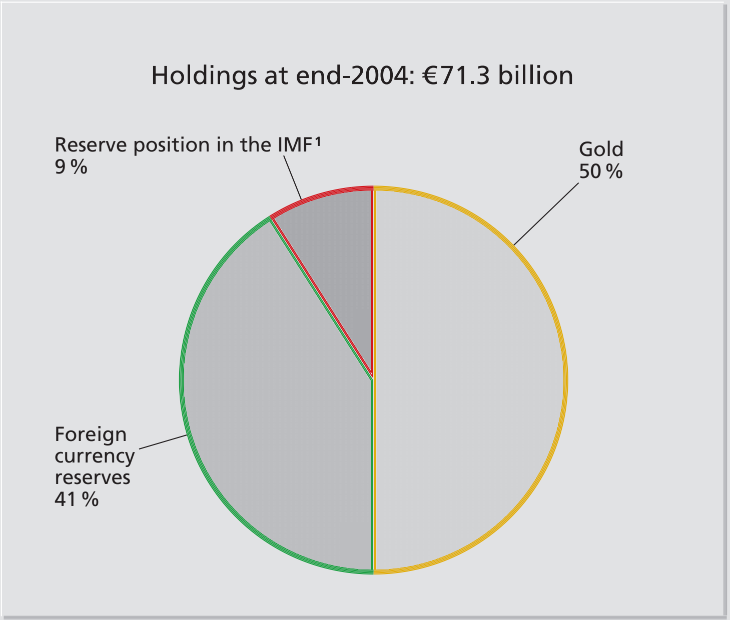


Direct investment outflows

Cross-border direct investment resulted in sizeable net capital exports amounting to €25 billion in 2004. These came about primarily through foreign enterprises withdrawing funds from Germany, which, at €31 billion, reached considerable proportions. The redemption of intra-group direct investment loans that had previously been granted to their German subsidiaries played a key role in this respect (€46 billion). At the same time, foreign proprietors again reduced their participating interests in Germany. They supplied their German subsidiaries and branches with just €21½ billion of fresh capital. This is likely to reflect, among other things, the fairly moderate economic growth in Germany in 2004 by international standards. German enterprises also withdrew capital from

Reserve assets of the Bundesbank

Chart 21



1 Including special drawing rights.

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abroad last year (€6 billion). The main reason for this was the sale of a major enterprise at the start of the year, the value of which more than offset the other direct investment by German firms. In particular, the provision of intra-group loans to subsidiaries and branches abroad as well as the redemption of loans that subsidiaries domiciled abroad had previously granted to their German parent companies were important factors.

Net capital imports through credit transactions of non-banks and large outflows of funds from the banking system

The statistically recorded non-securitised credit transactions of non-banks resulted in net capital imports in 2004, following relatively large outflows of funds in the previous year (€6½ billion compared with -€26 billion). The financial operations of enterprises and individuals were the main factor in this respect, which led to lower external assets and greater borrowing abroad. By contrast, cross-border transactions by general government largely cancelled each other out. In the case of non-securitised credit transactions by credit institutions, there were net outflows of funds amounting to €89 billion in 2004, mainly in the form of short-term funds, with the result that the balance is essentially a reflection of all other balance of payments transactions. The Bundesbank's external transactions that are classified as credit transactions resulted in further outflows of funds amounting to €5½ billion.

Decline in the reserve assets

The Bundesbank's reserve assets declined by €1½ billion last year measured at transaction values. If these were valued at market prices, price losses of around €4 billion would also have been incurred. In total, the balance sheet value of the reserve assets at the end of 2004 was €71½ billion. Gold reserves accounted for around half of the total holdings whereas the foreign exchange holdings comprised just 41% of the reserve assets following the sharp fall in the US dollar exchange rate. The reserve position in the IMF went down by €1 billion, owing primarily to transactions, with the result that its share of total German reserve assets was around 9% at the end of 2004.

3 Situation of public finances still very strained

(a) Developments in 2004

Maastricht deficit ceiling breached yet again

Germany's general government deficit amounted to 3.7% of GDP last year. It was therefore somewhat lower than the level in 2003. The deficit ceiling of 3% as set by the Maastricht Treaty was overshot for the third year in succession. In the context of the excessive deficit procedure launched in January 2003, Germany was initially called upon to bring the deficit back down to the reference value by 2004 at the latest. However, by autumn 2003 it was already evident that this would not be achieved. The European Commission then recommended to the Ecofin Council to issue Germany with a formal warning as the last stage before imposing sanctions. The Ecofin Council did not follow this recommendation, thus halting the excessive deficit procedure. The commitment to comply with the deficit ceiling was, in effect, postponed to 2005.

Further rise in debt ratio

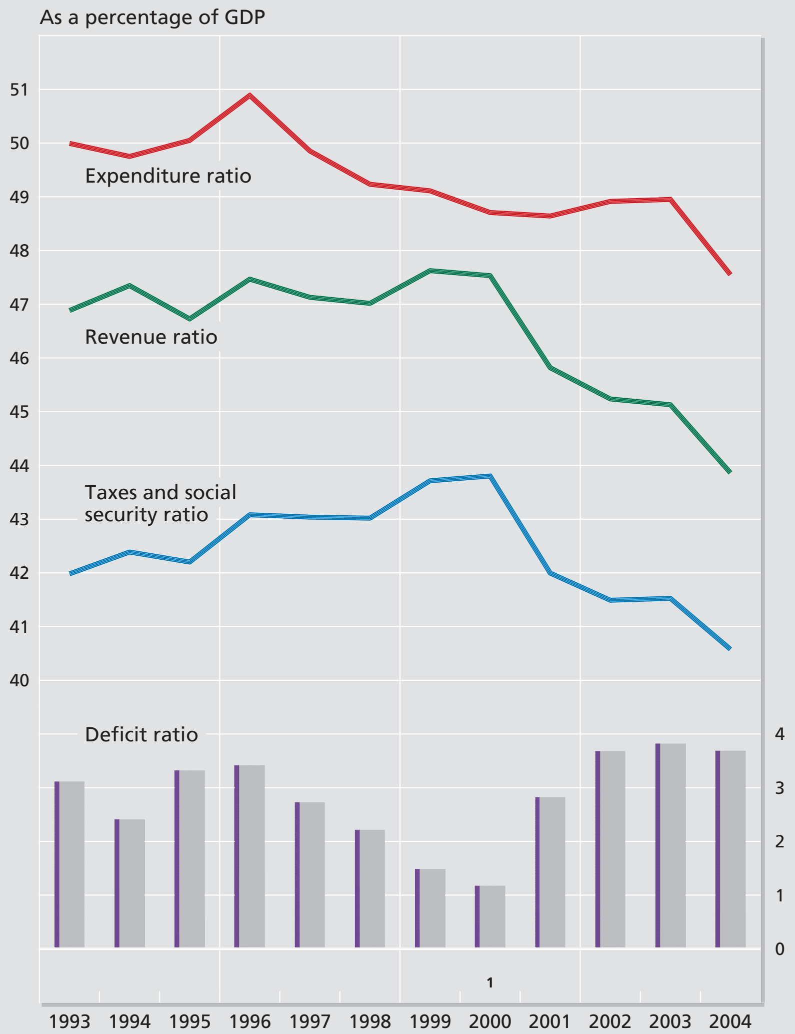
The high deficit resulted in a sharp rise in general government debt. Despite an accelerated increase in economic growth, the debt ratio rose again by almost 2 percentage points to 66%. In three years it has risen by nearly 7 percentage points. Germany has, therefore, also failed to comply with the second reference value of the fiscal Maastricht criterion, which stipulates a debt ceiling of 60% of GDP and allows exceptions only when the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Marked fall in revenue and expenditure ratios

The main reason for the failure to reduce the deficit was the fall in government revenue. Although the course of macroeconomic development was more favourable than in 2003, this was offset by the cut in income tax rates and the fact that the pattern of overall economic growth tended to yield less revenue.

General government fiscal ratios*

Chart 22



* As defined in the national accounts. — 1 Excluding the proceeds from the UMTS auction.

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This reinforced the negative cyclical impact on the budget somewhat. The weak revenue trend (-½%) was offset by the fact that the public sector followed a rigorous consolidation path and likewise lowered expenditure by just over ½%.

Weak development of tax revenue ...

The decrease in the revenue ratio which had already been evident in previous years accelerated in 2004; it went down by nearly 1½ percentage points to just under 44%. A major reason for the fall in the tax ratio by ½ percentage point was the entry into force of the second stage and the partial advancement of the third stage of the income tax reform, which lowered the top rate from 48.5% to 45% and the bottom rate from 19.9% to 16%. Tax-boosting measures in

General government as defined in the national accounts *

Table 8

Item	2002	2003	2004 pe	2002	2003	2004 pe
	€ billion			Year-on-year change		
				as %		
Expenditure	1,031.7	1,042.7	1,036.1	2.2	1.1	– 0.6
of which						
Social benefits	573.1	587.1	588.5	4.4	2.4	0.2
Compensation of employees	168.0	167.9	166.4	1.4	– 0.0	– 0.9
Intermediate consumption	84.5	83.9	84.9	4.3	– 0.7	1.2
Interest	66.0	66.7	66.2	– 2.6	1.1	– 0.8
Gross capital formation	35.9	31.9	30.6	– 2.4	– 11.2	– 4.0
Memo item						
Old-age provision 1	279.4	285.2	286.2	3.6	2.1	0.3
Health 2	146.6	148.6	145.0	2.9	1.4	– 2.4
Labour market 3	71.6	74.8	74.1	9.0	4.5	– 1.0
Revenue	954.2	961.4	955.8	0.3	0.8	– 0.6
of which						
Taxes	486.0	489.9	487.9	– 0.5	0.8	– 0.4
Social contributions	389.3	394.8	396.5	1.5	1.4	0.4
				€ billion		
Balance	– 77.5	– 81.3	– 80.3	– 18.9	– 3.9	1.0

***** In accordance with ESA 95, including customs duties, the EU's share in VAT revenue and EU subsidies which have no effect on the balance. — **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** Expenditure of the Federal Labour Office and on unemployment assistance.

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other areas only marginally compensated for these shortfalls. For example, the tax amnesty yielded around €1 billion and thus barely one-fifth of the originally anticipated receipts. The increase in the tobacco tax resulted in a slump in demand, which actually lowered revenue. In the case of mineral oil tax, too, the sharp rise in crude oil prices resulted in a decline in consumption and hence tax revenue. This was compounded by the weak development of gross wages and salaries and of private consumption, which subdued wage tax and turnover tax receipts. By contrast, profit-related taxes grew sharply, primarily owing to the positive trend in profits – albeit from a very low starting position.

... and of social contributions and other revenue

The stagnation of gross wages and salaries also had an impact on social contributions; their ratio to GDP likewise declined. Reductions in contribution rates effectively played no role in this because the statutory health insurance institutions used the savings from the health system reform, which entered into force at the beginning of 2004, to first lower their high deficits and repay their debts. The average contribution rate to the statutory health insurance funds therefore only went down from 14.3% to 14.2%. A greater role was actually played by the fact that company pensions were subjected to the full contribution rate.

General government finances Table 9

Item	2002 pe	2003 pe	2004 pe	2002 pe	2003 pe	2004 pe
	€ billion			Year-on-year change		
Central, state and local government				as %		
Expenditure	608.2	615.4	611.5	1.4	1.2	– 0.5
of which						
Central government	271.6	278.8	273.5	3.9	2.6	– 2
State government	257.9	259.6	257	0.9	0.7	– 1
Revenue	551.1	547.9	544.5	– 0.8	– 0.6	– 0.5
of which						
Taxes	441.7	442.2	443	– 1.0	0.1	0
				€ billion		
Balance	– 57.0	– 67.5	– 67	– 12.8	– 10.4	0
of which						
Central government	– 32.7	– 39.2	– 40	– 12.0	– 6.5	– 0.5
State government	– 29.3	– 30.4	– 25	– 4.6	– 1.1	5
Social security funds				as %		
Expenditure	466.0	474.4	468.5	3.8	1.8	– 1
Revenue	457.7	467.8	470	2.8	2.2	0.5
				€ billion		
Balance	– 8.3	– 6.6	1.5	– 4.3	1.7	8
of which						
Statutory pension insurance scheme	– 4.4	– 2.3	– 1.5	– 3.5	2.1	0.5
Statutory health insurance scheme	– 3.6	– 3.7	4	– 0.3	– 0.1	7.5

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Other revenue declined considerably, primarily owing to the small size of the Bundesbank profit.

But also falling expenditure ratio

Since government expenditure went down in 2004 in absolute terms, the expenditure ratio declined by just under 1½ percentage points to just over 47½%. This was largely due to expenditure on social benefits; its ratio to GDP fell significantly after achieving a record high in 2003. This was mainly attributable to reform-induced savings. Thus, as part of the health system reform, greater co-payments by insured persons, benefit cuts and discounts from the pharmaceutical industry resulted in a considerable reduction in spending for the health insurance institutions, particularly on pharmaceuticals. The statutory pension insurance scheme was relieved by the fact that the customary mid-year pension adjustment did not occur and that since April 2004 pensioners have had to pay the full (instead of a half) contribution to the statutory long-term care insurance scheme. Finally, despite the higher unemployment, labour market-related spending was slightly lower than the previous year's level because expenditure on active labour market policy was restricted further and an increasing number of unemployed persons received the lower unemployment assistance following the expiry of their entitlement to unemployment benefit. However, the social as-

General government debt Table 10

€ billion

Item	2003 Level at year-end 1	2004 pe Level at year-end 1	2003 Year-on-year change 2	2004 pe Year-on-year change 2
Loans against borrowers' notes	431.3	433	+ 8.3	+ 2
Securities	920.0	991	+ 73.4	+ 71
Other debt	6.8	5.5	– 1.2	– 1
Total debt	1,358.1	1,429.5	+ 80.5	+ 71.5
Central Government 3	767.7	812	+ 42.3	+ 44.5
State government (western)	355.7	376.5	+ 27.3	+ 21
State government (eastern)	68.1	72	+ 4.3	+ 4
Local government (western) 4	90.9	94.5	+ 6.8	+ 3.5
Local government (eastern) 4	17.0	17.5	+ 0.2	+ 0.5
German Unity Fund	39.1	38.5	– 0.3	– 0.5
ERP Special Fund	19.3	18	– 0.1	– 1
Indemnification Fund	0.5	0.5	+ 0.1	– 0

1 In the definition relevant for compliance with the EMU convergence criterion, government indebtedness comes to €1,366 billion (2003) and €1,437 billion (2004). — **2** The change in the debt level differs from net borrowing, since it includes the assumption of old debt and transfers of items previously included in the general government accounts. — **3** Including the special funds not shown separately here. — **4** Including municipal special purpose associations.

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sistance payments financed by local government grew sharply again. Besides social benefits, the ratio of other current government expenditure to GDP also decreased. This mirrors the reaction of central, state and local government to the budgetary pressures. In the area of personnel expenditure, for example, many special bonuses were reduced and the number of staff was lowered further. The interest expenditure ratio went down marginally to 3.0% despite high new borrowing because the low interest rate level resulted in a further decline in the average interest paid on government debt. The acquisition of non-financial assets was also reduced again. Besides the pressure on local government to consolidate, this was, however, presumably also attributable to the decline in expenditure to overcome the flood damage.

Persistently high general government deficits

Fiscal developments were quite different at the individual levels of government. The financial situation of central government – the deficit of which (as defined in the government financial statistics on which the budgets were based) amounted to almost €40 billion in 2004 and was thus even higher than in 2003 (€39 billion) – developed much more unfavourably than originally planned. This overshot the figure anticipated in the original budget plans by just over €10 billion, largely due to tax shortfalls, the smaller size of the Bundesbank's profit and

Chronology of general economic and fiscal policy measures

1 January 2004
Various economic and fiscal policy measures enter into force. These mainly include lowering the income tax schedule to a bottom rate of 16% and a top rate of 45%, reducing various tax concessions and loopholes, the tax amnesty, the reform of the statutory health insurance scheme, short-term measures to stabilise the contribution rate to the statutory pension insurance scheme and further labour market reforms.

28 January 2004
In its Annual Economic Report, the Federal Government anticipates that the economic recovery, which began in the second half of 2003, will continue and strengthen. Real GDP growth of 1.5% to 2% is expected for 2004. This should lead to a turnaround on the labour market. Whereas unemployment should decline somewhat on an annual average, not least as a result of the labour market reforms, a gradual increase in employment is expected; this will, however, not be strong enough to record any growth on an annual average. 2004 is declared to be a year of innovation with a view to strengthening the growth prospects.

29 January 2004
An unscheduled updated version of the German stability programme is presented which takes account of the outcome of the parliamentary mediation committee meeting from December 2003 (especially the only partial advancement of tax cuts); in particular, it envisages a marginal downward revision (to 3¼%) of the deficit ratio for 2004.

13 February 2004
The Bundestag rejects the Bundesrat's objection to the Act implementing the supplementary Federal budget for 2003 and the 2004 Budget Act, which does not incorporate the outcome of the mediation committee meeting from the end of 2003. The budget plans envisage a deficit of €29.6 billion for 2004. The overstepping of the constitutional upper limit for net borrowing set at the level of investment expenditure is justified by invoking the exemption clause that this is necessary to avert a disruption of the overall economic equilibrium.

1 March 2004
The first stage of the Act amending tobacco taxation raises this tax to finance non-insurance related benefits of the statutory health insurance scheme.

24 March 2004
The Bundesbank presents its annual accounts and transfers the balance sheet profit, which is reduced to €248 million (compared with almost €5½ billion in the previous year) as a result of extensive depreciations of foreign reserve assets, to the Federal Government.

1 April 2004
The provision according to which the statutory pension insurance scheme pays half of pensioners' contributions to the long-term care insurance scheme is abolished; from now on pensioners have to pay the full amount themselves.

13 May 2004
The Working Group on Tax Estimates lowers its revenue

expectations from autumn 2003 by almost €10 billion based on only slightly reduced assumptions for macroeconomic development in 2004. About half of the shortfall is accounted for by changes in tax law which have since come into force. In contrast to the medium-term estimate from May 2003, the shortfalls are now expected to reach €27 billion in 2007 if there are no further amendments to tax law.

11 June 2004
The Bundesrat approves the Retirement Income Act. From 2005, there will be a gradual transition to the downstream taxation of contributions and benefits under the statutory pension insurance scheme and comparable private pension arrangements. The regulation of supplementary private pension plans (Riester pensions) is simplified and the tax exemption of endowment life insurance policies is abolished for new contracts concluded after 31 December 2004.

16 June 2004
The Bundestag formally adopts the Pension Insurance Sustainability Act. In particular, as of 2005 the pension adjustment formula will be supplemented by a sustainability factor resulting in smaller pension increases if the ratio of pensioners to contribution-payers rises. In addition, the lowest eligible age for claiming early retirement as a result of unemployment or as part of age-induced part-time work is to be progressively raised and the recognition of periods of college education for the purposes of additional pension entitlements will be restricted. A decision on raising the statutory retirement age is not planned until 2008.

23 June 2004
The Federal Cabinet agrees the draft Federal budget for 2005 and the medium-term fiscal plan up to 2008. To ensure that the standard ceiling for net borrowing is observed – at €22 billion, net borrowing remains just under €1 billion below investment expenditure – among other things, privatisation proceeds of €15½ billion are to be mobilised in 2005. Given that proceeds from asset sales will peter out after 2006, the medium-term fiscal plan envisages only a modest reduction of the deficits to just under €20 billion in 2008.

9 July 2004
The Bundesrat adopts the Municipal Option Act. Under this Act, up to 69 local governments can assume responsibility for providing basic social security for jobseekers, initially for a period of six years. The costs are to be borne by central government. In order to ease the pressure on municipal budgets by €2½ billion, a clause is approved amending central government's contribution to the housing costs of persons receiving unemployment benefit II. Central government's contribution is initially set at 29.1%, resulting in an additional burden of €1½ billion for the Federal budget in 2005.

13 July 2004
The European Court of Justice rules on an action brought by the European Commission against the Ecofin Council, which on 25 November 2003 did not follow the recommendation from the Commission to give notice to Germany and France under the excessive deficit procedure and, instead, issued recommendations to the two countries outside of the regular procedure. The Council of Ministers' decision is found to be void because it was not based on a recommendation from the Commission. The Council was, however, within its rights to reject the Commission's motion. Thus, the excessive deficit procedures remain suspended.

24 September 2004
The Bundestag adopts the Fourth Act Amending the Third Book of the Social Security Code and other Laws. Among other things, this provides for a more critical examination of the viability of a proposed business venture before a start-up grant is awarded, and for a basic tax allowance of €4,100 for each child included in an application for benefits under unemployment benefit II.

6 October 2004
The Federal Cabinet agrees a draft supplementary budget for 2004, which incorporates, in particular, the expected tax revenue shortfalls and the smaller than estimated Bundesbank profit. The deficit is now estimated at €44 billion, €14½ billion higher than previously estimated. The further overstepping of the upper limit for net borrowing is again justified by invoking the exemption clause that this is necessary to avert a disruption of the overall economic equilibrium.

4 November 2004
The tax estimate foresees only a slight downward revision of revenue expectations for 2004 of €1½ billion. Negative corrections

Chronology of general economic and fiscal policy measures

(cont'd)

totalling €3½ billion are made for 2005, about half of which are the result of changes in tax law which have since come into force. The shortfalls relate primarily to the Federal budget.

5 November 2004
The Bundesrat adopts the Act on the Organisational Reform of the Statutory Pension Insurance Scheme. The consolidation of the wage and salary earners' pension insurance funds under the name of "Deutsche Rentenversicherung" (German pension insurance scheme) is designed primarily to save administrative costs.

18 November 2004
The German Council of Economic Experts anticipates GDP growth of 1.4% in 2005. After adjustment for the smaller number of working days, the pace of growth is about the same as in 2004. Even if there is still no sign of a widespread upturn in the domestic economy, investment in machinery and equipment and private consumption are still expected to make a positive contribution to growth. Employment may increase again slightly. However, unemployment will also rise because the implementation of Hartz IV will mean that recipients of social assistance who are able to work will be registered as unemployed. At 1.6%, consumer price inflation is set to remain subdued in 2005, too.

26 November 2004
The Act Accounting for Children, according to which childless persons born after 1939 are liable to pay an additional 0.25% contribution to the long-term care insurance scheme upon reaching the age of 23, and the Act to Adjust the Financing of Dentures are formally adopted by the Bundestag. From 1 July 2005, the members alone will pay an additional 0.4% contribution to finance dentures. In addition, the introduction of the special contribution of 0.5% will be brought forward to this date. The simultaneous lowering of the general contribution rate by 0.9 percentage point will ease the contribution burden for both members and employers or, as the case may be, the pension insurance scheme by 0.45% in each case.

The Bundestag also adopts the 2005 Budget Act. Since the cabinet decision was taken, an €8 billion shortfall relating to taxes, the Hartz IV reform and the Bundesbank profit has accrued. This is compensated for by the sale of Post Office pension fund claims, the shifting of privatisation proceeds and an increase in across-the-board spending cuts. Thus, the deficit should remain at €22½ billion, just adhering to the constitutional limit for net borrowing.

1 December 2004
The Federal Cabinet agrees an updated stability programme. This envisages a decrease in the deficit ratio to 2.9% in 2005 (compared with 3¾% in 2004). It is foreseen that a level of 1½% will be achieved in 2008 following ongoing reductions. This presupposes a reduction of the government expenditure ratio by a total of 4 percentage points to 43½% in 2008. The debt ratio is initially expected to continue to rise slightly from 65½% at end-2004 and then progressively decrease to 65% in 2008. This would still be well above

the 60% ceiling prescribed by the Maastricht Treaty.

A further increase in tobacco tax also comes into force.

14 December 2004
The European Commission announces that the excessive deficit procedure against Germany should remain suspended as the measures prescribed in the stability programme are deemed to be sufficient to observe the 3% ceiling for the deficit ratio in 2005.

15 December 2004
The Bundestag opposition parties, CDU/CSU and FDP, file an action with the Federal Constitutional Court against the 2004 Federal budget on the grounds that it is unconstitutional; it is planned that the action will later be extended to the supplementary budget which has not yet been adopted by the Bundesrat. The grounds given for the action are non-compliance with the precept demanding that the estimates be comprehensive, and the obligation to be truthful pursuant to article 110 of the Basic Law as well as the borrowing limit prescribed by Article 115 of the Basic Law.

17 December 2004
The Bundesrat approves the supplementary budget for 2004. The 2005 Budget Act is, however, referred to the parliamentary mediation committee.

The Federalism Commission announces the failure of its efforts to allocate responsibilities more clearly to the individual levels of government and to simplify the legislative process. It cites ongoing differences of opinion between central and state government regarding the allocation of responsibilities in education policy as the reason for the failure.

1 January 2005
Various economic and fiscal policy measures enter into force: with the final stage of the 2000 tax reform, income tax rates are lowered again. The first stage of the downstream taxation of pension contributions and retirement income is introduced. Unemployment assistance and social assistance for recipients able to work are amalgamated in unemployment benefit II, which also entails stricter criteria for refusing job offers. In the long-term care insurance scheme childless members now pay the special contribution of 0.25%. The motorway toll for heavy goods vehicles is introduced on Germany's motorways.

14 January 2005
The preliminary audit of the 2004 Federal budgetary position shows a deficit of almost €40 billion, which is €4 billion less than estimated. This was due mainly to lower expenditure on the Federal grant to the Federal Employment Agency as well as on interest payments, among other things.

26 January 2005
According to its 2005 Annual Economic Report, the Federal Government expects the growth path which began in mid-2003 to continue. 16% growth in real GDP is expected. This will hinge on a clear upturn in domestic demand, in particular in the areas of private consumption and investment in machinery and equipment. By contrast, export activity is expected to slacken off. The number of persons in work is expected to rise by more than twice the rate recorded in 2004 and unemployment, measured in terms of the unemployment rate calculated by the Federal Employment Agency, is expected to rise to 10.7%.

9 February 2005
A pay agreement with a term of 35 months is concluded for the salaried staff and wage earners of central and local government. For employees in western Germany it provides for one-off payments of €300 a year instead of pay rises. For employees in eastern Germany it foresees a progressive increase in negotiated pay rates from 92.5% to 97% of the level in western Germany up to 2007. In addition, performance-related bonuses and cuts are agreed starting in 2007. A standard working week of 39 hours is introduced for central government employees throughout Germany.

18 February 2005
The Bundestag votes down the Bundesrat's objection to the 2005 Federal budget. No adjustments are made to the November 2004 version.

22 February 2005
The Federal Statistical Office announces a deficit ratio, as defined by the Maastricht Treaty, of 3.7% for 2004 – following 3.8% in 2003.

the delay in introducing motorway tolls for heavy goods vehicles. The deficit amounting to €44 billion estimated in the Federal Government's supplementary budget was, however, ultimately undershot. Despite the increase in economic growth central government had to invoke, for the third year in a row, the exemption clause of Article 115 of the Constitution, which allows new borrowing to exceed investment expenditure if this is necessary in order to avert an overall economic disruption. By contrast, state government's budget deficits fell (by €5 billion to €25 billion), particularly since revenue – partly as a result of the temporary shift in the distribution of turnover tax in favour of state government – developed less weakly than was the case for central government. After amounting to just over €8 billion in 2003, the deficits of local government are likely to have been reduced by half, primarily as a result of the sharp rise in local business tax revenue. This was, however, achieved at the expense of a further decline in municipal investment. Conversely, the financial situation of the special funds deteriorated sharply; their surplus of just over €10 billion recorded in 2003 fell to just under €2 billion. This was mainly due to the fact that more of the resources collected last year in the flood disaster fund were disbursed and that the Redemption Fund for Inherited Liabilities received no share of the Bundesbank's profit. The combined budget deficits of central, state and local government (as defined in the government's financial statistics) were probably on a par with the level in 2003.

Overall improvement of the financial situation of the social security funds

On the other hand, the financial situation of the social security funds improved. In 2004, they recorded a small surplus, whereas they had run up a deficit of €6½ billion in 2003. The main contributing factor was the reform of the statutory health insurance funds, which resulted in a financial improvement of €7½ billion and a resulting surplus of €4 billion. Despite the relief measures and the sale of the participating interest in the GAGFAH housing company, the deficit of the statutory pension insurance scheme amounted to €1½ billion and was therefore only marginally lower than in 2003. As a result of the weak contribution trend arising from the stagnation of gross wages and salaries, the considerable consolidation efforts made in the area of social security funds, while sufficient to prevent the contribution rates from being raised (which otherwise would have been necessary), were unable to bring about the anticipated reduction.

b) Further outlook

Commitment to comply with the 3% deficit ceiling in 2005 ...

In the meeting of the Financial Planning Council in November 2004, central, state and local government all affirmed their commitment to comply with the European Stability and Growth Pact and to lower the deficit in 2005 to under 3% of GDP. The Federal Government then emphasised this in its updated stability programme of December 2004 irrespective of the discussion of a reform of the Pact (see box on page 85). This objective is indeed a key requirement of fiscal policy in 2005. Germany must fulfil a self-imposed commitment made to the Ecofin Council. Sound public finances – and not extensive escape clauses that provide scope for debt financing, which is occasionally suggested in the discussion about the reform of the Pact – are also in Germany's national interest. Only sustainable public finances can ensure a sufficient radius of action for national fiscal and social policy in the future. The high debt ratio, foreseeable considerable burdens arising from the demographic changes and low government investment all demonstrate how important this task is. Continued debt financing, for example of the transfers associated with German unification or of net payments to the EU, would mean intolerable additional burdens for future generations.

... requires strict expenditure restraint

Against the background of further revenue shortfalls ensuing from the last stage of the income tax reform, the necessary reduction in the deficit ratio by around ¾ percentage point will not be easy to achieve. In the Federal Government's stability programme, a decrease in the revenue ratio of ½ percentage point is expected while a fall in the expenditure ratio of 1½ percentage points is envisaged. This requires stringent expenditure restraint at all levels of government. The continuation of the reform measures on the labour market, in the healthcare system and the pension system are also likely to help. Furthermore, the currently low interest rate level allows inexpensive refinancing of maturing long-term loans.

Need for continuing consolidation course ...

The planned sharp reduction in the Federal Government's budget deficit (by €17½ billion vis-à-vis the level in 2004 to €22 billion) will only partly contribute towards lowering the general government deficit ratio in 2005 to under 3%. This is because it will largely be achieved by stepping up the sales of participating interests. Although such financial transactions are used to keep net borrowing under the constitutional limit, they have no bearing on the deficit as defined in the Maastricht Treaty. Furthermore, part of the relief measures planned also with a view to lowering the Maastricht deficit (primarily the suspension of grants to the Post Office pension fund, whose borrowing requirements in 2005 should be covered by the sale of claims to the Post Office successor enterprises), are temporary and will burden the government budgets in future years. For this reason, too, continuing stringent spending restraint is, therefore, crucial in the coming years. If the measures taken so far prove insufficient to achieve the general government deficit target, additional measures – as called for by the European Commission and the Ecofin Council during the assessment of the German stability programme – will have to be taken.

... and reforms

Last year and at the beginning of this year, important structural reforms in the area of public finances, which on balance merit a positive assessment, entered into force (see the Chronology on pages 76-79). Nevertheless, this process may not yet be considered as completed. Even though considerable opposition from stakeholders will have to be overcome, further comprehensive reforms, particularly in the area of the healthcare system, old-age provision, taxes and the financial constitution, should remain on the agenda in order to simultaneously improve the macroeconomic framework in Germany and to promote growth.

V European and international cooperation

1 European integration

(a) Continuing fiscal stability and convergence problems

Further excessive deficit procedures in accordance with the SGP

In 2004, the fiscal policies of numerous EU countries once again breached the requirements of both the EC Treaty and the Stability and Growth Pact (SGP). Excessive deficit procedures were initiated against two euro-area countries (Greece and the Netherlands) as well as the United Kingdom and six of the new EU member states (Cyprus, the Czech Republic, Hungary, Malta, Poland and Slovakia). However, the procedure against the United Kingdom, which the Commission initiated on the basis of a report on the country's budgetary situation, was discontinued owing to the expectation that the 3% deficit threshold would be exceeded for only a short period of time. In the case of Greece, the budgetary data proved to be unreliable. It emerged that the country had constantly exceeded the 3% deficit threshold. This also applies to the general government balance in 1999, which played a significant role in the convergence assessment for accession to EMU in 2001. However, the Council decision, which was based on the knowledge available at the time, remains valid. In order to eliminate (as far as possible) such sources of error in future convergence assessments and ongoing budgetary surveillance, the European Commission has now adopted an initiative to improve the quality of budgetary statistics. Moreover, in December, it opened an infringement procedure against Greece for reporting incorrect data. This is intended to make it clear that the Commission can ultimately enforce certain statistical requirements with regard to all member states.

Suspension of the excessive deficit procedures against Germany and France

In May 2004, the Ecofin Council ended the excessive deficit procedure initiated against Portugal in September 2002; however, the procedures initiated against Germany and France in November 2002 and April 2003, respectively, are continuing. When it became evident in autumn 2003 that neither Germany nor France would manage to correct their excessive deficits in 2004 as originally specified, the European Commission recommended that, while both countries should be allowed more time to make fiscal adjustments, they should also be given notice in accordance with the provisions of the SGP. Germany and France would thus have moved a step closer to having possible sanctions imposed. However, these recommendations did not achieve the required majority of votes in the Ecofin Council. Instead, the Council suspended the procedures and asked both countries to correct their excessive deficits by the end of 2005 at the latest. The Commission reacted by bringing an action before the European Court of Justice. In its judgment of July 2004, the Court confirmed that the Council had been within its discretionary rights not to follow the Commission's recommendations. However, the conclusions adopted by the Council were annulled as they came about outside the prescribed statutory procedure. In December 2004, the Commission delivered a Communication to the European Parliament and the Ecofin Council in which it stated that no further steps were necessary in the excessive deficit procedures against Germany and France as a correction of the deficits was expected in 2005. The Ecofin Council concurred with this view in January 2005.

Bundesbank strictly opposed to proposals for reforming the SGP

In the light of the debate on the SGP, in September 2004 the Commission published a set of reform proposals, which largely accommodated the deficit countries' calls for more flexible provisions. In the Commission's view, country-differentiated application of the SGP could encourage deficit countries to obey the rules. The Bundesbank has clearly voiced its opposition to these ideas and the even more extensive proposals of various member states in several public statements.[1] Proposals to relax the criterion of a balanced budgetary position in the medium term, to introduce additional reasons for justifying deficits over the 3% ceiling and to extend the Pact's correction deadlines are, in the Bundesbank's opinion, aimed at watering-down the existing obligation to pursue a sound fiscal policy. If the reform proposals were to be implemented, the scope for discretion accorded to the Council at the various procedural stages by the EC Treaty would be extended, while the envisaged obligations of the member states to increasingly consolidate their budgets in "good times" as well as the intention to take greater account of high debt ratios and long-term aspects of debt sustainability would no doubt ultimately retain their informal status. A further cause for concern is not least that a less effective deficit threshold could also be applied to the convergence criteria. There would then be the risk of the euro being introduced in countries which have not yet achieved the necessary degree of economic convergence.

(b) EU enlargement

Following EU enlargement, further accession processes set in motion

In May 2004, the European Union gained ten new members from central Europe and the Mediterranean. In addition, four further countries currently have the prospect of becoming members of the EU. The European Council set the political course for this in December 2004. The accession treaty negotiated with Bulgaria and Romania is to be signed accordingly in April 2005 with a view to these countries joining the EU in January 2007. The European Council also decided to open negotiations with Croatia. Finally, Turkey was given the promise that accession negotiations will begin in October 2005; it has been a candidate country since 1999. The European Council has indicated that long transitional periods, specific agreements or permanent safeguard clauses may be necessary for any accessions still to be negotiated. Moreover, the negotiations cannot be concluded until the financial framework for the period from 2014 has been laid down. All in all, the accession negotiations are to be regarded as an open-ended process.

First new EU countries join ERM II

All of the countries that joined the EU in 2004 are obliged to work towards accession to monetary union. The prerequisite for accession to EMU is that the convergence criteria defined in the EC Treaty are met. These criteria specify,

1 See, for example, "Do not weaken the Stability and Growth Pact", Deutsche Bundesbank press release issued on 7 September 2004, printed in Deutsche Bundesbank, *Monthly Report,* September 2004, p 9; "Comments on reforming the Stability and Growth Pact", statement by the Deutsche Bundesbank presented at the hearing of the Financial Committee of the Bundestag on 19 January 2005, printed in Deutsche Bundesbank, *Monthly Report,* January 2005, pp 37-43.

The debate on reforming the Stability and Growth Pact

On 3 September 2004 the European Commission presented proposals for a reform of the Stability and Growth Pact (SWP).[1] The central demand is to take increased consideration of country-specific circumstances, as reflected particularly in the rate of economic growth, the level of outstanding government debt, the carrying out of structural reforms and the need for additional government investment. The Commission substantiates this call for a differentiated assessment by saying that the heterogeneity of the Community has increased and claiming that this would increase the member states' willingness to comply with the SWP. Essentially, the demands are as follows.

- Commitment of the deficit countries to consolidate their government budgets more vigorously during an economic upturn

- Taking greater account of the debt ratio and the sustainability of public finances, *inter alia,* by specifying the demand contained in the Maastricht Treaty that debt ratios above the 60% reference value must be "sufficiently diminishing" and approaching the reference value "at a satisfactory pace"

- Use of country-specific conditions when defining the medium-term budgetary objective and evaluating deviations from targets

- Broadening of the scope of exceptional circumstances allowing deficit ratios to exceed the 3% ceiling

- Extension of the correction deadlines for excessive deficits

The governments of various member states, including Germany, have made additional demands that go beyond the Commission's proposals. For example, expenditure on education, research and development, defence and the net payments to the European Union should allegedly not be included in the deficit calculation or should at least be taken into consideration when evaluating the deficit situation.

The Bundesbank considers the reform of the SWP to be a weakening of the commitment to maintain budgetary discipline. It therefore believes that the reform proposals should be rejected in their entirety. The intention to supplement the concept of a medium-term balanced budget with country-specific aspects is particularly problematic. Such an approach would lead to more complexity and less transparency and would therefore impair the enforceability of the commitments. Whereas the current interpretation of the SWP under "normal" economic conditions allows at most cyclically induced deficits of ½ percentage point of GDP, the implementation of the Commission's proposals would allow the majority of countries greater freedom to incur debt in the future. Even with ongoing, but muted economic growth the budgetary positions might then come dangerously close to the 3% reference value.

Extending the derogations for deficits of more than 3% of GDP and the envisaged longer correction deadlines will ultimately serve to undermine the deterrent of sanctions and weaken the upper limit for annual government new borrowing. Increasing debt levels as a result of entrenched deficit positions of more than 3% of GDP would run counter to the objectives of the fiscal framework. Not least, there are no convincing economic reasons for the demand to exclude net payments to the EU from the deficit calculation. Instead of shifting the financing burdens onto future generations by borrowing, payments to the EU budget should be met out of current revenue.

1 *Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact,* Communication from the Commission to the Council and the European Parliament of 3 September 2004.

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among other things, a minimum two-year period of participation in the European Exchange Rate Mechanism II (ERM II). The central rate and fluctuation bands must be laid down jointly with the responsible Community institutions. Moreover, an agreement must be reached about whether the member state concerned is pursuing an economic policy which is consistent with the aim of ERM II, namely to keep the exchange rates as stable as possible. Many of the new EU members still have a considerable need for adjustment in this respect. In June 2004, Estonia, Lithuania and Slovenia became the first new EU countries to join ERM II. The standard fluctuation band of ±15% applies for all three accession currencies. The narrower fluctuation band of ±2.25% is intended only for member states which are at a very advanced stage of convergence, such as Denmark. However, both Estonia and Lithuania have retained the special fixed exchange rate regimes which they operated previously (currency boards pegged to the euro) as a unilateral arrangement. In order to increase confidence in their stability policies, the new participants in ERM II have undertaken to continue with budgetary consolidation (wherever necessary), to reduce their external imbalances – which are extremely high in some cases – and to implement further structural reforms.

(c) Agreement reached on a Constitution for Europe

Treaty establishing a Constitution for Europe is signed

In October 2004, the Heads of State or Government of the 25 EU member states signed the Treaty establishing a Constitution for Europe (European Constitution), which they had unanimously adopted in June 2004. The Treaty must now be ratified by all EU countries. The Heads of State or Government agreed that 1 November 2006 should be the target date for the Treaty to enter into force. A number of member states plan to hold a referendum prior to ratification.

Price stability anchored as the Union's objective

In contrast to the European Convention's draft Constitution, the contents of which were described in the Bundesbank's *Annual Report* for 2003, Part I of the Treaty now awaiting ratification contains an obligation for the Union as a whole to aim to achieve price stability. In the draft Constitution, this commitment to stability was restricted to the policies of the ECB and ESCB in derogation of the current EC Treaty. The member states' departure from this intention was in response to the emphatic objections of the ECB and the Eurosystem national central banks. However, it is still particularly unsatisfactory that the independence of the national central banks – unlike the independence of the ECB – has been laid down in a chapter of the Constitution which allows amendments according to a simplified procedure, albeit that such amendments would be possible only with the consent of all member states in accordance with their respective constitutional requirements.

2 Functioning of the international monetary and financial system

(a) Deficiencies in the adjustment mechanisms for reducing external imbalances

East Asian countries' foreign exchange purchases still extremely high

The continued rise in the US current account deficit, with its main counterpart in East Asia, sustainably weakened the US dollar's confidence base in 2004, ultimately leading to a further appreciation of the euro and other freely floating currencies. By contrast, several east Asian countries have allowed their currencies to appreciate only slightly or not at all owing to massive official purchases of US dollars. All Asian countries increased their foreign currency reserves in 2004 by a combined US$528 billion following an already unprecedented increase in 2003 of not less than US$472 billion (both including unidentifiable valuation gains from reserves denominated in those currencies that appreciated against the US dollar). Taken by itself, this means that, last year, Asian monetary authorities financed around three-quarters of the US current account deficit. As in previous years, China and Japan were responsible for the lion's share of foreign exchange purchases. At US$207 billion, China's accumulation of foreign currency reserves was even considerably larger than in 2003. Japan, which saw its foreign currency reserves go up by US$171 billion but did not purchase any more foreign currency after April 2004, remained somewhat below its 2003 record level.

Seen globally, exchange rates should play a greater role in the adjustment process

International institutions believe that the current discrepancies in the global balance of payments entail the risk that the dollar might continue to fall considerably, leading to impacts on competitiveness and interest rates that could put a severe damper on the global economic climate. Economic policymakers are therefore called upon to waste no time in getting to the root causes of the problematic balance of payments imbalances. This should also include countries with external surpluses allowing their currencies' exchange rates to appreciate by an acceptable margin. This has been repeatedly advocated specifically by the Group of Seven (G7) since autumn 2003. It last commented on this topic in the communiqué of its London meeting at the beginning of February 2005. Since some key East Asian countries with external surpluses have failed to show any major reaction thus far – Japan, too, has not ruled out further intervention against a

Movement of Asian countries' foreign currency reserves

Table 11

Country/group of countries 1	Holdings		Year-on-year change					
	1998	2004	2002	2003	2004	2002	2003	2004
	US$ bn					as %		
Japan	203.2	824.3	63.7	201.3	171.5	16.4	44.6	26.3
Asian developing countries	575.2	1,595.1	180.2	271.0	356.3	22.9	28.0	28.8
of which								
China 2	145.0	609.9	74.2	116.9	206.7	35.0	40.8	51.3
Hong Kong	89.6	123.5	0.7	6.5	5.2	0.7	5.8	4.4
India	27.0	125.2	21.7	30.6	27.5	48.1	45.7	28.2
Indonesia	22.4	34.7	3.7	4.0	0.0	13.7	13.0	– 0.1
Malaysia	24.7	65.4	3.7	10.2	21.9	12.5	30.6	50.5
Philippines	9.1	12.8	– 0.3	0.3	– 0.5	– 2.2	2.5	– 4.1
Singapore	74.4	111.5	6.5	13.6	16.5	8.7	16.7	17.4
South Korea	52.0	198.2	18.3	33.7	43.7	17.9	27.9	28.3
Taiwan	90.3	241.7	39.4	45.0	35.1	32.3	27.8	17.0
Thailand	28.4	48.5	5.7	2.9	7.5	17.6	7.7	18.4
Asia, total	778.4	2,419.4	243.9	472.3	527.8	20.8	33.3	27.9
Memo item								
Industrial countries excluding Japan	466.9	486.8	47.9	17.2	21.7	12.0	3.8	4.7
of which								
USA	36.0	42.7	4.8	5.9	3.0	16.7	17.5	7.5
Euro area 3	284.4	179.3	7.9	– 27.8	– 8.7	3.8	– 12.9	– 4.6
Other developing countries	398.0	826.6	63.5	130.5	155.8	13.3	24.1	23.2
Africa	40.7	125.3	7.7	18.8	34.6	12.0	26.2	38.1
Europe 4	101.0	328.6	47.6	62.9	80.0	34.5	33.9	32.2
Latin America and Caribbean	158.4	216.0	1.1	33.2	24.9	0.7	21.0	13.0
Middle East	97.9	156.7	7.1	15.5	16.3	6.0	12.4	11.6

Source: IMF. — **1** Classified into industrial and developing countries according to the IMF's International Financial Statistics. — **2** In 2003, foreign currency inflows were even higher than shown as US$45 billion worth of foreign exchange reserves were used to recapitalise state banks. — **3** Comprises the foreign exchange reserves of all of today's member states for the period prior to the beginning or enlargement of monetary union. — **4** Including Turkey and the countries of the former Soviet Union.

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possible trend appreciation of the yen – the question is warranted as to whether the IMF, in line with its mandate of monitoring member countries' exchange rate policies, should take a more vocal stand on the issue. According to earlier IMF Executive Board decisions, protracted and large-scale foreign exchange market intervention in one and the same direction should be interpreted as a clear indicator of a problematic exchange rate policy. Although the Fund has no instruments within the framework of its "Article IV consultations" with which it can force members to change their exchange rate policies, it is better suited to informed persuasion than any other agency. The IMF would have to point out, among other things, that experience has shown that undervaluation of a country's currency will, sooner or later, increase internal price pressures and will ultimately damage that country's own competitiveness through price increases rather than through nominal appreciation. Owing to its myriad of disadvantages, however, inflation can never be a recommendable solution.

(b) Ongoing debate on the IMF's financing role

IMF needs to return to its core mandate

The 60th anniversary of the founding of the Bretton Woods institutions in 2004 retrained the public spotlight on the debate about the IMF's strategic direction, which has already been going on for years. This raises the key question of how the IMF should confront the risks to stability associated with the increasing integration of its members in international financial markets. An expansion of its lending, including the granting of large financial packages, which has been evident since the mid-1990s, would be fraught with problems. Instead, fundamental regulatory policy considerations suggest that the Fund should return to its core mandate, ie giving only limited volumes of relatively short-term liquidity assistance in its role as a monetary institution. The IMF, in particular, must put the market mechanism first so that capital can be allocated internationally in a risk-appropriate manner. Its activities should therefore be focused on economic surveillance activities and dispensing policy advice with the goal of increasing the transparency of the state of its members' economies and, in particular, reducing their financial vulnerability. The Fund's increased and still-increasing involvement in development cooperation is also in conflict with its monetary character. Such support essentially belongs within the remit of the World Bank and the regional development banks.

Unlimited precautionary credit lines would be extremely problematical

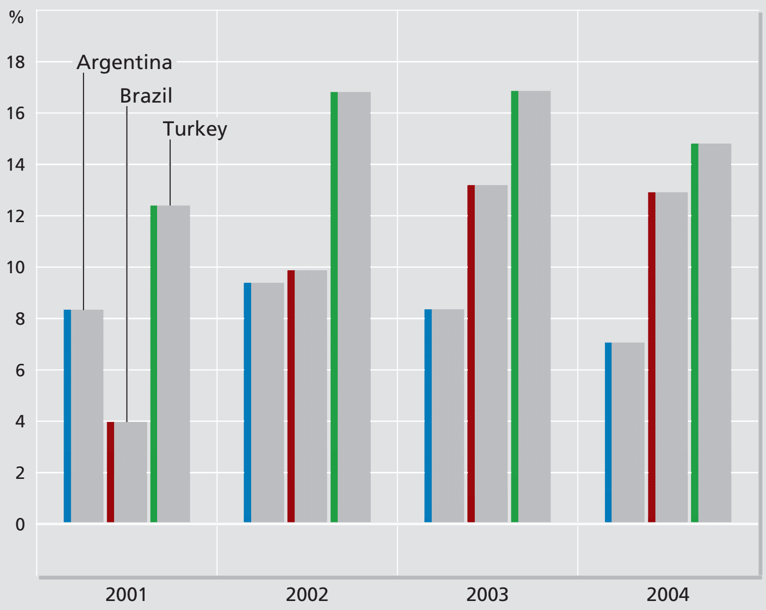
The – at times erratic – fluctuations in international financial flows have tended to make those IMF member countries that rely on the international financial markets more vulnerable to crisis. Various parties are therefore calling on the IMF to react by increasing its financial involvement and providing new crisis prevention instruments. On that vein, the proponents of a new and more extensive IMF role propose introducing precautionary lines of credit without a quantitative limit ("crisis prevention facility"). The Bundesbank, however, believes that this facility, unlike the small-volume precautionary arrangements to borrow within the regular access limits which have already been part of the IMF's range of instruments for a long time, would be much more disturbing from a perspective of economic governance and financial stability than even the "Contingent Credit Line", which was designed to avert contagion risk and allowed to expire in November 2003. This would cast the Fund in the role of an international "risk insurer", which would be incompatible with its task of providing short-term balance of payments support at terms that do not differentiate between individual country risks. Irrespective of the fact that, if one dealing merely with a "potential" capital account crisis, a decision on the volume of the loan and the need for economic adjustment would be arbitrary, such financial assistance would confront the IMF with additional large-volume credit risks that would be incompatible with the Fund's revolving, foreign-reserve-based financing mechanism. Above all, creditors and debtors alike would most likely indulge in riskier behaviour, or "moral hazard", if they knew from the outset that the Fund could be instrumentalised as a "fire brigade for crises". With a view to impeding market-based incentive mechanisms as little as possible, the Bundesbank strongly advocates the rigorous observance of the four criteria issued by the IMF Executive Board in September 2002 that need to be met simultaneously when granting exceptionally large IMF loans. These criteria are as follows: exceptional acute balance of payments pressures on the capital account, a debt that is sustainable over the medium term, the prospect of regaining access to financial markets in the near future, and an adjustment programme that is convincing and stands a chance of being delivered politically. The objective is to restrict exceptional access to IMF loans to rare cases.

"Non-borrowing programmes" could serve as IMF seal of approval

The Bundesbank believes that an alternative to precautionary lines of credit with exceptional access to IMF financial resources lies in "non-borrowing programmes", the introduction of which is also being discussed at present. These are regular IMF adjustment programmes that do not, however, allow access to financial resources. With the help of such an instrument, interested countries without an acute balance of payments need can apply for and obtain an "IMF seal of approval" to enhance their status on the international financial markets or secure access to other official agencies' longer-term financial resources. The IMF seal of approval is not a hierarchical country rating scale. Principles of economic governance dictate that it should be left to market players to assess the risk of their investment. In addition, non-borrowing programmes could also serve as an exit strategy from IMF financial support, thus counteracting the prolonged use of IMF financial resources. To ensure that they send a positive signal to the markets, they would have to contain rigorous economic policy requirements similar to those that are standard for the upper credit tranches. The Executive Board would also have to review the implementation of the programme regularly.

The IMF's share in the total foreign currency debt of its three largest borrowers

Chart 23



Sources: IMF and the above countries' national statistics.

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Disturbing accumulation of credit risk to the IMF

Despite an overall decline in the Fund's exposure, a considerable volume of credit risk has developed in the past few years. Both the concentration of IMF lending to certain borrowers and the share of IMF loans in the total government foreign currency debt of the main borrowers are unusually high. In 2004, 63% of all IMF loans were to only three sovereign borrowers – which are already heavily indebted to other creditors. What this means in practice is that the IMF's status as a preferred creditor could be increasingly jeopardised. Last year, the G10, in which the IMF's traditional creditor countries work together, therefore examined the Fund's financial risks in detail. At their October 2004 meeting, the Group's finance ministers and central bank governors recommended several measures to cope with the current challenges. In addition to effective economic policy monitoring, these measures include a continuation of the policy of strict conditionality of IMF lending, greater emphasis on debt sustainability when taking decisions on loans and the rigorous application of the agreed criteria for exceptional access to IMF financial resources. The Bundesbank believes that the creation of incentives for promoting punctual debt repayment and reducing the frequency of prolonged use should also be studied. An analysis of the Fund's lending policies vis-à-vis Argentina by the IMF's Independent Evaluation Office, moreover, revealed conspicuous conceptual deficits. Insufficient programme efficiency and the miscalculation of debt sustainability were two of the main criticisms. The Bundesbank views this as a vindication of its often-voiced criticisms of the sharp rise in the IMF's lending to Argentina.

Unresolved financing issues regarding assistance for poor countries

With the IMF's externally financed Poverty Reduction and Growth Facility (PRGF) about to be replaced by an internally financed mechanism, one of the unresolved issues is the annual lending volume. In addition, no financial provision has yet been made for resolving the issue of the long-standing payment arrears on the part of three African countries embroiled in civil war. Finally, new proposals aimed at debt relief for the most heavily impoverished countries vis-à-vis international financial institutions also raise critical financing questions. The Bundesbank generally advocates using the scarce PRGF resources sparingly and with the goal of sustainably strengthening the balance of payments of low-income borrowing countries. Furthermore, the Fund should extend additional low-interest loans or grants to poor developing countries only in situations in which these amounts can be soundly raised, ie through bilateral contributions by donor countries. Any new loans must also continue to be restricted and oriented to the sustainability of borrowing countries' debt in order to avoid creating new debt problems. The goal of the Fund and low-income countries alike must ultimately be to eliminate dependency on IMF lending programmes and, instead, to develop relationships centred on advice and technical assistance. The Bundesbank is of the opinion that repeated proposals, borne of extensive budget problems, that the IMF's gold reserves be used to pay for financial assistance to and debt relief for poor developing countries represent a step in the wrong direction, since the Fund's open and hidden reserves constitute a key bulwark of shareholder insurance in view of the aforementioned large credit risk.

(c) Improving crisis prevention and crisis resolution

Steps to improve multilateral surveillance

Further improvements were made to the IMF's multilateral surveillance procedures in the year under review. As a result of the regular biennial review of the Fund's surveillance, which last took place in 2004, the financial sector, the exchange rate regime and the regional impact of national economic policies are to be examined more closely in the future. An additional objective is to steadily improve the debt sustainability assessments. For practical reasons, the Bundesbank is sceptical of the proposal by some member countries to separate the monitoring of lending from surveillance activities in organisational terms in order to enhance the latter's objectivity. What would be especially desirable from a German perspective is the establishment of a database accessible to all members with current primary information to make it easier to assess debt sustainability, in particular. The Bundesbank believes that, in the future, a stronger emphasis should also be placed on the IMF always basing its stress tests for assessing debt sustainability on a realistic evaluation of the base case scenario, as this is the only way to reveal the true risk potential. This includes not simply assuming that fiscal policy consolidation aims will be achieved.

Increasing attention being given to risks emanating from financial markets

In addition, risks to the global economy which may emanate from the international financial markets are being given increasing attention, not only by the IMF. In particular, the Financial Stability Forum (FSF), which counts as its members representatives from the key financial centres as well as important international institutions and regulatory authorities, plays a crucial role here through its semi-annual meetings. Topics for debate include assessments of the state of the global economy and its importance for financial market players as well as various specific risks associated with certain financial instruments or sectors. In 2004, the Forum commissioned a review of the vulnerability resulting from credit risk transfer. The recommendations contained in the published report aim at improving risk management practices and expanding disclosure requirements. A study on the global reinsurance market published under the Forum's auspices last year represents the first quantitative overview of the structure of this financial market segment. In addition, the FSF has promoted the observance of internationally accepted standards and codes in the financial centres of countries that are not members of the IMF and hence not subject to the procedures governing the Fund. Furthermore, the G10 Committee on the Global Financial System (CGFS), which is based at the Bank for International Settlements (BIS) and is also represented in the FSF, published a report in March 2004 on the importance of foreign direct investment in emerging market economies' financial sectors. This study, based on an evaluation of the relevant literature and case studies as well as interviews with investors, places particular emphasis on the advantages of FDI for the efficiency and stability of the financial sector in the recipient countries. Special meetings in Mexico, Korea and Poland between the CGFS and representatives from each region served as a means of transmission for disseminating the report's findings in emerging market economies. In the past year, the CGFS also continued its exchange of views on ways of improving stress tests for internationally active financial institutions.

In the past year, the Group of Twenty (G20), under Germany's chairmanship, also closely examined issues relating to the prevention of financial crises in emerging market economies. This was based on the knowledge that the internation-

Reducing currency mismatches by strengthening domestic financial systems

al debt crises that have occurred since the mid-1990s have mostly developed from considerable currency mismatches caused by the use of debt denominated in foreign currency to finance domestic economic activity. When confidence deteriorated, this not only led to refinancing problems and consequently to balance of payments difficulties but also made the countries concerned vulnerable to a depreciation of their currency. When the debt service payment burden computed in domestic currency skyrocketed owing to depreciation, dramatically rising government expenditure, corporate insolvencies and banking crises were the inevitable result. The real economic situation encountered by these confidence-crisis-stricken countries was thus all the worse. Against this background, the G20 has been a proponent of creating stable and efficient financial systems in emerging market economies as a crisis prevention tool. This would help to increase the saving ratio, improve credit allocation and prevent capital flight. Over the longer term, strong domestic financial systems could become attractive to foreign investors and thus enable the import of capital denominated in domestic currency. The experiences of smaller industrial nations show that this is a generally feasible way for most countries to decisively reduce external vulnerability. The following concepts epitomise the reform policy necessary to achieve this goal: enshrining monetary and fiscal policy discipline; creating legal certainty; observing internationally accepted standards and codes for the financial sector; improving exchange rate flexibility and linking it to the increasing liberalisation of capital movements; and developing long-term securities markets.[1] These guidelines for strengthening domestic financial systems were incorporated into a G20 Accord for Sustained Growth that, at the proposal of the German presidency, was adopted by finance ministers and central bank governors in Berlin at the November 2004 annual meeting. The G20 agreement is to provide a basis on which finance ministers and central bank governors intend to regularly monitor all members' economic policy in future.

Key G10 recommendations on CACs largely being complied with

In order to facilitate the rescheduling of debt made necessary by unsustainable debt burdens from international government bonds, international committees, especially the G10, have for a long time strongly advocated the general inclusion of collective action clauses (CACs) in sovereign bonds issued on foreign financial markets, which will remain a key channel for emerging market economies to import capital for years to come. In the meantime, for such paper issued under New York law – the most important market segment, which previously did not envisage such clauses – CACs have become virtually a market

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1 See also Deutsche Bundesbank, Report on the stability of the German financial system, *Monthly Report,* October 2004, pp 32-33.

standard with which only very few issuers do not comply. What most of the collective action clauses being applied under different legal systems today have in common is that a majority of 75% of bondholders (measured in terms of outstanding principal) can amend the payment terms of a bond for all bondholders. This can considerably facilitate any negotiations with the debtor. In addition, nowadays, bonds that include CACs in their terms regularly contain provisions that make it impossible for small minorities of bondholders to litigate on their own in the event of payment arrears, thereby frustrating the debt restructuring process. With this development, two core recommendations proposed to market participants by the G10 in September 2002 have been put into practice by the markets. Other G10 recommendations regarding such clauses, however, have not become generally widespread. This particularly concerns the possibility of immediately naming, upon each issue, a permanent creditor representative, who could quickly contact the debtor in the event of payment difficulties.

Legislation on the admissibility of CACs in Germany still pending

CACs are still not included in government bonds issued by foreign governments under German law. The markets are of the opinion that CACs need a legal foundation so as not to come into conflict with the investor protection principles applicable in Germany. Although the Federal Government and the Bundesbank already issued a joint declaration at the beginning of 2000 rejecting this view, no change in market practices has been achieved. A draft act is therefore currently being prepared – with important contributions from the Bundesbank – to eliminate any remaining legal uncertainty. The reservations regarding consumer protection issues that emerged during the discussions have not yet been resolved. The Bundesbank sees no convincing reason for such reservations. The terms of bond issues are to be regarded as a key contractual element and therefore – as in other key countries – should in future be expressly exempted from scrutiny under consumer protection guidelines. It must also be taken into consideration that German investors can readily purchase, from their home banks, euro-denominated bonds containing CACs that have been issued, for instance, under English or Luxembourg law. Legislation to clarify the legal status remains urgently necessary in order to prevent lasting damage to Germany's standing as a financial centre. As CACs are nowadays to be regarded as a market standard, the issuance of emerging market government bonds under German law remained at an extremely low level last year. The percentage of outstanding emerging market government bonded debt issued under German law therefore went down to only 6% in 2004 after peaking at not less than 26% in 1993. Even the new debt exchange bonds offered by Argentina are subject to other governing

G20 Accord for Sustained Growth *

Stability, Competition and Empowerment: Mobilising Economic Forces for Satisfactory Long-Term Growth

We, the Finance Ministers and Central Bank Governors of the G20, have a common goal of promoting employment, welfare and development in our countries. We are convinced that strong and sustained economic growth is necessary both at national and global level to achieve this end. We have therefore discussed the requirements for long-lasting growth on the basis of our own experience and believe that domestic policy needs to address three tasks: establishing and maintaining monetary and financial stability; enhancing domestic and international competition; and empowering people to participate. Transparency and accountability within an internationally agreed framework of codes and standards remain key to ensuring sustained economic growth and stability at the global level. We agreed on the following key elements that will guide our domestic economic policies in the future. In implementing these elements, microeconomic aspects must be given due consideration. As these principles are interlinked, they must be implemented consistently, with due regard to possible trade-offs and complementarities, because many single elements have the potential of blocking the positive effects of others. While appropriate and credible policies are the basis for economic growth, they need to be backed by high-quality institutions, including ethical standards in corporate governance. Policymakers should build institutions in parallel with engaging in reforms and also ensure that institutions stay consistent with the requirements of a changing environment. However, given the diversity of institutional settings and the success of different economic strategies among G20 countries, there is no single template for strong long-term growth. Policies need to be shaped to the special circumstances in individual countries. Efforts along these lines will unfold their full potential in a favourable international environment, in particular in the context of a robust and effective international financial and trade architecture which supports countries in the adoption of these principles.

* Annex to the Communiqué of the G20 Meeting of Finance Ministers and Central Bank Governors in Berlin on 20-21 November 2004.

Monetary and financial stability

Price stability is indispensable for sustainable economic growth as it fosters investment and saving. Inflation is destabilising and has a strong negative impact on the poor. Deflation squeezes profits, discourages investment and leads people to postpone spending. Experience has shown that central bank independence helps to achieve the goal of price stability in the long run.

Fiscal discipline is equally important. Fiscal policy must ensure that public expenditures and debt remain at reasonable levels in relation to national aggregates in order to prevent economic growth being restrained by crowding-out, anticipated future tax increases and inflationary pressures. Public expenditure composition and the tax system should ensure fiscal sustainability without discouraging investment and employment. Demographic challenges may generate additional needs for consolidation and restructuring of public expenditure, including reforms to ensure the viability of public pension schemes. In addressing these challenges, transparent budget procedures are of the utmost importance.

The domestic financial sector must be able to withstand economic shocks without giving rise to systemic problems which impair the allocation of savings to investment opportunities and the processing of payments in the economy. Excessive borrowing in foreign currencies for domestic activities has been identified as a major cause of international financial crises. Currency mismatches could be diminished by strengthening domestic banking systems and capital markets. Strong domestic financial sectors can reduce the need for foreign currency borrowing and become an alternative channel of external funding by attracting foreign investors into domestic currency instruments. High priority must be given to implementing the relevant internationally recognised standards and codes.

The liberalisation of the capital account yields essential efficiencies and benefits for economic growth. However, countries still opening their capital account should proceed prudently in order to avoid an excessive volatility of capital flows. A prudent approach would be based on sound macroeconomic policies and gradual deregulation of the domestic financial sector combined with adequate enhancements of the supervisory framework.

The elimination of restrictions on capital movements should be appropriately sequenced. Experience has shown that countries seeking domestic monetary autonomy while substantially liberalising their capital account should increase the degree of exchange rate flexibility accordingly.

Enhancing domestic and international competition

Competition is the driving force of economic growth because it fosters efficiency and stimulates innovation. It is also essential for strong investment activity. Carefully designed policies of deregulation, privatisation, and liberalisation of international transactions are important means of strengthening competition. However, ensuring competition and the functioning of markets requires setting the right incentives through efficient institutional arrangements. In particular, policymakers should aim at strengthening and enforcing intellectual and other property rights, contract law, bankruptcy procedures and anti-trust regulations. Also, efforts will be required to promote good governance and combat corruption.

Global trade liberalisation is an essential instrument to promote growth by channelling resources to their most productive use. While trade liberalisation needs to take due account of adjustment costs, policymakers worldwide should move ahead vigorously on the basis of multilateral commitments. Multilaterally consistent bilateral and regional agreements can also contribute to trade liberalisation.

Flexible labour market conditions are crucial cornerstones in achieving high employment levels and broad participation of the labour force. Both wage levels and working hours need to be responsive to market requirements and reflect national circumstances. Flexibility in work arrangements needs to be complemented by policies to provide opportunities and incentives to gain and improve skills, foster labour mobility, strengthen incentives to work in the formal sector and reduce information asymmetries.

Small and medium sized enterprises (SMEs) are an important element of dynamic economies as they play a central role in creating jobs, facilitating the absorption and adaptation of technology and strengthening entrepreneurial skills. Policymakers can support SMEs by committing themselves to non-discriminatory measures and ensuring access to financial services, risk capital, innovation networks and public R&D programmes.

A favourable overall investment climate, including adequate infrastructure, will support domestic capital accumulation and also be attractive for foreign direct investment (FDI). FDI is generally a powerful means of enhancing competition and the growth potential. For one thing, FDI facilitates the international transfer of know-how, thus fostering the competitiveness of the host country directly. For another, FDI can help to improve the productivity of local companies by stimulating imitation of new technologies.

Empowering the people and reducing poverty

Mobilising all productive forces of a society requires empowering individuals and enhancing economic participation. Equal economic opportunities allow people to better provide for themselves and their families, thus helping to reduce poverty and social tensions. Education and training are key requirements as they improve people's chances of finding jobs and contribute to higher productivity. The broadly-based provision of high-quality primary and secondary education should be a responsibility of governments and provides the basis for successful tertiary education. Raising the level of education contributes to the quality of governance as an educated population is better placed to demand the provision of good governance and sound institutions.

Broadly-based access to a wide range of financial services and reducing impediments to small businesses, such as the time to start a business, is of crucial importance as it fosters entrepreneurial capacities and facilitates the integration of people into the formal economy.

While employment is the first and best safeguard against social exclusion, social safety-nets are needed to cushion the effects of unemployment. Moreover, the elements of social infrastructures such as clean water, sanitation and basic health services are public goods whose provision has a positive impact on welfare and potential growth. It is important to design social policies so as to permit market mechanisms to function effectively.

laws owing to the inclusion of CACs, which means that the share of bonds issued under German law may shrink even further.

Agreement on voluntary guidelines for improving crisis management

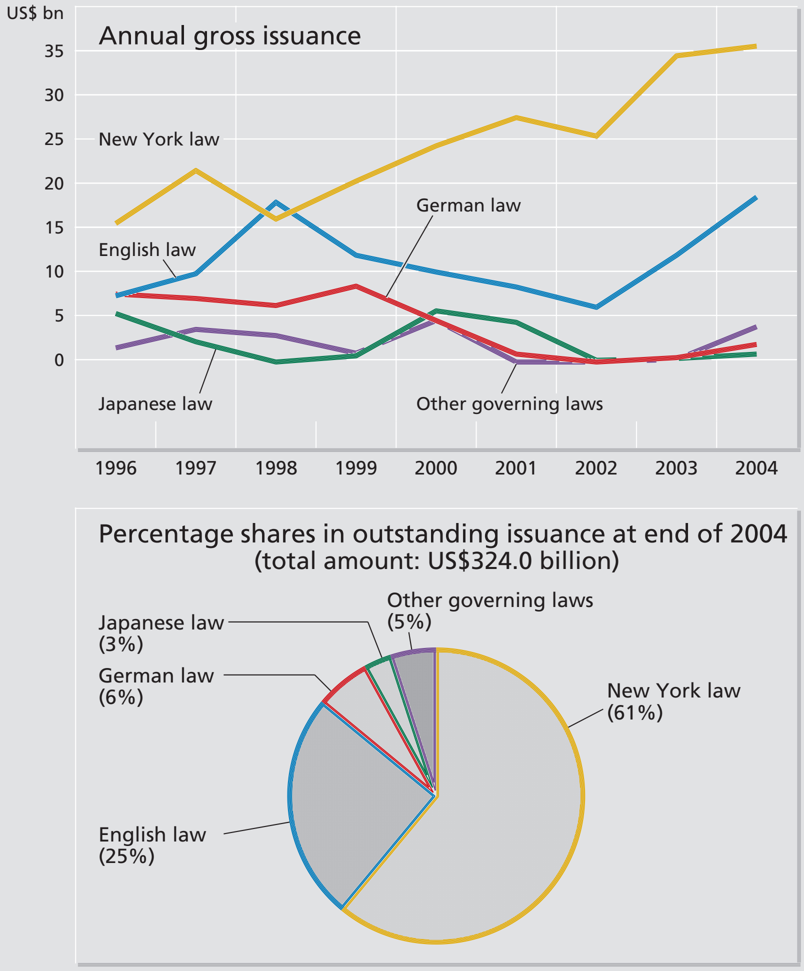
The increasing spread of CACs represents the closure of a gap in the set of debt rescheduling instruments. As a complement to the Paris Club for bilateral public sector debt and the London Club for bank loans, CACs can facilitate crisis management for securitised assets, whose role in international capital movements has increased sharply since the early 1990s. However, there is still no procedure – comparable with a national insolvency code – that could, in a crisis, guarantee the debtor an orderly general payment deferral and the coordination of the interests of all creditors. With the IMF's proposals for the creation of a "Sovereign Debt Restructuring Mechanism" for this purpose having been shelved for the time being owing to considerable reservations on the part of financial intermediaries and key emerging market economies alike, there was a growing interest in at least voluntarily agreeing a few principles whose observance between the debtor country and its private creditors could be of service to both crisis prevention and crisis management. With the support of the G20, representatives from the private sector and a number of emerging market economies last year reached an agreement on a short list of rules of conduct. This document entitled "Principles for stable capital flows and fair debt restructuring in emerging markets" was presented to the public in Washington, DC in November 2004 under the lead of the Institute of International Finance (which represents the interests of over 340 financial institutions from all over the world) after having been welcomed as a crucial step forward by the finance ministers and central bank governors of the G20 at their Berlin meeting a day earlier. The code gives market participants numerous recommendations intended to enshrine the following four core issues.

– Debtor countries should make it easier for investors to assess risk by improving transparency concerning the economic situation and, particularly in the event of tensions, should also disclose detailed information on economic policy assumptions and intentions.

– Relations between debtors and private creditors should be based on regular and close dialogue in line with traditional "investor relations". In a crisis, this is intended to inform the debtor how, in the investors' opinion, the crisis could be prevented from coming to a head, and what financial bridging assistance the creditors might be able to provide (eg maintaining credit lines) in order to avert a full-scale restructuring.

Foreign currency denominated sovereign bonds of developing countries* by governing law

Chart 24



Source: Dealogic Bondware. — * Defined according to the IMF's International Financial Statistics.

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– If restructuring ultimately becomes inevitable, debtors and private creditors should engage in good faith dialogue with the goal of reducing the debt burden to a level that is sustainable over the longer term. This would have to be accomplished through negotiations, for which a representative creditor committee would normally have to be formed.

– Finally, discrimination against individual creditors should be avoided. However, short-term trade and interbank loans, in line with current practice, could be excluded from restructuring or could at least be given preferential treatment. It would also have to be ensured that creditors potentially under the control of the sovereign do not participate in a vote on a restructuring.

Agreed guidelines could still be improved

For these principles to be able to play their intended role in future, it is important to obtain the broadest possible support for them from market participants. This process is being emphatically pushed forward by the Institute of International Finance. The unsatisfactory experiences of Argentina's private creditors in current attempts at crisis resolution should give an additional boost to efforts to achieve broad support for a code of conduct. It remains to be seen whether these guidelines will thereby be further improved. For instance, the discussions held in the G20 highlighted a need for revision. The guidelines, for instance, contain an appeal to the IMF "not to give any appearance of encouraging a debtor to default". In reality, the IMF has tended, in the past, to extend additional loans even to excessively indebted countries to avert restructurings which would, in fact, have been called for. In a concrete case, the necessary corrections to the IMF's lending policy should by no means be equated with a call for a standstill. What could also be examined is whether the agreed principles, which expressly target the case of necessary restructurings, should also lay down modalities for the introduction and duration of a payment standstill. Moreover, the recommendation that a debtor country experiencing payment difficulties should, as a sign of good will, try to resume its debt service payments in part prior to the conclusion of restructuring measures, has come under criticism. This petition could easily come into conflict with the principle of equal treatment of all creditors. Therefore, priority should always be given to the rapid conclusion of negotiations, including payments on deferred interest.

3 International financial assistance

Outstanding IMF credit declined, but proportion of loans exceeding the normal access limits barely reduced

In the light of the improved global economic situation, the need for IMF credit declined. In 2004, disbursements under new loans totalled SDR 5 billion, which was well below the level of previous years. At the same time, sizeable repurchases were made which meant that outstanding IMF credit, which had reached an all-time high of SDR 72 billion at the end of 2003, declined to SDR 62 billion (US$96 billion) by the end of 2004. Approximately two-thirds of all outstanding credit continued to be accounted for by the Fund's three largest borrowers. The proportion of lending exceeding the normal IMF access limits fell only slightly in the course of 2004 from 40% to 39% of the total volume. This raises the problem of the conditions under which follow-up loans may be granted to countries

IMF credit: purchases, repurchases and total amounts outstanding Table 12

SDR billion

Item	2000	2001	2002	2003	2004
Purchases	7.7	24.6	26.6	21.1	5.0
Repurchases	15.8	14.1	16.0	19.7	14.8
Net purchases	– 8.2	10.6	10.6	1.4	–9.8
Total IMF credit outstanding 1	49.3	59.9	70.5	71.9	62.1
of which					
Exceptional access 2	2.4	14.1	24.4	28.7	21.5
Type of credit/facilities					
Credit tranches 3	20.8	34.8	46.5	49.6	42.6
Extended Fund Facility (EFF)	15.7	15.0	14.6	13.9	11.7
Compensatory Financing Facility (CFF) 4	3.0	0.8	0.6	0.2	0.1
Poverty Reduction and Growth Facility (PRGF) 5	6.4	6.5	6.9	6.9	6.8
Other facilities	3.4	2.8	2.0	1.3	0.9
Regional breakdown 6					
Africa	6.5	6.2	6.1	5.5	5.1
The Americas	6.8	19.0	28.2	32.1	27.9
Asia	18.6	12.4	10.3	9.9	8.6
Europe	16.7	21.6	25.2	23.8	19.8
Middle East	0.6	0.6	0.6	0.6	0.8

Sources: IMF and Bundesbank calculations. — **1** End-of-year level. — **2** Above the access limit of 300% of the quota. — **3** Including total credit outstanding under the Supplemental Reserve Facility (SRF). — **4** Formerly the Compensatory and Contingency Financing Facility (CCFF). — **5** The PRGF is the successor facility to the Enhanced Structural Adjustment Facility (ESAF), which in turn succeeded the Structural Adjustment Facility (SAF). It is financed out of special assets administered by the Fund. — **6** Delineation of regions according to IMF definitions; Europe therefore includes Turkey and the countries of the former Soviet Union.

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that already have exceptional access to IMF resources. Essentially, every extension of credit which results in a debt level of more than 300% of the IMF quota should be regarded as exceptional access to IMF resources. In such cases, the criteria mentioned above for assessing the need for assistance to the capital account should be applied. Typically, the mandatory prerequisite that the country is suffering from sudden and exceptionally high capital outflows does not apply in the case of such follow-up loans. Moreover, under the agreed criteria, the initial, exceptionally large loan would have been granted only under the premise that the borrower would rapidly regain access to the market, meaning that the IMF financial assistance would merely serve a bridging function. The refinancing of matured obligations vis-à-vis the IMF would, therefore, be incompatible with these criteria. Consequently, the new loans recently granted to Brazil and Turkey were agreed by the Bundesbank only subject to the proviso that the exceptional access had occurred before the new access criteria came into force ("grandfathering") and therefore assistance could be granted to repay the net debt to the IMF more slowly. In the case of future large loans, there should be hardly any question of follow-up loans of this kind which, when viewed in isolation, would not fulfil the four criteria mentioned. Otherwise, the agreed framework for exceptional access would lose credibility.

Higher lending commitments by the World Bank, but net reflows through extensive redemptions

In its 2004 financial year (July 2003 to June 2004), the lending commitments of the World Bank (IBRD and IDA), at US$20 billion, were slightly higher than in the preceding 12-month period (US$18.5 billion). This is due entirely to a rise in the highly concessional credits granted by the IDA. They rose from US$7.3 billion in the 2003 financial year to US$9 billion in the 2004 financial year. As in the case of the IMF, sizeable redemptions to the IBRD (including early repayments of loans granted on the occasion of the East Asian financial crisis) led to net reflows of US$8.4 billion (following US$8 billion in the previous year). Thus, in the course of the 2004 financial year, the sum of outstanding IBRD loans declined from US$116 billion to US$110 billion. The Bundesbank takes a critical view of efforts by the World Bank and other development banks to reverse this trend by effectively subsidising the loans. Rather, the multilateral development banks should focus on improving the underlying economic conditions and the investment climate in the developing and transition countries in order to make their clients more attractive to private investors.

Net reflows for regional development banks, too

The lending commitments of the major regional development banks were, on the whole, stable. As in the previous year, in 2004 the Inter-American Development Bank, the African Development Bank and the Asian Development Bank, as well as the European Bank for Reconstruction and Development, approved loans to developing and transition countries totalling approximately US$20 billion. However, redemptions exceeded disbursements here, too. This year the Asian Development Bank – together with the World Bank – will play a special role in assisting those Asian countries affected by the flood disaster. Altogether, the two institutions are planning jointly to provide more than US$2 billion, primarily in the form of grants or as highly concessional loans for priority reconstruction work in Indonesia, Sri Lanka and the Maldives.

Renewed extension of HIPC initiative

In September 2004, the Executive Board of the IMF and the World Bank Board of Executive Directors decided to extend the Heavily Indebted Poor Countries (HIPC) Initiative for a further two years up to the end of 2006. This is important for those countries whose debt level was still deemed to be unsustainable at the end of 2004 even after the traditional debt relief had been granted. The IMF and the World Bank plan to present a final list of countries which may be considered for the HIPC initiative and an estimate of the costs of the extended debt initiative in mid-2005. They will need to take into account the fact that, at their meeting in London in February 2005, the G7 countries agreed their willingness to provide 100 per cent debt relief in individual cases, where justified. However, it remains to be seen how an even more extensive HIPC initiative is to be funded in the future. As already mentioned, the proposed use of IMF gold reserves for this purpose cannot be justified.

Framework in preparation for assessing debt sustainability in low-income countries

The HIPC initiative is helping to reduce the HIPC countries' debt level, in some cases considerably. However, experience has shown that it cannot guarantee long-term debt sustainability. Consequently, in the past year the Executive Board of the IMF and the World Bank Board of Executive Directors have deliberated on a framework for systematically assessing the debt sustainability of low-income countries. The concept provides for debt-sustainability thresholds, while at the same time differentiating according to the quality of a country's economic policy and the strength of its institutions. The framework is also intended to serve as a basis for deciding whether low-income countries should, in future, receive loans or primarily grants. Care will need to be taken to avoid giving emerging market economies the wrong incentives. Poor economic policy in the past should not be rewarded with greater debt relief and larger shares in development grants.

Innovative funding proposals to achieve Millennium Development Goals

Against the backdrop of the United Nations review of the progress made towards achieving the Millennium Development Goals, which is due to take place in autumn 2005, the debate has intensified about innovative funding proposals to significantly increase official development assistance. The United Kingdom has launched a proposal to establish an International Finance Facility to finance higher disbursements for development assistance relatively rapidly at the expense of future years through borrowing on the financial markets based on long-term donor commitments. Other financing proposals include, for example, the introduction of taxes on financial transactions, arms sales or aviation fuel. The debate also includes proposals for containing tax evasion, making voluntary credit card donations and establishing ethical funds. The Bundesbank takes a critical view of the proposed International Finance Facility and the taxation of financial transactions for reasons of principle as well as for practical reasons. The advance financing of development assistance through the financial markets would entail the risk of uncertain repayment of the funds raised, which could ultimately increase government debt, placing an additional burden on future generations. By contrast, taxation on financial transactions should be rejected on the grounds that evasion would be easy, leading to competitive distortion and misallocation.

Operations of the Deutsche Bundesbank

I Structural reform

Objectives of the structural reform

Immediately after the Seventh Act Amending the Bundesbank Act entered into force on 30 April 2002, the Executive Board initiated a comprehensive restructuring of the Bundesbank. In addition to improving cost-effectiveness in fulfilling its tasks, the new structure ensures the German central bank's ability to function in a European context. The key elements of the restructuring were streamlining the way in which the Bank is organised with a clear assignment of tasks and a concentration of operations of the same type at a single location. Furthermore, it was decided to make a further reduction in the branch network and to streamline the range of services offered in cash payments. The Annual Reports for 2002 and 2003 contain a more detailed account of the individual measures taken.

Large parts of the new organisational structure at Central Office and the nine regional offices were introduced in 2003, which meant that they were already put in place during the first third of the implementation phase.

Establishment of service centres almost complete

The concentration of tasks of the same type (procurement, for example) in service centres, each of which is usually located at one regional office, required extensive preparation in some cases. Now, 20 of the total number of 22 service centres have taken on all of their designated tasks. The few measures that still have to be implemented will be completed in 2005 within the time-frame originally envisaged by the Executive Board.

Decision on a timetable for closing 19 branches and 21 operating units

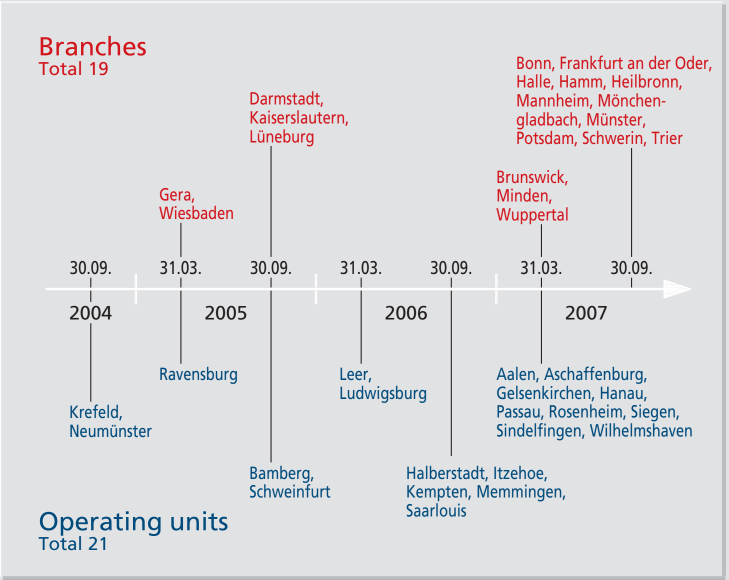
In 2003, a decision was taken to reduce the branch network to 47 locations by the end of 2007. In the year under review, this decision was set out in more detail. In June 2004, the Executive Board adopted a timetable for the closure of 19 branches and 21 operating units.

In the reporting year, a total of 14 operating units were closed (12 as of 31 March 2004 and two as of 30 September 2004). This means the streamlining of the Bundesbank's branch network is running on schedule.

Concentration of housing stock

With the decisions it took in 2004 concerning the Bundesbank's future real estate portfolio, the Executive Board backed up its rulings on the branch and personnel strategies. In line with this, up to 2009 the Bundesbank will concentrate its stock of housing for staff on those work locations where the housing market

Closures of branches and operating units* Chart 25



* As of 31 march 2004, the following operating units had already been closed: Albstadt, Arnsberg, Bad Hersfeld, Celle, Esslingen, Hamlin, Husum, Ingolstadt, Landshut, Lingen, Neuss, Wesel.

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is tight and where alleviating the effects of the restructuring process at the Bank calls for an adequate supply of housing. In the long run, the housing stock will be reduced to those units needed for operational purposes.

Significant savings have already been made as a result of implementing the structural reform (see 2003 Annual Report, p 118).

Effects of the structural reform

– The new organisational structure has brought a saving of 40% of all former managerial positions.

– As of 31 December 2004, the overall staffing level was 13,414, which was a reduction of as much as roughly 15% compared with the end of 2002. The reduction in staffing levels is therefore proceeding on schedule.

– The actual costs for the production process in 2004 (excluding the costs of banknote printing) were €207.3 million (around 16%) lower than the comparable costs for 2002.

II Processing cash payments and cashless payments

1 Cash payments

Euro currency in circulation in the Eurosystem

During 2004, the volume of euro banknotes in circulation issued by the Eurosystem increased again sharply by 14.9% to €501.3 billion. The volume of coins in circulation rose by 9.1% to €15.4 billion. At the end of the year, 97.0% of euro currency in circulation issued by the Eurosystem consisted of banknotes, and 3.0% of coins.

In the financial year 2004, the Bundesbank paid out 14.4 billion euro banknotes with a value of €437.6 billion and 13.6 billion euro coins with a value of €6.7 billion. During the same period, it received from its customers inpayments of 13.8 billion euro banknotes with a value of €403.3 billion and 11.6 billion euro coins with a value of €6.4 billion.

Besides the coins in circulation, euro collector coins were issued in all participating countries; these were legal tender only in their respective country of issue. In Germany, issues of German euro collector coins in 2004 had a total value of €189 million.

Euro currency in circulation

Table 13

Trend

€ million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation 1
2001	145,280	133,050	12,230
2002	370,968	358,535	12,433
2003	450,198	436,131	14,067
2004	516,613	501,259	15,354

Pattern at the end of 2004

Banknotes in circulation			Coins in circulation		
Notes of €	€ million	Percentage of total	Coins of €	€ million	Percentage of total
500	153,115	30.6	2.00	6,081	39.6
200	28,628	5.7	1.00	4,505	29.3
100	91,940	18.3	0.50	2,006	13.1
50	162,750	32.5	0.20	1,244	8.1
20	41,589	8.3	0.10	753	4.9
10	17,004	3.4	0.05	443	2.9
5	6,233	1.2	0.02	202	1.3
			0.01	120	0.8
Total	501,259	100.0	Total	15,354	100.0

1 Circulation of euro coins excluding commemorative coins.

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Temporary hold-up in the supply of small-denomination coins

As a result of the unexpected and persistently high demand for small-denomination coins of 1, 2 and 5 cent and the difficulties in supplying blanks owing to the tight situation on the steel market, the demand from credit institutions, cash-in-transit companies and retailers could not be met fully for a time.

Continuous new minting at the German mints and taking delivery of existing stocks from neighbouring central banks led to an easing of the supply situation in the second half of the year.

Deutsche Mark currency in circulation

The volume of Deutsche Mark currency in circulation was reduced to DM15.2 billion by the end of 2004. Banknotes accounted for around DM7.9 billion of this amount and coins for roughly DM7.3 billion.

DM currency in circulation Table 14

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
2002	16,876	9,383	7,492
2003	15,819	8,432	7,387
2004	15,178	7,876	7,302

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Destruction of banknotes

Compared with 2003 – when the volume of destroyed Deutsche Mark banknotes had shown a sharp decrease – there was only a marginal decline in the year under review.

The volume of destroyed euro banknotes was roughly twice as high as in 2003 owing to the increasing average age of notes since the first issue. Almost 97% of destroyed euro banknotes were of the denominations of €5 to €50; €5 notes made up nearly one-third of this amount.

Destruction of DM/euro banknotes Table 15

Item		2000	2001	2002	2003	2004
DM banknotes	Number (millions)	782	1,781	2,426	95	92
	DM billion	85.1	260.9	246.5	44.1	38.4
Euro banknotes	Number (millions)	–	–	137	310	627
	€ billion	–	–	3.3	6.9	15.2

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Euro counterfeits

The number of counterfeit euro banknotes and euro coins detained in payments and recorded by the Bundesbank was significantly higher than the number of counterfeits in the previous year.

Counterfeits detained in payments as recorded by the Bundesbank Table 16

Year	Banknotes		Coins	
	Number	€ thousands	Number	€ thousands
2002	13,698	872	1,032	2
2003	50,205	3,402	16,500	33
2004	80,703	6,070	50,767	98

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The €50 banknote was the most frequently counterfeited denomination (48%), followed by the €100 note (35%). The counterfeit coins were primarily of the €2 denomination (93%).

Preventing counterfeit banknotes

As part of counterfeit prevention, the Bundesbank has conducted more than 1,000 training sessions throughout Germany focusing on the rapid and assured recognition of counterfeit banknotes by cashiers at banks and retail outlets.

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

In December 2004, the Governing Council of the ECB adopted the Framework for the detection of counterfeits and fitness sorting of euro banknotes by credit institutions and other professional cash handlers. This framework sets out uniform requirements for banknote recycling by credit institutions and other professional cash-handlers for both staff and customer-operated systems. The new framework thus takes the place of the earlier agreement on the use of (customer-operated) cash-recycling machines and (customer-operated) cash-in machines, which had been adopted by the Governing Council on 18 April 2002. Furthermore, it extends the range of options for banknote recycling to staff-operated systems, which are usually operated at the central institutions of the cash handlers. The agreement contains, *inter alia*, provisions for detecting and detaining counterfeits, thus giving concrete shape to the binding requirements set out in Article 6 of Council Regulation (EC) No 1338/2001. Above and beyond that, the framework contains rules for the fitness detection and sorting of euro banknotes. Both provisions should help to ensure the high quality of banknotes in circulation even when cash flows fluctuate. The national central banks of the

Eurosystem will implement the framework with regard to institutions and other professional cash handlers no later than the end of 2006.

2 Cashless payments

Slight increase in the number of payments via the Bundesbank

The number of domestic and cross-border payments made through the Bundesbank in 2004 again showed a slight increase on the year. Overall, 2.3 billion credit transfers and collection orders to the value of €130,620 billion were settled in the year under review, signifying a 1.9% increase in the number of items submitted.

Rising number of cheque conversions by banking industry

As a result of the completely paperless procedure which has been agreed for payments between banks, the Bundesbank now accepts only large-value cheques from credit institutions in paper-based form. In consultation with the banking industry, the minimum amount for such cheques was raised from €3,000 to €6,000 as of 1 November 2004. The credit institutions thereby made a commitment to convert more cheques than before themselves and to collect them in paperless form. Cheques to an amount of €6,000 or more are converted by the Bundesbank only and settled in a paperless form; the Bundesbank also ensures that the original cheques are transferred and submitted separately.

RTGS^{plus} – successful within Germany …

The payments processed via the Bundesbank's real-time gross settlement system, RTGS^{plus}, in the year under review again showed an increase on the year. In 2004, a total of somewhat more than 112,000 domestic payments were settled every working day.

… and in the European TARGET setting

Besides national large-value payments, more than 19,000 cross-border credit transfers were submitted to RTGS^{plus} every working day and then transferred to the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system of the EU central banks. RTGS^{plus} achieved a total "market share" of just under 50% of national and cross-border individual and large-value payments of all the EU central banks.

Payment systems oversight

By analysing payment systems and payment instruments and observing the payments market, the Bundesbank's payment systems oversight makes a significant contribution to the stability of the financial system and the efficiency of payments. Oversight does not affect just payment systems of the banking industry

Cashless payments of the Deutsche Bundesbank

Table 17

Item	2003 Number (million)	2003 € billion	2004 Number (million)	2004 Percentage change	2004 € billion	2004 Percentage change
Domestic payments	2,219.1	98,617	2,259.7	1.8	93,487	– 5.2
Retail payments	2,188.3	2,101	2,228.7	1.8	2,122	1.0
RPS						
Direct debits, cheques	1,265.2	1,127	1,244.5	– 1.6	1,054	– 6.4
of which Conversions	28.0	621	22.1	– 21.1	544	– 12.5
Prior 3 payments	923.1	975	984.2	6.6	1,067	9.5
of which Conversions	1.8	11	1.5	– 14.0	9	– 17.4
Large-value payments	30.8	96,516	31.0	0.8	91,365	– 5.3
RTGS^{plus} 1	28.2	92,710	29.1	3.1	89,282	– 3.7
Other 2	2.6	3,806	2.0	– 24.8	2,084	– 45.3
Cross-border payments	9.6	35,872	10.6	10.3	37,133	3.5
Retail payments	4.8	2	5.4	13.2	3	26.2
MASSE 3	4.8	2	3.8	– 20.7	2	– 19.6
STEP2 via RPS 4	0.0	0	1.6		1	
Large-value payments	4.8	35,870	5.2	7.4	37,130	3.5
TARGET 5						
via RTGS^{plus}	4.6	35,833	5.0	8.3	37,084	3.5
AZV 6	0.2	37	0.2	– 13.8	47	27.2
Cashless payments	2,228.7	134,489	2,270.3	1.9	130,620	– 2.9

1 Bundesbank's real-time gross system. — **2** For example, special procedures for public authorities, payments within ELS following the introduction of RTGS^{plus}. — **3** Procedure for cross-border retail payments of public authorities. — **4** Procedure for cross-border retail payments (link to the STEP2 procedure of the EBA, Paris). — **5** Procedure (of the EU central banks) for cross-border individual/large-value payments in EU countries. — **6** Procedure for cross-border individual/large-value payments in EU/EEA countries and non-EU/EEA countries.

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and card systems, a significant aspect is also the ongoing monitoring of RTGS^{plus} as part of the ESCB's oversight of TARGET.

3 Developments in the national and European setting

Status of the TARGET2 project

Major changes have been occurring in the TARGET environment since October 2002 when the Governing Council of the ECB adopted the main principles for the next generation of the TARGET system. The Governing Council's decision envisaged that TARGET2 would be comprised of several individual platforms and a single shared platform. A subsequent public consultation exercise revealed a strong preference on the part of the banking industry for a TARGET2 system with just one single platform. In October 2003, the Bundesbank, Banca d'Italia and the Banque de France (the 3CB) submitted a joint bid to the ESCB for the development and operation of a single shared platform (SSP). In December 2004, they received a clear mandate from the ECB Governing Council to develop and operate the SSP. The launch of the SSP is scheduled for January 2007. All euro-area central banks have confirmed that they will join in the SSP in 2007.

Significance for the Bundesbank

The SSP presents a first-time opportunity to realise the service centre concept in the ESCB. It will draw on the national central banks' know-how, existing resources and technical infrastructure to perform central ESCB tasks. The Bundesbank is a key part of this service centre and pool of expertise for the development and operation of TARGET2. As the RTGS^{plus} system operator, the Bundesbank's contribution to the development of TARGET2 will lie in the operational design (eg liquidity-saving settlement in a gross system) and a number of key features (eg the wide range of options for managing liquidity).

Price discussions

The Governing Council's decision of October 2002 provides for a single domestic and cross-border unit price for the core service throughout the Eurosystem. In 2004, initial discussions were held concerning a price model. In line with the Governing Council's requirements, "guidelines" for a TARGET2 price model were agreed. According to these guidelines, participants should be given the choice between a price model based on a transaction fee or a combination of a fixed annual or monthly fee and low transaction fees. Subject to further discussions in the Eurosystem, a model with prices on a degressive scale according to the number of payments can be expected, with prices ranging from €0.25 to €0.80 per transaction.

Connection of new EU member states to TARGET

Since their accession to the EU in May 2004, the new member states have been able to connect to TARGET; once they introduce the euro – in mid-2006 at the earliest – a TARGET link in the countries concerned will be absolutely essential. As the single shared platform will not be available before 1 January 2007, there may be a need for an interim solution. An interim solution will also be necessary if the SSP cannot be put into operation in January 2007, but new member states still enter monetary union. The new member states will be offered various options for a simplified connection to the current TARGET system.

Participation of the Slovenian central bank in RTGS^{plus}

For example, a new member state's central bank and credit institutions can participate directly in an existing TARGET component by means of remote access. Since mid-October 2004, the central bank of Slovenia has been connected directly to RTGS^{plus}, although currently only with regard to its own direct STEP2 participation. The STEP2 procedure, which is operated by the Euro Banking Association (EBA) in Paris – a private-law organisation of major credit institutions –, is the first pan-European clearing house for the settlement of EU credit transfers up to €12,500 in compliance with the EU pricing regulation. The Slovenian central bank will initially use RTGS^{plus} exclusively for the settlement of its own STEP2 payments. However, a remote-access RTGS^{plus} link is planned for the Slovenian banks for the settlement of their euro payments from mid-2006.

Third SEPA Progress Report

On 2 December 2004, the Governing Council approved the report "Towards a Single Euro Payments Area – Third progress report". In these progress reports, the Eurosystem analyses and assesses at regular intervals the current status of the work initiated in 2002 by the European banking industry aimed at establishing a single euro payments area (SEPA) by 2010. The Eurosystem ultimately concludes that, while some initial tangible progress has been achieved in cross-border credit transfers, work in some areas is behind schedule. In order not to endanger the SEPA project, the European banking industry should work towards enabling customers to use European payment instruments from 2008 onwards. In addition, a SEPA-compatible infrastructure ought to be constructed by 2010.

Harmonisation and standardisation necessary ...

The main focus of the efforts to establish a SEPA are the standardisation of payment instruments, technical procedures and business practices. In particular, the use of the International Bank Account Number (IBAN), which makes it possible to identify the accounts involved in a payment transaction in a uniform manner throughout Europe, plays a key role. The IBAN can already be used in some cross-border payments today, but use in domestic payments is not yet possible. Moreover, there is also considerable need for adjustment with regard to the payment instruments themselves. With this in mind, the European banking industry is currently working on a new pan-European direct debit procedure which can be used for collection orders throughout Europe.

... but entail considerable efforts

Ultimately, the SEPA project will affect every consumer, enterprise and bank in Europe. Enormous efforts are therefore required of all the parties involved. Given the advantages associated with the SEPA, the earliest possible availability of the new pan-European instruments and procedures would be desirable. However, it would be wrong if, owing to pressure of time, harmonisation were to lead to a deterioration in the current level of service. In view of this and the intrinsically very complex nature of the European coordination process, the target date of 2008 for the availability of pan-European instruments is extremely ambitious.

Pan-European infrastructure

An essential component of the SEPA project involves adapting current clearing procedures (eg giro networks, bilateral exchange agreements) to enable them to process European instruments and apply technically harmonised standards in the future. This also applies to the Bundesbank's Retail Payment System (RPS). The first concrete steps towards achieving this were undertaken in late 2003 when the link to the pan-European STEP2 system was established. Further consolidation in the European clearing field may seem likely and, for smaller countries with their own infrastructure, essential. Nevertheless, it remains to be seen whether, at the end of the day, only a few pan-European clearing houses will be left or whether a completely interoperable structure will emerge, consisting of several providers with, in some cases, different regional focuses and business orientations. As the first stage of adjustment, not only do the national clearing structures need to prepare for new standards, they must also open their doors to foreign participants.

SEPA project governance

The main decision-making body of the SEPA is the European Payments Council (EPC), which is made up of representatives of the European banking industry. A total of seven of the 65 representatives are from Germany. To ensure the success of the SEPA, it is essential that the decisions taken by the EPC are made binding for all credit institutions in the euro area. The way to achieve this has not yet been decided. For Germany it would make sense to use the tried and tested instrument of interbank agreements, which are concluded by the central associations of the banking industry for their member institutions and, for the most part, also signed by the Bundesbank. To accompany the activities in this area, the Central Credit Committee (CCC) of the German banking industry has established a SEPA office and set up various working groups in which the Bundesbank is also actively involved.

E-money still awaiting breakthrough in Germany

Overall, the use of electronic money in Germany remains at a relatively low level. While there have been measures by the banking industry to promote the CCC GeldKarte, it still remains to be seen whether a breakthrough can be achieved with automated ticket dispensers and other vending machines, in car parks or on the internet. The new juvenile protection feature now offered with the CCC GeldKarte could play a significant role as the requirements for the protection of juveniles have been extended in Germany. Besides a few other small-scale activities relating to the issuance of e-money in Germany using mobile telephones and the internet, there are some cross-border initiatives, as well. The Eurosystem is closely monitoring their level of acceptance and use. As part of its duty to oversee payments, the Bundesbank is already monitoring security and efficiency at the national level and is also involved in Eurosystem oversight activities for such systems and processes.

4 Activities at the G10 level

Work in the CPSS and the cooperative oversight of SWIFT

In the year under review, 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 and in the cooperative oversight of SWIFT (Society for Worldwide Interbank Financial Telecommunication).

General guidance for the development of payment systems as a contribution to practical development aid

In 2004, the CPSS set up the Working group on general guidance for the development of payment systems. The objective of the working group is to define general guidelines for the development of payment systems based on the experience of the G10 central banks and the central banks of selected emerging market economies. The guidelines are intended to assist developing countries, in particular, in the process of successfully establishing and developing their payment infrastructure.

Developments in large-value payment systems and in oversight

In 2004, the Bundesbank continued its work in two working groups established in 2003; the Working group on new developments in large-value payment systems and the Working Group on oversight of payment and settlement systems. Reports on both of these topics are due for publication in the near future.

Cooperative oversight of CLS

The cooperative oversight of the Continuous Linked Settlement (CLS) system – a privately operated global system for the clearing and settlement of foreign exchange transactions – focused on the expansion of the number of CLS-eligible currencies from 11 to 15. Since December 2004, it has been possible to settle transactions in CLS in Hong Kong dollar, Korean won, New Zealand dollar and South African rand.

Cooperative oversight of SWIFT

Primary responsibility for the oversight of SWIFT lies with the Belgian central bank as SWIFT is domiciled in Belgium. The Bundesbank is involved in the cooperative oversight of SWIFT, too. The oversight activities involve, for example, discussions about systemic risks, questions of security, as well as the availability and the business policy of SWIFT.

III Securities clearing and settlement

Role of the Bundesbank

The Bundesbank's activities include overseeing securities clearing and settlement systems. Moreover, the Bundesbank makes a further contribution to efficiency and security in this field through its participation in national, European and international bodies.

Report of the ESCB/CESR working group on standards for securities clearing and settlement systems

In November 2004, the Governing Council of the ECB and the Committee of European Securities Regulators adopted the report on standards for securities clearing and settlement systems that had been prepared by a joint working group. The report contains 19 standards designed to enhance the security and efficiency of securities clearing and settlement systems. They are based on the recommendations for securities settlement systems published by the CPSS and the International Organization of Securities Commissions (IOSCO) in 2001, adapting them to the specific circumstances in the EU. This set of standards will not be final and come into force, however, until an assessment methodology has been developed and the impact of the standards has been analysed. In the course of developing the assessment methodology, various issues listed in the introduction to the report, on which the working group was unable to reach a final decision, will be studied in close cooperation with market players. In this context, the Bundesbank attaches great importance to striking a reasonable balance between the costs and benefits of any additional regulatory measures. In particular, the Bank advocates that the requirements for the lending business of banks and central securities depositories with a banking licence associated with settlement be geared to Basel II. A European go-it-alone approach to regulating lending in the context of clearing and settlement based on ESCB/CESR standards might otherwise result in competitive distortions to the disadvantage of European banks.

CPSS/IOSCO recommendations for central counterparties

Having due regard to the stability of the global financial system, the Bundesbank remained committed to its involvement in the CPSS/IOSCO working group in the year under review. After finalising consultation on a draft report in summer 2004, the working group published a report entitled "Recommendations for

Central Counterparties" in November. The aim of these recommendations is to facilitate adequate risk management on the part of central counterparties and thereby contribute to the stability of the financial system. The report therefore focuses on recommendations concerning the risk management of central counterparties and contains a methodology for assessing the implementation of these recommendations.

Assessment of the procedures for the cross-border posting of collateral for refinancing

A CPSS working group commissioned in June 2004 is analysing possible improvements to the procedures for refinancing at central banks by means of the cross-border use of collateral. The G10 central banks are thus responding to an initiative by globally operating commercial banks which are interested in a flexible use of their collateral portfolio and which, among other things, had asked the central banks to add foreign securities to the group of eligible assets.

IV Money market operations and foreign reserve management

Counterparties

Participation in the Eurosystem's monetary policy operations is conditional on credit institutions having counterparty status. All counterparties are financially sound institutions which are subject to the minimum reserve requirements stipulated in Article 19.1 of the Statute of the ESCB. In order to have access to monetary policy operations, counterparties must also satisfy certain operational requirements. In Germany, for instance, they need to be linked up to the Automatic Bidding System (ABS) to carry out tender operations. Access to the two standing facilities is open only to institutions that comply with their minimum

Counterparties and participation in tenders

Table 18

	Counterparties (Year-end levels)								Participation in tenders (Bidders, annual average)			
	Minimum reserves		Regular open market operations		Marginal lending facility		Deposit facility		Main refinancing operations		Longer-term refinancing operations	
Country/region	2004	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004	2003
Germany	2,148	2,225	1,245	1,272	1,604	1,653	2,007	2,074	221	169	114	95
Euro area	6,406	6,593	2,090	2,149	2,549	2,629	2,971	3,083	339	267	159	133

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reserve requirements themselves, that is to say, that do not have recourse to an intermediary institution. On account of the more stringent operational and technical requirements involved, only a small group of institutions can be considered for fine-tuning operations. A key selection criterion is a credit institution's activity in the money market or the foreign exchange market. At present, the Bundesbank could, in case of need, call on a maximum of 39 counterparties for purely euro-denominated money market operations and 15 for possible money market operations involving foreign currencies (currency swaps); in the Eurosystem as a whole the corresponding figures at the end of 2004 were 136 and 71 institutions respectively. Although the number of counterparties has declined in the wake of the ongoing mergers in the banking industry, participation in the main and longer-term refinancing operations has increased since changes were implemented to the Eurosystem's monetary operational framework in March 2004 (see table on page 118).

Main and longer-term refinancing operations

In 2004, around 77% of the refinancing requirements were met through the weekly main refinancing operations (main tenders). All 52 main refinancing operations were conducted as variable rate tenders with a minimum bid rate of 2.00% using a multiple rate procedure. The amount outstanding in the Eurosystem averaged €241.6 billion over the year, just over half of which (€123.9 billion) was accounted for by counterparties of the Bundesbank. A total of 12 longer-term refinancing operations each with a pre-announced volume of €25 billion were conducted in 2004. The transactions were executed as American-style variable rate tenders with no minimum bid rate. The volume outstanding in the Eurosystem averaged €70.2 billion over the year, ie around 23% of the aggregate refinancing needs. The German share averaged around 67%. To take account of the expected higher need for liquidity in the euro-area banking sector in 2005, the Governing Council of the ECB decided to increase the amount allotted in all longer-term refinancing operations carried out in 2005 to €30 billion.

Fine-tuning operations

To even out liquidity imbalances at the end of reserve maintenance periods, three fine-tuning operations were conducted in 2004 using a quick tender procedure. On 11 May 2004 and on 7 December 2004, excess liquidity was absorbed for one day from the market through the collection of fixed-term deposits; on 8 November 2004 a reverse transaction was conducted to inject liquidity into the market.

Standing facilities

On a calendar-day average in 2004 (as in 2003), institutions took little recourse to the relatively expensive marginal lending facility, borrowing €0.2 billion in the Eurosystem as a whole (€0.1 billion at the Bundesbank). Major recourse on individual days was mainly taken to cover individual liquidity shortages at the end of the reserve maintenance periods. Owing to the relatively low rate of interest paid, the credit institutions used the deposit facility as a rule only when they had unexpected excess liquidity, generally at the end of a reserve maintenance period. On an annual average, this facility was used as little as in 2003 (€0.2 billion in the Eurosystem as a whole and €0.1 billion at the Bundesbank).

Range of assets eligible as collateral for refinancing operations

Assets which the Bundesbank deems eligible for the Eurosystem's monetary policy operations are, pending the eventual introduction of a single collateral list, divided into two categories: tier one assets and tier two assets. The list of assets eligible as collateral for refinancing operations is published on the ECB's website. At the end of December 2004, the outstanding volume of such marketable eligible assets posted there was just under €7,900 billion. Around one-third of that amount was accounted for by eligible assets listed or held in Germany.

Volume of eligible assets pledged to the Bundesbank

At the end of 2004 counterparties had eligible assets totalling €482 billion pledged in their collateral pools at the Bundesbank as cover for refinancing operations and intraday loans. That figure included €204 billion of assets made available across national borders for refinancing purposes at the Bundesbank. Some 35% of the assets pledged to the Bundesbank were covered bank debt securities (Pfandbriefe). One-quarter was accounted for by government bonds and just under one-third by uncovered bank debt securities. Just under one-tenth of the total was made up of other marketable assets and lending to the private sector.

Single list of collateral – policy decisions for securities and bank loans

With a view to introducing a single list of collateral, the ECB Governing Council decided in 2004 to expand the category of tier one assets as from 30 May 2005 to include previously ineligible euro-denominated debt instruments issued by entities established in those Group of Ten (G10) countries that are not a part of the European Economic Area (EEA). Furthermore, securities which hitherto have been exclusively traded on non-regulated markets and are currently therefore usually eligible as tier two assets are to be integrated into the category of tier one assets. As a further step, the Governing Council has decided that bank loans may be included in the single list of collateral. The Eurosystem is still working out the numerous details of the criteria on this issue. It was also decided that equities (only tier two assets) will not be included in the singe list of collateral.

Positioning of the foreign reserve asset portfolios

In managing the Bundesbank's and ECB's foreign reserve assets, the aim is to at least match or outperform the return of a benchmark portfolio for each respective currency by way of limited management of duration and yield curve positions. Each year, the Bundesbank's Executive Board sets the benchmark for the Bundesbank's reserves in line with risk control criteria. Each month, the Executive Board of the ECB sets the benchmark for the ECB reserves in line with medium-term considerations. The portfolios are managed in line with the decisions made in the respective investment committees. In addition, the front office is allowed a marginal degree of operational discretion. The investment committees and the front office are supported by continuous assessments of macroeconomic developments and financial market and portfolio analyses. Adherence to these discretionary bounds is monitored daily by the risk controlling unit.

V The Bundesbank's involvement in the issuance of Federal securities; asset management and central bank services

As the Federal Government's fiscal agent, the Bundesbank carries out various tasks relating to the issuance and settlement of Federal securities. In 2004 the Bundesbank continued to conduct auctions of Federal securities on behalf of the German Finance Agency (Federal Republic of Germany – Finance Agency GmbH) and for the account of the Federal Government, was involved in sales of Federal tap issues and carried out price-smoothing operations on the German stock exchanges.

Issuance of Federal securities by auction

Federal bonds (Bunds), five-year Federal notes (Bobls), Federal Treasury notes (Schätze) and Treasury discount paper (Bubills) are issued by auction through the Bund Issues Auction Group. The issue volume of the 34 auctions carried out in 2004 came to €187.5 billion (2003: €174.5 billion in 35 auctions). The total volume of Bunds issued was €59.0 billion (2003: €64.0 billion), for Bobls it was €36.0 billion (2003: €41.8 billion), two-year Schätze amounted to €59.0 billion (2003: €48.0 billion) and Bubills reached a nominal value of €72.0 billion (2003: €65.3 billion).

Issues of Federal bonds (Bunds) in 2004

Table 19

Issue	Auction date	Amount issued (€ billion)			Terms	
		Total	Amount allotted by auction	Market management amount	Weighted average allotment price (%)	Average yield (% pa)
4.75 % Bund of 2003 (2034)						
ISIN DE0001135226						
Increase	28 Jan	5.0	4.5	0.5	97.48	4.91
Increase	21 July	5.0	4.5	0.5	97.85	4.89
		[1] 10.0				
4.25 % Bund of 2003 (2014)						
ISIN DE0001135242						
Increase	7 Jan	9.0	7.4	1.6	99.76	4.28
Increase	25 Feb	7.0	5.9	1.1	101.23	4.09
		[2] 16.0				
4.25 % Bund of 2004 (2014)						
ISIN DE0001135259	26 May	9.0	7.7	1.3	99.23	4.34
Increase	7 July	8.0	6.7	1.3	99.97	4.25
Increase	18 Aug	8.0	6.6	1.4	101.60	4.05
		25.0				
3.75 % Bund of 2004 (2015)						
ISIN DE0001135267	24 Nov	8.0	6.5	1.5	99.76	3.78

1 Total amount issued: €20 billion.
2 Total amount issued: €24 billion.

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Issues of five-year Federal notes (Bobls) in 2004

Table 20

Issue	Auction date	Amount issued (€ billion)			Terms	
		Total	Amount allotted by auction	Market management amount	Weighted average allotment price (%)	Average yield (% pa)
3.25 % Bobl series 144 of 2004 (2009)						
ISIN DE0001141448	11 Feb	8.0	7.0	1.0	99.27	3.40
Increase	10 Mar	5.0	4.5	0.5	100.60	3.12
Increase	12 May	5.0	4.6	0.4	98.74	3.53
		18.0				
3.50 % Bobl series 145 of 2004 (2009)						
ISIN DE0001141455	25 Aug	8.0	6.9	1.1	100.43	3.41
Increase	6 Oct	5.0	4.5	0.5	100.87	3.31
Increase	17 Nov	5.0	4.5	0.5	102.05	3.04
		18.0				

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Price-smoothing operations

As in previous years, the Bundesbank carried out price-smoothing operations (for the account of the issuers) for Federal securities which are officially listed on the German stock exchanges.

Federal savings notes and Federal Treasury financing paper

In the year under review the Bundesbank continued to be involved, through credit institutions, in selling Federal savings notes and Federal Treasury financing paper issued on tap. In 2004 €1.7 billion was raised from placing Federal savings notes, which have maturities of six and seven years and annually rising interest rates and are sold only to natural persons and non-profit institutions (2003: €1.2 billion). Issues of Federal Treasury financing paper (issued in the form of discount paper) with maturities of one year and two years raised a total of €0.9 billion (2003: €0.8 billion).

BaFin added to third-party portfolio

In the field of third-party portfolio management, the Bundesbank last year prepared the ground for managing the pension provisions of the Federal Financial Supervisory Authority (BaFin) as from the turn of the year.

Planned extension of portfolio management for the Federal Government

In connection with a legislative initiative concerning the funding of pension claims of newly appointed Federal civil servants, the Bundesbank is advising the Federal Government on assuming the associated portfolio management function in the course of 2005. The management of the existing pension reserves of the Federal Government and the Association of German Pension Insurance Funds is aimed at immunising the portfolios against interest rate risks and is implemented by selecting bonds with a maturity profile that matches the expected payment structure of the pension obligations. In its function as the Federal Government's fiscal agent the Bundesbank also advised on investing the assets of charitable foundations.

Central bank services

The services offered by the Bundesbank to foreign central banks, monetary authorities and international organisations in the field of reserve management were restructured in 2004 in line with the Eurosystem's efforts to provide a harmonised range of services. The basis for executing this business are two Guidelines of the European Central Bank, which were published in the Official Journal of the European Union on 13 July 2004 and on 16 December 2004.

Issues of Federal Treasury notes (Schätze) in 2004

Table 21

Issue	Auction date	Amount issued (€ billion) Total	Amount allotted by auction	Market management amount	Terms Weighted average allotment price (%)	Average yield (% pa)
2.75 % Schätze of 2003 (2005)						
ISIN DE0001137040						
Increase	14 Jan	1 5.0	4.3	0.7	100.624	2.41
2 % Schätze of 2004 (2006)						
ISIN DE0001137057	24 Mar	8.0	7.6	0.4	99.797	2.11
Increase	14 Apr	7.0	6.4	0.6	99.363	2.35
		15.0				
2.75 % Schätze of 2004 (2006)						
ISIN DE0001137065	23 June	9.0	8.5	0.5	100.007	2.75
Increase	14 July	6.0	5.1	0.9	100.250	2.61
		15.0				
2.50 % Schätze of 2004 (2006)						
ISIN DE0001137073	22 Sep	9.0	8.4	0.6	99.808	2.60
Increase	13 Oct	8.0	6.9	1.1	100.069	2.46
		17.0				
2.25 % Schätze of 2004 (2006)						
ISIN DE0001137081	8 Dec	7.0	6.7	0.3	99.896	2.30

1 Total amount issued: €12 billion.

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Issues of Treasury discount paper (Bubills) in 2004

Table 22

Issue / ISIN	Auction date	Amount issued (€ billion) Total	Amount allotted by auction	Market management amount	Terms Weighted average allotment price (%)	Average yield (% pa)
January 2004 (DE0001114635)	12 Jan	6.0	4.0	2.0	99.003	1.992
February 2004 (DE0001114643)	16 Feb	6.0	4.0	2.0	99.018	1.962
March 2004 (DE0001114650)	15 Mar	6.0	4.6	1.4	99.031	1.935
April 2004 (DE0001114668)	19 Apr	6.0	4.6	1.4	99.021	1.956
May 2004 (DE0001114676)	10 May	6.0	5.0	1.0	98.936	2.048
June 2004 (DE0001114684)	14 June	6.0	5.4	0.6	98.943	2.113
July 2004 (DE0001114692)	12 July	6.0	5.0	1.0	98.967	2.065
August 2004 (DE0001114700)	16 Aug	6.0	5.0	1.0	98.977	2.044
September 2004 (DE0001114718)	13 Sept	6.0	5.4	0.6	98.950	2.099
October 2004 (DE0001114726)	18 Oct	6.0	5.4	0.6	98.965	2.069
November 2004 (DE0001114734)	15 Nov	6.0	5.4	0.6	98.986	2.107
December 2004 (DE0001114742)	13 Dec	6.0	5.0	1.0	98.956	2.087

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VI The Bundesbank's participation in banking supervision and changes in banking supervision legislation

1 International harmonisation of banking supervision

(a) Activities in the Basel Committee on Banking Supervision

Adoption of Basel II

The Basel Committee adopted the Framework on the new capital rules for banks (Basel II) on 26 June 2004. This new integral supervisory concept comprising the elements of more risk sensitive capital requirements (Pillar 1), the supervisory review process (Pillar 2) and greater transparency through enhanced disclosure (Pillar 3) is intended to make an important contribution to promoting financial system stability. Basel II will come into force on different dates depending on the risk measurement approach chosen: at the end of 2006 for credit institutions opting to apply the Standardised Approach or the Foundation Internal Ratings-Based Approach, and at the end of 2007 for banks using the most advanced approaches to measure their credit risk and operational risk.

Issues for discussion

The Basel Committee is currently still discussing above all trading book issues (together with IOSCO). A key topic in this respect is how to deal with the "double default" effect, ie the acceptance of a lower default risk in the case of loans guaranteed by third parties owing to the improbability that the borrower and the guarantor will default at the same time.

Review of risk weight calibration

The outstanding issues in relation to the new capital rules include the review of risk weights in the Internal Ratings-Based Approaches (IRB Approaches). Studies, in which credit institutions voluntarily identify the impact of future regulatory capital requirements, serve as an essential basis for this. A Fourth Quantitative Impact Study (QIS 4) became necessary owing to several new provisions in the Framework of June 2004, such as the exclusive consideration of unexpected losses in the risk weight functions or additional qualitative standards for the estimation of loss given default. The participating credit institutions submitted their responses between December 2004 and February 2005. The results, which are to be evaluated together with the data from other countries which have also conducted the QIS 4, are to provide information for the review of risk weight calibration, which is to be completed by mid-2006.

Accord Implementation Group (AIG)

The Bundesbank, like BaFin (the Federal Financial Supervisory Authority), is a member of the Basel Committee's Accord Implementation Group (AIG), which is discussing implementation issues regarding Basel II in an intensive exchange of information with banks and associations. This is necessary for both institutions and supervisors owing to the wide scope of discretion with respect to implementation, leading to a need for international coordination. Through promoting cooperation and an exchange of information, for example, regarding supervisory approaches, the planned structure of national options or cross-border cooperation in the licensing and monitoring of internal risk measurement methods, the AIG's goal is to help to strengthen the level playing field and to reduce the implementation costs for internationally operating institutions.

Cross-border cooperation among supervisory authorities

BaFin and the Bundesbank, as home supervisors, will invite relevant host supervisors to attend conferences in Germany in 2005. The aim with regard to the implementation of Basel II is to lay down the details of cross-border cooperation between the supervisory authorities concerned in individual cases.

IAS/impact on regulatory capital

In the area of International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS), supervisors' interest focused on IAS 39 (Financial Instruments: Recognition and Measurement), the recently published Exposure Draft ED 7 (Financial Instruments: Disclosures) as well as the IAS/IFRS-related effects on balance sheet capital, which forms the basis for regulatory capital (core capital and additional capital). The Basel Committee discussed whether and to what extent national supervisory authorities should accept the effects which IAS/IFRS have on regulatory capital. This concerns, for instance, cash flow hedges, available-for-sale securities and the impact of changes in a credit institution's own creditworthiness on the valuation of its liabilities.

Prudential filters to take account of IAS/IFRS effects

The need to take account of the effects which the IAS/IFRS have on regulatory capital is being dealt with at a European and national level, too (development of prudential filters). Although – pursuant to section 10a of the German Banking Act (*Gesetz über das Kreditwesen*) – consolidated supervision in Germany is carried out on the basis of aggregated individual accounts (drawn up in accordance with the German Commercial Code (*Handelsgesetzbuch*)), internationally active banks may additionally calculate their Basel capital ratio on the basis of consolidated financial statements drawn up using IAS or US GAAP. At least in this respect it will be necessary for supervisors to also implement the EU's prudential filters at a national level.

(b) Harmonisation and cooperation in the EU

Establishment of the Committee of European Banking Supervisors

As agreed by the European finance ministers, the Committee of European Banking Supervisors (CEBS), which was established with effect as of 1 January 2004, is based in London. The Committee held its first meeting in Barcelona on 29 January 2004 and began its work immediately.

Advising the European Commission and promoting supervisory convergence

CEBS advises the European Commission on the preparation of directives amending the Codified Banking Directive and the Capital Adequacy Directive, ie the process of implementing Basel II. CEBS has thus, for example, drawn up proposals on the reduction of national discretion in the new Capital Requirements Directive. CEBS' tasks also include promoting the consistent implementation of EC Directives and the convergence of supervisory practices. With regard to the supervisory assessment of intended outsourcing moves and the Supervisory Review Process (SRP), the second pillar of Basel II, CEBS has developed a set of principles and released them for public consultation. This work will provide the credit institutions with an early insight into the implementation of the new provisions and will contribute to supervisory convergence in Europe. Another important area of activity apart from Basel II relates to work on issues regarding the new accounting principles (IAS/IFRS).

(c) Cooperation within the European System of Central Banks

BSC focus on analysing financial stability in the banking sector and extending the agreements on the exchange of information

The focal point of the work carried out by the Banking Supervision Committee (BSC) lies in analysing the stability and structure of the European banking and financial systems. The Committee once again published comprehensive analyses in this field in the year under review. Furthermore, as part of the enlargement of the EU, the two multilateral memoranda of understanding regarding the exchange of information between the European credit registers as well as between EU supervisory authorities and central banks in the event of a crisis were extended to include the new EU member states.

2 Development of the national prudential supervisory standards

"Implementation of Basel II" Working Group

BaFin and the Bundesbank have discussed issues regarding the national implementation of Basel II with the institutions and associations of the German banking industry within the "Implementation of Basel II" Working Group as well as its specialist sub-committees on the "IRBA", "Credit protection techniques", "Operational risk", "Securitisation", "Pillar 2" and "Pillar 3". The aim is to give German credit institutions adequate surety about implementation in view of the fact that the relevant EU legislation has not yet been finalised. The findings of the specialist sub-committees are posted regularly on BaFin's and the Bundesbank's websites.

Licensing of internal ratings-based (IRB) systems

According to a survey conducted by BaFin and the Bundesbank in the summer of 2004, 446 of the 1,000 credit institutions which responded plan to use an IRB Approach for regulatory capital purposes. Of these banks, 239 aim to use the Foundation IRB Approach as of 1 January 2007; 207 intend to use an IRB Approach as of a later point in time. BaFin and the Bundesbank informed all banks about the licensing process for the IRB Approach at the end of 2004 and made available the necessary documentation. All interested banks – with an appropriate level of preparation – can therefore submit applications for an IRB licence forthwith.

Initial assessments of the methodological concepts

In preparation for the IRB Approach approval tests, BaFin and the Bundesbank carried out initial assessments of the methodological concepts in 2004. 25 banks and associations submitted around 80 existing IRB Approach rating systems, or rating systems which were about to be implemented, for appraisal. The assessments of the rating systems submitted revealed that most banks are at a quite advanced stage of preparation and that it thus appears realistic that the IRB Approaches will be widely used as of 2006 already.

Risk management procedures for operational risk (OpRisk)

According to a second survey conducted in August 2004, 133 institutions intend to use the Standardised Approach (TSA) and 61 institutions plan to use the Advanced Measurement Approach (AMA) for operational risk. In order to determine the level of implementation of "internal" Advanced Measurement Approaches and by way of preparation for the licensing procedures, the Bundesbank in cooperation with BaFin launched a further study entitled "Industry action regarding AMA for operational risk" in October 2004 to gain a cross-sectional view of the various possible structures of Advanced Measurement Approaches. The study takes the form of a written questionnaire on around 60 topics and more in-depth on-site discussions at 18 institutions of very different sizes. A summary evaluation is to be published in the summer of 2005.

Supervisory Review Process (SRP) and "Risk-focused supervision" Working Group

Within the framework of the Supervisory Review Process (SRP), the second pillar of Basel II, institutions' capital adequacy and risk management procedures will be scrutinised on the basis of a flexible, qualitative supervisory process. In 2004, BaFin and the Bundesbank set up the "Risk-focused supervision" Working

Group to prepare the framework for the implementation of the SRP. This Working Group also ensures the proper development of the eligibility criteria for the advanced approaches in Pillar 1 and coordinates the development or modification of appropriate instruments and methods for monitoring the institutions in a risk-oriented and resource-saving manner.

Investment Modernisation Act

The Act on the Modernisation of Collective Investment Facilities and the Taxation of Investment Fund Assets (*Gesetz zur Modernisierung des Investmentwesens und zur Besteuerung von Investmentvermögen*) – the Investment Modernisation Act (*Investmentmodernisierungsgesetz*), Federal Law Gazette I, page 2676 – entered into force on 1 January 2004. It translates two directives amending the UCITS Directive (85/611/EEC) into national law and amalgamates the Act on Investment Companies (*Gesetz über Kapitalanlagegesellschaften*) and the Foreign Investment Act (*Auslandsinvestmentgesetz*). The Act's objective is to make Germany more attractive as an investment location through increasing investment opportunities, for example, in hedge funds, and to improve investor protection. Furthermore, the Act contains new provisions regarding the taxation of shares in domestic and foreign mutual funds.

Act Implementing the Financial Conglomerates Directive

The Act Implementing Directive 2002/87/EC of 16 December 2002 (Federal Law Gazette I, page 3610) defines financial conglomerates as groups of enterprises located in both the insurance and the banking and investment services sectors, in which at least one enterprise is subject to supervision. Moreover, for a group to be classified as a financial conglomerate, the enterprises must have considerable aggregated and consolidated operations in both the insurance and the banking and investment services sectors. This can be assumed to be the case if the enterprises' balance sheet total in each sector amounts to at least €6 billion. Responsibility for determining whether a group of enterprises which is active in various sectors is a financial conglomerate lies with BaFin.

Bundesbank's involvement, areas of conglomerate supervision

The Bundesbank is involved in the supervision of German financial conglomerates. This means, in particular, that, irrespective of whether the superordinated enterprise in the conglomerate is an insurance corporation, a credit institution or a financial services institution, all reports must also be submitted to the Bundesbank for processing. The supervision of financial conglomerates in this respect covers the conglomerate's capital adequacy, intra-group transactions and concentrations of risk. Intra-group transactions are transactions in which supervised conglomerate enterprises directly or indirectly draw on the support of other enterprises within the same financial conglomerate to fulfil an obligation.

With regard to concentrations of risk, all exposures which carry a counterparty risk, a credit risk, an investment risk, an insurance risk or a market risk and are large enough to jeopardise the solvency or general financial situation of the conglomerate enterprises, are to be reported.

National measures to improve audit quality, independent supervision of external auditors

In the year under review, the Bundesbank was again involved in shaping the latest developments regarding annual account audits as external auditors' reports will continue to be an important foundation for banking supervision despite the increase in on-site elements in future. The requirements regarding the independence of auditors were tightened in Germany in 2004 as part of the Accounting Legislation Reform Act (*Bilanzrechtsreformgesetz*), whereby a new section 319a of the German Commercial Code lays down more stringent requirements for auditors of publicly traded companies. Moreover, the new Act on the Supervision of External Auditors (*Abschlussprüferaufsichtsgesetz*) has put in place for the first time a watchdog independent of the profession, namely the supervisory commission for external auditors (*Abschlussprüferaufsichtskommission*), a body of independent experts based at the Chamber of Auditors (*Wirtschaftsprüferkammer*) which, in future, will be ultimately responsible for dealing with certain breaches of professional duty committed by auditors.

3 Ongoing banking supervision operations

Slower concentration process

At the end of 2004, 2,400 domestic credit institutions had been registered for supervisory purposes (the figure had been 2,471 at the end of 2003).[1] The net decrease of 71 credit institutions indicates a slowdown in the streamlining of the German banking network for the fifth year in succession (decrease of 257 institutions in 2000, 213 in 2001, 164 in 2002 and 146 in 2003). A total of 96 credit institutions closed down, owing predominantly to mergers; 58 of these institutions were credit cooperatives and 14 were savings banks. The decrease was partly offset by 25 new institutions, mainly commercial banks. The number of financial services institutions fell only slightly to 827 (compared with 1,043 in 2001, 906 in 2002 and 831 in 2003).

Responsibility for ongoing monitoring

Pursuant to section 7 (1) of the Banking Act, the Bundesbank is responsible for the ongoing monitoring of credit institutions and financial services institutions.

1 Credit institutions pursuant to section 1 (1) of the Banking Act (including institutions which are in liquidation or being wound up). For systematic reasons, all 45 securities trading banks are also included here although 36 of these institutions provide only financial services.

Ongoing monitoring of institutions

Table 23

Number of operations conducted

Item	2002	2003	2004
Individual reports pursuant to sections 13 to 14 of the Banking Act	206,971	153,035	186,754
Single borrowers listed in the summary reports submitted pursuant to sections 13 to 14 of the Banking Act	2,314,292	1,832,038	2,126,336
Reports pursuant to sections 24 and 24a of the Banking Act	47,585	44,561	47,002
Monthly returns and other data pursuant to sections 25 and 25a of the Banking Act	42,992	40,918	38,558
Reports on the volume of foreign lending (country risk) pursuant to section 25 (3) of the Banking Act	270	370	912
Audit reports on annual accounts	3,378	3,263	3,253
Reports on the auditing of safe custody accounts	614	483	644
Routine, special and deposit guarantee fund audit reports	1,887	1,755	1,678
Audits pursuant to sections 44 and 44c of the Banking Act	69	79	155
Audit reports on the special funds of investment companies	1,431	1,309	1,459
Reports from investment companies on their activities	6,635	6,891	6,606
Reports under Principle I	32,846	29,923	28,907
Reports under Principle II	31,617	28,990	27,789
Audits of internal risk models	8	9	6
Reports under the Basel Capital Accord	76	76	81

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The credit reports, monthly returns, balance sheets and any other information which the institutions submit to the Regional Offices are evaluated and processed there before being transferred to BaFin. BaFin thus obtains the relevant data and supervisory information for its decisions. The table above provides an overview of these activities performed by the Bundesbank’s Regional Offices.

Credit register of loans of €1.5 million or more

The number of loans of €1.5 million or more to be reported quarterly pursuant to section 14 of the Banking Act fell from 30 September 2003 to 30 September 2004 by just over 2% to around 503,600 reports. Nevertheless, the total volume of reported loans of €1.5 million or more increased during this period from almost €7.0 trillion to around €7.1 trillion on the reporting date of 30 September 2004 (the table on page 132 shows the figures since 1998). At this date, 2,547 credit institutions and financial services institutions, 1,271 financial enterprises and 635 insurance corporations had submitted reports on loans of €1.5 million or more. In 2004, a total of 2,311 insolvencies of registered borrowers were recorded (459 cases or 16.6% fewer than in 2003). The volume of loans of €1.5 million or more reported for insolvent borrowers amounted to around €8.3 billion (-30%)

Credit register of loans of €1.5 million or more

Table 24

Third quarter	Volume of loans of €1.5 million or more		Number of loans of €1.5 million or more reported		Number of reporting		
	€ billion	Change (%)	Number	Change (%)	institutions [1]	financial enterprises	insurance corporations
1998	4,790	+ 16.3	464,507	+ 4.1	3,496	963	607
1999	5,662	+ 18.2	484,443	+ 4.2	3,355	900	626
2000	6,487	+ 14.6	509,567	+ 5.2	3,129	993	645
2001	7,087	+ 9.2	525,020	+ 2.9	2,946	955	644
2002	7,161	+ 1.0	526,552	+ 0.3	2,777	1,075	621
2003	6,995	– 2.3	514,433	– 2.3	2,624	1,174	633
2004	7,118	+ 1.8	503,632	– 2.3	2,547	1,271	635

1 Credit institutions and financial services institutions.

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Lenders' access to data

Since December 2004, the Bundesbank has offered lenders the opportunity to access stored data on borrowers, borrower units and lenders online via the Bundesbank's ExtraNet. The Working Group on Credit Registers, which reports to the ESCB's Banking Supervision Committee, has pushed ahead with work on the cross-border data exchange among EU credit registers to be launched in 2005.

Bundesbank audits of banking operations and models

The Bundesbank performed the first audits of the "Minimum requirements for the credit business of credit institutions" (organisation of credit business) at credit institutions on the basis of section 44 (1) sentence 2 of the Banking Act starting in the middle of 2004. In the same year, a total of 66 audits of the "Minimum requirements for the trading activities of credit institutions" were carried out with a special focus on risk controlling, risk management and the separation of functions. In addition, the Bundesbank performed six audits of internal market risk models in 2004.[1]

Principle I and capital ratios

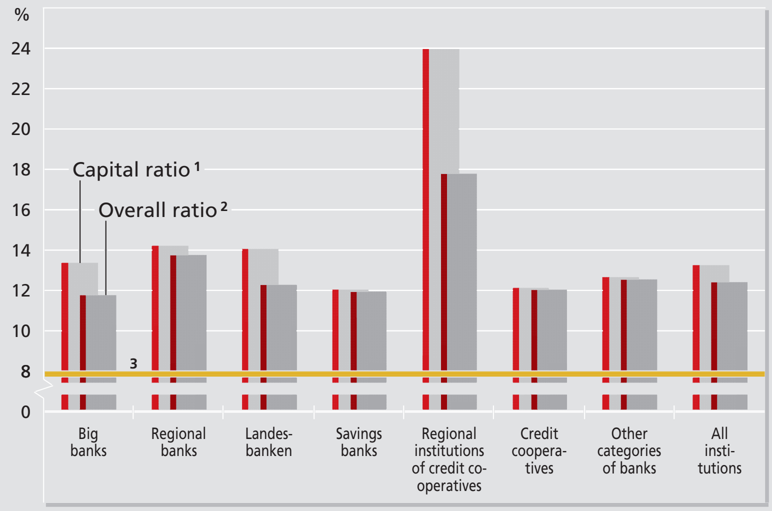
On 31 December 2004, the capital ratio pursuant to sections 10 and 10a of the Banking Act and Principle I – which reflects the ratio of risk-weighted assets to liable capital – of single institutions was 13.3% on average (2003: 13.4%). Groups of institutions/financial holding groups submitting Principle I reports on a consolidated basis had an average ratio of 12.5% (2003: 12.7%). The average overall ratio – which gives the ratio of all positions that have to be backed by capital to eligible own funds – of institutions reporting on an individual basis was 12.4% on 31 December 2004 (2003: 12.5%). Groups of institutions/finan-

1 These audits, which were mostly divided into several parts, were performed pursuant to section 44 of the Banking Act in conjunction with section 10 (1c) of the Banking Act and section 32 (3) sentence 2 of Principle I.

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

Chart 26

End-2004 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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cial holding groups had an average overall ratio of 11.5% (2003: 11.5%). At 92%, risk-weighted assets accounted for the largest share of risk positions to be backed by capital. The average capital ratios and overall ratios of various types of German banks are shown in Chart 26.

Principle II/ liquidity ratios

On 31 December 2004, 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 1.36 (2003: 1.36). Chart 27 shows the average liquidity ratios of various types of German banks on 31 December 2004 and a comparison with 2003. Differences in the liquidity ratio level could be the result of structural differences in the refinancing operations of each individual type of bank.

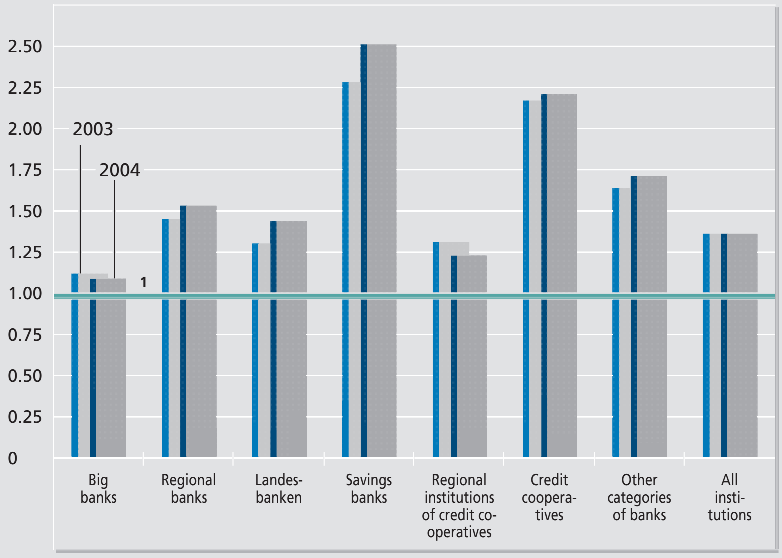
Prudential discussions

Prudential discussions – be they routine or ad hoc – are a key instrument of ongoing monitoring activities which the Bundesbank has been using more and more since 2004. These discussions have proven to be a means of obtaining up-to-date information about the general condition and prospects of an institution. They are also welcomed without exception by the institutions. The aim is to conduct an annual prudential discussion if possible with every institution in future.

Liquidity ratio of individual institutions submitting Principle II reports *

Chart 27

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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VII UN/EU financial sanctions: new developments

New EU financial sanctions

During the period under review, restrictions on the movement of capital and payments were newly imposed in support of the International Criminal Tribunal for the former Yugoslavia (ICTY), on Liberia and on Sudan.

Sanctions to support the ICTY

To support the effective implementation of the ICTY's mandate, the EU adopted financial sanctions against certain persons indicted by the ICTY.[1] The funds and economic resources of these persons shall be frozen, and no funds shall be made available to these parties. The list of persons concerned was changed twice during the period under review.[2]

1 Council Regulation (EC) No 1763/2004 of 11 October 2004, OJ EU L 315/14.
2 Last amended by Commission Regulation (EC) No 2233/2004 of 22 December 2004, OJ EU L 379/75.

Sanctions against Liberia

The financial sanctions imposed against Liberia by the United Nations (UN) were implemented via Council Regulations (EC) No 234/2004[1] and 872/2004.[2] They include a ban both on the financing of military activities and on making financial or economic resources available to certain persons and organisations. All funds and economic resources of this group of persons shall be frozen. The list of persons and organisations affected by these measures was amended three times during the period under review.[3]

Sanctions against Sudan

For the first time, the EU imposed financial sanctions on Sudan.[4] They prohibit the direct or indirect provision of financing or financial assistance related to military activities.

Sanctions against Zimbabwe and the Federal Republic of Yugoslavia

The EU financial sanctions against Zimbabwe were extended and are now based on Council Regulation (EC) No 314/2004.[5] Financial sanctions against the Federal Republic of Yugoslavia,[6] which were limited to Slobodan Milosevic and 12 other people on 21 June 2001,[7] continue to apply.

The following legal acts imposing financial sanctions saw changes in the lists of persons, groups and entities affected.

Change to the list of parties affected by legal acts imposing financial sanctions

– Financial sanctions against persons and entities associated with Usama bin Laden, the Al-Qaida network and the Taliban;[8]

– Financial sanctions against Iraq;[9] and

– Financial sanctions against Burma/Myanmar.[10]

1 Of 10 February 2004, OJ EU L 40/1.
2 Of 29 April 2004, OJ EU L 162/32.
3 Most recently by Commission Regulation (EC) No 1580/2004 of 8 September 2004, OJ EU L 289/4.
4 Council Regulation (EC) No 131/2004 of 26 January 2004, OJ EU L 21/1.
5 Council Regulation (EC) No 314/2004 of 19 February 2004, OJ EU L 55/1.
6 Council Regulation (EC) No 2488/2000 of 10 November 2000, OJ EC L 287/19.
7 Commission Regulation (EC) No 1205/2001 of 19 June 2001, OJ EC L 163/14.
8 Council Regulation (EC) No 881/2002 of 27 May 2002, OJ EC L 139/9; list of designated persons and entities last amended by Commission Regulation No 2145/2004 of 15 December 2003, OJ EU L 370/6.
9 Council Regulation (EC) No 1210/2003 of 7 July 2003, OJ EU L 169/6; list of designated persons and entities last amended by Commission Regulation No 1086/2004 of 9 June 2004, OJ EU L 207/10.
10 Council Regulation (EC) No 1081/2000 of 22 May 2000, OJ EC L 122/29; list of designated persons and entities last amended by Commission Regulation (EC) No 2297/2003 of 23 December 2003, OJ EU L 340/37.

The persons and entities covered by the Council Regulation combating terrorism[1] are defined by the Council through a separate Decision, the most recent having been taken on 2 April 2004.[2]

Lifting of UN sanctions against Libya

The UN financial sanctions against Libya (section 69n of the Foreign Trade and Payments Regulation) that had been suspended since 1999 were lifted permanently with effect from 16 December 2004.[3]

VIII Research Centre

Goals and effects of monetary policy are key focus of research

The work of the Research Centre has various focal points that are reflected in the research programme, the variety of academic publications and the conferences organised by the centre. Of the 47 discussion papers published in 2004, around half dealt with issues concerning monetary policy transmission and the monetary policy strategy. Around half of the 36 publications in academic journals or anthologies addressed the same issues. In addition, in the year under review the Research Centre hosted a conference on "Real-Time Data and Monetary Policy" which examined the special problems faced by monetary policy makers in relying on data that are fraught with measurement bias.

Other focal points include real economic developments ...

The second focal point of the Bundesbank's staff research activities deals with long-term real economic developments in Germany and Europe and their implications for the central bank. This includes studies on the outlook for growth. In the past year, the centre published several papers asking to what extent innovative enterprises, which play a key role in growth, are confronted with special problems in procuring finance and how these problems may be remedied. This was also the topic of the sixth Bundesbank Spring Conference. In addition, the research on real economic developments includes studies on a range of issues relating to the increasingly international structure of the German economy. One area of special focus is German companies' investment in other countries and, conversely, foreign companies' investment in Germany. Such work is typified by research papers on the determinants of such investment. They often permit an-

1 Council Regulation (EC) No 2580/2001 of 27 December 2001, OJ EC L 344/70.
2 Council Decision (EC) No 2004/306/EC, OJ EU L 99/28.
3 67th Regulation amending the Foreign Trade and Payments Regulation of 7 December 2004, Federal Gazette No 238, p 24209.

swers to key economic policy questions such as effects on the labour markets, the reverse impact of changes in taxation regimes or implications for international economic integration. Such issues were also discussed at a conference on "Multinationals and International Integration" which was hosted jointly by the Research Centre and the Kiel Institute for World Economics.

... and stability of the financial system

Questions concerning the stability of the German financial system are an additional focal point of research. In particular, the Bundesbank intensified its research in the field of banking supervision in 2004. Studies on the structure and stability of the banking sector, issues relating to the profitability and efficiency of credit institutions, the economic determinants of consolidation within the German banking sector and the procyclical effects of Basel II on bank lending deserve special mention here. The bank-oriented research examined the determinants of difficulties faced by banks in Germany and developed stress tests for the German banking system. The Bundesbank's activities also focused on the mathematical and econometric modelling of banks' credit risk, examples being studies on the asset correlations of German enterprises, the determinants of the loss given default of bank loans and the development of a quantitative credit risk indicator for unquoted banks.

Finally, some papers address ways of improving forecasting methods. Among other things, the macroeconomic structural model was converted to seasonally adjusted data in order to further improve the integration of the model in the ESCB's forecasting process.

Scientific Advisory Council ...

There were several personnel changes in the Scientific Advisory Council in 2004. Professor Charles Goodhart of the London School of Economics and Professor Jürgen Wolters of the Free University of Berlin were newly appointed to the Council. Professor Axel Weber left the council upon appointment to the post of President of the Bundesbank and Professor Peter Kugler of the University of Basle left at the end of his term.

... and networks

In 2004 the Research Centre was involved in various research networks. Several staff members participated in a large research association of the ECB and the ESCB national central banks that is intended to obtain a better understanding of persistence in the euro-area inflation process and thus to improve the ability to gauge the impact of monetary policy. Networks with some other national central banks in Europe exist as well. Finally, an intensive exchange with external researchers is taking place involving studies using microdata on corporate balance sheets and FDI maintained by the Bundesbank for research purposes. Around one-third of Bundesbank staff discussion papers last year were written in collaboration with non-Bundesbank researchers.

IX Technical central bank cooperation

Continued high level of worldwide interest in technical central bank cooper-ation

As in previous years, the Bundesbank's support for countries in transition, emerging market economies and developing countries in setting up and developing market-oriented central bank systems met with great interest throughout the world in the year under review. Some 2,600 central bank staff members from over 70 countries took part in around 300 training and advisory activities in Germany and abroad in 2004. As in previous years, the Bundesbank's technical central bank cooperation activities concentrated mainly on the new EU member states and EU accession countries, Russia and the other former Soviet Union states, and China. There was hence a marked increase in the volume of training provided in the area of technical central bank cooperation compared with the previous year. Besides the general growth in demand from all parts of the world, this was primarily the result of the Bundesbank's greater involvement in European Union (EU) assistance programmes in other European countries. Despite the significant year-on-year rise, it was, as in the past, not possible to fully meet the demand from foreign central banks for technical central bank cooperation services. Since the Technical Central Bank Cooperation Division was established in 1992, over 17,500 central bank professionals from all over the world have attended some 1,900 Bundesbank training events in Germany and abroad. The high demand for technical central bank cooperation from the Bundesbank is expected to continue in the coming year.

In its technical central bank cooperation activities, the Bundesbank continued to use its wide range of well-established and, in some cases, highly flexible tools. A new development is its involvement in EU twinning projects.

EU twinning projects

These EU-financed projects are intended to strengthen the institutional structures in the new EU member states and in countries aspiring to join the EU. Unlike "traditional" technical central bank cooperation, the Bundesbank does not act autonomously in this regard; rather, it operates in accordance with EU rules and regulations. Its main involvement was in four EU twinning projects with the Czech Republic. Banking supervision, financial stability and auditing were the key issues tackled with the Czech central bank. Given the pace of European integration, there is likely to be an increase in EU twinning projects for central banks over the coming years.

TACIS programme for the Bank of Russia

Together with eight other national central banks and the ECB, the Bundesbank is currently running what is now the third TACIS (Technical Assistance to the Commonwealth of Independent States) programme for the Bank of Russia. This is also an EU assistance programme, which is, however, directed exclusively at the former Soviet Union states with the exception of the Baltic countries. The aim of the third TACIS programme is to train Bank of Russia staff in banking supervision.

X Organisation and staff

Further staff cuts following the Bundesbank's structural reform

In 2004 the Bundesbank made further progress in pursuing its reform concept aimed at streamlining its structure. The number of core staff fell by 1,070 (or around 7.6%) to 12,959, with the branch network being most affected.

Refinement of the staffing concept accompanying the structural reform

The staffing concept accompanying the Bundesbank's structural reform was further refined to support the branch strategy and ongoing restructuring of the Bundesbank. By using instruments to promote mobility and specific further training measures, staff are being equipped to assume new tasks that will last into the future. Besides internal retraining measures, greater consideration was also given to external placement. Staff who, for personal reasons, are unable to accept a position at another Bundesbank location will be given personal assistance to find a new job. As far as reducing the number of staff is concerned, in the year under review a further 500 staff took advantage of the early retirement scheme agreed with the staff representative body for those to whom the wage agreements apply.

Number of openings for trainees fall owing to the reform

Since fewer staff will be needed in the future, far fewer trainee civil servants began training during the year under review than in previous years (181 compared with 272 in 2003).

Bundesbank staff on 31 December 2004 *

Table 25

Item	Staff numbers 1				Year-on-year changes			
	Total	Regional Offices	Branches	Central Office	Total	Regional Offices	Branches	Central Office
Civil servants	6,109	1,781	2,530	1,798	– 265	– 25	– 261	+ 21
Salaried staff	6,682	1,641	3,326	1,715	– 875	– 79	– 741	– 55
Wage earners	623	214	265	144	– 35	–	– 32	– 3
Total	13,414	3,636	6,121	3,657	– 1,175	– 104	– 1,034	– 37
of which								
Trainee civil servants/other trainees 2	455	127	125	203	– 105	– 24	– 95	+ 14
Core staff	12,959	3,509	5,996	3,454	– 1,070	– 80	– 939	– 51
of which								
Staff with permanent contracts	12,843	3,495	5,953	3,395	– 764	– 70	– 613	– 81
Staff with temporary contracts	116	14	43	59	– 306	– 10	– 326	+ 30
Memo item								
Core staff pro rata (Full-time equivalent)	12,132.9	3,293.8	5,539.1	3,300.0	– 1,061.2	– 90.7	– 909.1	– 61.4

	End-2004	End-2003
* Not included:		
Members of staff on secondment for 12 months or more	121	119
Members of staff on unpaid leave	582	612
Members of staff in the second phase of the partial retirement scheme	400	374
1 *Of which* part-time employees	1,948	1,965
2 Other members of staff undergoing training: civil servants changing their career path	43	31

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The Bundesbank's involvement in the training pact

As in previous years, there were again far more commercial training vacancies at the Bundesbank than were needed to ensure an intake of junior staff (274). The Bank is therefore taking part 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, 83 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.

Part-time work

The Bundesbank is endeavouring to comply as far as possible with its employees' wishes regarding part-time work. At around 15%, part-time employment was up slightly on the previous year (14%). If part-time and full-time employees are taken together on the basis of their contractual working hours, the Bundesbank had the equivalent of around 12,133 full-time employees (in 2003 the number was 13,194, ie staff figures decreased by approximately 8%).

Partial retirement

On 31 December 2004, 900 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 400 employees in the second pre-retirement phase.

Project management qualification

In order to provide project managers with increasingly vital project management skills, a training and qualification programme geared towards the Bundesbank's needs was introduced involving both on and off-the-job training.

Internationalisation of further training in banking supervision

In addition, training and qualification programmes in banking supervision were continued and extended in 2004. This means that this was the third year in which training measures for Basel II auditors took place. These were complemented by internationally oriented specialist programmes conducted in English that are also open to staff from other European central banks and banking supervisory authorities.

XI 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]

- Dr Jürgen Stark, Vice-President
  Alternate, Board of Directors, BIS[1]
  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[2]
  Member of the Credit Committee, Liko-Bank[2]
  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[2]
  Member of the Administrative Council, BaFin

1 *Ex officio.*
2 Partnership agreement.

- Dr Hans Reckers
  Alternate, Administrative Council, Liko-Bank[1]

- Professor Hermann Remsperger
  Chairman of the Board of Trustees, Monetary Stability Foundation

- Professor Franz-Christoph Zeitler
  Alternate, Administrative Council, Liko-Bank[1]
  Alternate, Credit Committee, Liko-Bank[1]

1 Partnership agreement.

Annual accounts
of the Deutsche Bundesbank
for 2004

I Balance sheet of the Deutsche Bundesbank as at 31 December 2004

Assets

				31.12.2003
			€ million	€ million
1	Gold and gold receivables		35,495	36,533
2	Claims on non-euro-area residents denominated in foreign currency			
	2.1 Receivables from the IMF	6,548		(7,609)
	2.2 Balances with banks, portfolio investment, external loans and other external assets	29,292		(32,538)
			35,840	40,147
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	143,005		(129,912)
	5.2 Longer-term refinancing operations	47,318		(32,279)
	5.3 Fine-tuning reverse operations	—		(—)
	5.4 Structural reverse operations	—		(—)
	5.5 Marginal lending facility	109		(89)
			190,432	162,280
6	Other claims on euro-area credit institutions denominated in euro		3	2
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		(1,225)
	9.2 Claims arising from the transfer of foreign reserves to the ECB	11,762		(12,247)
	9.3 Claims related to the allocation of euro banknotes within the Eurosystem (net)	—		(—)
	9.4 Other claims within the Eurosystem (net)	7,793		(4,221)
			20,737	17,693
10	Items in course of settlement		39	34
11	Other assets			
	11.1 Coins	514		(458)
	11.2 Tangible and intangible fixed assets	1,837		(1,977)
	11.3 Other financial assets	2,669		(2,494)
	11.4 Off-balance-sheet instrument revaluation differences	—		(—)
	11.5 Accruals and prepaid expenses	649		(722)
	11.6 Sundry items	316		(359)
			5,985	6,010
			293,272	267,439

Liabilities

				31.12.2003
			€ million	€ million
1	Banknotes in circulation		136,342	121,369
2	Liabilities to euro-area credit institutions related to monetary policy operations denominated in euro			
	2.1 Current accounts	41,218		(44,523)
	2.2 Deposit facility	96		(75)
	2.3 Fixed-term deposits	—		(—)
	2.4 Fine-tuning reverse operations	—		(—)
			41,314	44,598
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		(58)
	4.2 Other liabilities	355		(497)
			392	556
5	Liabilities to non-euro-area residents denominated in euro		5,903	7,650
6	Liabilities to euro-area residents denominated in foreign currency		4	8
7	Liabilities to non-euro-area residents denominated in foreign currency		2,021	2,785
8	Counterpart of special drawing rights allocated by the IMF		1,380	1,426
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)	63,392		(44,590)
	9.3 Other liabilities within the Eurosystem (net)	—		(—)
			63,392	44,590
10	Items in course of settlement		3	1
11	Other liabilities			
	11.1 Off-balance-sheet instruments revaluation differences	—		(—)
	11.2 Accruals and income collected in advance	303		(154)
	11.3 Sundry items	2,834		(4,388)
			3,137	4,543
12	Provisions		5,907	5,603
13	Revaluation accounts		27,801	29,063
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		676	248
			293,272	267,439

II Profit and loss account of the Deutsche Bundesbank for the year 2004

				2003
			€ million	€ million
	– Interest income	4,903		(4,867)
	– Interest expense	– 1,742		(– 1,586)
1	Net interest income		3,161	3,281
	– Realised gains/losses arising from financial operations	191		(544)
	– Write-downs on financial assets and positions	– 2,389		(– 2,328)
	– Transfers to/from provisions for general risks, foreign exchange risks and price risks	224		(274)
2	Net result of financial operations, write-downs and risk provisions		– 1,974	– 1,511
	– Income from fees and commissions	59		(58)
	– Expense relating to fees and commissions	– 11		(– 11)
3	Net income from fees and commissions		48	47
4	Income from participating interests		35	201
5	Net result arising from allocation of monetary income		– 461	– 91
6	Other income		1,314	54
7	**Total net income**		2,122	1,982
8	Staff costs		935	1,000
9	Other administrative expenses		224	263
10	Depreciation on tangible and intangible fixed assets		178	172
11	Banknote printing		53	82
12	Other expenses		56	217
13	**Profit for the year**		676	248

Frankfurt am Main, 23 February 2005

DEUTSCHE BUNDESBANK

Executive Board

Professor Axel Weber — Dr Jürgen Stark

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

III Unqualified auditors' report for statutory audits of annual financial statements

Auditors' report

We have audited the annual financial statements, together with the bookkeeping system, of the Deutsche Bundesbank for the financial year from 1 January 2004 to 31 December 2004. 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 *[in Deutschland] (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 the generally accepted accounting principles and the principles for the accounting of the Deutsche Bundesbank are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Deutsche Bundesbank and evaluations of 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, the annual financial statements give a true and fair view of the net assets, financial position and results of operations of the Deutsche Bundesbank in accordance with generally accepted accounting principles and the principles for the accounting of the Deutsche Bundesbank.

Frankfurt am Main, 15 March 2005

PwC Deutsche Revision
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Borgel — ppa. 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.

Cash/settlement approach
Recording of spot transactions in gold, foreign currency instruments and securities in the Bundesbank's accounts 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 must be converted at the mid-market rate at the end of the year and reversed at the same rate. Realised gains and losses 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.

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

Gains and losses arising from off-balance-sheet instruments shall be recognised and treated in a similar manner to on-balance-sheet instruments.

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 (former) Central Bank Council of the Deutsche Bundesbank decided to adopt those principles as the "accounting principles of the Deutsche Bundesbank"[1] (decision of 3 December 1998, amended by the decisions of 9 March 2000 and 28 December 2002 as well as by that of the Executive Board of 18 December 2002). 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 12 national central banks of the euro-area countries, which together comprise the Eurosystem, have been issuing euro banknotes since 1 January 2002. 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 12 national central banks in proportion to their paid-up shares in the capital of the ECB. The Bundesbank, which has a 29.6% share in the paid-up capital of the ECB, therefore has a 27.2% share 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

1 Published as a revised edition in Bundesbank Notice No 10001/2003 of 14 January 2003.
2 Decision of the European Central Bank of 6 December 2001 on the issue of euro banknotes (ECB/2001/15).

circulation also gives rise to remunerated intra-Eurosystem balances.[1] If the 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 current main refinancing operations rate.

From 2002 until 2007 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 period between July 1999 and June 2001 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 will be reduced in annual stages until the end of 2007, after which income on banknotes will be allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital. 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 in the form of an interim quarterly distribution of profit in the same financial year as the income arose at the ECB.[2] It is distributed in full in proportion to the paid-up shares of the national central banks of the Eurosystem in the ECB capital unless the ECB's net profit for the year is less than the income earned on euro banknotes in circulation. For the financial year 2004 all of the ECB's income from the banknotes allocated to it will be required to cover losses which have essentially arisen from the market-related valuation of US dollar holdings at

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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).
2 Decision of the European Central Bank of 21 November 2002 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/2002/9).

31 December 2004. The interim profit distributed for 2004 has therefore been transferred back to the ECB. Pursuant to Article 33.2 of the ESCB Statute, the ECB Governing Council has also decided to cover the loss incurred by the ECB with the monetary income allocated to the national central banks in 2004. The shortfall covered by this monetary income is shown in the Bundesbank's profit and loss account under item 5 "Net result arising from allocation of monetary income".

Change in ECB capital key on 1 January 2004 and 1 May 2004

Pursuant to the provisions laid down in Article 29.3 of the ESCB Statute, the key establishing the respective subscriptions of the ESCB national central banks to the ECB's capital is to be adjusted every five years. At the beginning of 2004 a corresponding adjustment was made for the first time since the establishment of the ECB. This was done on the basis of the EU Council Decision of 15 July 2003 on the statistical data to be used for determining the key for subscription to the capital of the European Central Bank. On 1 January 2004 the Bundesbank's share in the ECB's subscribed capital of €5,000 million changed from 24.5% to 23.4%, and its share in the fully paid-up capital was reduced, accordingly, from 30.2% to 29.4%. Consequently, the "Participating interest in the ECB" shown in asset sub-item 9.1 declined by €54 million to €1,170 million.

A further adjustment was made to the capital key on 1 May 2004 as a result of the accession of ten new member states to the EU. As the ECB's subscribed capital increases proportionally, pursuant to Article 49.3 of the ESCB Statute, whenever new countries accede to the EU, the capital was increased to €5,565 million on 1 May 2004. The Bundesbank's share of the ECB's subscribed capital declined from 23.4% to 21.1%. Owing to the rise from 29.4% to 29.6% in the Bundesbank's share in the ECB's capital fully paid in by the 12 national central banks, sub-item 9.1, "Participating interest in the ECB", increased marginally to €1,176 million. Sub-item 9.1 also reflects the Bundesbank's relative share in the accumulated net profits of the ECB as at 30 April 2004 amounting to €7 million.

Furthermore, the adjustments made to the key for subscription to the ECB's capital on 1 January 2004 and 1 May 2004 led to adjustments in the Bundesbank's claims arising from the transfer of foreign reserves to the ECB (see asset sub-item 9.2, "Claims arising from the transfer of foreign reserves to the ECB"). As a result of the corresponding change in the share in the capital key, these claims initially declined from €12,247 million to €11,702 million on 1 January 2004 and increased again to €11,762 million on 1 May 2004.

Preparation and auditing of annual accounts

The Executive Board drew up the Bundesbank's annual accounts for the financial year 2004 on 23 February 2005. The annual accounts were audited by PwC Deutsche Revision Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Frankfurt am Main, which the Executive Board had appointed as external auditors on 28 January 2004 in accordance with section 26 (3) of the Bundesbank Act. The auditors confirmed without qualification on 15 March 2005 that the Bundesbank's annual accounts for 2004 and its bookkeeping comply with German law and present an accurate picture of the Bundesbank's assets and liabilities, financial position and profitability. After studying the external auditors' report, the Executive Board approved the publication of the annual accounts and set the date of the transfer of the Bundesbank's profit to the Federal Government for 15 March 2005.

V Notes on the individual balance sheet items

1 Assets

Gold and gold receivables

At the end of 2004 the Bundesbank's holdings of fine gold (ozf) amounted to 3,433,259 kg or 110 million ounces. The gold was valued at market prices (1 kg = €10,338.46 or 1 ozf = €321.562). In the year under review the gold holdings declined by 6,283 kg or 0.2 million ounces. This was due to the sale of gold to the Federal Government 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 €6,548 million (SDR 5,746 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

Receivables from the IMF

Table 26

Item	31.12.2004 SDR million	31.12.2004 € million	31.12.2003 SDR million	31.12.2003 € million	Change from previous year SDR million	%	€ million	%
Drawing rights within the reserve tranche (net)	4,419	5,036	5,152	6,069	– 733	– 14.2	– 1,033	– 17.0
Special drawing rights	1,327	1,512	1,307	1,540	+ 20	+ 1.5	– 28	– 1.8
Total	5,746	6,548	6,459	7,609	– 713	– 11.0	– 1,061	– 13.9

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(€14,824 million) and the euro balances amounting to €9,787 million (SDR 8,589 million) at the disposal of the IMF at the end of the year.

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 2004 amounted to €1,512 million (SDR 1,327 million) compared with €1,540 million (SDR 1,307 million) on 31 December 2003.

No loans were granted to the IMF as a result of special credit arrangements under both the General Arrangements to Borrow and the New Arrangements to Borrow in 2004.

SDR-denominated drawing rights in the reserve tranche, special drawing rights and the counterpart of special drawing rights allocated are shown in the balance sheet on the basis of the market rate calculated by the ECB at the end of the year for all central banks participating in the Eurosystem (SDR 1 = €1.1396).

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

The balances with banks, portfolio investment, loans and other foreign currency claims amounted to €29,292 million at the end of 2004 compared with €32,538 million on 31 December 2003. These are almost exclusively US dollar holdings amounting to US$39,100 million (= €28,706 million), representing a decline of US$1,232 million from the previous year. This sub-item also contains holdings in yen (¥81,056 million = €580 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$36,351 million,

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

Table 27

Item	31.12.2004	31.12.2003	Change from previous year	
	€ million	€ million	€ million	%
Current account holdings and overnight deposits	572	735	– 163	– 22.2
Claims arising from reverse repurchase agreements (reverse repos, held in US dollars)	3,613	3,706	– 93	– 2.5
Fixed-term deposits and deposits at notice (held in US dollars)	5,603	5,210	393	7.5
Marketable securities	19,383	22,762	– 3,379	– 14.8
of which: amount held in US dollars	19,178	22,551	– 3,373	– 15.0
Other	121	125	– 4	– 3.2
Total	29,292	32,538	– 3,246	– 10.0

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which is US$467 million down on the year. 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$1.3621 (compared with €1 = US$1.2630 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 income from the investment of this money is at the disposal of a trust fund which is administered by the IMF and from which the debt relief granted by the IMF is financed. The loan has a maturity of ten years.

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

This item reflects the volume and 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 €28,152 million higher than on 31 December 2003.

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 interest rate tenders with a minimum bid rate. At the end of the year the main refinancing operations amounted to €143,005 million, which was €13,093 million more than the level on 31 December 2003 (€129,912 million). On a daily average the main refinancing operations amounted to €123,929 million (2003: €103,322 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 €47,318 million at the end of 2004 and was therefore €15,039 above that of the previous year. On a daily average the volume of longer-term refinancing operations amounted to €46,870 million (2003: €32,214 million).

The marginal lending facility (overnight liquidity) is permanently available at a predetermined interest rate (standing facility). The extent to which recourse to the marginal lending facility was being taken on 31 December 2004 had risen by €20 million since the previous year to €109 million. The extent to which it was being used on a daily average amounted to €130 million (2003: €205 million).

Other claims on euro-area credit institutions denominated in euro

This item contains claims on credit institutions which have no connection with monetary policy operations. These claims are mainly 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 connection 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 ESCB national central banks are the sole subscribers to the capital of the ECB. In accordance with rules laid down in Article 29 of this statute, the key for subscription to the ECB's capital is revised and adjusted every five years. On 1 January 2004 a corresponding adjustment was made for the first time since the establishment of the ECB, and the Bundesbank's subscribed share of the ECB's capital was reduced as a result. The Bundesbank was paid €21 million in compensation for this. The capital key was again adjusted on 1 May 2004 in connection with the accession of ten new member states to the EU. On 31 December 2004 the Bundesbank had a 21.1% share in the ECB's subscribed capital. This share amounted to €1,176 million. Sub-item 9.1 also reflects the Bundesbank's relative share in the accumulated net profits of the ECB as at 30 April 2004 amounting to €7 million. The adjustments to the ECB's capital key are explained in the *General information on annual accounts.*

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. The adjustments to the key for subscribing to the ECB's capital on 1 January 2004 and on 1 May 2004 also resulted in adjustments to the Bundesbank's claims arising from the transfer of foreign reserves to the ECB (see the *General information on annual accounts*). On 31 December 2004 these claims amounted to €11,762 million. As the transferred gold does not earn interest, the claims are remunerated at 85% of the present main refinancing operations rate.

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 2003, the Bundesbank again had no claims at the end of last year 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 current main refinancing rate. At the end of the year the Bundesbank obtained from its assets

Tangible and intangible fixed assets — Table 28

€ million

Item	Purchase/ production costs 31.12.2003	Additions	Disposals	Accumulated depreciations	Book value 31.12.2004	Book value 31.12.2003	Depreciation 2004
Land and buildings	3,225	34	– 125	– 1,477	1,657	1,768	– 97
Furniture and equipment	829	95	– 99	– 656	169	197	– 71
Computer software	96	10	– 7	– 88	11	12	– 10
Total	4,150	139	– 232	– 2,220	1,837	1,977	– 178

Deutsche Bundesbank

and liabilities net claims amounting to €8,010 million (2003: €4,474 million). This item also contains the liabilities arising from the allocation of monetary income to the national central banks amounting to €58 million (see profit and loss item 5 "Net result arising from allocation of monetary income") and the liabilities to the ECB arising from the retransfer of the interim distribution of profit for the first three quarters of the year amounting to €159 million (see *General information on annual accounts*) as they were not settled with the ECB as TARGET payments until January.

Items in course of settlement

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

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 €1,837 million compared with €1,977 million in 2003; it comprises land and buildings, furniture and equipment and computer software.

Sub-item 11.3 "Other financial assets" amounting to €2,669 million contains the Bundesbank's fixed-interest euro assets (€2,617 million) as a counterpart to the pension commitments as well as its participating interests (€52 million). The participating interests are in the Liquiditäts-Konsortialbank GmbH, Frankfurt am Main, the Bank for International Settlements (BIS), Basel, and the cooperative society SWIFT, La Hulpe (Belgium).

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.

The participating interest in the BIS was unchanged at the end of the year and consisted of 47,677 shares from the German issue amounting to the equivalent value of €12 million.

As in 2003, the participating interest in the cooperative society SWIFT amounted to just under €2 million.

Sub-item 11.5 "Accruals and prepaid expenses" contains the accrued and prepaid expenditure identified at 31 December 2004. These chiefly consist of interest income which is due in the new financial year from the transfer of foreign reserves to the ECB, from securities denominated in US dollars and from monetary policy operations acquired or undertaken 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 2004, the Bundesbank had 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 €436,240 million to €501,257 million. In accordance with the allocation key, the Bundesbank shows holdings of euro banknotes worth €136,342 million at the end of the year compared with €121,369 million at the end of 2003. The value of the euro banknotes actually issued by the Bundesbank in the year under review increased from €165,958 million to €199,734. As this was more than the allocated amount, the difference of €63,392 million (2003: €44,590 million) is shown in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)".

Sub-item 2.1 "Current accounts" contains the deposits of the credit institutions, amounting to €41,218 million (31 December 2003: €44,523 million), which are

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

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 €37,887 million (2003: €37,909 million).

Sub-item 2.2 "Deposit facility" amounting to €96 million (31 December 2003: €75 million) contains overnight deposits at a predetermined interest rate (standing facility). On a daily average the deposit facility amounted to €119 million (2003: €169 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 *Land* Governments and other public depositors. The deposits of other public depositors constitute balances held by social security funds and local authorities. On 31 December 2004 general government deposits amounted to €36 million in all (31 December 2003: €58 million).

The deposits of enterprises and individuals are the main items shown in sub-item 4.2 "Other liabilities". At the end of 2004 these deposits amounted to €355 million compared with €497 million on 31 December 2003.

Liabilities to non-euro-area residents denominated in euro

This balance sheet item, amounting to €5,903 million (31 December 2003: €7,650 million) contains primarily the fixed-term deposits of central banks and the working balances held for settling the payments of monetary authorities, commercial banks and international organisations.

Liabilities to euro-area residents denominated in foreign currency

This item contains the US dollar deposits of banks and of branches that are domiciled in the euro area and owned by banks domiciled outside the euro area and those of general 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 essentially liabilities in US dollars, amounting to US$2,710 million (€1,990 million) compared with US$3,513 million (€2,782 million) in 2003, which have arisen from securities repurchase agreements (repos).

The counterpart of the special drawing rights allocated by the IMF free of charge and shown as sub-item 2.1 "Receivables from the IMF" on the assets side of the

Counterpart of special drawing rights allocated by the IMF

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 banknotes allocation key (see liability item 1 "Banknotes in circulation"). At the end of the year these liabilities amounted to €63,392 million (2003: €44,590 million).

The net liabilities balance arising from other assets and liabilities within the Eurosystem would be shown in sub-item 9.3. At the end of the year the Bundesbank incurred 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 settlement transactions circulating within the Bundesbank.

Other liabilities

Sub-item 11.2 "Accruals and income collected in advance" contains the accrued income identified at 31 December 2004. 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" consists mainly of the Deutsche Mark banknotes which are 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. At the end of the year the Deutsche Mark banknotes of the series BBk I/Ia and BBk III still in circulation amounted to a total of €4,027 million compared with €4,311 million at the end of 2003. Of the banknotes of series BBk I/Ia whose recall date of 30 June 1995 was announced on 23 June 1994 a volume worth €1,364 million was still in circulation on the balance sheet day. In accordance with accounting principles, liabilities may be written off provided it is almost certain that no further use will be made of the service concerned. To some extent this applies in the case of the Deutsche Mark banknotes of series BBk I/Ia which are still in circulation and an ever decreasing number of which are presented for exchange. For that reason €1,237 million of the total amount involved was taken off the books at the end of the year (see profit and loss item 6 "Other income"). The amount to be charged off is calculated on a mathematical-statistical basis using monthly rates of return per denomination and taking due account of a 99% confidence interval, a 1% error probability and a forecast horizon of 30 years. Account is also taken of the fact that rates of return tend to be higher for large denominations than for smaller denominations. The calculated amount to be written off therefore ranges from 84% to 98% depending on the denomination; overall, it amounts to 91% of the BBk I/Ia banknotes still in circulation. This procedure draws on the partial writing-off of banknotes issued by the Bank deutscher Länder in the 1970s; at that time most of the resultant liabilities were written off between five and nine years after expiry of the official exchange deadline period, depending on denomination. The recorded value of the Deutsch Mark banknotes still in circulation amounts to €2,790 million after the write-off; the banknotes belonging to the series BBk I/Ia account for €127 million of this. Regardless of the write-off, all banknotes of this series will continue to be redeemed on presentation for an unlimited period.

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 unchanged foreign currency risks, especially in the case of the Bundesbank's US dollar and SDR positions. The €224 million decline in the provisions is due mainly to the year-on-year reduction in the euro value of the US dollar position (see asset item 2.2 "Balances with banks, security investment, external loans and other external assets").

Following an increase of €36 million, the Bundesbank's provisions for direct pensions amount to €2,237 million; the increase is based on an actuarial expert opinion. According to calculations by appropriately qualified experts, indirect pension liabilities arising from the Bundesbank's obligation to act as guarantor for pension payments out of the supplementary pension funds for public sector employees amounted to €406 million on 31 December 2004 (2003: €389 mil-

Provisions

Table 29

Provision for	31.12.2004 € million	31.12.2003 € million	Change from previous year € million	 %
General risk	2,266	2,490	– 224	– 9.0
Pension commitments	2,643	2,590	53	2.0
Pre-retirement part-time work	106	87	20	22.6
Staff restructuring schemes	187	116	71	61.1
Share of ECB loss	402	–	402	.
Other	303	321	– 17	– 5.5
Total	5,907	5,603	304	5.4

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lion). After an increase of €20 million for actuarial reasons a provision of €106 million for pre-retirement part-time work was shown in the balance sheet as of 31 December 2004. The provision for future payment commitments arising from staff restructuring schemes that had already been carried out by the balance sheet day was increased as of 31 December 2004 by €71 million to €187 million.

A provision of €402 million was made to cover the Bundesbank's share of the ECB's loss for the financial year 2004 (see profit and loss item 5 "Net result arising from allocation of monetary income").

The other provisions were created primarily for the threat of losses on the sale of property and for unrealised holidays as well as for doubtful liabilities.

Revaluation accounts

This item contains the disclosed hidden reserves from the initial valuation at the time of the changeover to market valuation on 1 January 1999 (revaluation items "old") and the resultant unrealised profits arising from market valuation on 31 December 2004 (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 dissol-

Revaluation accounts

Table 30

Item	Revaluation items "old" € million	Revaluation items "new" € million	Total 31.12.2004 € million	31.12.2003 € million	Change from previous year € million	%
Gold	19,078	8,300	27,379	28,402	– 1,023	– 3.6
Foreign exchange	–	0	0	0	0	7.0
Securities	–	422	422	661	– 239	– 36.1
Total	19,078	8,722	27,801	29,063	– 1,262	– 4.3

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ution also takes place in the event of net reductions if the end-of-year 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 €35 million in the year under review. The dissolution amount is shown in the profit-and-loss item 2/sub-item "Realised gains/losses arising from financial operations".

Revaluation items "new"

In the case of gold holdings, the net positions in each foreign currency and the securities portfolio the positive difference between their market value on 31 December 2004 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 average acquisition costs carried forward have remained unchanged at 1 ozf = €246.368 since 1 January 1999. At the end of the year the market price for a fine ounce of gold was €321.562, with the result that the market value of the gold position exceeded its acquisition value and a revaluation item amounting to €8,300 million arose (2003: €9,289 million). In the case of the US dollar position the market value at the end of the year (€1 = US$1.3621) was lower than the acquisition value (€1 = US$1.2622), with the result that, as in the previous year, there was no revaluation gain but, instead, a valuation loss; much the same applies to the Bundesbank's yen and SDR holdings (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.

Valuation gains of €320 million arose from the valuation of US-dollar-denominated securities; there were also valuation gains of €101 million arising from the valuation of euro portfolios.

Capital and reserves

In accordance with section 2 of the Bundesbank Act, the liable capital amounts to €2.5 billion. The statutory reserves amount to 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 2004 closed with an annual surplus of €676 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 lower than in the previous year, falling by €121 million to €3,161 million. Of this total amount, €889 million was in foreign currency (primarily foreign reserves) while the euro holdings amounted to €2,272 million (primarily from the use of monetary policy instruments).

Interest income

Interest income in foreign currency declined by €245 million from the previous year. This was due primarily to the lower rate of interest on US dollar assets on an annual average as well as to the depreciation of the US dollar itself. The interest income from gold is derived from gold leasing transactions, which are remunerated in US dollars.

Interest income in euro increased by €281 million from the previous year. Despite the year-on-year decline in interest rates (to 2.0% for main refinancing operations on an annual average and 2.1% for longer-term refinancing operations compared with 2.3% in each case a year earlier), income from the refinancing of credit institutions (€3,537 million) rose by €314 million. The reason for this development was the increased volume of the main refinancing operations (which expanded on an annual average from €103 billion to €124 billion) and the greater volume of longer-term refinancing operations (€47 billion in 2004 on an annual average compared with €32 billion a year earlier).

Interest expenses

Interest expenditure increased year on year by €157 million to €1,742 million, essentially as a result of the €155 million rise in interest paid in euro terms. Ex-

Interest income

Table 31

Item	2004	2003	Change from previous year	
	€ million	€ million	€ million	%
Interest income in foreign currency				
Gold	6	7	– 1	– 19.4
IMF	93	96	– 3	– 3.5
Current account holdings and overnight deposits	1	2	– 0	– 6.7
Reverse repo transactions	67	57	10	17.2
Fixed-term deposits and deposits at notice	64	65	– 2	– 2.4
Marketable securities	682	930	– 248	– 26.7
Other	2	2	0	11.2
Total	915	1,160	– 245	– 21.1
Interest income in euro				
Main refinancing operations	2,553	2,405	148	6.2
Longer-term refinancing operations	980	812	169	20.8
Fine-tuning operations	0	–	0	.
Marginal lending	4	7	– 3	– 42.2
TARGET balances in the ESCB	94	95	– 1	– 1.6
Claims arising from the transfer of foreign reserves to the ECB	205	244	– 40	– 16.3
Financial assets	98	89	9	9.9
Other	55	56	– 1	– 1.8
Total	3,988	3,707	281	7.6
Grand total	4,903	4,867	36	0.7

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penditure on remunerating the minimum reserve volume, which was almost unchanged from the previous year, declined by €113 million as a result of the lower average interest rate of 2.0% (2003: 2.3%). In the case of settlement payments in the Eurosystem, expenditure on remunerating intra-Eurosystem liabilities arising from the allocation of euro banknotes increased by €342 million owing to the rise in the euro banknotes in circulation (see *General information on annual accounts* and liability item 1 "Banknotes in circulation").

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

The sub-item "Realised gains/losses arising from financial operations" amounted to €191 million compared with €544 million in 2003. In the case of foreign currency there were realised gains arising from the disposal of US dollars (€11 million) and SDRs (€21 million). The realised gains from gold also include the partial dissolution (€35 million) of the revaluation item "old" created on 1 January 1999 (see liability item 13 "Revaluation accounts"). This partial dissolution was due to the disposal of gold.

Most of the valuation losses of €2,389 million recorded in the sub-item "Write-downs on financial assets and positions" occurred in the US dollar position (€2,106 million) and the SDR position (€185 million).

Interest expenditure

Table 32

Item	2004	2003	Change from previous year	
	€ million	€ million	€ million	%
Interest expenditure in foreign currency				
Repo transactions	26	24	2	7.0
Other	0	0	0	.
Total	26	24	2	7.4
Interest expenditure in euro				
Minimum reserves	771	884	– 113	– 12.8
Deposit facility	1	2	– 1	– 44.3
Fixed-term deposits	101	143	– 42	– 29.6
TARGET balances in the ESCB	73	102	– 28	– 27.8
Net liabilities related to the allocation of banknotes	762	420	342	81.4
Other	8	11	– 2	– 19.9
Total	1,716	1,561	155	9.9
Grand total	1,742	1,586	157	9.9

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The sub-item “Transfers to/from provisions for general risks, foreign exchange risks and price risks” contains the reduction of €224 million in the provision for general risks, which is due mainly to the year-on-year reduction in the euro equivalent value of US dollar holdings (see liability item 12 “Provisions”).

Net income from fees and commissions

There was a slight year-on-year increase of €1 million to €48 million in net income from fees and commissions. Whereas the income from the handling of cash and cashless payments declined, income arising from securities trading and safe custody account business rose.

Income from participating interests

This item contains the Bundesbank’s profit from its participating interests in the Liquiditäts-Konsortialbank GmbH, the BIS and the ECB. The fall of €165 million in income to €35 million is due almost exclusively to the reduced income from the Bundesbank’s participating interest in the ECB.

Net result arising from allocation of monetary income

The monetary income of the national Eurosystem 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

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).

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

Tabelle 33

Item	2004	2003	Change from previous year	
	€ million	€ million	€ million	%
Realised gains/losses				
Gold	50	48	3	5.5
Foreign currency	32	– 88	120	– 136.7
Securities	108	584	– 476	– 81.5
Total	191	544	– 353	– 64.9
Write-downs				
Foreign currency	– 2,310	– 2,305	– 6	0.2
Securities	– 78	– 23	– 55	233.2
Total	– 2,389	– 2,328	– 60	2.6
Transfers to/from provisions for general risks, foreign exchange risks and price risks	224	274	– 50	– 18.2
Grand total	– 1,974	– 1,511	– 463	30.7

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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 had to pay on the items of the liability base mentioned reduces the amount of the monetary income to be transferred by the national central bank concerned.

A national central bank's earmarked assets consist of the following items: asset item 5 "Lending to euro-area credit institutions related to monetary policy operations denominated in euro", asset sub-item 9.2 "Claims arising from the transfer of foreign reserves to the ECB", asset sub-item 9.3 "Claims related to the allocation of euro banknotes within the Eurosystem (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.

Fees and commissions

Table 34

Item	2004	2003	Change from previous year	
	€ million	€ million	€ million	%
Income				
Securities trading and safe custody account business	12	9	3	34.8
Cashless payments	33	35	– 2	– 6.7
Cash payments	9	10	– 1	– 8.2
Other	5	5	1	15.0
Total	59	58	1	1.2
Expenditure				
Securities trading and safe custody account business	7	7	0	5.1
Other	4	5	– 0	– 3.9
Total	11	11	0	1.5
Grand total (net income)	48	47	1	1.2

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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 €461 million for the Bundesbank (2003: a net liability of €91 million). This net liability consists of a liability of €58 million arising from the distribution of monetary income for 2004 among the national central banks and the Bundesbank's share – amounting to €402 million – of the ECB's loss in the financial year 2004. The liability of €58 million mentioned above was due to the difference between monetary income, amounting to €2,490 million, which the Bundesbank paid into the common pool and the sum, amounting to €2,431 million, reallocated to the Bundesbank corresponding to its share in the paid-up capital of the ECB.

Pursuant to Article 33.2 of the ESCB Statute, any loss incurred by the ECB may be offset against the general reserve fund of the ECB and, if necessary, following a decision by the Governing Council of the ECB, against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks in accordance with Article 32.5 of the ESCB Statute. The Governing Council decided that monetary income of all national central banks would be used to cover the ECB's loss in 2004. In line with its 29.6% share in the ECB's fully paid-up capital, the Bundesbank has a financial commitment amounting to €402 million and has made a corresponding provision to be debited to its net result arising from the allocation of monetary income (see liability item 12 "Provisions").

Other income

The remaining income amounted to €1,314 million compared with €54 million in 2003. This item includes the countervalue of the partial write-off of Deutsche Mark banknotes belonging to series BBk I/Ia amounting to €1,237 million (see liability item 11.3 "Sundry items").

Staff costs

Expenditure on staff, which includes the changes in the provisions relating to this item, decreased by €65 million (6.5%) to €935 million in 2004. If the additions to and deductions from the provisions are excluded, overall expenditure declined year on year by €34 million (4.1%). The main reason for this was the reduction in staff numbers; savings were also achieved as a result of the staff restructuring schemes introduced in 2003. The effects of changes in the year under review in the pay of civil servants and of wage and salaried staff and to changes in social legislation have cancelled out to some extent.

The Executive Board of the Deutsche Bundesbank approved the *Code of Conduct for the members of the Executive Board of the Deutsche Bundesbank* on 14 July 2004; this stipulates that the remuneration received by each member of the Bundesbank's Executive Board is to be published. For the year 2004 the President of the Bundesbank (who has been in office since 30 April 2004) received a pensionable salary of €186,849.04, a special non-pensionable remuneration of €51,342.22, a special payment of €9,339.95 in accordance with the *Bundessonderzahlungsgesetz* (federal special payment law) and a standard expenses allowance of €3,422.84, amounting to a total of €250,954.05. In 2004 the Vice-President received a pensionable salary of €222,273.19, a special non-pensionable remuneration of €61,355.03, a special payment of €11,111.16 in accordance with the *Bundessonderzahlungsgesetz* and a standard expenses allowance of €3,067.80, amounting to a total of €297,807.18. Each of the six other members of the Executive Board received €223,623.58 for 2004, €166,717.46 of which was in the form of a pensionable salary, €46,016.27 as a special non-pensionable remuneration, €8,333.37 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 €12,631,061.54 in 2004 (2003: €13,080,219.10).

In the year under review a total of €183 million was spent on retirement pensions including the transfers to provisions for pensions (2003: €195 million). Expenditure on retirement pensions also includes payments made to staff of the former Deutsche Reichsbank to whom Article 131 of the Basic Law applies and to other persons for whom the Bundesbank is required to provide in accordance with section 41 of the Bundesbank Act.

Expenditure on staff includes other costs, notably provisions 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 fell year on year by €39 million (14.8%) to €224 million. Most of the reduction was due to the reduced expenditure on computer hardware and software as well as on the maintenance of buildings.

Depreciation on tangible and intangible fixed assets

The depreciation of land and buildings, of furniture and equipment and of computer software amounted to €178 million compared with €172 million in 2003 (see asset sub-item 11.2 "Tangible and intangible fixed assets").

Banknote printing

Expenditure on banknote printing declined by €29 million (34.9%) to €53 million because the Bundesbank procured a much smaller number of banknotes than in 2003.

Other expenses

Other expenses declined by €161 million to €56 million year on year. This was due mainly to the fact that the transfer to the provisions for anticipated losses on the sales of property was much less than in 2003.

Branches and operating units of the Deutsche Bundesbank

on 1 April 2005

Locality number	Bank location	Regional Office[1]
390	Aachen	D
720	Augsburg	M
	Kempten[2]	
	Memmingen[2]	
773	Bayreuth	M
100	Berlin	B
480	Bielefeld	D
430	Bochum	D
	Gelsenkirchen[2]	
380	Bonn	D
290	Bremen	H
270	Brunswick	H
870	Chemnitz	L
570	Coblenz	MZ
370	Cologne	D
180	Cottbus	B
508	Darmstadt	F
440	Dortmund	D
850	Dresden	L
300	Düsseldorf	D
350	Duisburg	D
820	Erfurt	L
360	Essen	D
215	Flensburg	HH
500	Frankfurt/M	F
	Hanau[2]	
170	Frankfurt/O	B
680	Freiburg	S
	Lörrach[2]	
513	Giessen	F
260	Göttingen	H
450	Hagen	D
	Siegen[2]	
800	Halle	H
200	Hamburg	HH
410	Hamm	D
250	Hanover	H
620	Heilbronn	S
540	Kaiserslautern	MZ
660	Karlsruhe	S
520	Kassel	F
210	Kiel	HH
	Itzehoe[2]	
860	Leipzig	L
545	Ludwigshafen	MZ
230	Lübeck	HH
240	Lüneburg	H
810	Magdeburg	H
	Halberstadt[2]	
550	Mainz	MZ

Locality number	Bank location	Regional Office[1]
670	Mannheim	S
840	Meiningen	L
490	Minden	D
310	Mönchengladbach	D
700	Munich	M
	Rosenheim[2]	
400	Münster	D
150	Neubrandenburg	HH
760	Nuremberg	M
	Bamberg[2]	
280	Oldenburg	H
	Leer[2]	
	Wilhelmshaven[2]	
265	Osnabrück	H
160	Potsdam	B
750	Regensburg	M
	Passau[2]	
640	Reutlingen	S
130	Rostock	HH
590	Saarbrücken	MZ
	Saarlouis[2]	
140	Schwerin	HH
600	Stuttgart	S
	Ludwigsburg[2]	
	Sindelfingen[2]	
585	Trier	MZ
630	Ulm	S
	Aalen[2]	
694	Villingen-Schwenningen	S
790	Würzburg	M
	Aschaffenburg[2]	
	Schweinfurt[2]	
330	Wuppertal	D

1 Abbreviations
B = Berlin
D = Düsseldorf
F = Frankfurt am Main
H = Hanover
HH = Hamburg
L = Leipzig
M = Munich
MZ = Mainz
S = Stuttgart
2 Operating units