DEUTSCHE
BUNDESBANK

ANNUAL REPORT

2003 2004 2005 2006 2007

We mourn the death in 2003

of the former President of the Land Central Bank in the Free State of Bavaria
and Member of the Central Bank Council
Lothar Müller
† 2 February 2003

of the former President of the Land Central Bank in Saarland and Member of
the Central Bank Council
Hans Gliem
† 4 October 2003

and of the following members of our staff

Robert Fitz	6 January 2003
Erwin Köder	24 January 2003
Wolfgang Poschmann	31 January 2003
Beate Schwalbach	5 February 2003
Heinz-Gerhard Ruppert	8 February 2003
Peter Thom	26 February 2003
Dieter Plass	17 March 2003
Manfred Steinkopf	24 March 2003
Gerhardt Hoffmann	29 March 2003
Peter Ruhnau	23 April 2003
Klaus Peglow	27 April 2003
Karl-Heinz Brandau	10 May 2003
Sabine Gripp	16 May 2003
Manfred Müller	17 May 2003
Sylvia Pera	7 June 2003
Brigitte Schneider	18 July 2003
Hans Engelmann	3 August 2003
Winfried Laleike	9 August 2003
Irene Kreutz	13 August 2003
Heinz Kern	10 October 2003
Gerhard Lichy	23 November 2003
Dagmar Süßbauer	1 December 2003
Michael Holtrichter	23 December 2003
Ingrid Giere	29 December 2003

We also remember the retired staff members of the Bank who died in 2003.

We will honour their memory.

DEUTSCHE BUNDESBANK

Members of the Executive Board of the Deutsche Bundesbank

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President of the Deutsche Bundesbank

Dr Jürgen Stark
Vice-President of the Deutsche Bundesbank

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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	Figure unknown, not to be published or not meaningful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 Deutsche Bundesbank, 2003 was a year suffused by internal restructuring activity. The Executive Board had decided, one year previously, to make far-reaching changes to the Bank's structure; now we had to translate those decisions into reality. The new division of responsibilities – with policy issues being handled at Central Office and operational matters at the Regional Offices – called for extensive internal adjustments. Much of the new organisational structure was already in place by mid-2003. Moreover, 13 of the planned 22 service centres became fully operational last year.

Steps were taken to streamline the branch network, as agreed in May 2002. Moreover, after careful consideration, the Executive Board decided at the end of 2003 to close a further 19 branches over the next four years. This decision was a response to the need for consolidation arising from the changes to the underlying framework – banking services becoming increasingly automated, banking sector concentration and changes in central bank refinancing associated with monetary union. On the one hand, streamlining the network makes cash management far more cost-effective. On the other, there are still sufficient branches to ensure that central bank services are being provided throughout the country.

For the German economy, too, 2003 was a year of major change. At the start of the year, Germany was in a severe crisis of growth and confidence. However, in the second half of the year, the German economy finally managed to break free from the underlying stagnation in which it had been entrenched for three years. In economic policy, the path was smoothed for a whole raft of reform legislation. This includes a number of labour market reforms which make it easier to appoint new staff and are intended to increase the incentives for those out of work to take up employment. With regard to the statutory health and pension insurance schemes, measures were taken to stabilise the contribution rates. In addition, the abolition of subsidies and tax concessions which have a distorting effect on allocation were set in train. The Federal Government thus took major steps towards reform, these being essentially in line with the proposals made by the Bundesbank in its March 2003 policy document "Ways out of the crisis".

In the first quarter of 2004, the German economy is still in the early stages of a recovery. Most of all, the general improvement in the underlying conditions suggests that the recovery is set to continue as the year goes on. The global economic revival, for instance, has since turned into a robust and broadly based upswing. The German economy is still proving able to absorb the appreciation of the euro. The price environment in Germany is decidedly consumer-friendly. Costs are evolving at a moderate pace and enterprises are still enjoying favourable financing conditions. From both monetary and financial perspectives – the high degree of price stability, low interest rates and the ample supply of liquidity – there is thus a firm basis for more growth.

The more positive outlook for growth has also boosted the earnings prospects of German banks. Many banks have also made considerable progress in cutting costs and scaling down risks. However, further adjustments are needed to enable the German banking system to achieve a sustainable level of profitability. In December 2003 the Bundesbank presented its first report on the stability of the German financial system, which carefully analyses these developments. This move reflects the growing importance assumed by financial stability issues in recent years. Further reports will be published at regular intervals.

The positive assessment of what has been achieved should not, however, be allowed to obscure the fact that there is still a long way to go in terms of what needs to be done and what reforms are still outstanding. The social security systems are still inadequately prepared to deal with current demographic trends. The prime task here is to make lasting inroads into the negative impact of social security contributions on labour. At the same time, further consolidation is needed in the area of fiscal policy. The Federal Government is expecting Germany to record a general government deficit of more than 3% of GDP in 2004 for the third year in succession. According to the rules of the Stability and Growth Pact, the next stage in the excessive deficit procedure against Germany should therefore have been triggered in autumn 2003. However, the Ecofin Council rejected the recommendation to that effect made by the European Commission. In order to avoid the Pact being undermined further still, strict compliance with the Maastricht criteria is to be ensured in 2005 and the deficit pulled back to below 3% of GDP.

Stability must remain the guiding principle of the economic and monetary regime in Europe. This naturally also applies to the future European constitution and the process of EU enlargement. The changes envisaged in the draft constitution of July 2003 with regard to economic and monetary union are thus taking the wrong route. The Governing Council of the ECB therefore asked the intergovernmental conference to incorporate the provisions of the Maastricht Treaty in the constitution as they are. In December 2003 the Governing Council also published its policy position on exchange rate issues relating to the acceding countries. It recommends that these countries wait until necessary transition processes and internal and external stabilisation are well advanced before joining the European exchange rate mechanism.

After first analysing the international and European setting, this *Annual Report* takes a detailed look at the Eurosystem's monetary policy and developments in the financial markets during the past year. It also reviews economic trends in Germany and more recent developments in international and European cooperation. In addition, it outlines the Bundesbank's structural reform. The *Annual Report* also contains the Bank's annual accounts for 2003, which were drawn up by the Executive Board and have been independently audited.

The other 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 2003. Besides thanking them for their commitment, I should like to encourage them to continue their active support of the Bank's restructuring process and to see the "new" Bundesbank as opening up a number of opportunities. My thanks also go to the staff representative bodies for their positive contribution to all discussions.

Frankfurt am Main, March 2004

Ernst Welteke
President of the Deutsche Bundesbank

Currency
and economy

I The international and European setting

1 Recovery of the world economy

Recovery of the world economy in the second half of the year

After a difficult first half of the year in 2003, the world economy is now on a broadly based upswing with growth concentrated on the United States and East Asia. Overall, global economic output is likely to have risen last year by almost 4% in real terms and therefore at a somewhat more rapid pace than in 2002. World trade, too, which had suffered especially from the Iraq war and SARS in the first half of the year, picked up significantly in the ensuing period. This meant that, in 2003 as a whole, global trade in goods and services was likewise around 4% up on the year and will probably expand at a faster pace in 2004. Global economic growth was supported by expansionary monetary and fiscal policies in many countries as well as by favourable financing conditions. Inflation rates remained low in most cases. Nevertheless, concern is being caused by the global imbalances, which have also been reflected in sharp exchange rate movements.

USA once again engine of growth but increasing imbalances

Once again, the United States proved to be the crucial provider of stimulus to the global economy. The additional tax cuts adopted at the end of May 2003 – supported by persistently low interest rates – particularly boosted private consumption and led to a quite significant surge in growth in the summer quarter. On an annual average, US real gross domestic product (GDP) went up by somewhat more than 3%. Domestic demand was strengthened by buoyant investment and by distinctly higher military expenditure in connection with the Iraq conflict. However, together with lower tax receipts, this pushed up the government budget deficit to some 5% of GDP. This figure was a fairly close match for the US current account deficit, which reached a new record high last year. The twin fiscal and current account deficits could prove to be a major strain if the high general government deficits and the sizeable US net borrowing requirement were to bring about a rise in long-term interest rates and crowd out private investment. This is especially the case as the considerable level of household debt and the petering out of mortgage refinancing (which lowered interest rates on the existing debt level) could have a dampening impact on consumer demand.

Economic recovery in Japan remains heavily dependent on exports but is being increasingly sustained by domestic investment demand as well. In the reporting

Macroeconomic benchmark figures of selected industrialised countries

Table 1

Countries	Real GDP		Consumer prices 1		Current account balance		Unemployment rate 2	
	2002	2003 pe	2002	2003 pe	2002	2003 pe	2002	2003 pe
	Annual percentage change				As % of GDP		In %	
OECD *of which*	1.7	2.0	1.5	2.0	– 1.1	– 1.4	6.9	7.1
Euro area	0.9	0.4	2.3	2.1	0.9	0.4	8.4	8.8
United Kingdom	1.7	2.3	1.6	2.9	– 0.9	– 2.7	5.1	5.0
United States	2.2	3.1	1.6	2.3	– 4.6	– 4.9	5.8	6.0
Japan	– 0.4	2.7	– 0.9	– 0.3	2.8	2.9	5.4	5.3
Canada	3.3	1.7	2.2	2.8	2.0	1.9	7.7	7.6

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

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Stabilisation of recovery in Japan

year, however, the increase in private consumption was still being attenuated by the ongoing decline in wages and salaries. All in all, economic growth in the year as a whole, at 2¾%, was clearly better than expected. Besides these positive developments in the economy, progress was achieved with the structural reforms initiated in the past few years. There was a decline in the percentage of non-performing loans at the big banks and equity capital levels showed an improvement on average. Nevertheless, profitability – especially that of the banks and of small and medium-sized enterprises – is still unsatisfactory. Added to this is the uncertainty about future developments in the yen's exchange rate. What now seems to be needed more than anything is to lay a broader foundation for the upswing through additional reforms.

East Asia as a second pole of growth

The East Asian emerging markets were a second pole of growth in the world economy alongside the United States. In particular, the Chinese economy grew even more sharply in 2003, at 9% in real terms, than it had done in the preceding years. Just like the other emerging East Asian economies, China coped with the SARS epidemic better than had been feared initially. Factors which played a role in the region's notable economic growth were the recovery in the IT sector as well as China's advancing integration into the global economy. This was assisted by the renminbi (and other East Asian currencies) being pegged to the US dollar and the resulting effective depreciation against major trading partners. Especially in China, however, initial signs of overheating are already identifiable.

Robust economic growth in the acceding countries

In their final year before becoming members of the European Union, the acceding countries of central and eastern Europe posted 3½% economic growth. They were thus able once again to somewhat reduce the disparity between their incomes and those of the current member states. Even so, growing government deficits could soon bring some of them into conflict with the budgetary rules of the EU. On several occasions in the past, these fiscal positions have given rise to differences of opinion between national governments and the national monetary authorities. Some central banks felt that an expansionary fiscal policy was increasingly jeopardising the achievement of their inflation targets. The general signs in some countries at present suggest a retreat from the original intention of joining the new European Exchange Rate Mechanism (ERM II) as soon as possible and then entering European monetary union at the earliest possible date. Particular attention also deserves to be paid to the fact that most of the reform states have large current account deficits. Although this is due mainly to the process of catching up with the highly developed industrial countries, the deficits – some of which are at over 10% of GDP – are on a scale that could jeopardise steady economic growth over the longer term.

Improved underlying economic conditions in Russia and the countries of Latin America

In the other countries of eastern Europe and Latin America, the underlying economic scenarios showed an improvement during the past year. Russia benefited from the persistently high oil prices and achieved a 7% annual average growth in economic output. At the same time, it initiated major reforms for liberalising capital movements and in tax law. Other requirements are more effective financial market supervision and a strengthening of competition among enterprises. In Latin America, the main cause for cautious optimism is the containment of the economic crisis in Argentina. GDP showed an increase for the first time since 1998 – by 8% in real terms, although this only marginally offset the decline that had occurred in the intervening years. In Brazil, output fell slightly on an annual average, but there are good prospects of an upswing in the current year. Even so, there are considerable risks of a setback since the continued recovery depends mainly on the willingness of international investors to become more involved in Latin America again. Business activity in Mexico last year, given economic growth of 1% in real terms, was still subdued but in 2004 is likely to benefit increasingly from the upswing in the USA.

Economic performance in the euro area

Table 2

Country	Real GDP 2002	Real GDP 2003 pe	Consumer prices 1 2002	Consumer prices 1 2003 pe	Unemployment rate 2 2002	Unemployment rate 2 2003 pe	General government fiscal balance 2002	General government fiscal balance 2003 pe
	Annual percentage change				in %		as % of GDP	
Euro area	+ 0,9	+ 0,4	2,3	2,1	8,4	8,8	– 2,3	– 2,7
Germany	+ 0.2	– 0.1	1.3	1.0	8.6	9.3	– 3.5	– 3.9
France	+ 1.2	+ 0.2	1.9	2.2	8.8	9.4	– 3.2	– 4.1
Italy	+ 0.4	+ 0.3	2.6	2.8	9.0	...	– 2.3	– 2.4
Spain	+ 2.0	+ 2.4	3.6	3.1	11.3	11.3	+ 0.0	+ 0.3
Netherlands	+ 0.2	– 0.8	3.9	2.2	2.7	3.8	– 1.9	– 3.0
Belgium	+ 0.7	+ 1.1	1.6	1.5	7.3	8.1	+ 0.1	+ 0.2
Austria	+ 1.4	...	1.7	1.3	4.3	4.4	– 0.2	– 1.1
Finland	+ 2.3	+ 1.9	2.0	1.3	9.1	9.0	+ 4.3	+ 2.3
Portugal	+ 0.5	– 1.3	3.7	3.3	5.1	6.4	– 2.7	– 2.8
Greece	+ 3.8	+ 4.7	3.9	3.4	10.0	...	– 1.4	– 1.7
Ireland	+ 6.9	...	4.7	4.0	4.3	4.6	– 0.2	+ 0.2
Luxembourg	+ 1.3	...	2.1	2.5	2.8	3.7	+ 2.7	– 0.1

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

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Weak annual result again in the euro area but recovery is under way

After stagnating in the first half of 2003, overall output in the euro area picked up perceptibly in the second half of the year. However, real GDP rose by barely ½% on an annual average in 2003. This was the smallest increase since 1993, when a 1% decline had been posted. Economic growth therefore lagged noticeably behind the increase in potential output, which ECB estimates put in a range between 2% and 2½%. The negative output gap has therefore become even wider. In 2003, the euro area showed a certain phase shift against cyclical movements in the United States and Japan. Measured in terms of GDP growth, the USA's expansionary lead amounted to 2½ percentage points. The current forecast for 2004 suggests little change, with a 1½ percentage point increase in growth for both regions.

Decline in real net exports

In the second half of 2003, seasonally adjusted euro-area real exports – which, as defined in the national accounts, include intra-euro-area exports – were 2% up on the first half of the year. Up to the end of the period under review, the expansionary stimuli owing to the improvement in the global economic climate were clearly more than offsetting the retarding factors resulting from the appreciation of the euro against the US dollar. The export sector in the euro area made a weak start to 2003 and exports declined in the first two quarters. As a result, goods and services exported on an annual average in 2003 showed no increase on the year. At constant prices and after adjustment for seasonal variations, imports declined in the first two quarters, but picked up again sharply in the remaining part of the year. For 2003 as a whole there was a rise of 1½%. Measured by GDP, real net exports therefore went down by ½ percentage point in 2003 to 2½%.

Weak growth in domestic demand

The cyclical upturn in the second half of 2003 was not yet broadly based since final domestic demand, ie excluding changes in inventories, in the fourth quarter of 2003 was only slightly higher than in spring. As an annual average, it was no more than ¾% up on the year. Total domestic demand increased somewhat more sharply (+1%) as inventory investment was stepped up perceptibly. This restocking was due, firstly, to the higher level of petroleum storage in early 2003 on account of the looming war in Iraq. Secondly, more goods were being imported at the end of last year. This has to be seen mainly in the context of accelerating industrial output, which has led to a greater need for imported inputs. An additional factor is that the appreciation of the euro has boosted demand for foreign goods.

Further fall in fixed investment...

Domestic activity was curbed mainly by the renewed (1¼%) decline in gross fixed capital formation. This was determined mainly by enterprises' caution in the first half of the year. The key factors behind this were the uncertainty caused by the Iraq war and the spread of SARS, which had initially appeared to pose a major threat in the spring months. In the ensuing period, however, the effects of these negative global factors waned and corporate confidence began to pick up again. Given the general improvement in sentiment, the fact that financing conditions remained favourable assumed greater weight again in corporate investment decisions.

... but favourable preconditions for an upturn in investment activity

Real spending on new machinery, equipment and premises in the second half of the year did not suggest that there was any firm expansion in investment yet. Even so, the underlying conditions for this are very favourable, however, insofar as the corporate financial situation in the euro area continued to stabilise in 2003. New borrowing by non-financial corporations in the euro area did show some increase on the year in 2003 but it was still well down on the level in 2000-01. In relation to GDP, there was virtually no further increase in the level of corporate debt between the end of 2001 and the end of 2003. At just over 3% of outstanding debt financing, the average remuneration of corporate loans and bonds was at an all-time low in 2003.

Subdued consumer propensity to buy

Private consumption was not yet being affected by the cyclical recovery in the euro area in the second half of 2003. The annual average increase of 1% was mainly based on the perceptible surge from 2002 and higher spending, especially on energy, in the first quarter of 2003. Households' propensity to buy was subdued overall – something which was particularly marked in the case of durable goods. The continuing weak state of the labour market and the small increases in employees' compensation are likely to have been among the main causes of this. This year, however, more buoyant economic activity in the euro area will probably give a greater boost to private consumption than has been the case so far. By contrast, government consumption expanded relatively sharply last year, ie by 2% at constant prices, with its contribution to GDP growth amounting to just under ½ percentage point.

Smaller growth differentials

Growth differentials across the countries of the euro area continued to narrow in 2003. There is a 5½ percentage points differential between Greece – whose overall output has been boosted mainly by the extensive construction work in connection with the Olympic Games to be held in summer 2004 – and the Netherlands, which is the current straggler. This is still a high figure, albeit a smaller one than in 2002 when the differential between Ireland and Germany was measured at over 6½ percentage points. In 2003, the unweighted standard deviation fell by ½ percentage point to 1½ percentage points. By contrast, the deviation weighted by the share of euro-area GDP remained at 1 percentage point. This discrepancy is due to the fact that there was a very sharp slowdown in economic growth in a number of smaller economies last year – the figure for Ireland, for example, went down by 5½ percentage points to an estimated 1½%.

Higher unemployment

Weak economic activity in the euro area meant that unemployment, which had started to go up in mid-2001, initially continued rising in 2003. Even so, the standardised rate went up by no more than 0.2 percentage point in the course of the year, compared with a 0.5 percentage point increase – given noticeably higher GDP growth – in 2002. In total, 12.3 million persons, or 8.8% of the statistically recorded labour force, were out of work last year. The fact that the rise in the standardised unemployment rate was relatively small was due mainly to special factors operating in Germany and Italy. In Germany, for example, the criteria for registering unemployed persons have been tightened, which has led to increased outflows from the official unemployment statistics.[1] Last year, too,

1 This will impact on the standardised method of calculating the unemployment rate in Germany and thus in the euro area as a whole because the results of the Labour Force Survey, conducted once a year in the spring, are updated in the following months using the official unemployment statistics.

Spain reported the highest unemployment rate at 11.3%, followed by France (9.4%) and Germany (9.3%). The rates in the Netherlands, Ireland, Austria and Luxembourg remained below 5%.

Favourable outlook for 2004

The cyclical recovery in the euro area persisted after the turn of 2003-04. The industrial confidence indicator – starting from the depressed level of 2003 – rose in January and February, matching its multi-year average value again. The cyclical improvement now also appears to be less export-dependent and therefore to be more broadly based. Seen in that light, there are growing signs that gross fixed capital formation will gain further momentum despite the expected appreciation-induced retarding effects on exports. According to the investment survey conducted last autumn, industrial enterprises are planning to increase real spending on new machinery, equipment and premises in the euro area by 2% in 2004, which will be the first increase since 2001. This expansion in investment is also being favoured by the fact that, with interest rates still low, it has become easier to raise equity capital on the reviving stock markets. Also, the improved terms of trade are providing relief for enterprises on the cost side and wage developments are likely to remain moderate in 2004. At the end of the period under review, consumer sentiment in the euro area had also become somewhat more positive, albeit starting from a low level. However, an across-the-board improvement in consumption is still being impeded by the difficult situation on the labour market. A cyclical turnaround may be expected in this respect later in the course of 2004.The seasonally adjusted unemployment rate remained stub-bornly at 8.8% in January.

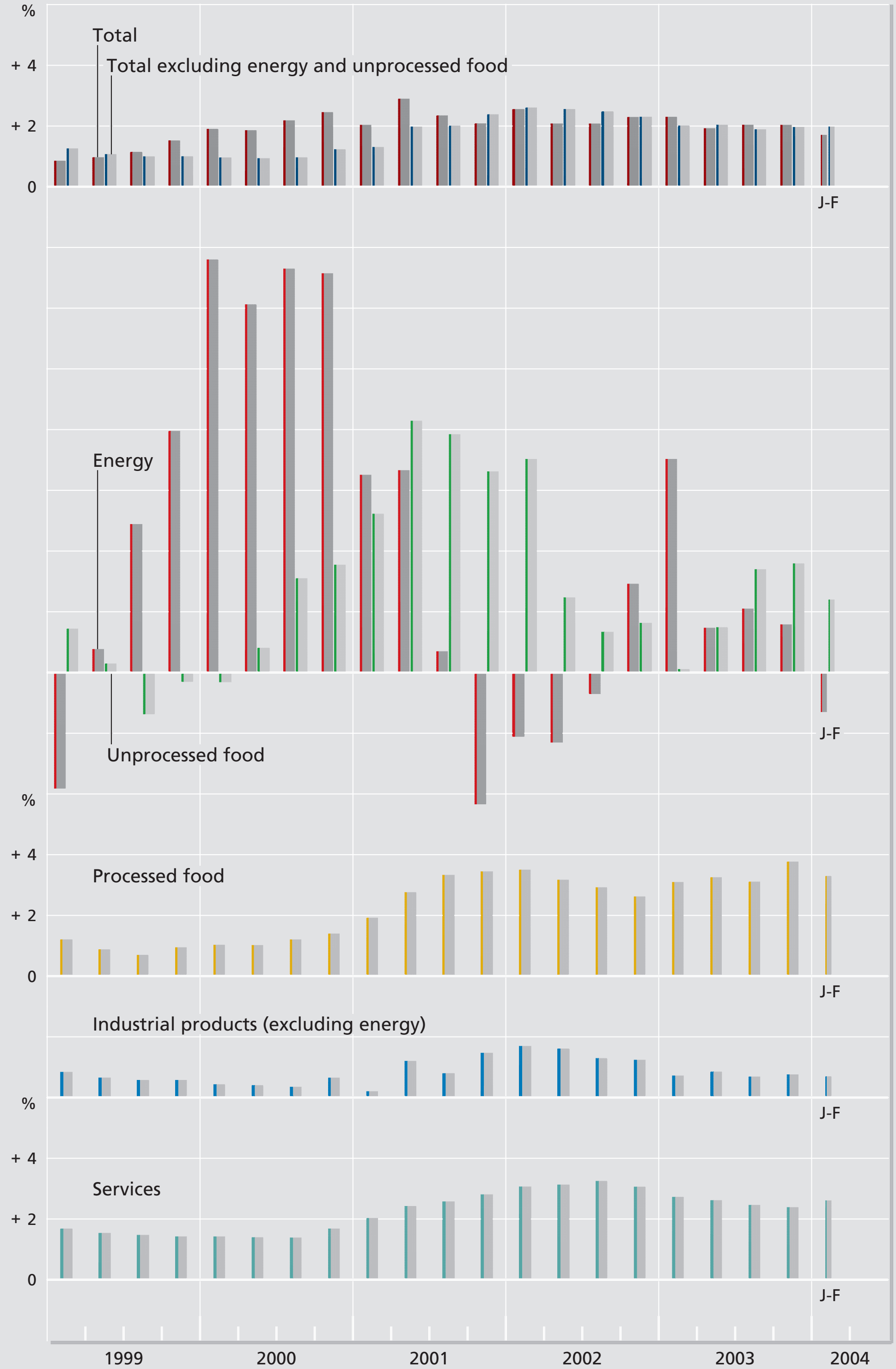
Consumer prices

The rate of consumer price increases in the euro area slowed down last year under the impact of the initially prevalent trends towards stagnation in the real economy. The annual average rate of inflation measured by the Harmonised Index of Consumer Prices (HICP) was 2.1% and therefore only slightly lower than in 2002 (+2.3%). Excluding energy and unprocessed food, the prices of which are heavily dependent on the international commodities and foreign exchange markets as well as on weather conditions, the rate of inflation went down by ½ percentage point to 2.0%. The prices of both goods (excluding energy and food products) and of services rose perceptibly more slowly than in the year before. The rate of inflation for processed food – which includes luxury food, drink and tobacco – went up to no less than 3.3%, however. Higher taxes on tobacco products were a particular contributory factor in this in some countries. The cost of unprocessed food rose quite sharply during the course of the year owing to the very hot and dry summer weather in large parts of Europe. At

Consumer prices in the euro area

Chart 1

Year-on-year change, quarterly



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2.1%, the annual average rise was weaker than in 2002, however. Energy prices, which had shown a slight decline in 2002, went up by 3.0%.

Regional price developments

The divergence in euro-area price developments, which had been very marked between 2000 and 2002, showed a noticeable decline during 2003. In December 2002, the range of inflation rates had amounted to as much as 3.4 percentage points but narrowed to no more 2 percentage points one year later. This finding is confirmed by other measurements of divergence which take account of the distribution of inflation rates and the differing size of the member states' economies. The main reason for the smaller inflation differential was the easing of inflationary pressure in countries which had previously had above-average rates of inflation. The slower pace of economic growth in those countries also played a part in this. In December 2003, five countries had a rate of inflation below 2%. In six countries, the inflation rate was between 2% and 3%. Only Greece had an inflation rate higher than 3%. One year earlier, prices had risen by 3% or more in as many as six countries.

Price developments in early 2004 and outlook

There was a surge in prices in some euro-area countries in January 2004 – mainly as a result of higher indirect taxes and administered prices. Even so, the year-on-year rate of increase in the HICP for the euro area fell to 1.9%. In February, the rate of inflation went down to as low as 1.6% owing to the baseline effect of very high energy prices 12 months earlier. In this connection, it should be noted that, against a backdrop of persistently high dollar prices on the international oil markets, there was a marked year-on-year fall in energy prices in the euro area owing to the appreciation of the euro. Excluding the categories of goods which are especially volatile and the administered prices, upward pressure on prices is likely to ease further in 2004, with prices moving in the range of stability again.

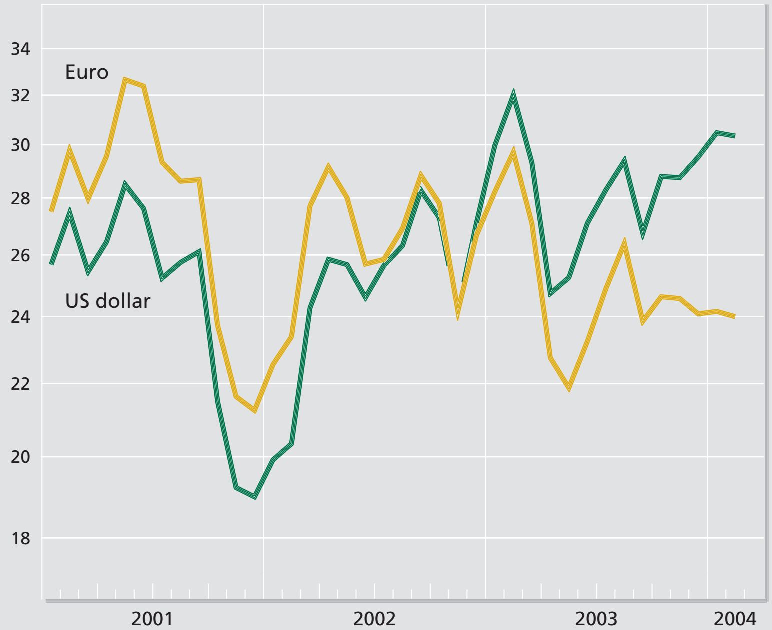
Minor global price risks ...

Price inflation was quite low last year from a global perspective, too, despite a sharp increase in commodity and energy prices on average in 2003 on a dollar basis. This impacted on the domestic price level in the dollar area and in those countries whose currencies are pegged to the dollar, although it had very little or no effect on the domestic price level in countries with appreciating currencies. Enterprises' spare capacity and the situation on the labour markets both had a dampening impact on prices. The generally abundant supply of labour meant that wage developments were predominantly moderate. Global concerns about deflation, which had emerged sporadically at the start of 2003, subsided again in the second half of the year, if not earlier, with the rapid reaction of

World market prices for crude oil

Chart 2

Price per barrel (Brent), monthly averages, log scale



Source: Thomson Financial Datastream, Bundesbank calculations.

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some central banks and the upturn in the world economy. Overall, consumer prices in the OECD countries (excluding the high-inflation countries) went up by no more than 2% in 2003.

... allow retention of easy monetary policy

The favourable price climate allowed many central banks to continue their mostly accommodating monetary policy. The ECB and the US Federal Reserve cut their key rates to 2% and 1% respectively in the first half of the year, for example, and the Bank of Japan made several increases in its target for current account balances at the central bank, ie its supply of liquidity to the commercial banks. The Bank of England first lowered its repo rate in two stages by a total of ½ percentage point to 3.5% but then raised it again in November 2003 and, most recently, in February 2004 by 25 basis points on each occasion in order to contain latent price risks given the continuing property boom and the cyclical upturn in the United Kingdom. Not least given largely inflation-free growth in the major industrial countries at present, the underlying conditions for a further strengthening of global economic activity are, all in all, decidedly positive on the monetary side. However, the central banks will have to ensure that the considerable surplus liquidity which exists in some cases does not give rise to increasing inflationary pressure over the medium term.

2 Favourable international securities markets and significant exchange rate gains for the euro

Improvement in economic outlook stimulates securities markets

The uncertainty which prevailed at the beginning of the year as a result of the geopolitical risks and the indeterminate effects of these risks on the world economy gave way later in the year to a considerable improvement in sentiment. During the second quarter a sharp upturn in share prices, which was spurred by the more favourable economic outlook, growing investor confidence, low inflation rates and official interest rates as well as an ample supply of liquidity, set in worldwide. Although bond yields subsequently broke away from the lows reached early in the third quarter, when concern about deflation, especially in the United States, had resulted in a veritable flight into debt securities with first-class ratings, they are still decidedly low if measured in the light of the widely held optimistic expectations about world economic growth. As interest rate premia for corporate bonds and for debt securities issued in emerging markets have also fallen again in response to the declining risk aversion on the part of investors, the capital markets are still providing borrowers with favourable financing terms on the whole.

Shifts in exchange rate parities

Exchange rate parities shifted substantially on the international foreign exchange markets last year, not least as a result of further increasing imbalances in the global structure of current accounts. This was due mainly to the pronounced weakness of the US dollar, which depreciated by 14½% on a weighted average during 2003 after losing considerably in value also in the previous year (-10%).[1] By contrast, the euro, the Canadian dollar and the Australian dollar made substantial gains.

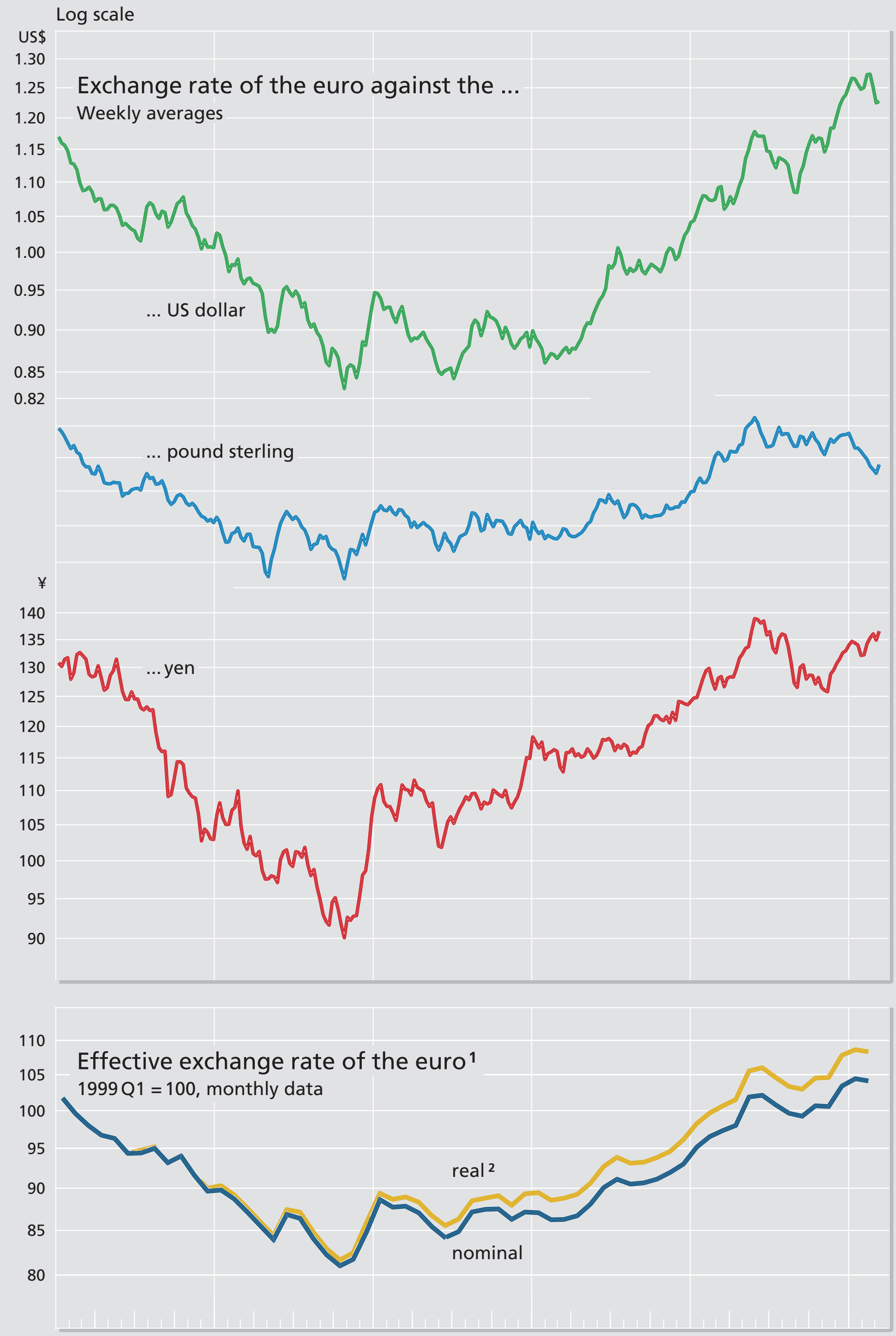
Pronounced weakness of US dollar...

The ever increasing doubts which market participants had about the sustainability of the large US current account deficit and the generally sluggish response of the US labour market to the economic upturn were the main factors adversely affecting the US currency. The downward pressure exerted on the US dollar was passed on to other currencies by the foreign exchange market intervention of some central banks whose currencies are officially or unofficially pegged to the dollar, with the result that the exchange rate adjustment was distributed asymmetrically among the various currencies (see also pages 98-100). Against the yen, for example, the US dollar did, in fact, depreciate somewhat during the second half of the year; however, the extent of the fall was limited (to 10½% during

1 Except in the case of the euro this is based on the nominal external values against the currencies of 19 industrial countries, which the Bundesbank calculates and publishes regularly.

Exchange rate of the euro

Chart 3



1 According to ECB calculations against the currencies of 12 countries. — **2** Based on consumer prices.

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2003) owing to the Bank of Japan's foreign exchange market intervention, which helped to ensure that on a weighted average the external value of the Japanese currency remained virtually unchanged in terms of its end-of-year performance.

... reflected mainly in appreciation of euro

By contrast, the shifts in the exchange rate of the euro against the US dollar during the year were much greater than those of the yen and amounted in all to an appreciation of 20½%. After the euro, at the end of May 2003, had reached its highest level – at just over US$1.19 – since the start of monetary union, it was initially forced to relinquish some of its gains in the third quarter. During this period positive economic reports from the United States had evidently resulted in market expectations about the future development of the US economy being revised markedly upwards whereas recovery in the euro area was expected to be comparatively slow. Furthermore, the interest rate disadvantage of long-term US bonds vis-à-vis comparable euro-area issues was reversed for a time. The renewed turnaround began in September when publication of unexpectedly weak US labour market data aroused fears of a jobless recovery. Repeated warnings that there might be an abrupt fall in the US dollar exchange rate in the light of the large US current account deficit is likely to have put an additional strain on the US dollar. At the end of 2003 and the beginning of 2004 the pace of the euro's appreciation increased considerably; at ever decreasing intervals the single currency soared to new heights and by mid-February had reached a record US$1.29.

Euro also appreciates against yen and pound sterling

During the first few months of last year the euro also surged ahead against the yen and the pound sterling, peaking at ¥140 and £0.72 at the end of May. However, it subsequently lost part of the ground gained after the growth prospects for the Japanese and British economies had improved. Whereas the euro exchange rate moved within a relatively narrow corridor against the pound sterling in the second half of the year, namely between just over £0.68 and £0.71, it again appreciated discernibly against the yen in the first quarter of 2004. With quotations of up to ¥135, however, it did not regain the high levels reached in May 2003. Over the year as a whole the euro appreciated by 8½% against both the pound and the yen and therefore by a much smaller margin than against the US dollar.

Rise in euro curbs price competitiveness

In the course of 2003 the euro rose substantially in value (+11½%) on a weighted average against the currencies of the euro area's 12 most important trading partners and in mid-January 2004 hit its highest level against these currencies since the launch of monetary union. The single currency also gained considerably in real terms, ie after differences in the inflation rates of the euro-area countries and the non-euro-area partner countries have been taken into account, a development which had a correspondingly deteriorating effect on the price competitiveness of the euro area's trade and industry. It was particularly the pace of the euro's appreciation at the end of 2003 and the beginning of 2004 that posed a certain problem for exporting enterprises. Even so, the exchange rate developments are not detracting from the positive stimuli which the revival in the world economy and world trade is exerting on the euro area.

II Monetary policy and monetary development in the euro area

1 The Eurosystem's successful monetary policy

(a) Central bank rates unchanged after monetary easing

Review of the monetary policy strategy, ...

In spring 2003 the Governing Council of the ECB subjected its monetary policy strategy to a thorough review. At its meeting on 8 May 2003 it agreed to continue to define price stability as an increase in the Harmonised Index of Consumer Prices for the euro area of under 2%. At the same time, however, the Governing Council made it clear that, in its efforts to maintain price stability, it was aiming for a medium-term rate of inflation of below, but close to, 2%. This should result in a sufficient safety margin to guard against deflation and allow for potential statistical distortion when measuring the rate of inflation and the inflation differentials among the euro-area countries.

... especially as it affects the communication of monetary policy decisions

Furthermore, the Governing Council of the ECB decided to continue to base its monetary policy decisions on a comprehensive analysis of monetary, real economic and financial indicators. It made it clear that it bases its assessment of shorter-term price developments primarily on non-monetary indicators and makes greater use of monetary analysis to assess longer-term risks of inflation. In particular, this enables the assessment of the shorter-term outlook for prices to be cross-checked from a medium to long-term perspective.

Finally, the Governing Council of the ECB also agreed to stop conducting a review of the reference value for M3 non-inflationary growth on an annual basis.

Chronology of domestic and external monetary policy measures

23 January 2003
The Governing Council of the ECB decides to maintain at €15 billion the allotment amount for each of the longer-term refinancing operations to be conducted in 2003.

In order to improve the operational framework for monetary policy, the Governing Council of the ECB decides to change the timing of the reserve maintenance period. From spring 2004, it will always start on the settlement day of the main refinancing operation (MRO) following the Governing Council meeting for which the monthly assessment of the monetary policy stance is scheduled. Furthermore, as a rule, the implementation of changes to the standing facility rates will be aligned with the start of the new reserve maintenance period. At the same time, the maturity of the MROs will be shortened from two weeks to one.

6 March 2003
The Governing Council of the ECB lowers the minimum bid rate on the main refinancing operations by 0.25 percentage point to 2.50%, starting from the operation to be settled on 12 March 2003. Interest rates on both the marginal lending facility and the deposit facility are also lowered by 0.25 percentage point, to 3.50% and 1.50% respectively, both with effect from 7 March 2003.

21 March 2003
The EU Heads of State or Government approve the voting modalities in the Governing Council of the ECB. A rotation system ensures that the Governing Council of the ECB is still in a position to take its decisions efficiently and in a timely manner in an enlarged euro area.

26 March 2003
The Executive Board of the Deutsche Bundesbank determines that the profit to be distributed to the Federal Government shall amount to €5.4 billion.

8 May 2003
The Governing Council of the ECB reviews its monetary policy strategy. It confirms the existing definition of price stability, namely as a "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". At the same time, the Governing Council states that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term. This creates a buffer against the risks of deflation. It will also take account of the "measurement bias" in the HICP and the inflation differentials within the euro area.

The Governing Council confirms that its monetary policy decisions will continue to be based on a comprehensive analysis of the risks to price stability. To improve communication, the President's introductory statement will be restructured. It will begin with the economic analysis, which identifies short and medium-term price risks. The statement will then proceed to the monetary analysis, in which medium to long-term trends in inflation are assessed in view of the relationship between monetary growth and prices.

To underscore the longer-term nature of the reference value for monetary growth as a benchmark for the assessment of monetary developments, the Governing Council also decides that it will no longer conduct a review of the reference value on an annual basis. However, it will continue to assess the underlying conditions and assumptions.

5 June 2003
The Governing Council of the ECB decides to lower the minimum bid rate on the main refinancing operations by 0.50 percentage point to 2.0%, starting from the operation to be settled on 9 June 2003. It also decides to lower the interest rates on both the marginal lending facility and the deposit facility by 0.50 percentage point, to 3.0% and 1.0% respectively, both with effect from 6 June 2003.

30 October 2003
The Executive Board of the Deutsche Bundesbank decides to close further branches by the end of 2007. Concentration on 47 locations makes cash management more cost-effective.

1 November 2003
Jean-Claude Trichet becomes the new President of the ECB, succeeding Dr Willem F Duisenberg, who held the office from 1 June 1998 to 31 October 2003.

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.

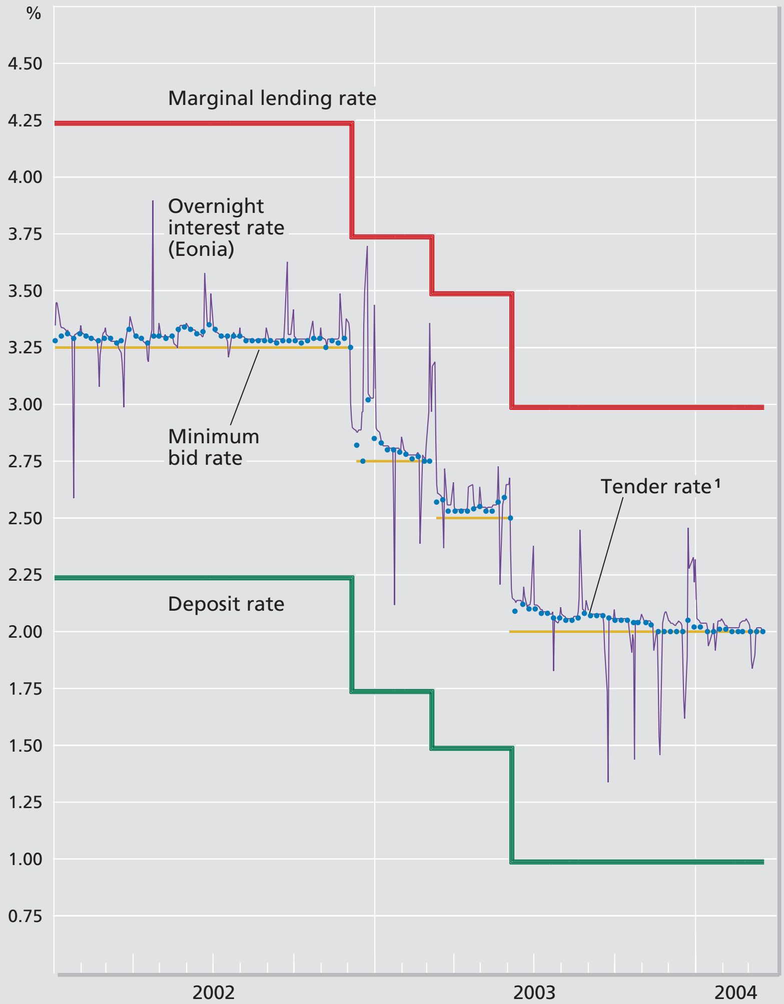
10 March 2004
The maturity of the regular main refinancing operation conducted on 8 March 2004 is, for the first time, just one week. Also for the first time, the reserve maintenance period begins on the settlement day of the main refinancing operation following the Governing Council meeting for which the monthly assessment of monetary policy is scheduled. From now on, changes to the standing facility rates will generally also take effect on the settlement day of the refinancing operation. These measures will implement the changes to the monetary policy instruments agreed in spring 2003.

24 March 2004
The Executive Board of the Bundesbank determines that the profit to be distributed to the Federal Government shall amount to €0.2 billion.

Official interest rates and overnight interest rate

Chart 4

Daily data



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

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This should underline the longer-term nature of the reference value for monetary development. The Governing Council of the ECB will, however, still continuously monitor the conditions and assumptions underlying the reference value and subject it to an adjustment, if necessary.

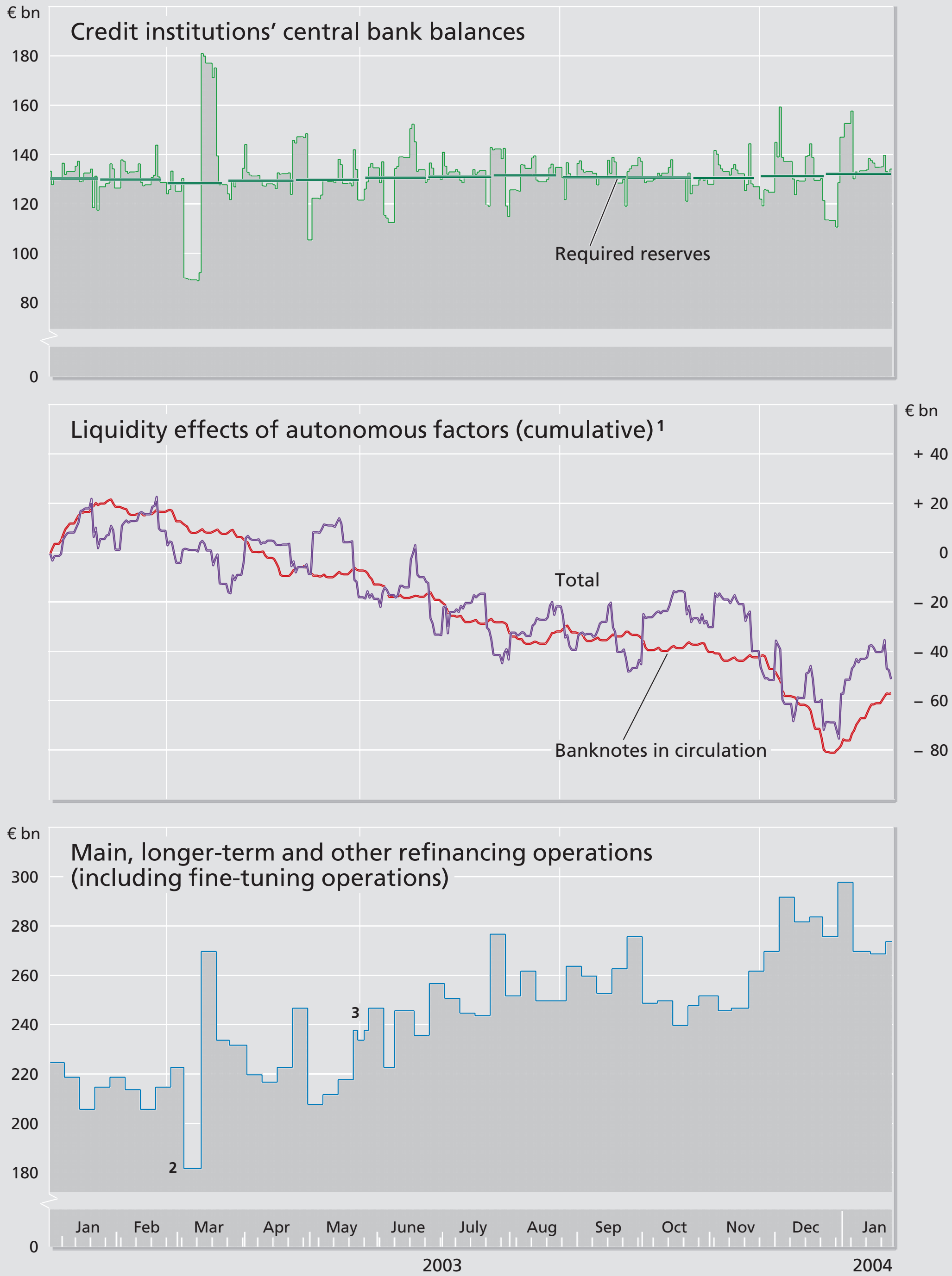
Improved outlook for prices in the first half of the year ...

In line with the Eurosystem's monetary policy objective, last year the Governing Council of the ECB again geared its interest rate policy decisions to the medium-term outlook for prices in the euro area. After having cut the Eurosystem's key interest rates by ½ percentage point in December 2002, the Governing Council of the ECB lowered them by a further ¼ percentage point in early March 2003.

Liquidity management in the Eurosystem

Chart 5

Daily data



1 Banknotes in circulation, general government deposits with the Eurosystem, net foreign reserve assets of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances. — 2 Allotment in the main refinancing operation on 4 March 2003 lower than planned owing to the low volume of bidding by the credit institutions. — 3 Fine-tuning operation consisting of the collection of fixed-term deposits amounting to €3.9 billion between 23 and 25 May 2003.

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Money market management and liquidity needs

Last year the Eurosystem's money market management operations were again aimed at enabling euro-area credit institutions to fulfil their minimum reserve requirements consistently and thus at maintaining the level of the overnight rate, as measured in terms of the weighted average Eonia rate, as close as possible to that targeted by the Governing Council of the ECB. This involved predicting fluctuations in credit institutions' demand for central bank balances as accurately as possible and offsetting them in a timely manner through appropriate open market operations.

Owing to autonomous liquidity factors, credit institutions' demand for central bank balances increased by €54.2 billion overall during 2003 (see table on adjacent page; for the evolution of central bank balances during the year, autonomous factors and open market operations, see chart 5). This meant that the banking system's liquidity needs grew even faster than during the previous year. The development of individual items, however, varied considerably, the volume of banknotes – where a €74.1 billion liquidity-absorbing increase was recorded – marking the greatest changes. This has now more than compensated for the decline in banknotes in circulation in the months prior to the introduction of euro banknotes and coins on 1 January 2002.

The drawdown in the Eurosystem's net foreign reserves also boosted liquidity needs. To a considerable extent, however, the €51.7 billion decrease is a reflection of liquidity-neutral valuation losses resulting from the appreciation of the euro, particularly against the US dollar. By contrast, the €6.7 billion decline in general government deposits with the Eurosystem boosted liquidity slightly, with the €64.9 billion change in other factors upping it considerably. Although other factors were also affected by valuation changes, the substantial build-up during 2003 of the Eurosystem's holdings of euro-denominated securities that are not connected with monetary policy injected a not insignificant amount of liquidity into the banking system.

The clear overall increase in the banking system's liquidity needs was covered by the Eurosystem's move to add significantly to the volume of weekly main refinancing operations (MROs) with a two-week maturity, expanding it by €56.3 billion. The Eurosystem made use of "split tenders" three times. These involve carrying out a reduced volume two-week operation and an additional one-week operation instead of a two-week main refinancing operation. Following the underbidding in the 4 March main refinancing operation, which resulted from market participants' high expectations of interest rate cuts, this method was applied to the 12 March operation in order to remedy the subsequent liquidity deficit without causing too great a divergence in the volumes of parallel tenders. A second split tender operation was carried out on 7 May because major discrepancies would otherwise have occurred in the volumes of the outstanding MROs. This did not ease the situation for too long, however, as speculation about interest rate cuts once again sparked underbidding in the main refinancing operation on 4 June. During the following weeks, the gap between the volumes of the ongoing MROs continued to widen, finally spurring a third split tender operation on 9 July.

The volume of the monthly longer-term refinancing operations with a three-month maturity remained unchanged, with the result that there was a marked drop in their contribution to the overall refinancing volume in 2003. Starting with the operation on 29 January 2004, however, the volumes of individual operations were expanded from €15 billion to €25 billion with a view to increasing the overall outstanding volume of longer-term refinancing operations by a total of €30 billion during 2004.

In terms of volume, other operations did not play a role in the refinancing of the banking system. However, in order to counter the extraordinarily large amounts of excess liquidity on hand at the end of the April/May reserve maintenance period, on 23 May the Eurosystem conducted a fine-tuning operation which consisted of collecting €3.9 billion of fixed-term deposits for three days. The fact that

Factors determining bank liquidity *

€ billion; year-on-year changes

Item	24 Jan 2002 to 23 Jan 2003	24 Jan 2003 to 23 Jan 2004
I Provision (+) or absorption (-) of central bank balances by		
1 Change in volume of banknotes in circulation (increase: -) [1]	– 9.2	– 74.1
2 Change in general government deposits with the Eurosystem (increase: -)	– 5.3	+ 6.7
3 Change in net foreign reserves [2]	– 24.2	– 51.7
4 Other factors [2, 3]	+ 0.5	+ 64.9
Total	– 38.3	– 54.2
II Monetary policy operations of the Eurosystem		
1 Open market operations		
(a) Main refinancing operations	+ 57.9	+ 56.3
(b) Longer-term refinancing operations	– 15.0	± 0.0
(c) Other operations	– 3.7	–
2 Standing facilities		
(a) Marginal lending facility	+ 0.1	– 0.2
(b) Deposit facility (increase: -)	+ 0.3	+ 0.2
Total	+ 39.5	+ 56.3
III Change in credit institutions' credit balances (I + II)	+ 1.2	+ 2.1
IV Change in the minimum reserve requirement (increase: -)	– 2.1	– 1.9

***** Daily averages in the last reserve maintenance period in the period under review less the daily averages of the previous year's reserve maintenance period. — **1** From January 2003, only euro banknotes. — **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.

the Eurosystem made use of fine-tuning operations only once last year shows that autonomous factor forecasts were, in connection with the averaging provision of the minimum reserve system, generally reliable enough to facilitate efficient money market management solely by means of the weekly MROs.

Even though the overall level of recourse to the standing facilities was low, they still played a role in the success of the money market management in that they absorbed short-term liquidity excesses or provided additional liquidity at counterparties' request.

Consequently, the Eurosystem's liquidity management operations enabled it to maintain the overnight rate (Eonia) last year more or less at the level targeted in its monetary policy (see chart 4). The spread between Eonia and the minimum bid rate slipped from a year-on-year average of 7 to 6 basis points in 2003. Larger deviations from the minimum bid rate on MROs arose mainly at the end of the reserve maintenance periods. Nevertheless, measured in terms of the standard deviation, the volatility of the 2003 spread between the Eonia and the minimum bid rate climbed by 3 basis points to 15 year on year, which, however, is not surprising for periods stalked by a relatively large amount of interest rate uncertainty in the market.

The introduction of the new operational framework for monetary policy in 2004 should largely solve the problems of divergent tender volumes and underbidding in an environment of interest rate cut expectations that occasionally plagued the Eurosystem's liquidity management in 2003. Starting with the main refinancing operation on 10 March 2004, only one-week operations will be carried out. Furthermore, provided that they are taken at scheduled monetary policy meetings, decisions of the Governing Council of the ECB on the minimum bid rate and on the interest rates for the standing facilities will, as of March 2004, generally not take effect until the following reserve maintenance period and will apply for at least one period so that there is no longer any possibility of underbidding in times of speculation about interest rate cuts. However, these new regulations mean that more time will lapse between the last MRO and the end of a reserve maintenance period, with the result that there could tend to be a rise in the need to use fine-tuning operations.

These interest rate policy measures took account of the change in the outlook for prices. In particular, muted economic growth – not least owing to general uncertainty caused by the war in Iraq – and the increase in the external value of the euro had slowed the medium-term upward pressure on prices in the euro area. It also soon became apparent that no immediate acceleration of economic growth in the euro area was generated by the unexpectedly swift end to the war in Iraq. In addition, given the continuing distinct, rapid appreciation of the euro (which slowed the rise in prices), the Governing Council of the ECB, at its meeting on 5 June 2003, made use of the recently derived monetary policy manoeuvrability to cut interest rates by a further ½ percentage point. Since then, the main refinancing operations have been conducted as variable rate tenders with a minimum bid rate of 2% and the interest rates on the marginal lending facility and the deposit facility have been 3% and 1% respectively. The Governing Council maintained this stance up to the end of the period under review since, given the signs in the second half of 2003 that the economy was tending to pick up again, the strong euro formed an effective counterweight to the historically low central bank interest rates.

... despite strong increase in money stock

Overall, the money stock M3 continued to grow strongly in the euro area in 2003. A persistently high degree of uncertainty in the financial markets and disappointed hopes that the economy would soon recover had again accelerated the rise in liquidity in the first half of the year. Even though monetary dynamics lost steam again in the second half of the year, the surplus liquidity holdings that were built up until the middle of the year remained high. In view of the fact that the economic upturn in the euro area was no more than moderate, the risk of surplus money holdings being used to purchase goods is currently low. Even so, in a definite economic upturn, the possibility of funds being used in this way cannot be ruled out entirely. For this reason, a careful analysis of monetary developments remains necessary.

(b) Successful money market management by the Eurosystem against a backdrop of an initial further fall in interest rates

Interest rate measures came as no surprise

The Eurosystem's two interest rate cuts were both anticipated by market participants. Despite the reduction in key interest rates in December 2002, the shape of the yield curve remained inverted over the first few months of 2003. Forward interest rates, some of which lay noticeably below the corresponding short-term money market rates, especially at longer maturities, were likewise a sign that money market rates were expected to fall. In view of the deflation debate that was particularly lively in the first few months of the year and unsatisfactory economic developments in the euro area, even the interest rate cut at the start of March was unable to noticeably dampen expectations of interest rate cuts. Only a further ½ percentage point cut in interest rates at the start of June and the signs of an economic turnaround flagged by some economic indicators in the third quarter led to a normalisation of the money market yield curve and finally to very distinct expectations of an interest rate rise as early as spring 2004. In connection with the strong appreciation of the euro around the turn of 2003-04, however, the market expected the Eurosystem's first interest rate increase to take far longer to materialise.

Liquidity management largely successful

Larger fluctuations in the overnight rate (Eonia) over the past year generally occurred only at the end of the reserve maintenance periods. In the run-up to the March interest rate cut, however, there was distinct underbidding in the main refinancing operations (MROs), the outcome being that the liquidity shortage even pushed money market rates perceptibly higher for a time. Nonetheless, an additional main refinancing operation with a reduced maturity up to the next regular MRO maturity took Eonia back towards the marginal interest rate. Otherwise, it lay very close to the minimum bid rate for most of last year. Following the interest rate cut in June, however, cautious bidding, owing not least to the usual shortage of liquidity at the half-year changeover, initially prevented the marginal rate from moving more rapidly towards the minimum bid rate. This did not occur until July, after the Eurosystem had provided a generous amount of liquidity. As a result of the implementation of the changes to the monetary policy instruments agreed at the start of 2003, liquidity management is likely to run even more smoothly in future (for further details on the measures taken, see the box entitled "Money market management and liquidity needs").

2 Portfolio shifts and low interest rates continue to bolster monetary expansion

(a) Persistently strong monetary growth in the euro area

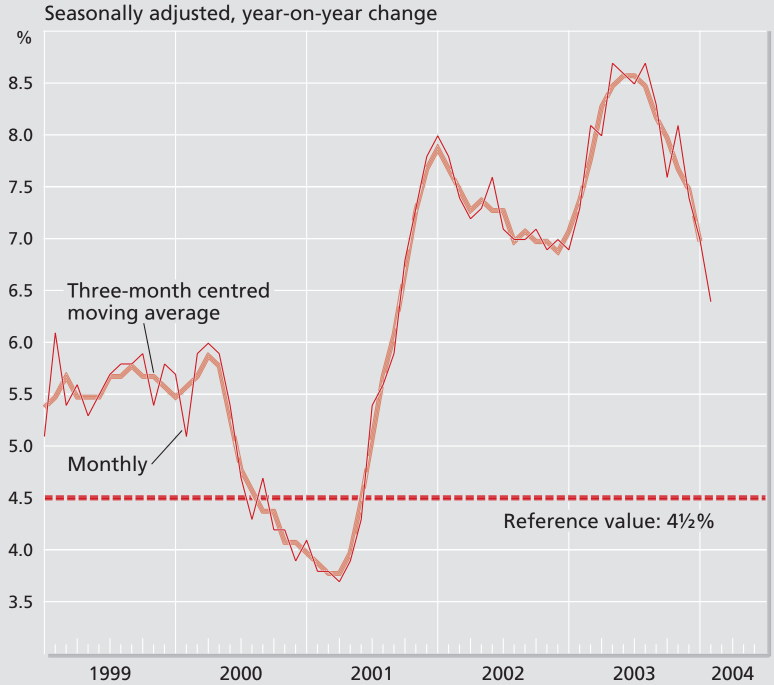
Persistently high M3 growth rate

The money stock M3 continued to rise strongly in 2003, with the three-month moving average of its 12-month growth rates reaching 7.0% at the end of the year. The build-up of liquidity was particularly pronounced in the first half of the year, when renewed financial market uncertainty boosted demand for liquid and secure bank deposits. While investment behaviour was particularly affected

M3 growth in the euro area

Chart 6

Seasonally adjusted, year-on-year change



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by continued fluctuations on the stock markets in the first quarter, it was primarily the performance of the bond markets during the second quarter that triggered the recent portfolio reallocations behind M3 growth. Concerns about potential deflationary risks, in particular, temporarily pushed up US and European government bond prices and made investors uneasy about further interest rate developments, with the result that they parked a considerable amount of their investable funds as liquid money holdings. There was no loss of monetary dynamics until the second half of the year. A new wave of economic optimism sparked a further significant rise in capital market rates and opened up attractive investment opportunities on the stock market. Accordingly, the effects of the second-quarter portfolio shifts on the M3 growth rate waned in the second half of the year, although there has not yet been any notable reduction in surplus liquidity.

Further marked expansion of currency in circulation

Of the components of the monetary aggregate M3, euro cash holdings outside the MFI sector once again showed the strongest growth in the euro area. The 25% surge in currency in circulation during 2003, however, was not quite as strong as in 2002 (just over 42½%) when the introduction of euro banknotes and coins precipitated a particularly large increase in cash holdings. The heavy demand for high-denomination euro banknotes also indicates that the expansion of currency in circulation is increasingly attributable to cash hoarding within the euro area and abroad. It is, however, unlikely that these cash holdings will affect demand within the euro area in the foreseeable future.

Sight deposits ...

There was also a sharp 8½% rise in overnight deposits in 2003. The increase in the second half of the year was somewhat less marked than in the first half but the range of fluctuations in the seasonally adjusted monthly increases was considerably wider during this period. While showing slightly less interest in highly liquid sight deposits, investors nevertheless adopted a more cautious liquidity management strategy during periods of market uncertainty and tension.

... and other components showed differing trends

By contrast, there was considerable variation in the changes displayed by other short-term bank deposits. While short-term time deposits (with an agreed maturity of up to two years) dropped by 2½%, deposits redeemable at notice of up to three months went up by just over 10%. Given the narrower interest rate spread between short-term savings deposits and short-term time deposits remunerated more closely in line with market rates, investors attached considerable importance to the greater flexibility advantage of short-term savings deposits. Nevertheless, funds are also likely to have been shifted out of deposits with a longer period of notice (over three months), these having been reduced markedly in 2003.

There was a further increase in short-term marketable instruments held by domestic non-banks during 2003. However, the increase was only of money market fund shares, which are thus the most important component. By contrast, the year showed a marked decrease in repurchase agreements and short-term bank debt securities (with an initial maturity of up to two years).

(b) Heterogeneous determinants of monetary growth

Recovery in lending to the private sector

Following a spell of extreme weakness, euro-area bank lending to domestic enterprises and households made a notable recovery last year. At the end of December 2003, loans were up 5½% year on year; longer-term loans (with a maturity of over one year) were in particular demand. Not only did more households take out longer-term housing loans, enterprises also built up their longer-term indebtedness with euro-area banks more strongly than their total unsecuritised borrowing from banks within the euro area. Euro-area banks also topped up their holdings of securities issued by domestic enterprises by almost 8%,

Monetary developments in the euro area

Table 3

Changes in the course of the year

Item	Euro area 2002	Euro area 2003
	in %	
I Growth of the monetary aggregates [1]		
M1 [2]	9.7	10.5
M2 [3]	6.6	7.5
M3 [4]	6.9	7.0
	€ bn	
II Money stock and its counterparts	370.1	402.7
Money stock M3 (= 1 + 2 – 3 – 4 – 5)		
Currency in circulation and overnight deposits	216.8	254.1
Other shorter-term bank deposits	86.5	114.6
Marketable instruments	66.6	34.0
Balance sheet counterparts		
1 Total credit to non-MFIs in the euro area	380.6	579.4
Credit to general government	35.9	134.9
Credit to private sector non-MFIs in the euro area	344.7	444.5
2 Net claims on non-euro-area residents	166.8	88.5
3 Deposits of central government	– 5.8	13.0
4 Longer-term financial liabilities to other non-MFIs in the euro area	188.4	225.6
5 Other counterparts of M3 [5]	– 5.3	26.6

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 and money market paper issued by MFIs in the euro area). — **5** Calculated as a residual.

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which is more than double last year's increase. Alongside securities other than shares, banks also purchased shares and other equities.

Marked expansion of lending to the public sector

In 2003, euro-area banks acquired a large amount of public sector securities, whereas their unsecuritised lending to the euro-area public sector showed only a comparatively low increase. Overall, lending to the public sector rose by 6½% during the course of last year.

Capital inflows in foreign payment transactions

During the year under review, foreign payment transactions by euro-area non-banks also had expansionary effects on monetary developments. The net external position of the euro-area banks, which reflects such payments, rose by €88½ billion. On the one hand, this is a reflection of the euro area's current account surplus but, on the other, it can also be attributed to securities transactions with countries outside the euro area, with non-residents once again purchasing considerably more domestic shares and fixed interest securities than euro-area residents did foreign paper. The euro-area's interest rate advantage over the dollar area, which was particularly evident in the first half of the year, and expectations of the euro appreciating are likely to have been an important incentive in this regard.

Sharp rise in monetary capital formation

The expansionary effects stemming from banks' asset-side business were offset partly by an increase of just over 5½% in monetary capital formation at domestic MFIs. In this regard, bank debt securities with an initial maturity of over two years were particularly popular during 2003; they alone constituted around two-thirds of the increase in monetary capital formation. In a low interest-rate environment, return-hungry investors preferred this kind of securities as they generally have a higher rate of interest than government securities. On account of this, however, their interest rate advantage dwindled during 2003. Owing to the increasing spread in the term structure of interest rates during the second half of the year, investors showed a keener interest in longer-term time deposits. By contrast, there was an accelerated decline in deposits redeemable at notice of more than three months as there is usually a time lag before their conditions are brought into line with market developments.

III Capital markets and banks

1 Bond and equity markets against the backdrop of global economic recovery

(a) Bond markets between deflationary concerns and new confidence

Interest rates fall to historical low at mid-year ...

In the first half of 2003 interest rates in the euro-area bond markets declined further, thus continuing the trend which started in May 2002 and which was interrupted only for a while during the Iraq war. By mid-June, interest rates had fallen to historical lows both in the euro area and the USA. At that time, yields on ten-year bonds were occasionally below 3¼% in the USA and around 3½% in the euro area compared with over 4% and 4⅓% respectively at the beginning of 2003. Despite the ECB's two interest rate cuts at the beginning of March and the beginning of June (by a total of ¾ percentage point), the yield curve in the euro area flattened considerably as a result. As the second half of the year began, there was, for a time, even an inverted yield curve at the short end of the maturities range, which gave rise to expectations of further monetary easing and thus to market participants' scepticism about the euro-area's further economic development.

... driven by potential deflationary risks

One of the main reasons for this development were concerns about possible deflationary risks, which were fanned further by statements made by the members of the Federal Reserve Board following their meeting on 6 May. At the same time, the Federal Reserve stated that, if necessary, it would also resort to unconventional monetary policy measures to prevent deflation. As a result, capital market rates fell far more strongly than the fundamental macroeconomic factors would suggest: in mid-June ten-year US Treasuries were priced considerably below the levels seen in the past when growth and inflationary expectations for the US economy were at a similar level and thus also put pressure on European bond yields (see chart on page 39).

Correction following overpricing in the summer

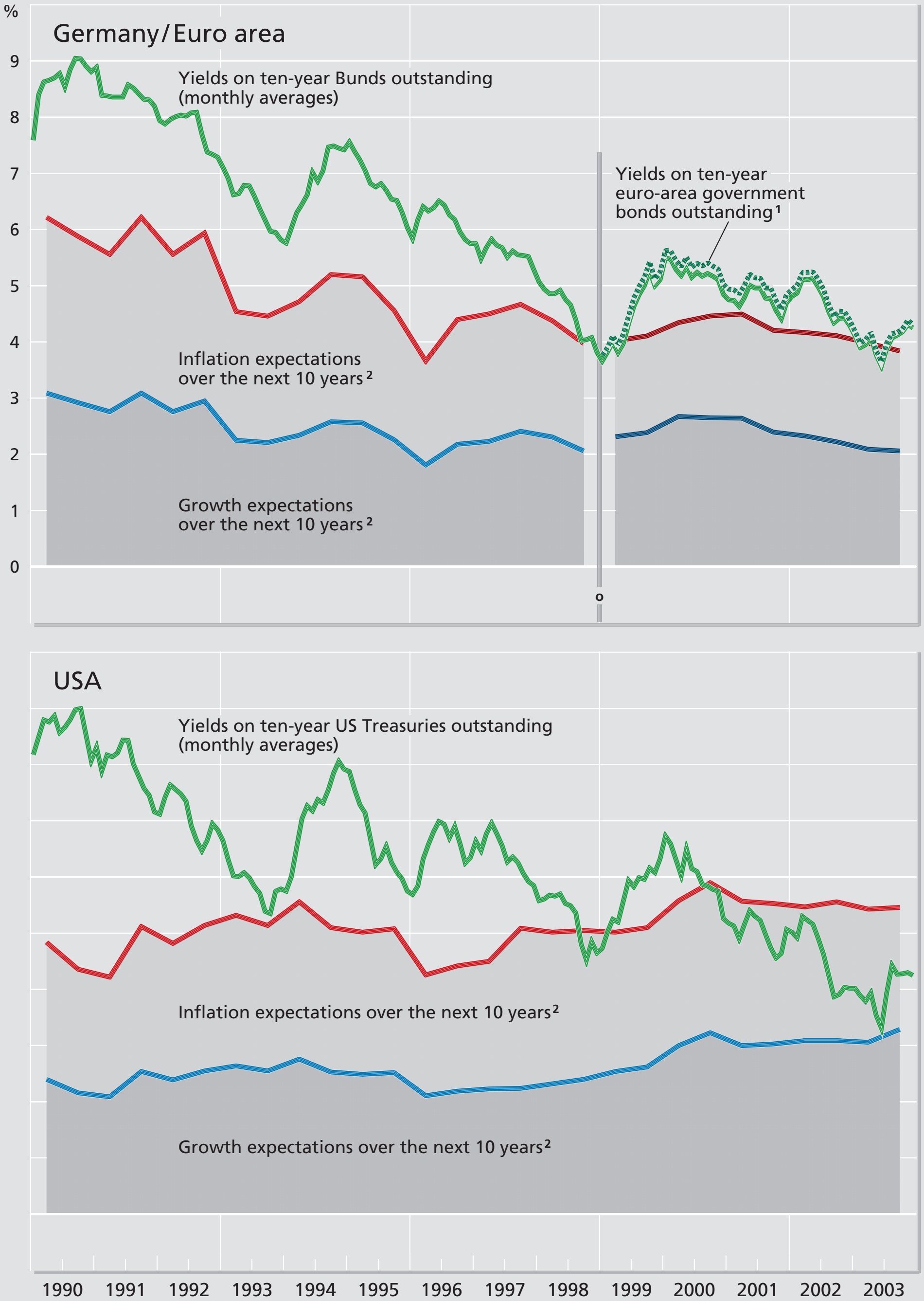
In the euro bond markets this bullish movement was not as strong. Accordingly, when the prospects for the US economy improved, the subsequent correction of the interest rates in the US bond market (1¼ percentage points) was also twice that in the euro area. Ten-year euro government bonds were priced at just under 4% at the end of the period under review. At the same time, the yield curve fanned out again considerably as a result. In the first two months of the year, the interest rate gap between ten-year government bonds and three-month funds was over 2 percentage points; in the summer of the previous year it had, at times, been less than 1½ percentage points. Taking account of market participants' longer-term inflationary expectations in the euro area, an expected real interest rate of approximately 2½% can be derived from the current yield on ten-year euro-area government bonds. From a historical perspective this is a relatively low rate.

Favourable financing terms for enterprises with access to the capital markets

European enterprises with access to the capital markets benefited over the course of the year from investors' "yield search". Owing, in particular, to demand from institutional investors, the yield spread between corporate bonds with a maturity of seven to ten years and less than a first-class rating (BBB rating) and government bonds with the same maturity declined both in Europe and in the USA from just under 2 percentage points in the second quarter to 1¼ at the time of the historical interest rate low in mid-June. Enterprises took advantage of the favourable financing terms expressed in the low interest-rate pre-

Bond yields and growth and inflation expectations

Chart 7



1 GDP weighted average. — **2** Bundesbank calculations based on biannual surveys of short and long-term expectations for the development of the consumer price index and the gross domestic product. Source: Consensus forecast. — **o** From 1999, expectations and, in addition, euro-area interest rates. In European monetary union, the nominal yields of German government bonds outstanding depends on the growth and inflation expectations for the entire euro area. Owing to the elimination of exchange rate risk following the start of European monetary union, the yield differentials between German government bonds and other euro-area government bonds arise solely from differences in credit rating and liquidity.

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mium by continuing to borrow extensively on the European capital market. In the second half of the year, the brightening growth and earnings prospects contributed to a further decline in the interest rate premia. At the same time, there were more signs of a stabilisation in enterprises' credit rating. Consequently, the ratio of rating downgrades to upgrades fell from 13:1 in the first quarter to 1.5:1 in the fourth quarter. At the end of the period under review, the interest-rate premium was just under ¾ percentage point for US issuers and nearly 1 percentage point for euro-area enterprises. Despite general price losses in bond investments, European issuers' debt securities were therefore able to show positive returns between mid-June and the end of the year.

(b) Rising share prices and corporate earnings prospects

Marked share price gains

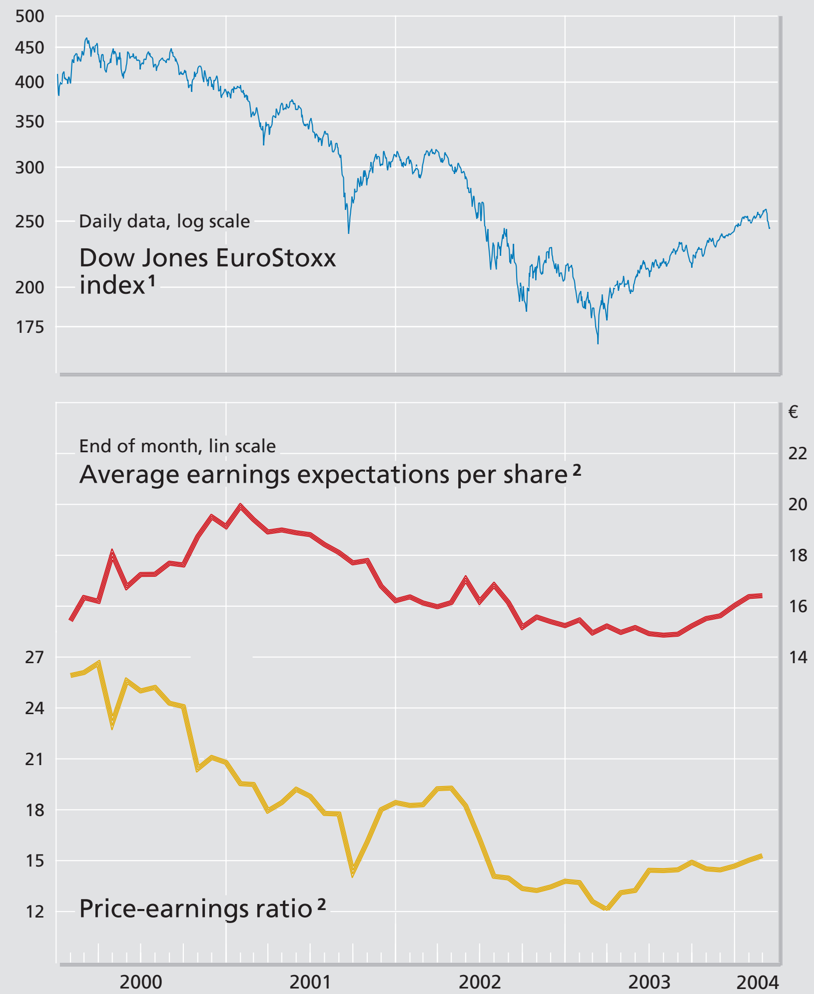
European equity markets showed a positive performance in the year under review. This applies particularly to the German market following a relatively pronounced collapse in share prices. The broad CDAX, for example, gained just over 25% between the beginning of 2003 and the time this report was concluded, compared with a rise in the Dow Jones EuroStoxx index of just over 12%. There were, however, considerable fluctuations over the course of the year. After share prices in Germany and the rest of Europe had fallen on average by approximately one-quarter between January and mid-March 2003 owing to geopolitical uncertainties, improved economic prospects and hopes of a rapid end to the Iraq conflict ushered in a turnaround in the equity markets in mid-March. Moreover, against the backdrop of lower risk assessments, the prices of German and other European shares have risen perceptibly since then. At all events, the breakdown of the share price performance of the DAX and the Dow Jones EuroStoxx index into the determinants contained in the dividend discount model suggests that, especially in the second and third quarters of 2003, the equity risk premium made a considerable contribution to the price rise. At the end of the period under review, the CDAX and Dow Jones EuroStoxx indices were, respectively, 70% and one-and-a-half times above their low points in spring 2003. From the beginning of 2003 onwards, technology shares made particularly strong gains in Europe, with similar developments for bank shares occurring in Germany.

Higher valuation level

The relatively consistent rise in share prices indicates that the deflationary fears that had at times characterised bond market performance had no obvious impact on the equity markets. However, a certain amount of initial scepticism with regard to the sustainability of the rise in sentiment is likely to have resulted in analysts taking a reserved stance with regard to year-on-year earnings prospects

Share prices and fundamental determinants

Chart 8



1 End of 1991 = 100. Source: Deutsche Börse AG. — 2 Based on expected earnings per share of the enterprises included in the Dow Jones EuroStoxx index for the next 12 months according to I/B/E/S. Source: Thomson Financial.

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in the third quarter. However, after economic indicators had continually improved, they became more confident and, in the autumn months, they made a substantial upward revision of their earnings expectations for listed German and European companies. Since share prices rose faster than year-on-year earnings estimates, the price-earnings ratio of German and European shares, calculated on this basis, rose from approximately 12 in March 2003 to just under 16 and around 15 respectively in February 2004.

Given higher share prices, the uncertainty as to future share price developments steadily waned. Whereas the implied volatilities of options on German, Euro-

Waning uncertainty in the equity markets

pean and US blue chips were still at very high levels in March 2003, the downward trend witnessed at the end of the period under review signalled a more favourable assessment of the geopolitical situation. Coupled with the rise in enterprises' valuations, it is ultimately an expression of the confidence that market participants have in their future earnings growth.

(c) European stock exchanges

Stock exchanges compete in share trading and settlement

Measured in terms of business volume, in 2003 stock market equity trading in Europe tended to continue shifting to the large trading platforms of the London Stock Exchange, Deutsche Börse AG and Euronext. Nonetheless, the liquidity of many national blue-chip stocks remained concentrated on the home stock exchanges. In this context, the competition between the trading platforms increasingly involved secondary listings of foreign blue chips. The competing stock exchanges and clearing houses were clearly endeavouring to attract trading participants and liquidity as well as settlement transactions of foreign shares by offering more favourable conditions and lower fees. An expression of the more intense competition, *inter alia*, was the fact that foreign securities were settled at national settlement conditions.

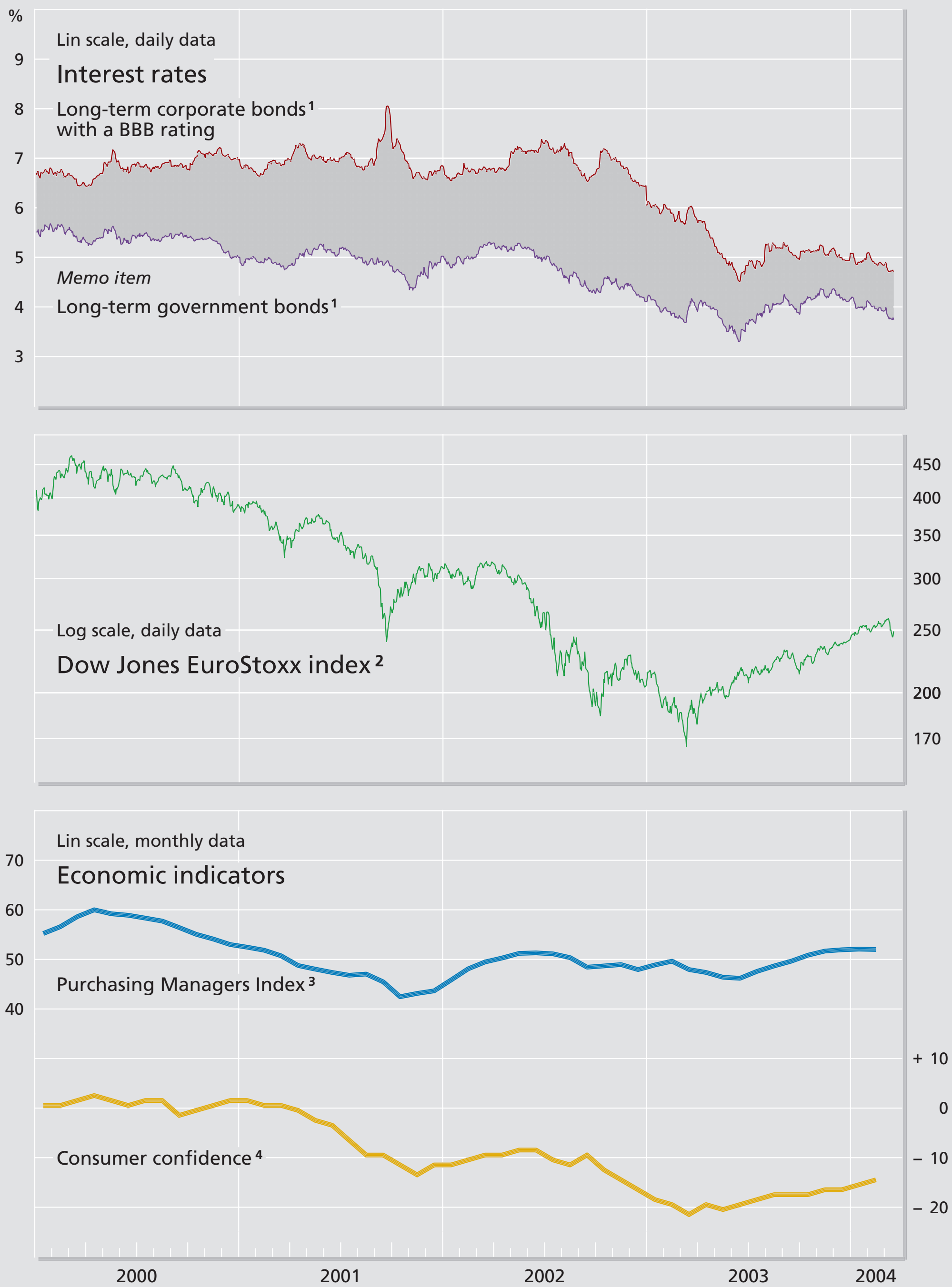
(d) Record issue volume in the German bond market

Bond sales

Against the backdrop of the government's precarious budgetary position and the favourable financing conditions, the level of funds raised in the German bond market increased further in the year under review. At €1,155 billion, gross sales of German debt securities again reached a new peak market value, topping last year's level of €934 billion. After deducting redemptions and adjusting for changes in issuers' holdings of their own bonds, net sales, at just over €134 billion, were up by €10 billion on the previous year. In particular, the public sector increased its capital market borrowing, owing to larger deficits. The Federal Government borrowed a total of €74½ billion net, compared with €66½ billion in the previous year. Sales of ten-year Bunds raised €34½ billion. The state governments (*Länder*), much as in 2002, increased their bond market debt by €34 billion. By contrast, net sales of corporate bonds and commercial paper amounted to €30½ billion, thus doubling on the year. The credit institutions raised €31½ billion net in the capital market, which was down on the previous year. This is in line with the decline in refinancing need resulting from the sharp growth in deposits and restrained lending.

Corporate valuations and economic indicators in the euro area

Chart 9



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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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
1999	292.7	94.6	150.0	114.0	111.3	37.7
2000	226.4	68.4	140.5	117.7	118.0	39.7
2001	180.2	93.6	81.5	64.0	97.0	35.5
2002	178.1	54.0	39.7	30.5	66.5	25.9
2003	170.2	35.7	17.4	0.5	48.2	20.1
2003 Q1	68.7	6.6	– 7.1	– 9.9	22.1	10.9
Q2	51.6	24.2	8.1	2.4	14.1	7.0
Q3	20.8	0.6	4.6	2.5	6.8	2.6
Q4	29.1	4.2	11.8	5.5	5.2	– 0.4

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
1999	136.9	46.9	81.0	84.5	74.7	18.6
2000	74.8	– 24.2	60.1	141.4	91.4	23.3
2001	63.1	84.9	81.3	11.3	35.8	– 14.7
2002	94.7	20.6	69.8	42.3	13.5	– 23.2
2003	68.6	25.3	65.8	– 14.9	35.7	7.1
2003 Q1	33.2	– 3.4	15.5	2.5	20.0	– 6.2
Q2	31.9	4.4	16.5	– 1.8	3.2	5.5
Q3	– 7.0	3.1	23.8	3.0	4.0	– 1.5
Q4	10.5	21.2	10.0	– 18.6	8.6	9.2

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Bond purchases

In the year under review, it was mainly foreign investors and domestic non-banks which were active in the bond market, partially a result of a move away from shares. They added domestic debt securities worth €68½ billion and €56½ billion respectively to their portfolios. Whereas foreign investors invested more in debt securities issued by the private sector, non-banks focused on public-sector debt securities. Domestic credit institutions increased their bond holdings by €9½ billion and invested €26½ billion in foreign paper.

(e) Increased level of primary market activity in the equity market

No IPOs in the year under review, but signs of a future primary market recovery

At just under €17 billion, the volume of issues in the domestic equity market in the year under review increased by €7½ billion on the previous year. The bulk of the funds raised (just over €12 billion) accrued to listed enterprises, including three large issues worth approximately €9 billion by insurance companies and banks. There was also an equity issue of €1½ billion, arising from the spin-off of a business area of a big bank at the beginning of October. Despite the recovery in the equity market there were no IPOs in the year under review. However, the

Net borrowing in
the German capital markets

Chart 10

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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currently favourable growth and earnings expectations give reason to hope that the share price recovery will also increasingly pave the way in the coming months for enterprises to go public. The recent announcements of planned IPOs at least give cause to expect increased primary market activity.

Equities purchased mainly by foreign investors

On balance, foreign investors were well in the lead as the main purchasers of German equities, acquiring €25½ billion almost entirely in the form of portfolio investments. German credit institutions added €3½ billion worth of both German and foreign equities to their holdings. On balance, domestic non-banks sold shares in the equity market. They sold German equities worth €12 billion and foreign equities worth over €3 billion.

(f) Further decline in capital accruing to mutual funds

Low sales of domestic mutual fund shares

The equity market slump, which lasted until spring, left its mark on mutual funds during the entire period under review. Sales of domestic mutual fund shares declined for the third year in succession. Specialised investment funds – with mixed funds continuing to prove particularly attractive to investors – and mutual funds open to the general public recorded net capital inflows of €24 billion and €20 billion respectively and both therefore fell short of the previous year's level. The sale of foreign mutual fund shares, which were mainly purchased by domestic non-banks, also declined by nearly half to just under €4½ billion.

Interest in open-end real estate funds wanes over the year

Although private investors' interest in domestic mutual funds open to the general public was still focused on low-risk, open-end real estate funds with favourable tax treatment, which, at €14 billion, achieved net sales receipts falling just short of the level attained in the record year 2002, the capital inflows did decline almost consistently over the course of the year. In December these funds actually redeemed shares worth just under €1 billion. Bond-based funds came a distant second; at over €4 billion, they sold somewhat more shares than in the previous year. Despite the large share price losses in the stock markets, savers with mutual funds did not, on balance, redeem any shares in share-based funds, but rather increased their holdings by just under €2½ billion, somewhat less than in the previous year. This reflected private investors' continued reticence to invest in share-based funds. Money market funds and pension mutual funds saw net capital outflows of just under €1 billion and €¼ billion respectively.

(g) Venture capital market gaining confidence

Market for venture capital weakened by developments in previous years ...

In the year under review, the German market for venture capital managed to offset only part of the losses of the previous years following the end of the stock market boom. Although the overall portfolio of the capital investment companies grew by over one-tenth to €17.9 billion, losses from existing investments are again likely to have restrained the growth in value of the portfolio, albeit less than in the previous year. At the same time, increased initial investments suggest a growing willingness on the part of capital investment companies to invest. Although overall gross investments remained constant in the year under review,

Entry into force of the Investment Modernisation Act

The Investment Modernisation Act, which entered into force on 1 January 2004, represents a far-reaching restructuring of the regulatory framework for investment companies in Germany. It is of particular importance that the new regulations permit the authorisation of hedge funds in Germany. In the interests of investor protection, only funds of hedge funds complying with certain risk diversification regulations may be sold publicly to private investors. For example, a fund of hedge funds may invest a maximum of 20% of fund assets in a target fund. Furthermore, the target funds have to be diversified by means of various portfolio strategies and no more than two target funds may be administered by the same fund manager. The authorisation of hedge funds will probably help to improve the allocation of individual economic agents' risks as well as strengthen the future role of Germany as a financial centre. The stringent disclosure requirements make it possible for individual investor groups to attain a relatively good understanding of the product in question and hence be able to make an educated assessment of the risks involved. This is a basic requirement for the successful launch of German hedge funds.

With the introduction of the Investment Tax Act, which contains the provisions relevant to tax, the earlier differences in taxation between domestic and foreign investment funds have been largely eliminated. This includes the elimination of the distorting disadvantages arising from the former non-application of the system of income tax relief in the case of investment income and sales of shares in foreign investment funds.

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the share of investment in the biotechnology as well as the information and communications technology sectors was reduced from 46% in the first quarter to 11% in the fourth quarter. The capital investment companies' increased risk aversion was also reflected in the still limited resources available for seed and start-up financing. Again, investors' interest was focused on buyout financing.

... but business climate improved in the second half of the year

However, the prospects on the German venture capital market brightened in the second half of the year. Since its low point in the second quarter, the German Private Equity Barometer has been showing an increasing ratio of positive to negative assessments of the current situation and at the end of the year under review indicated mainly optimistic business expectations.

2 Positive earnings prospects for banks in Germany

(a) Heterogeneous development of German banks' deposit and lending business with domestic customers

Marked build-up of deposits, only a small increase in lending

Last year German banks again saw their domestic customers' deposits increase far more strongly than their lending business. The build-up of deposits in Germany came about primarily because of the considerable uncertainty in the financial markets over lengthy periods of the year. Consequently, it was mainly the particularly liquid overnight bank deposits that experienced growth in 2003. The portfolio shifts associated with the high level of uncertainty in the financial markets were probably also a primary cause of last year's substantial increase, as part of their asset-side business, in the net external position of German banks. By contrast, there was again only a slight expansion of lending to domestic non-banks, this probably being mainly attributable to the stagnating economy. Credit demand and banks' willingness to grant loans generally both decline in that kind of macroeconomic environment.

Further strong increase in overnight deposits

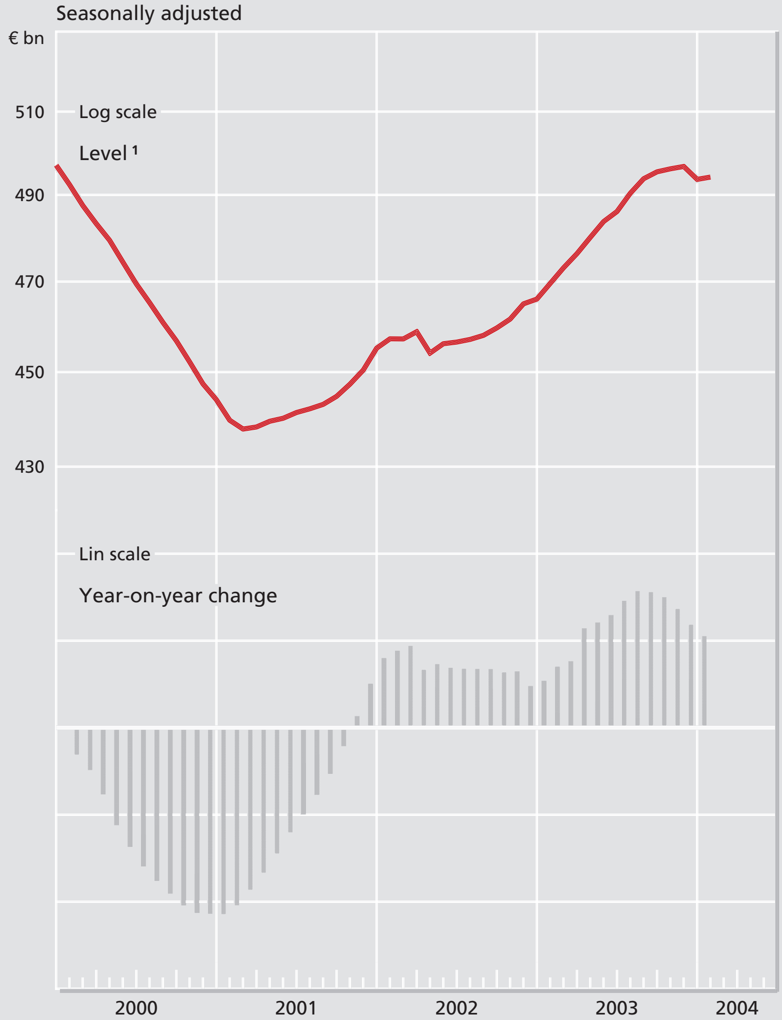
Of domestic customers' deposits with German banks, overnight deposits again increased strongly last year. All in all, they went up by 9%. However, developments were considerably uneven during the year. The Iraq war meant that investor uncertainty was particularly high in the early months of the year, which pushed cash holdings in the form of sight deposits up further. The subsequent decline in long-term interest rates encouraged the build-up of liquidity in the second quarter, at a time when prices in the international equity markets were again rising. However, the rise in long-term interest rates from the mid-year point, the dwindling of the yield advantage of euro investments and its temporary reversal over equivalent US dollar assets and the ongoing rise in equity prices put the damper on investors' distinct preference for overnight deposits in the summer months.

Dynamic build-up of short-term savings deposits ...

In addition to overnight deposits, deposits with an agreed period of notice of three months were also increased strongly in 2003. They went up by 6% last year. Since low interest rates mean low opportunity costs, the fact that these deposits are highly liquid appears to have represented a key investment motive. To an extent, these forms of investments were probably also boosted by the persistently marked decline in deposits with somewhat longer periods of notice (over three months); interest rates on these deposits had been cut more severely than in the case of deposits with shorter maturities. However, much as for over-

Short-term savings deposits
of domestic non-banks at German MFIs

Chart 11



1 End of month; statistical changes eliminated.

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night deposits, the willingness to invest money in short-term savings accounts declined noticeably over the course of the year. Apart from the changed liquidity preference, this was probably also due to the rise in capital market rates.

... but a sharp reduction in short-term time deposits

Short-term time deposits (with agreed maturities of up to two years) were also affected; their interest rates are traditionally linked to money market rates and became substantially less attractive after the Eurosystem twice reduced key interest rates. The decline of €31½ billion was almost three times that of the previous year. By contrast, there was a marked increase in longer-term time deposits, especially from the middle of the year onwards, with the main rises taking place in July and August.

Lending to the public sector stagnates

Lending by German banks to domestic government remained more or less unchanged for the second year in succession. A recent 2% decline in loans was offset by an increase in the banks' holdings of government securities.

Persistently low level of lending to the private sector

Growth in lending by German banks to the domestic private sector was, at 1%, again very weak last year. This is particularly true of securitised lending, which the banks cut back by just over 1½% while increasing their loans to domestic enterprises and households by just over 1%. The consolidation of short-term bank liabilities of households and enterprises by longer-term financing at favourable rates of interest seems to have been a factor here. At all events, the net increase was only in medium and long-term loans while both enterprises and households reduced their short-term borrowing from German banks.

Causes of sluggish credit business

Overall, the persistently small increase in lending to the private sector is probably mainly the result of stubbornly slow growth in Germany. This is likely to have dampened the willingness of enterprises and households to take out new loans. However, according to the results of the Eurosystem's quarterly bank lending survey, which has been conducted since January 2003, supply-side effects also played a role in credit developments. More restrictive and more risk-differentiated lending conditions were applied by the banks in an attempt to limit their credit risk and to widen their interest margins as a means of countering the changed assessment of risks and improving their performance. In the course of 2003, the tightening of banks' lending conditions eased and margins were widened less frequently as the year progressed (see left-hand side of chart on page 53). This tendency was true primarily of average lending, while further widening of the margins persisted for riskier loans – albeit in a partially weakened form. This development indicates that there is a sustained trend towards a risk-differentiated margin spread and that greater consideration is being given to borrowers' credit ratings when lending decisions are made. This is just as welcome in terms of allocations as with regard to the stability and resilience of the German banking system.

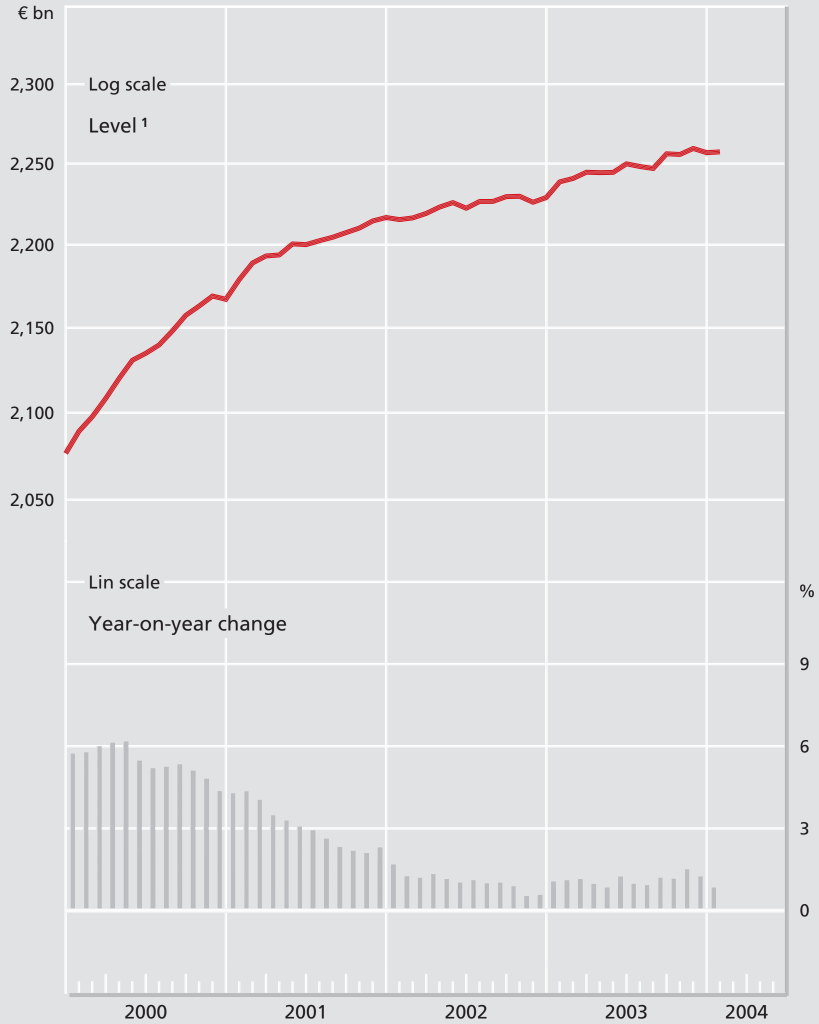
(b) Developments in the German banking sector

The lending practices of the different categories of banks nonetheless varied quite considerably. The bulk of new lending business was accounted for by the

Loans to enterprises and households in Germany

Chart 12

Seasonally adjusted



1 End of month; statistical changes eliminated.

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Smaller institutions make up for withdrawal of larger banks from lending business

savings bank sector, while the category of commercial banks taken as a whole reduced existing loans. The reduction in lending by the big banks, which was still considerable after revaluation adjustments, was a factor here. As in the previous year, this obscured the relatively strong increase in loans by regional and other commercial banks, which are included in the category of commercial banks together with the big banks. Comparatively high growth rates were recorded by special-purpose banks and mortgage banks as well as by foreign banks, most of which are included in the category of commercial banks. It was precisely these smaller categories of banks which, measured in terms of their market share, had a disproportionately large share of new lending business. By contrast, both the big banks and the regional institutions of credit cooperatives made a clear reduction and the Landesbanken a slight reduction in their lending to the private sector; savings banks and cooperative banks, however, increased their lending somewhat.

Improved performance but lower net interest received

The information currently available suggests that a slight improvement in the performance of German credit institutions is likely for 2003, following the poor figures for the previous year. Despite high growth in the area of low-yield deposits (referred to above) and initial relief generated by more strongly risk-differentiated margins, net interest received is likely to have been lower than in 2002 as, in particular, the reduction of risk assets limited the sources of income in this area. The data available to date indicate that there is also hardly any positive momentum to be gained from net commissions received in 2003. However, following the severe negative pressures in 2002, there are signs of a slight easing of tension in the area of loan provisioning. Although the number of corporate and private insolvencies increased further in 2003, the extensive valuation adjustments carried out in the previous year and the effects of the overall global economic recovery meant a distinct improvement in the underlying situation. Moreover, the fact that banks have reduced their risk assets will also ease the situation in this area. For instance, the institutions withdrew more strongly from critical or non-strategic credit positions.

New securitisation initiative expected to produce capital relaxation

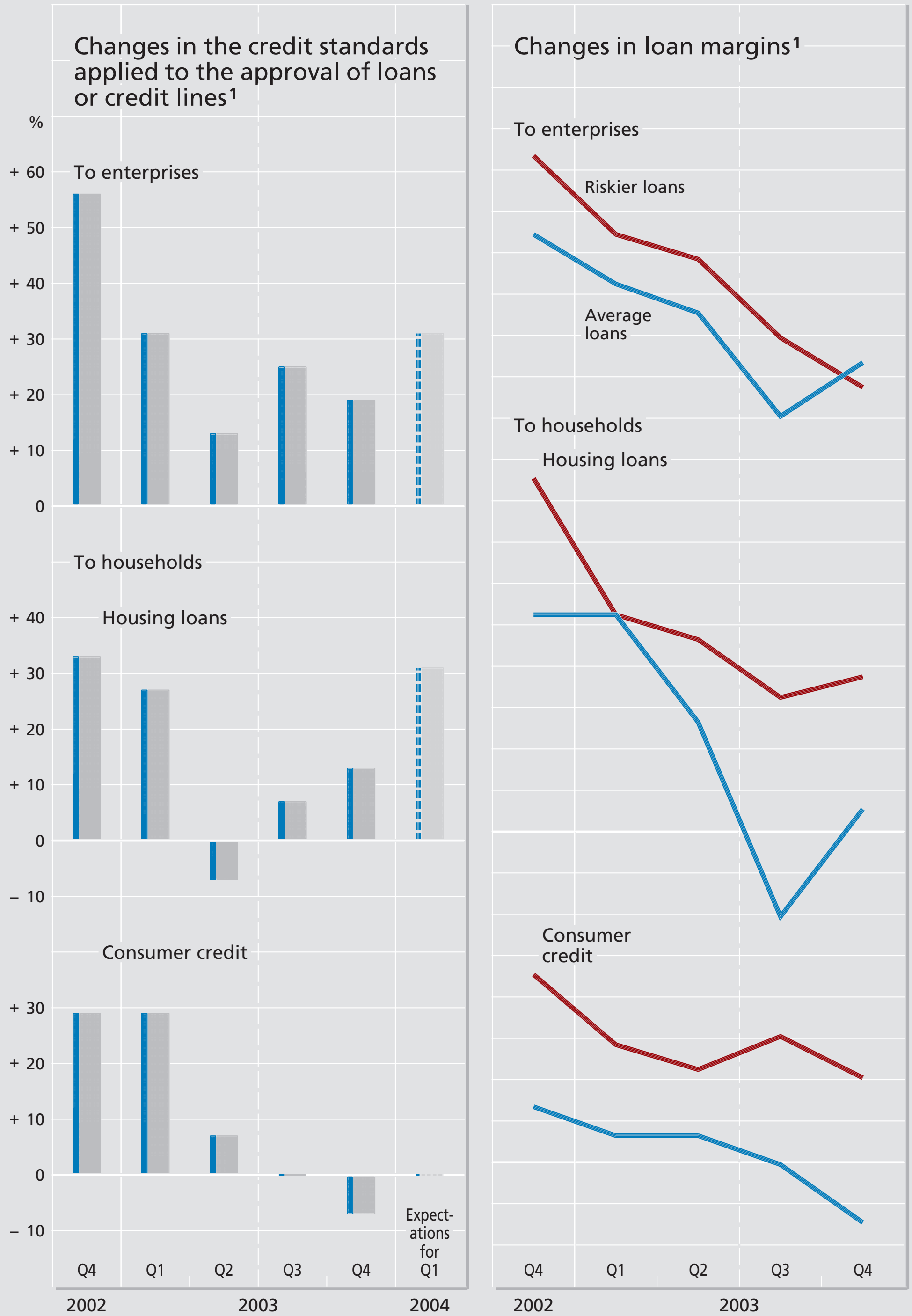
Against the backdrop of the recent large need for risk provisioning and attempts to achieve capital relaxation as a means of increasing flexibility in lending to small and medium-sized enterprises (SMEs), large German banks joined together last year in a cross-sector true sales initiative (TSI). Its aim is to promote the German securitised lending market and relies on (non-synthetic) sales of SMEs' credit portfolios. This initiative was accompanied by taxation changes, the previous system having hampered this type of securitisation in Germany. In 2004, therefore, as part of this initiative some banks can be expected to reduce their risk assets further, backed by the first noteworthy steps in portfolio securitisation.

Consolidation and focusing reduce costs further

Last year the banks took further incisive measures which led to cost-side savings. In addition to cutting jobs and streamlining the branch network, credit institutions continued to outsource business areas as part of their endeavours to focus more sharply on core competences. Moreover, further consolidation in the banking sector also associated with cost-cutting measures meant that the number of credit institutions reporting banking statistics went down by 139 to 2,226

Bank lending survey
Results for Germany

Chart 13



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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in the course of last year. The consolidation process was particularly evident at smaller institutions. Those most affected were the cooperative banks, with a reduction of 96 institutions, followed by the savings banks. The decline is likely to continue in 2004, mainly affecting these categories of banks.

IV Economic trends and economic policy in Germany

1 Under the influence of stagnation and change

Many gloomy aspects but distinct rays of hope at the end of the period

The year 2003 was another very difficult one for the German economy. Not only was it the third year of persistent stagnation in overall output – the longest period of economic standstill since the 1950s. At the start of 2003, there were also increasing signs that the chronic weakness in growth might be further exacerbated by a crisis of confidence. The considerable geopolitical risks and uncertainty about how global economic activity was developing proved to be serious detrimental factors. Added to this were a rising number of job losses, the increasingly precarious financial position of general government and difficulties in pushing through economic and social policy reforms.

In this problem-fraught setting, growing concerns were being voiced about risks of deflation in Germany, and critical questions were being asked about the functional viability of the German banking system. Even though many of these worries turned out to be unfounded or less serious than expected – there were no adequate grounds for suspecting an acute deflation scenario nor was there a real credit crunch – 2003, as no other year previously, showed how critical the combination of weak fundamentals, widespread pessimism and cyclical strains can become.

However, the sobering account of 2003 should not be allowed to obscure the changes in outlook that took place later in the year. Led initially by the US economy, global economic activity regained momentum in the second half of the year, positive expectations were increasingly coming to the fore on the financial markets and in the corporate sector and, last but not least, major structural reforms were adopted. In the third quarter, the business sector was able to move away gradually from its persistent line of stagnation and is now in a period of

Key economic variables in Germany

Table 5

Annual percentage change

Item	2000	2001	2002	2003
Growth (real) [1]				
Private consumption	+ 2.0	+ 1.4	− 1.0	− 0.1
Government consumption	+ 1.0	+ 1.0	+ 1.7	+ 0.9
Machinery and equipment	+10.1	− 4.9	− 9.1	− 3.0
Premises	− 2.6	− 4.8	− 5.8	− 3.4
Other investment	+ 9.0	+ 5.6	+ 1.6	+ 1.8
Changes in inventories				
Change (in € billion)	− 2.4	−16.6	+ 2.7	+14.7
Domestic use	+ 1.8	− 0.8	− 1.6	+ 0.3
Net exports [2]				
Change (in € billion)	+20.2	+32.0	+34.3	− 7.4
Exports	+13.7	+ 5.6	+ 3.4	+ 1.2
Imports	+10.5	+ 0.9	− 1.7	+ 2.6
Gross domestic product	+ 2.9	+ 0.8	+ 0.2	− 0.1
Contribution to GDP growth in percentage points				
Domestic use (excluding stocks)	+ 1.9	+ 0.1	− 1.7	− 0.5
Changes in inventories	− 0.1	− 0.8	+ 0.1	+ 0.7
Net exports	+ 1.1	+ 1.6	+ 1.7	− 0.4
Employment				
Employed [3]	+ 1.8	+ 0.4	− 0.6	− 1.1
Average working time per employed person	− 1.1	− 0.9	− 0.5	+ 0.2
Total number of hours worked	+ 0.7	− 0.5	− 1.1	− 0.9
Unemployed (in thousands) [4]	3,889	3,852	4,060	4,376
Western Germany	2,380	2,320	2,498	2,753
Eastern Germany	1,508	1,532	1,563	1,623
as percentage of the civilian labour force	9.6	9.4	9.8	10.5
Western Germany	7.6	7.2	7.6	8.4
Eastern Germany	17.1	17.3	17.7	18.5
Prices				
Consumer prices	+ 1.4	+ 2.0	+ 1.4	+ 1.1
Producer prices of industrial products [5]	+ 3.1	+ 3.0	− 0.6	+ 1.7
Construction prices	+ 0.7	+ 0.3	− 0.1	+ 0.1
Import prices	+10.1	+ 0.6	− 2.2	− 2.2
Export prices	+ 3.1	+ 1.0	− 0.2	− 0.2
Terms of trade	− 6.5	+ 0.5	+ 2.0	+ 2.0
GDP deflator	− 0.3	+ 1.3	+ 1.6	+ 1.0
Productivity and labour costs				
GDP per hour worked by employed persons [1]	+ 2.2	+ 1.4	+ 1.3	+ 0.8
Compensation per hour worked by employees [3]	+ 3.3	+ 2.5	+ 2.2	+ 1.5
Labour costs per unit of value added in real terms in the economy as a whole [6]	+ 1.1	+ 1.2	+ 0.9	+ 0.7

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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moderate recovery. Nevertheless, continued major efforts are needed to move on to a higher path of growth.

Ebbing of external stimuli

In contrast to what happened in previous years, exports were unable to impart any significant stimuli to the German economy in 2003. In the first half of the year, the backdrop of a difficult international setting and the earlier appreciation of the euro meant that exports of goods and services were declining in seasonally adjusted terms. This was a crucial factor in prolonging the lengthy period of sluggish domestic economic activity. From the middle of the year, however, export orders received by German industry recovered in the wake of the revival in global economic activity. The rapid processing of the new orders led in the third quarter to a sharp increase in deliveries. The volume of exports went up by 1¼% in 2003 on an annual average, compared with a 3½% increase in 2002. Even so, the expansion in exports lagged behind the growth of the export markets. German exporters therefore suffered losses in their market position, especially outside the euro area. Mainly as a result of the turnaround in stock management and partly owing to the exchange rate, real imports, at +2½%, increased about twice as sharply as exports despite the weakness of final demand. Overall, net exports depressed total economic activity by ½ percentage point.

Investment in machinery and equipment still on a downward trend

Investment in machinery and equipment was down again last year (by 3%). The cumulative decline since the last cyclical peak in the third quarter of 2000 was almost as pronounced, at around one-fifth, as the cutback in investment during the cyclical slowdown of the early 1990s. Given the persistently gloomy outlook for sales, the more cautious assessment of Germany's medium-term growth potential and the underutilisation of capacity, enterprises evidently saw no reason for stepping up domestic investment. However, the slight signs of recovery at the end of 2003 might be an indication that at least replacement investments were being made on a larger scale again. This is also suggested by the fact that domestic orders placed with capital goods producers were definitely on an upward trend. Enterprises also undertook extensive restructuring measures in terms of the real economy and financing during the three-year slowdown. This means that the prevailing underlying conditions for corporate investment are now good, especially as the cost of debt is at an all-time low.

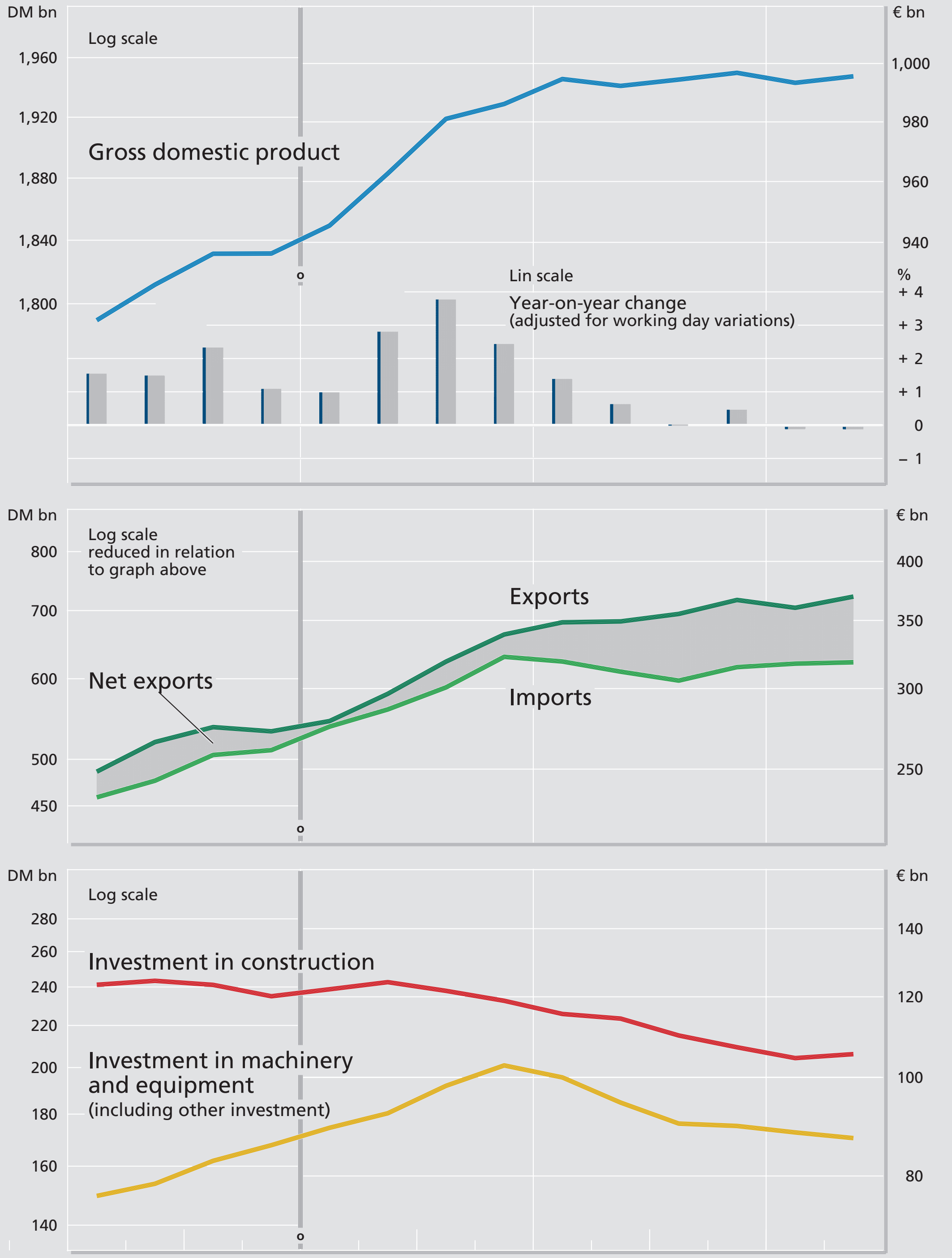
Adjustment crisis in construction continues

The process of contraction in the construction sector, which has been going on for several years, continued in the reporting year, albeit at a slightly slower pace. Real investment in construction was 3½% down on the year. Adjustment in eastern Germany was again particularly pronounced. The level was latterly more

Gross domestic product and
selected expenditure components

Chart 14

1995 prices, seasonally adjusted, half-yearly



o From 1999, data in euro.

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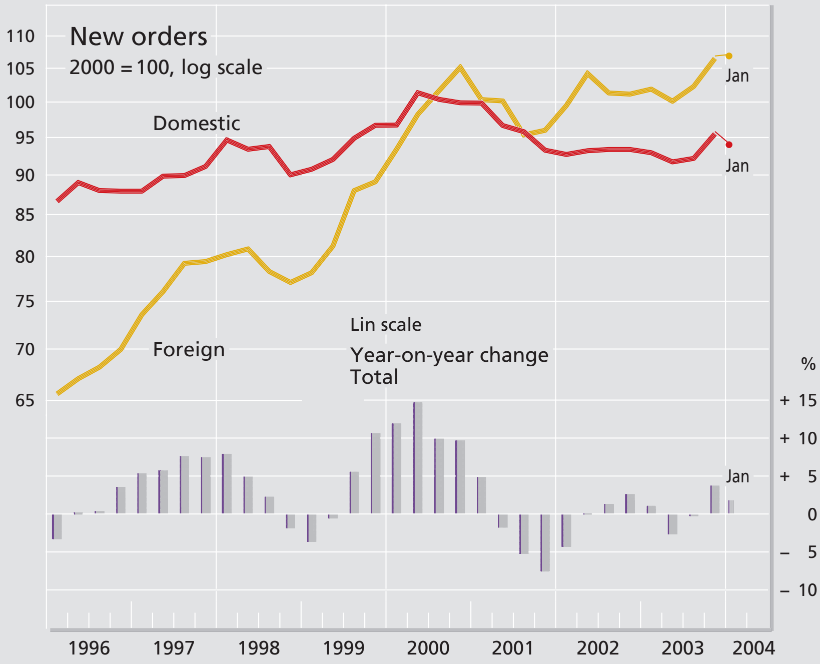
Demand for industrial products

Chart 15

Volume, seasonally adjusted, quarterly



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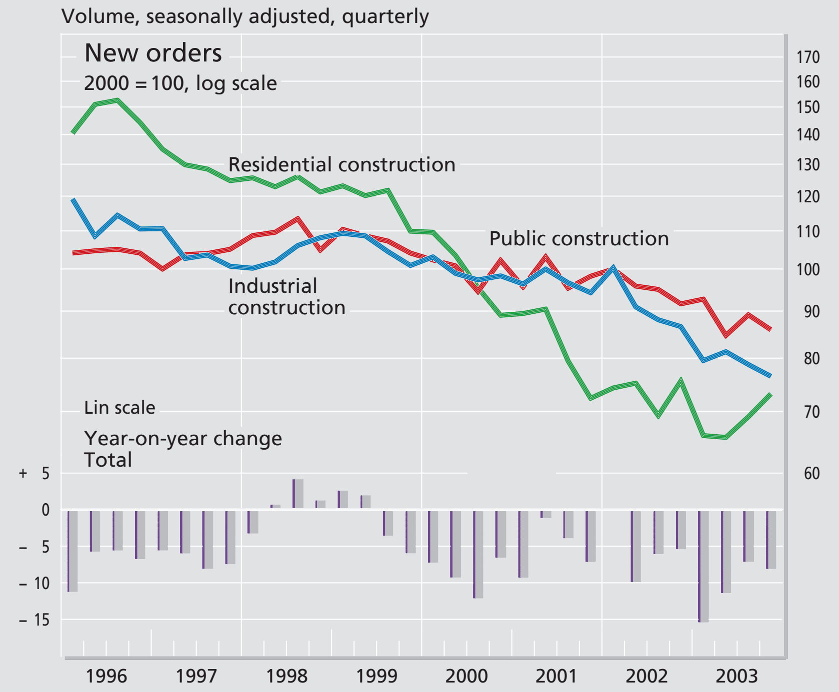
than 45% lower than in the mid-1990s, although the figure at that time was strongly influenced by extensive tax concessions and by what may now be seen as excessively optimistic expectations about the economic outlook for that part of the country. All construction subsectors were affected by the negative trend in both eastern and western Germany. Large (and in some cases increasing) numbers of vacant commercial properties and a reduced need to expand capacity continued to impede industrial construction activity. Investment in house-building likewise remained on a downward trend. The historically low interest rates even at the long end of the maturity range and isolated shortages in urban centres in western Germany are likely to have supported investment in house-building to some extent. These factors were a long way from being able to offset the counterforces resulting from large overhangs in eastern Germany and from the expectation that the residential population will decline over the longer term. However, the debate on the reduction or abolition of the grant to home-buyers had a stimulating impact, especially in the second half of the year. This had already become apparent towards the end of 2002 and the beginning of 2003 as a result of a higher number of construction permits. This was probably due to anticipatory effects in most cases. The government, too, made a signifi-

Demand for construction work

Chart 16



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cant reduction again in its construction activities owing to the pressing budgetary problems.

Capital formation at new all-time low

Gross fixed capital formation fell by a total of 3% in real terms. After deduction of depreciation, which represents the amount of fixed assets used up as a result of normal wear and tear and foreseeable obsolescence, net expenditure on fixed capital formation was no more than 2¾% of nominal GDP. The net investment ratio was therefore ½ percentage point down on 2002, which had previously marked the all-time low. The average over the past decade had been as high as 7½%. The further decline in investment was not without repercussions for fixed assets. The total capital stock went up by no more than 1½% in 2003, which was half as much as in the early 1990s. If new housing is excluded, the increase at the end of the period under review was only 1%. This means that overall capital formation, which comprises not only domestic net investment but also the funds which Germany makes available to non-residents in the form of capital exports, accounts for no more than just under 6½% of the disposable income of the domestic sectors, compared with an average of 8½% during the past decade. This does not yet take account of revaluation effects.

Inventory cycle stimulates economic activity

Enterprises' inventory operations, by contrast, were a supporting element last year. According to the figures in the national accounts, the depletion of inventories slowed down perceptibly in 2003. This produced a positive contribution to growth of ¾ percentage point. Although recorded inventory investment at the current end is to be interpreted with caution owing to inadequate baseline statistics, there are some indications that the inventory cycle is well advanced and that restocking in the near future will have a positive impact on economic activity.

Private consumption remains weak

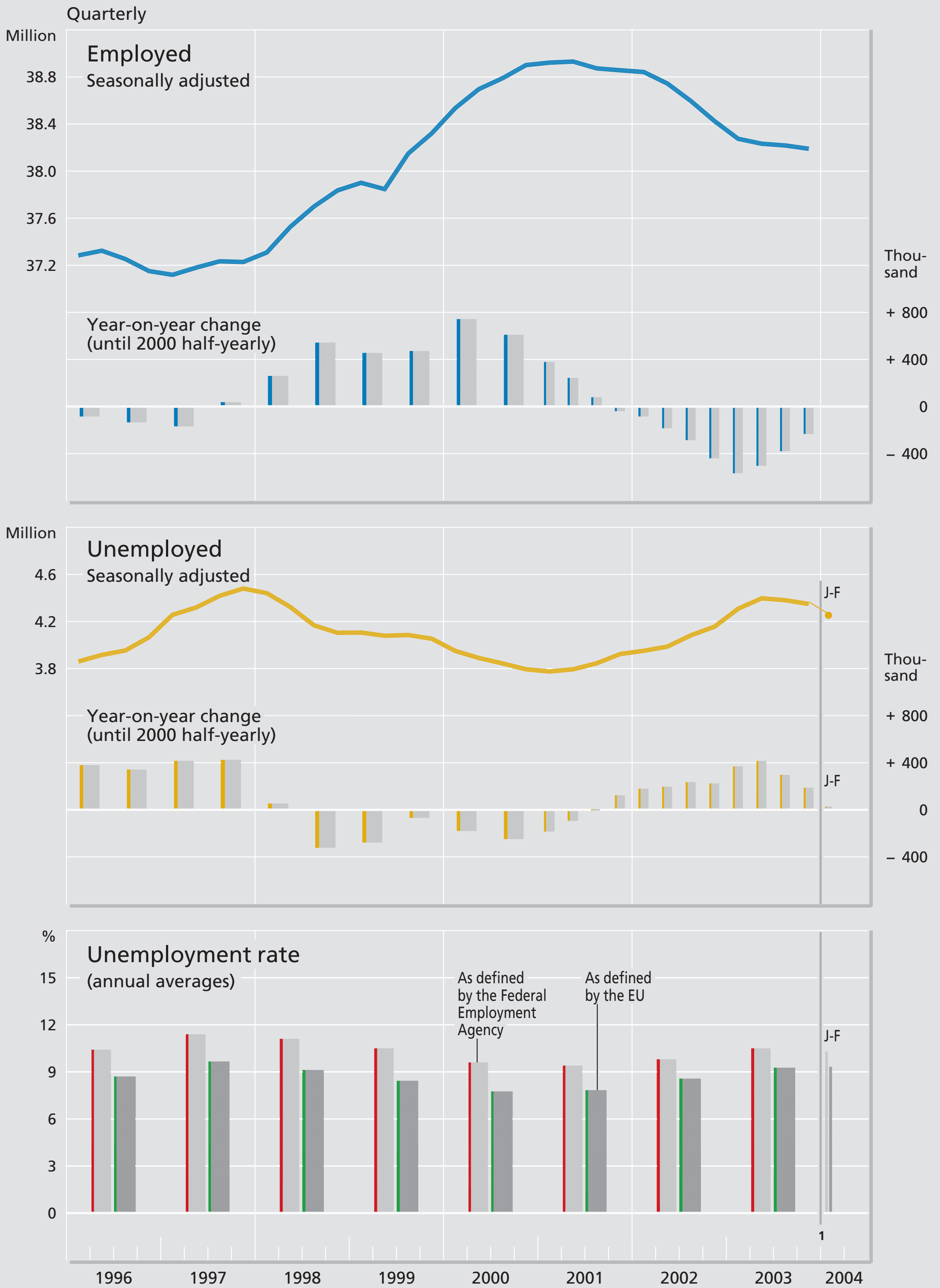
Households' propensity to consume remained weak in 2003. In real terms, households cut back their consumption spending somewhat further even in comparison with its already depressed level in 2002. This was due mainly to the subdued development in incomes. The accelerated decline in employment and the further increase in contribution rates to the social security funds meant that net wages and salaries fell by 1%. On the other hand, there were larger labour-market-related transfer payments, but the increase was smaller than in 2002. As self-employed persons' income and property income were only slightly up on the year, households' nominal disposable income rose by no more than 1%. After eliminating consumer inflation, it was roughly as high as in 2002. Households again increased their saving relative to disposable incomes, ie from 10½% to 10¾%. This increase in the saving ratio placed a further strain on consumption and is a sign of households' uncertainty about the development of the economy as a whole and, in particular, the sharp deterioration in the outlook for the labour market. The uncertainty up to the end of the year about the fiscal policy stance as well as public concerns about the long-term sustainability of the pay-as-you-go pension system are likely to have played a major role, too.

Sharp reduction in employment

Despite only a minor gain in productivity last year, weak production activity led to an accelerated reduction in employment, especially as the hope of a rapid recovery was increasingly evaporating. The number of persons in work fell to an average of 38.25 million in 2003. At around 420,000, or 1.1%, the decline was nearly twice as sharp as in 2002. Sharp falls were again recorded in industry and construction. The impact of this was all the greater as scarcely any new jobs were created in the services sector on balance. The employment record for the primary (non-assisted) labour market was even more unfavourable. It is true that additional employment opportunities were available in the form of self-employment and "mini-jobs" and "midi-jobs", but these are often employment arrangements with only a small number of working hours and a low level of labour productivity. Not least for that reason, the ratio of workers in short-time

Labour market

Chart 17



1 Unemployed and unemployment rate as defined by the Federal Employment Agency; from January 2004, excluding participants in aptitude tests and training schemes.

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employment showed a further increase in 2003. At the end of the period under review, the ratio was approximately 27¼%, compared with 23½% at the end of the 1990s. Even though the Institute for Employment Research (IAB) estimates that the average number of hours worked last year was no lower than before. This had mainly to do with an increase in second occupations and a declining sickness ratio. The flexible instruments of adjustment in the form of working time accounts were largely exhausted in 2003. The decline in the total number of hours worked last year, at just under 1%, was more or less the same as in 2002.

Rise in unemployment

The reduction in employment was accompanied by a rise in unemployment. The average 2003 increase in the number of persons officially registered as unemployed was 4.38 million. That was about 315,000, or 7¾%, more than in 2002. The unemployment rate, as defined by the Federal Employment Agency, was 10.5% on an annual average. Using the standardised EU method,[1] the unemployment rate was 9.3%. In 2002, the relevant figures for the unemployment rate were 9.8% and 8.6%, respectively. For the first time in a while, male workers in the producing sector were affected more than average, indicating a significant cyclical component in unemployment and a further contraction in the construction-related sectors. The unemployment rate in eastern Germany was again much more than twice as high as in western Germany. The federal state of Saxony-Anhalt had the highest rate, at 20½%. The best figure for Germany was posted by Baden-Württemberg at just over 6%.

Reorientation of labour market policy

In terms of numbers, the rise in unemployment was significantly smaller than the decline in employment. The labour force, defined as the effective supply of labour recorded by the statistics, therefore declined in 2003 as it had done in the previous year. This is connected with the reorientation of labour market policy. A number of statutory measures have been taken to tighten the criteria for registering as unemployed so as to encourage the unemployed into taking up work. This has resulted in a considerable number of persons being removed from the unemployment statistics because they have not demonstrated sufficient initiative in finding a job.

Outflows from unemployment

One indication of this is provided by extensive outflows from unemployment which, according to the definition of the Federal Employment Agency, are to be

1 The standardised unemployment rate is based on the Labour Force Survey which is conducted once a year in the second quarter. This is updated every month using the unemployment statistics of the Federal Employment Agency.

Labour market movements *

Table 6

Item	1999	2000	2001	2002	2003
	Number in thousands				
Inflows	7,218	6,935	7,035	7,412	7,886
Employment	3,439	3,333	3,424	3,629	4,216
Training/school	695	639	630	617	659
Non-employment	3,084	2,963	2,981	3,166	3,011
Unfitness for work	1,036	1,099	1,110	1,095	998
Other	2,048	1,864	1,871	2,071	2,013
	Year-on-year change				
Inflows	.	– 283	100	377	474
Employment	.	– 106	91	205	587
Training/school	.	– 56	– 9	– 13	42
Non-employment	.	– 121	18	185	– 155
Unfitness for work	.	63	11	– 15	– 97
Other	.	– 184	7	200	– 58
	Number in thousands				
Outflows	7,425	7,192	6,857	7,202	8,052
Employment	3,284	3,210	3,029	3,025	3,342
Employed	3,084	3,021	2,838	2,799	2,996
Self-employed	123	121	123	152	282
Training	723	751	692	710	503
Non-employment	2,994	2,830	2,763	3,046	3,775
Unfitness for work	1,187	1,207	1,207	1,265	1,597
Other	1,807	1,623	1,556	1,781	2,178
	Year-on-year change				
Outflows	.	– 233	– 335	345	850
Employment	.	– 74	– 181	– 4	317
Employed	.	– 63	– 183	– 39	197
Self-employed	.	– 2	2	29	130
Training	.	28	– 59	18	– 207
Non-employment	.	– 164	– 67	283	729
Unfitness for work	.	20	0	58	332
Other	.	– 184	– 67	225	397

* In line with the method of counting used up to the end of 2003.

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included in the category of "outflows into other non-employment". A total of 3.77 million such persons left the ranks of the unemployed in 2003, which was just over ¾ million more than the average figure over the previous few years. In just over 40% of such cases, the reason for deregistration was a notification of illness. Over 10% ended their working career. In the vast majority of cases, the persons involved made use of the available provisions for early retirement. The other two-fifths did not renew their registration as unemployed or fell into the category "Temporarily no longer counted as unemployed". Altogether, there were 1.55 million such persons, which was 380,000 more than on an average of the three previous years.

Cyclically induced increase in unemployment

The "administrative adjustment" of the unemployment database has resulted in a slightly declining seasonally adjusted unemployment level since the second quarter of 2003. By contrast, cyclical unemployment is likely to have risen further. Not only was there a greater net number of redundancies than of new recruitments. Over the year as a whole, the number of inflows into unemployment from employment was 875,000 higher than the number of outflows of unemployed persons into work. Moreover, policymakers have continued to give active support to the labour market on a large scale. The promotion of self-employment and integration into personnel service agencies (PSAs) have been added to the traditional job creation measures and vocational training schemes, which were cut back significantly. While no more than around 30,000 unemployed persons joined PSAs, support payments for self-employment were taken up nearly 250,000 times.

Labour market developments in early 2004

At 4.29 million in February 2004, the seasonally adjusted unemployment figure was lower than at the end of 2003. This was due mainly to a change in the statistics methodology, which means that persons taking part in aptitude tests and training measures are no longer counted as unemployed. The tighter regulations for the unemployed are likely to have had the ongoing effect of reducing officially recorded unemployment. However, it is reasonable to assume that the impact of administrative measures is gradually waning, which means that developments will be determined by the cyclical component again.

Mixed picture emerges from 2003 wage round

There was only a "small" wage round in 2003 as the collective pay agreements concluded in several sectors in 2002 had already provided for further increases in the last year. Overall, the new agreements were lower than those in 2002, with the result that the negotiated pay level last year, at 2%, went up in total by slightly over ½ percentage point less than in 2002. The approach taken by both employers and trade unions therefore took due account of the difficult macroeconomic setting. Despite moderation in wage policy, however, the real scope for income distribution, which had declined *ex post*, was largely exhausted by the rise in actual earnings, which was noticeably less than the negotiated pay increase. This is also shown by the overall employee compensation rate, which remained unchanged at 72% of national income.

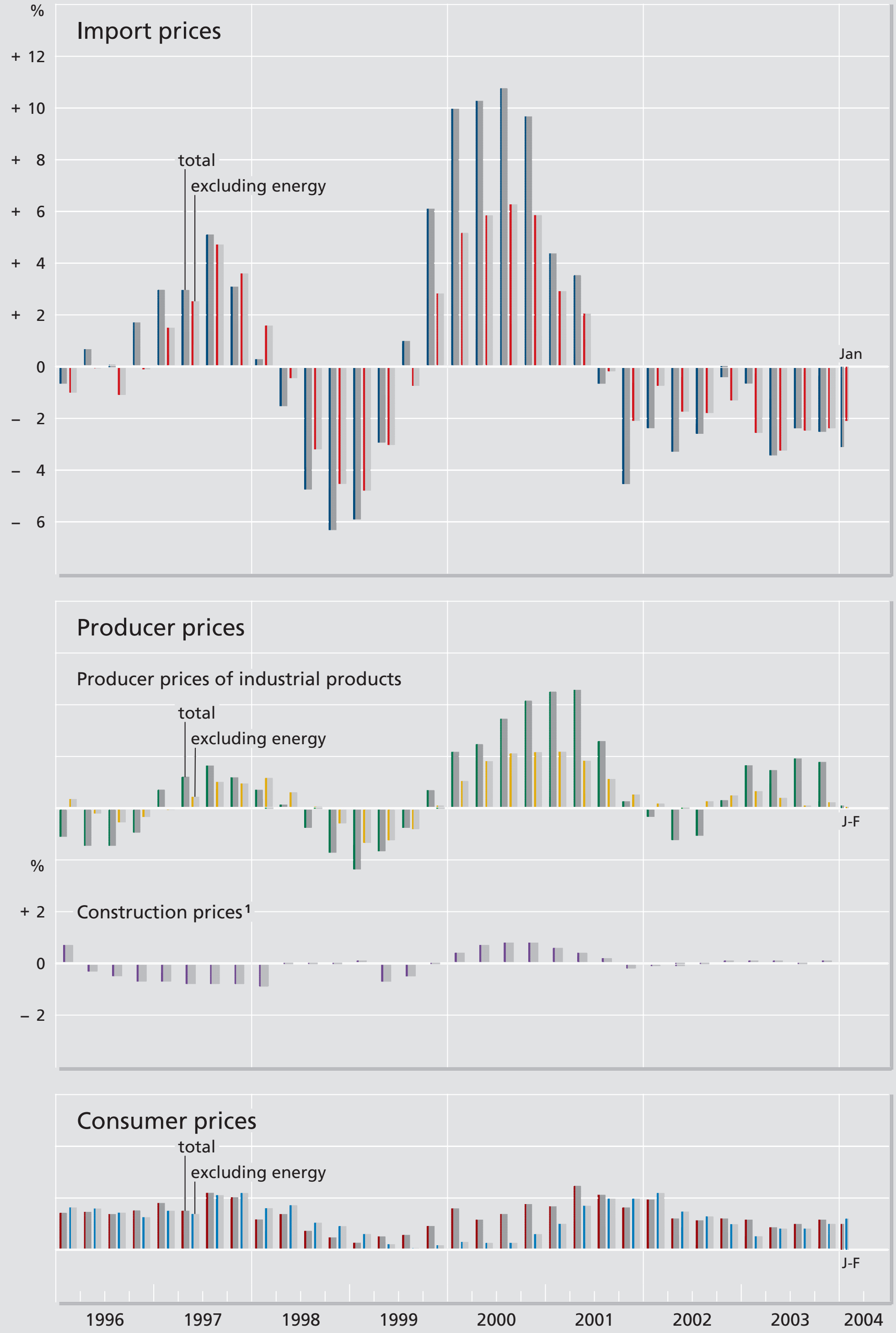
Larger tax and price wedge on the labour market

The enterprises also saw the negotiated pay rises as being too high, as is made clear by the further marked negative wage drift of ¾ percentage point. Consequently, actual earnings per employee rose by no more than 1¼%. The increase in the social contribution rates was an additional factor placing a strain on cor-

Import, producer and consumer prices

Chart 18

Year-on-year change, quarterly



1 Bundesbank calculations.

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porate costs. Taking the deflator of gross value added as an approximation of the net producer prices (ie before product taxes less subsidies) gives an increase in the producer real wage of almost 1%. This contrasts with a ½% decline in the real wage from the consumers' perspective. The outcome of this is a further increase in the price and tax wedge on the labour market. A further factor, besides higher direct levies in the form of social security contributions and wage taxes, was that the increase in indirect taxes drove consumer price inflation up somewhat more sharply than net producer prices.

Large degree of price stability

The price climate in Germany was favourable in 2003. Movements in industrial factory gate prices, construction prices, house prices and consumer prices were all within quite narrow bounds. More expensive energy contrasted with nearly stable prices for industrial goods at the producer and consumer levels. If energy is excluded, industrial factory gate prices were no more than 0.3% up on the year on an annual average of 2003. A similarly small figure had been posted in 2002. Construction work cost virtually the same as one year earlier. According to the index calculated by the Bundesbank, there was a slight decline in house prices for both new and second-hand dwellings.

Slower rise in consumer prices

Households' cost of living went up 1.1% in 2003. If energy is excluded, the rate of price increase was only 0.8%. That was almost half of the figure for 2002. Food was one factor contributing to this positive outcome. Although modest harvests led to price increases in the second half of the year, the level was no higher than in 2002 on an annual average. Industrial goods did become somewhat more expensive in the first few months of last year, a development which was due, in particular, to a further increase in tobacco tax. After that, the prices of industrial goods remained largely unchanged. The rate of price increase, at 0.3% on an annual average, was down on the year, when the figure had been 0.8%. In the services sector, developments were dampened, in particular, by almost stable prices for package holidays and a marked weakening of inflationary pressure in the telecommunications sector. Also, there was a period of restraint following some sharp price increases – such as for hairdressing – that accompanied the introduction of the euro. Even though the increase in the overall rate of price increase for services was higher than average, at 1.3%, it was perceptibly lower than in 2002 when the measured figure had been 2.4%. The moderate rise in house rents continued. With annual inflation at 1.2%, the increase was largely similar to that in 2002.

High energy prices

Prices for energy rose quite sharply in 2003. On a yearly average, the annual increase at the industrial producer level was 7.5%. For consumers, the relevant figure was 4.0%. Higher taxes played a major role in this. These affected the majority of energy sources with heating oil and coal being the only exceptions. Moreover, the effects of electricity deregulation, which had led to price reductions in previous years, had largely petered out, and the costs arising from the Energy Supply Act (*Energie-Einspeisungsgesetz*) were passed on to consumers. A start was made to opening the national market for gas – something which is also being promoted by the EU – and led to an agreement among the associations. So far, however, a real market with adequate competitive conditions has failed to emerge. At an annual average of US$28¼ per barrel of North Sea Brent, the price of oil (which is a yardstick for the overall energy price level) was around US$3 up on the year. Oil had not come near to being as expensive as this at any time over the previous 15 years with the exception of the year 2000. The appreciation of the euro dampened the surge for the countries of the euro area. At US$25¼ per barrel on a 2003 average, the euro-area price was, in fact, somewhat lower than it had been in 2002. This was not quite €6 down on the peak of 2000, when a figure somewhat higher than €31 had been reached.

Price surge in healthcare

Early 2004 saw a surge in consumer price inflation. The "healthcare" category of goods became much more expensive since payment for a whole range of products and services had been transferred from the health insurance institutions (*Krankenkassen*) to patients as part of the reform of the healthcare system. Just over ½ percentage point of the year-on-year rate of price increase is due to this redistribution of costs. If healthcare is excluded, the year-on-year inflation rate fell from just over 1% to around ½%. This was due to a baseline effect in the case of energy and tobacco products, the taxes which had been increased at the start of 2003. A further staggered increase in tobacco tax during 2004 will generate additional inflationary effects. By contrast, no particular price movements are to be expected in 2004 for the other goods and services included in the basket of goods relating to households. In February, CPI inflation was at 0.9%.

2 Emerging recovery of world economy helps exports

Exports pick up in second half of year

At the beginning of last year the underlying conditions for German exporters were still largely determined by geopolitical uncertainty and moderate economic growth in major partner countries. Compared with the situation in the second half of 2002, these retarding influences were reflected in a downturn in exports of goods. By mid-year, however, the external environment had begun to show a gradual improvement again as the global economy recovered. With rising export orders, exports, too, grew compared with the first half of 2003. The consumer goods sector benefited most from the more buoyant demand from abroad although the manufacturers of capital goods, who had continued to suffer from the global reluctance to invest in the first half of the year, benefited from it, too.

Appreciation of euro curbs export growth

Over the year as a whole, however, exports rose only slightly year on year (+1½%).[1] Another factor contributing to the modest increase in exports was the sharp appreciation of the euro against the currencies of major trading partners – especially those of the dollar area. Although Germany's price competitiveness is still regarded as being almost neutral, the competitive edge which German exporters used to enjoy, especially during the first few years of monetary union, increasingly diminished during 2003. In the end the value of goods exported to non-euro-area countries remained at the level of the previous year. Even so, German exporters had to make certain price concessions to potential customers outside the euro area, with the result that exports in real terms were slightly above the level in 2002. Exports to China, which was one of the fastest growing economies in the world last year, expanded very rapidly. Exports to the transition countries in central and eastern Europe also grew substantially, and there was greater demand for German products from customers in the EU countries outside the euro area. By contrast, there was a particularly steep decline in the export of goods to the United States; there was also a fall in the goods exported to Japan, the OPEC countries and the emerging economies in South-East Asia. German exports to the other euro-area countries benefited from the cyclical recovery in these countries during the year and from Germany's relatively favourable price and cost situation within the euro area; they rose by 4% in all. German exporters probably gained slight market shares inside the euro area whereas they were not quite able to retain their market positions in non-euro-area countries.

Improved terms of trade spur imports

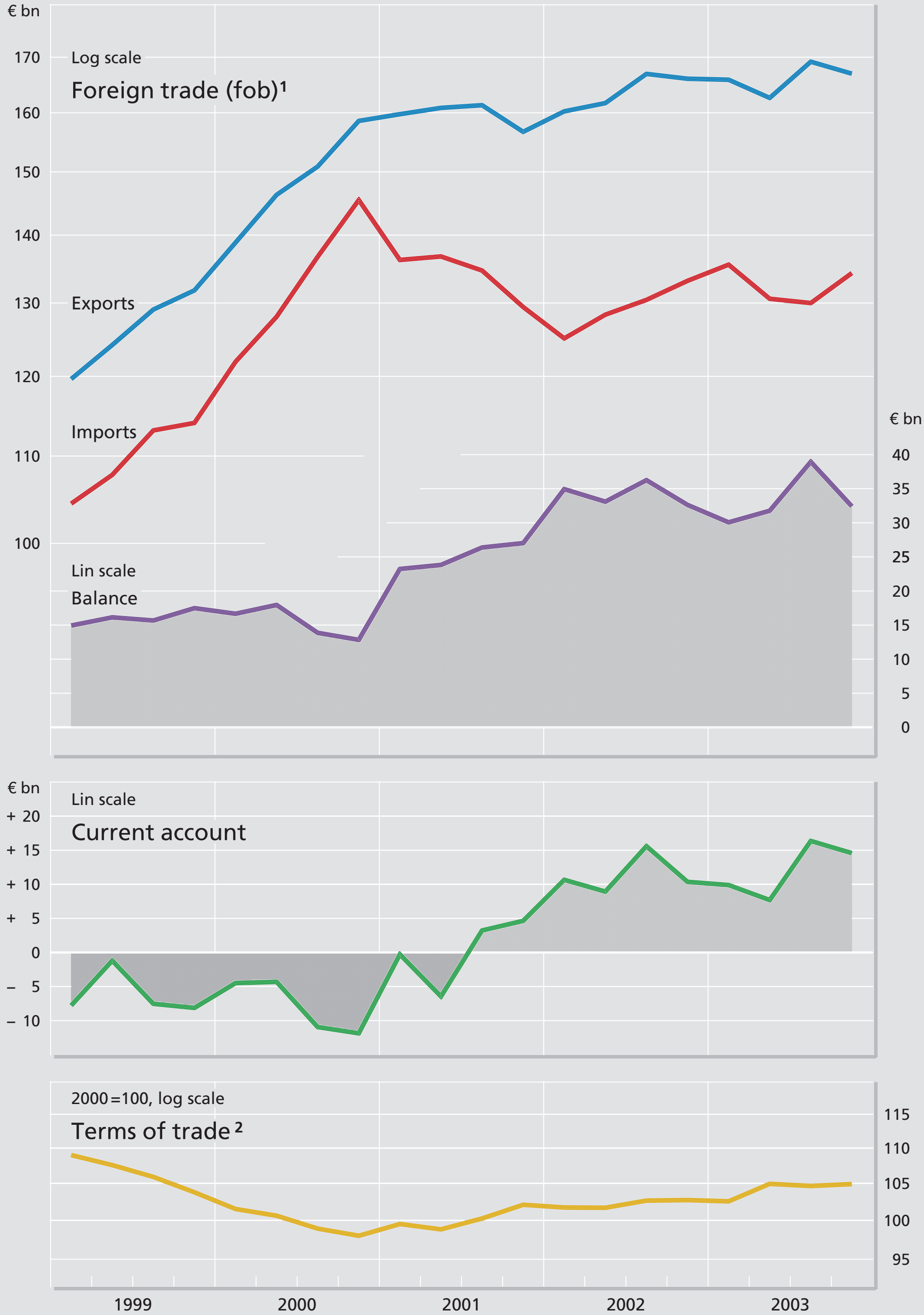
With a nominal increase of 2½% imports expanded slightly faster than exports last year. As there was a simultaneous fall of more than 2% in the price of imported goods, the rise in imports was even steeper in real terms. These average annual figures are due largely to the surge in imports which had continued up

1 The data on trade in goods as a whole 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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to the end of 2002 (statistical overhang) and to the build-up of energy stocks at a time of rising prices. In the second half of 2003 the growth in imports was also spurred by the increase in exports, which tend to contain a large proportion of imported materials. At the same time, the distinct (2%) improvement in the terms of trade helped to ensure that foreign goods became more attractive for German customers. Owing to the appreciation of the euro, it was mainly the prices of goods from non-euro-area countries that showed an appreciable decline. However, the differing movements in import prices and import volumes meant that the regional breakdown of imports produced a decidedly heterogeneous picture. For example, the increase in the value of goods imported from China and from the central and east European transition countries was particularly striking. By contrast, imports from the United States and Japan were much lower in nominal terms last year. The value of goods imported from other euro-area countries, which account for almost half of Germany's imports of goods and whose price is not directly influenced by exchange rate movements, rose by 3½%.

Sharp increase in imports reduces trade surplus

As imports rose more rapidly than exports in 2003, there was a slight year-on-year decline (of €3½ billion) in the trade surplus, which closed at €133½ billion. By contrast, the services account ran a smaller deficit (€45 billion) than in 2002 as expenditure on cross-border services fell more sharply than the corresponding income. Factor income ran a deficit of €12½ billion in 2003 compared with one of just under €17 billion a year earlier. This improvement was the result of an increase in investment income from abroad and a simultaneous decrease in payments made to non-residents. Furthermore, the deficit on current transfers increased by €1 billion to €29 billion, the main contributory factor here being larger net payments to the EU budget. Consequently, Germany's current account ran a surplus of €47 billion in 2003 compared with one of €45½ billion a year earlier.

Financial transactions determined by geopolitical tensions and changing economic outlook

The changing trends on the foreign exchange and capital markets as well as the recovery in the world economy were also reflected in the international capital flows. Although the overall amount of capital under way declined, a substantial volume was imported into Germany as a result of portfolio investment. In the first six months of the year a high degree of risk aversion was influencing the portfolio decisions of internationally operating investors, and net amounts of capital flowed primarily into bonds and notes. Later in the year, however, net imports of funds were switched to equities. All in all, net capital imports arising

Balance of payments

Table 7

€ billion

Item	2000	2001	2002	2003
I Current account	– 27.9	+ 1.7	+ 45.7	+ 46.8
1 Foreign trade [1]	+ 62.9	+ 100.7	+ 136.9	+ 133.3
Exports (fob) [1]	596.9	637.3	653.5	663.6
Imports (fob) [1]	534.0	536.6	516.6	530.3
2 Services	– 59.8	– 60.9	– 46.5	– 45.2
of which				
Foreign travel	– 37.2	– 38.0	– 35.4	– 36.1
3 Factor income	– 2.6	– 10.7	– 16.8	– 12.5
of which				
Investment income	– 2.1	– 10.4	– 16.7	– 12.4
4 Current transfers	– 28.4	– 27.4	– 27.9	– 28.8
of which				
Net contributions to the EU budget [2]	– 15.0	– 12.3	– 10.9	– 13.9
Other official current transfers to non-residents (net)	– 4.1	– 4.6	– 5.4	– 4.9
II Capital transfers [3]	+ 6.8	– 0.4	– 0.2	+ 0.3
III Financial account (net capital exports: –)	+ 28.3	– 26.2	– 68.7	– 55.0
1 Direct investment	+ 158.8	– 17.6	+ 29.1	+ 9.1
German investment abroad	– 61.4	– 41.2	– 9.2	– 2.3
Foreign investment in Germany	+ 215.2	+ 23.6	+ 38.3	+ 11.4
2 Portfolio investment	– 152.4	+ 26.5	+ 43.9	+ 59.0
German investment abroad	– 203.5	– 124.4	– 65.8	– 32.3
of which Shares	– 102.3	– 10.6	– 4.8	+ 7.6
Bonds and notes	– 70.1	– 95.1	– 49.1	– 37.8
Foreign investment in Germany	+ 51.1	+ 150.9	+ 109.8	+ 91.3
of which Shares	– 34.7	+ 86.8	+ 15.7	+ 24.2
Bonds and notes	+ 74.5	+ 80.3	+ 83.5	+ 69.2
3 Financial derivatives	– 12.5	+ 6.8	– 0.9	– 0.5
4 Credit transactions	+ 41.3	– 40.7	– 139.4	– 120.0
Credit institutions	+ 13.8	– 76.3	– 102.1	– 110.1
of which Short-term	+ 38.3	– 33.1	– 88.7	– 73.1
Enterprises and individuals	+ 4.5	– 7.9	+ 7.5	– 17.1
of which Short-term	+ 0.5	– 17.1	– 11.6	– 12.4
General government	– 19.4	+ 16.9	+ 5.5	+ 4.9
of which Short-term	– 17.9	+ 16.8	+ 5.5	– 0.6
Bundesbank	+ 42.4	+ 26.6	– 35.4	+ 2.2
5 Other investment	– 1.9	– 1.3	– 1.5	– 2.6
IV Change in the foreign reserves at transaction values (increase: –) [4]	+ 5.8	+ 6.0	+ 2.1	+ 0.4
V Balance of unclassifiable transactions	– 13.2	+ 18.8	+ 21.2	+ 7.4

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 SDR allocation and changes due to valuation adjustments.

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from portfolio investment amounted in 2003 to €59 billion, the largest sum in ten years.

High level of foreign investment in Germany

This development was due mainly to the fact that non-residents were continuing to invest fairly large amounts in the German securities markets even if the total sum invested in 2003 – €91½ billion – was somewhat less than in the previous year. Non-residents had a generally more cautious attitude. One indication of this was that, especially in the first six months of the year when geopolitical and economic uncertainties were dampening sentiment, they were interested primarily in federal bonds, ie paper with a first-class credit rating and a high degree of liquidity. However, they continued to find German debt securities attractive in the third and fourth quarters even if they did switch the focus of their interest from public bonds to private interest-bearing paper. During 2003 as a whole, foreign investors acquired German bonds and notes worth a total of €69½ billion. The underlying change in sentiment among foreign investors also left its mark on the German share market. At the beginning of the year, foreign investors were removing German equities from their portfolios. Towards the end of the year, however, after a significant improvement in the climate on the German share market, they were including such paper in their securities holdings again. They purchased German shares worth €24 billion net.

Germans reluctant to invest in foreign assets

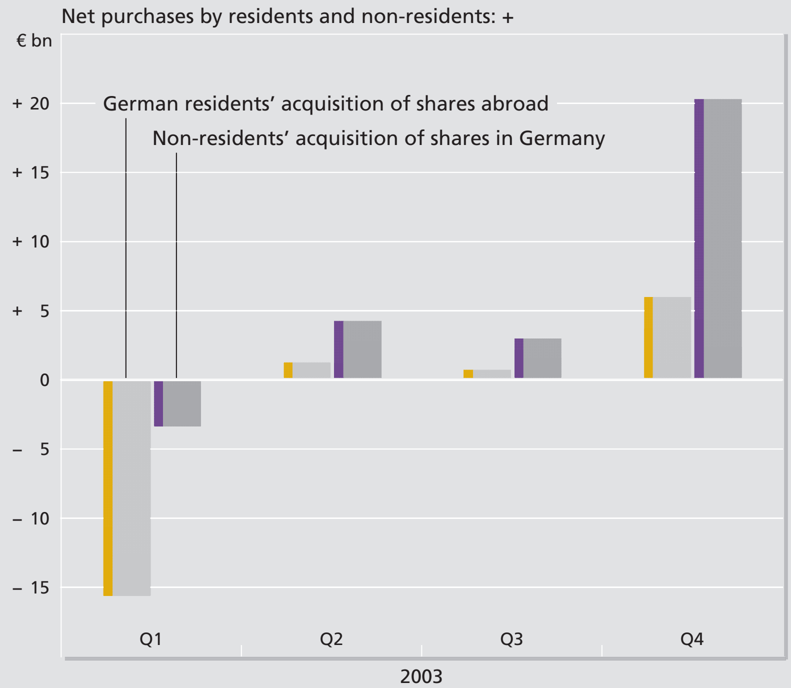
German residents cut back sharply on their investments in international securities markets. They spent a total of €32½ billion on foreign paper compared with €66 billion in 2002. They were particularly sceptical about foreign equities given the fairly uncertain economic conditions that were still prevailing at the beginning of the year and in view of the strong euro. Over last year as a whole they sold foreign corporate shares – worth €7½ billion – for the first time since 1995. By contrast, they bought foreign bonds and notes worth €38 billion net, but this amount, too, was far below the corresponding figure a year earlier (€50 billion). German residents switched to selling, mainly in the second and third quarters, when an interest rate swing occurred on the bond markets.

Further decline in direct investment

As in previous years, cross-border direct investment in both directions of the financial account continued to decline in 2003; in the end there were net capital imports of €9 billion. Given investor uncertainty at the beginning of 2003, the upturn in the world economy and the reawakened interest in corporate mergers were evidently not yet reflected in an increase in the acquisition of participating interests. At all events, German enterprises invested only €2½ billion in foreign companies, primarily in the United States and in EU partner countries (this com-

Cross-border acquisition of shares

Chart 20



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pares with €9 billion in 2002). Regarding direct investment operations in the opposite direction, foreign proprietors increased their corporate investments in Germany by a total of €11½ billion (compared with €38½ billion in 2002). This decline was due mainly to direct investment credits. As a result of this, €11 billion in the form of loan repayments flowed out of Germany in the year under review. In 2002 €22 billion had flowed into Germany.

Large net capital exports through credit transactions of non-banks ...

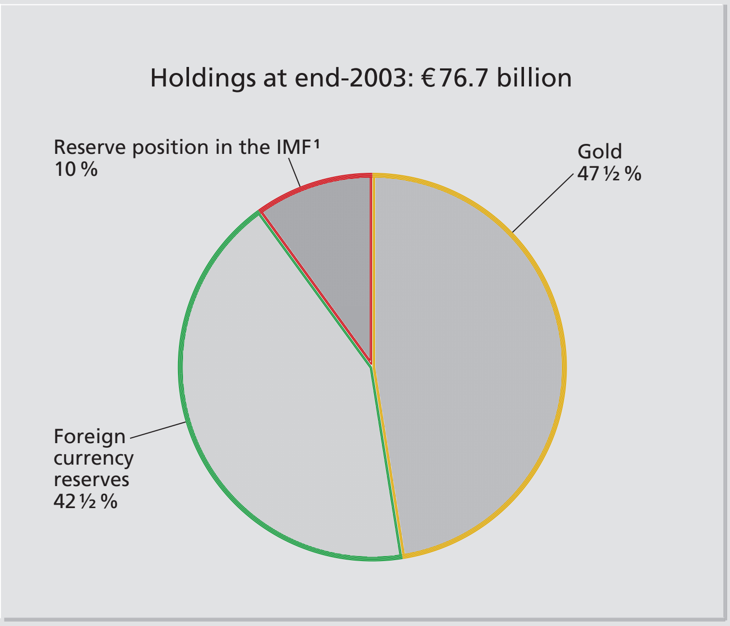
There were net capital exports as a result of the statistically recorded non-securitised credit transactions of non-banks in 2003. The operations of enterprises and individuals were the main reason for this. These two groups exported funds amounting to €17 billion, thereby "parking" proceeds from the sale of securities, among other things, in bank accounts abroad. By contrast, general government borrowed €5 billion net in foreign funds last year – primarily in the form of loans against borrower's notes.

... and large outflows of funds in the banking system as a whole

As a reflection, as it were, of the current account surplus and the aforementioned capital imports arising from financial transactions, the German credit institutions exported funds amounting to €110 billion net, two-thirds of this balance being due to transactions at the short end of the market. By contrast, the

Reserve assets of the Bundesbank

Chart 21



1 Including special drawing rights.

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Bundesbank's external transactions that are classified as credit transactions almost cancelled out.

Sharp fall in foreign reserves as a result of exchange rate movements

There was hardly any change in the Bundesbank's foreign reserves resulting from transactions in 2003; they declined by no more than €½ billion. If the balance sheet values at the end of the year are taken into account, the decline was very much greater owing to the fall in the dollar exchange rate. If valued at the market and exchange rates prevailing on the balance sheet date, the foreign reserves at the end of 2003 were worth about €76½ billion; this means that they were just under €8½ billion below the level at the end of December 2002. As a result of the revaluation, the ratio of foreign exchange reserves to foreign reserves as a whole was 42½% at the end of 2003 and therefore less than that of gold holdings (47½%) for the first time since 1970. The reserve position in the IMF (including the allocated special drawing rights) hardly changed on balance in 2003; at the end of last year its share of Germany's total foreign reserves was 10%.

3 Situation of public finances grows more acute

(a) Developments in 2003

Cyclically induced rise in government deficit

Last year the general government deficit in Germany widened further. It reached 3.9% of GDP (as defined in the national accounts), which was almost ½ percentage point higher than in 2002 and exceeded the ceiling laid down in the Maastricht Treaty for the second year in a row. The continued deterioration of public finances was attributable to the persistently weak macroeconomic momentum. Without the impact of the adverse cyclical development, the deficit ratio would have fallen slightly. The budgetary relief afforded by various consolidation measures – which, in addition to stringent budget management, also notably included the raising of social security contributions and indirect taxes – was offset by additional burdens vis-à-vis 2002. These comprised expenditure in connection with flood relief, higher transfers to the EU and a smaller Bundesbank profit. Moreover, tax revenue and social security contributions grew even more weakly than was expected in view of the already unfavourable development of the associated assessment bases.

Development of expenditure and revenue ratios

One of the factors behind the increase in the deficit was additional labour market-related expenditure, which in the context of low nominal economic growth was reflected in a considerable cyclically induced rise in the government expenditure ratio. At 49.1% in 2003, this was almost ½ percentage point higher than in 2002. The persistently weak revenue trend also had a negative impact. Although some indirect taxes and the contribution rates to the statutory pension insurance and health insurance schemes were raised, the taxes and social security ratio increased only marginally last year (to 41.6%). On balance, however, the revenue ratio remained constant, not least as a result of the drop in the Bundesbank profit.

Accelerated increase in the debt ratio

The higher government deficit together with weak nominal growth resulted in an accelerated increase in the general government debt ratio. This went up by almost 3½ percentage points to reach a new record high of 64.2%, thereby exceeding the reference value laid down in the Maastricht Treaty by an even larger margin than in 2002.

Budget outturn 2003

According to the definition used in the government's financial statistics – on which the respective budgets are based – the general government deficit rose more sharply than in the national accounts definition. Compared with 2002, it is

General government as defined in the national accounts *

Table 8

Item	2001	2002	2003	2001	2002	2003
	€ billion			Year-on-year change		
				as %		
Expenditure	1,009.9	1,028.4	1,045.1	2.1	1.8	1.6
of which						
Social benefits	548.7	572.9	588.3	3.0	4.4	2.7
Compensation of employees	165.5	167.7	168.2	– 0.1	1.3	0.3
Intermediate consumption	81.1	84.5	84.7	4.0	4.1	0.3
Interest	67.7	65.2	66.2	– 1.0	– 3.7	1.5
Gross capital formation	35.9	34.3	31.1	– 3.0	– 4.3	– 9.4
Memo item						
Old-age provision 1	268.4	278.3	284.5	3.1	3.7	2.2
Health 2	142.3	146.1	149.6	4.0	2.7	2.4
Labour market 3	65.7	71.6	74.7	2.8	9.0	4.3
Revenue	951.0	954.0	963.0	– 1.5	0.3	0.9
of which						
Taxes	488.3	486.0	490.5	– 4.6	– 0.5	0.9
Social contributions	383.6	389.0	395.5	1.4	1.4	1.7
				€ billion		
Balance	– 58.9	– 74.3	– 82.1	– 34.9	– 15.5	– 7.8

* 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, on civil servants' pensions and transfers to the pension fund for Post Office employees. — **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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likely to have gone up by €10 billion to €77 billion. This was due in part to the considerable reduction in the Bundesbank profit, which in the national accounts was recorded as having only a partial impact on the fiscal balance. The combined deficit of central, state and local government expanded by roughly €12 billion to €70 billion. Central government's budget outturn – which bore the brunt of the additional labour market-related expenditure – worsened by €7 billion. Its deficit reached €39 billion, which was twice as high as anticipated in the budget plan adopted in spring 2003. For the second time in a row, central government had to invoke the exemption clause of Article 115 of the Constitution, which allows borrowing to exceed investment expenditure if this is necessary in order to avert an overall economic disruption. The deficit of state government, too, again far exceeded the budgeted level, widening by another €2 billion compared with 2002 to €32 billion. Numerous state governments – as was the case with central government – exceeded the constitutional upper limit for new borrowing. At the municipal level, the deficit may have roughly doubled after reaching €4½ billion in 2002; this was attributable to the marked decline in revenue – including from transfers and proceeds from asset disposals. Many municipalities experienced growing financial gaps in their administrative budgets, which led to increased demands for cash advances. The special funds recorded a

General government finances

Table 9

Item	2001 pe	2002 pe	2003 pe	2001 pe	2002 pe	2003 pe
	€ billion			Year-on-year change		
Central, state and local government				as %		
Expenditure	601	608.4	616.5	0.9	1.2	1.5
of which						
Central government	260.9	271.6	279	– 1.6	4.1	2.5
State government	256.2	258.2	260	2.2	0.8	0.5
Revenue	554.1	550.3	546.5	– 1.3	– 0.7	– 0.5
of which						
Taxes	446.2	441.7	442	– 4.5	– 1	0
				€ billion		
Balance	– 47.8	– 58.1	– 70	– 13.9	– 10.3	– 11.5
of which						
Central government	– 21.1	– 32.7	– 39	2.8	– 11.6	– 6.5
State government	– 26.2	– 29.8	– 32	– 15.8	– 3.6	– 2.5
Social security funds				as %		
Expenditure	449.1	466.4	473.5	3.4	3.9	1.5
Revenue	445	457.9	466.5	2.6	2.9	2
				€ billion		
Balance	– 4.1	– 8.5	– 6.5	– 3.5	– 4.5	2
of which						
Statutory pension insurance scheme	– 0.8	– 4.4	– 3	– 1.2	– 3.6	1.5
Statutory health insurance scheme	– 2.9	– 3.7	– 3	– 2.6	– 0.7	0.5

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surplus of €10 billion, which was €1 billion higher than in 2002. By contrast, the social security funds saw their deficit decline by €2 billion to €7 billion. In particular, the outturn of the statutory pension insurance scheme improved significantly; this was due primarily to the raising of the contribution rate at the beginning of 2003 in conjunction with a steep rise in the maximum level of earnings subject to contributions and a smaller pension adjustment. Nevertheless, the required minimum reserve, which was lowered to half a month's expenditure, was not quite reached at the end of the year. In the case of the statutory health insurance scheme, the deficit declined only slightly despite various measures to curb costs and the increase in contribution rates.

Stagnant trend of tax revenue

On the revenue side, the weak trend in tax receipts continued. They merely matched the prior-year level; consequently, the overall tax ratio as defined in the financial statistics went down further (by just under 0.2 percentage point to 20.8%)[1] despite the increases – mainly in mineral oil tax and tobacco tax – which had entered into force. The result of the official tax estimate from autumn 2002, adjusted for changes in legislation, was likewise considerably undershot

1 According to the preliminary outturn, which includes only an estimate for local government taxes.

by over €18 billion or almost 0.9% of GDP. This was mainly attributable to the continued economic slowdown. Above all, revenue from wage tax and turnover tax was well below expectations. Wage tax receipts increased by just over ½% amid a stagnant trend of gross wages and salaries. Turnover tax actually recorded a fall in revenue of 1%; this development was even less favourable than might have been expected on the basis of the weak growth of domestic demand. This may have been influenced by further insolvency-related shortfalls and by greater tax evasion. Assessed income tax yielded two-fifths less than in 2002; this was primarily due to additional rebates in respect of the grant to home buyers and lower advanced and retrospective payments. Non-assessed taxes on earnings likewise recorded a sharp fall as a result of the decline in dividend payments. This was probably also partly attributable to the imposed moratorium for claiming corporation tax credits that had accumulated prior to the tax reform, although this simultaneously boosted the upward trend in corporation tax receipts. They amounted to just over €8 billion, which was €5½ billion higher than in 2002. Local business tax receipts also increased following a steep decline in revenue over the last two years.

Social security contributions and other revenue

Revenue from social security contributions grew by just under 2%. This reflected the increases in the contribution rates to the statutory pension and health insurance schemes and the fact that the maximum level of earnings subject to contributions was raised far more sharply than the customary annual adjustment. Excluding these measures, contribution receipts decreased somewhat. They developed even more unfavourably than overall gross wages and salaries. One factor behind this trend was that a sizeable number of members of the statutory health insurance scheme switched to private health insurance institutions. Other revenue of general government declined considerably, particularly as a result of the lower Bundesbank profit compared with 2002.

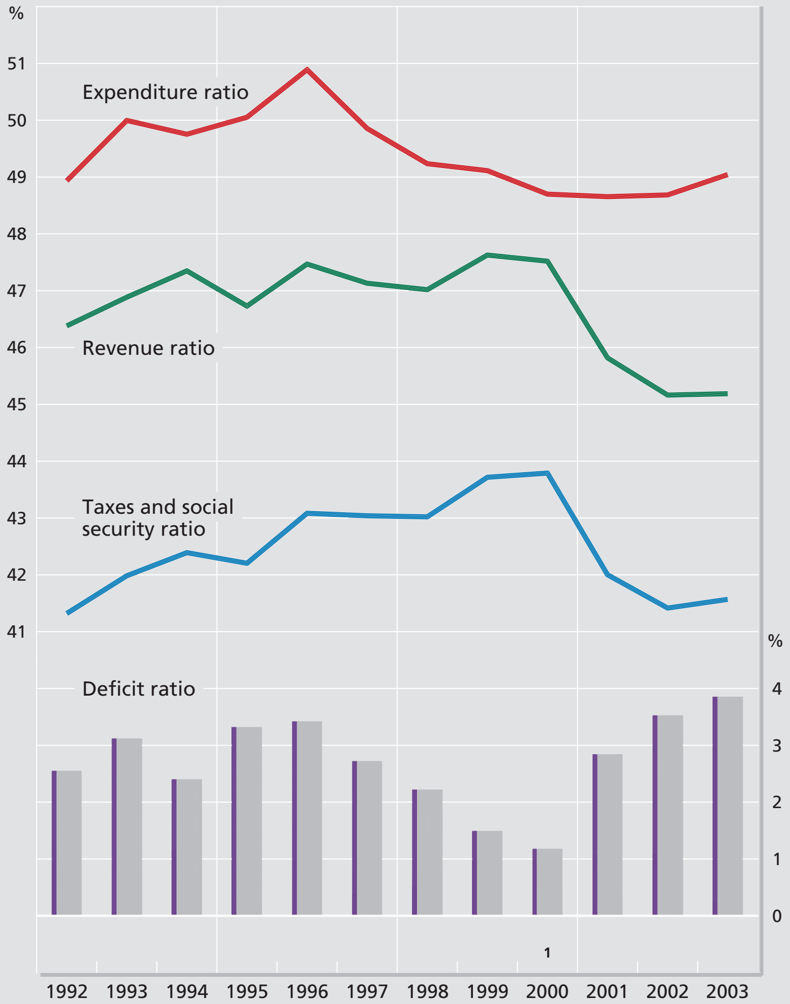
Expenditure

Expenditure of central, state and local government rose by just under 1½%; this was somewhat sharper than in 2002. A major element in this was spending in connection with repairing flood damage, which was chiefly disbursed in 2003. Grants to the statutory pension insurance scheme were raised again sharply by the last stage of the ecological tax reform. Transfers to households likewise increased significantly, not least as a result of the worsened labour market situation. By contrast, the rise in staff costs was dampened by the reduction of bonus payments and further job cuts. Interest expenditure remained virtually unchanged despite the sharp rise in government debt because maturing debts could in most cases still be financed more cheaply as a result of persistently low

General government fiscal ratios*

Chart 22

As a percentage of GDP



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

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interest rate levels. Other operating expenditure and investment went down. In the case of the social security funds, the rise in expenditure decelerated considerably (to 1½%) compared with 2002. Besides the lower pension adjustment and a smaller increase in the number of pension recipients, cost-curbing measures in the statutory health insurance scheme and the reduction of active labour market policies also had an impact. Overall, general government expenditure went up by 1%, which was noticeably weaker than in 2002.

Chronology of general economic and fiscal policy measures

1 January 2003
A number of fiscal policy measures come into effect. They include the last stage of the "ecological tax reform", the second stage of the tobacco tax increase, the temporary raising of the corporation tax rate and the curtailing of existing allowances under the "ecology tax" provision. In addition, the contribution rate to the statutory pension insurance scheme is raised by 0.4 percentage point to 19.5% and the income ceiling for paying contributions to the statutory pension and unemployment insurance schemes is increased significantly.

9 January 2003
A collective labour agreement which runs for 27 months is agreed for the public sector. A three-stage increase of 4.4% in total in negotiated wages and salaries, with an additional gradual adjustment of earnings in eastern Germany to the west German level by the end of 2009 at the latest, is accompanied by various counter-financing measures. The Federal Ministry of Finance quantifies the additional cost for public sector budgets in 2003 at €2.5 billion.

21 January 2003
The Ecofin Council, acting on a recommendation from the European Commission, formally concludes that an excessive deficit exists in Germany. In a recommendation addressed to Germany, the Council calls for the excessive deficit to be eliminated as quickly as possible. It demands, in particular, stringent budget management and the implementation of fiscal consolidation measures for 2003 amounting to 1% of GDP. Germany is given a time limit of four months, pursuant to the Stability and Growth Pact, to fulfil these requirements. The deficit ratio is to be lowered below the 3% ceiling by 2004 at the latest.

24 January 2003
In its Annual Economic Report, the Federal Government expects that economic activity will pick up above all in the second half of 2003. As an annual average, however, aggregate output will not grow by more than 1%. The number of unemployed persons will consequently go up by around 150,000 to 4.2 million on average in 2003.

14 March 2003
In a government policy statement the German Chancellor announces a series of major reforms for the labour market, the social security systems and local government finances ("Agenda 2010").

17 March 2003
The commission charged with reviewing the tax treatment of contributions to and income from retirement pensions presents its expert opinion which, in particular, advocates a changeover, following a lengthy transition period, to the downstream taxation of statutory pensions.

20 March 2003
The Bundestag adopts the Federal budget for 2003, involving a deficit of €19.3 billion, which is the same as in the draft from November 2002. Additional revenue shortfalls as a result of a smaller economic growth and privatisation proceeds are to be offset by pro rata additional revenue for central government of just over €2 billion arising from the planned tax amnesty, which is to enter into force in the middle of the year. Expenditure is expected to amount to €248.2 billion, representing a decrease of 0.4% compared with the outturn for 2002.

11 April 2003
The Bundestag and Bundesrat approve a compromise proposal agreed via the mediation proceedings for the Act to Reduce Tax Subsidies which, contrary to the government draft, includes only a limited number of changes to business taxation. This is expected to yield additional revenue of just under €1 billion in 2003, rising to €3½ billion by 2006.

22 May 2003
The Bundestag approves the parliamentary mediation committee's proposal for a settlement to introduce a distance-graduated motorway toll for heavy goods vehicles. The charge is to

average 12.4 cents per kilometre and raise additional annual revenue of €2.8 billion, €2.2 billion of which will be used to improve the transport infrastructure and €0.6 billion to finance the toll collection.

18 June 2003
The Federal Cabinet adopts a bill to promote honest tax declarations. The tax amnesty envisaged therein is to come into force at the beginning of 2004 (instead of mid-2003) and offer tax offenders penal exemption for a limited period upon the submission of a formal declaration and the retrospective payment of tax on the previously undeclared income at a rate of 25% (until the end of 2004) or 35% (in the first quarter of 2005) of the assessment base. This measure is expected to raise additional revenue of €5 billion in 2004.

24 June 2003
The parties of the government coalition introduce a draft Act to Reform the Labour Market. This aims notably to relax employees' employment protection rights in the case of small businesses and to shorten the entitlement period for receiving unemployment benefit.

2 July 2003
The Federal Cabinet adopts the draft budget for 2004 with an expenditure volume of €251.2 billion. Including the pro rata revenue shortfalls of the Federal Government arising from the advancement of the third stage of the tax reform which was adopted by the Cabinet, the deficit for 2004 is estimated to amount to €31.3 billion. Net borrowing exceeds investment expenditure in the draft budget, so that the exemption clause stipulated in Article 115 of the Constitution has to be invoked for the third year in succession. New borrowing is to be lastingly limited by consolidation measures which will provide relief of €14 billion for central government (€8.4 billion in savings and €5.6 billion in additional revenue) and around €23 billion for all tiers of government in 2004. The Federal Government's medium-term financial plan which is presented at the same time envisages an unchanged spending level for 2005 and 2006 and an increase in expenditure of 1.5% for 2007; at the same time, the minister of finance abandons the goal of achieving a balanced Federal budget by 2006 and now seeks to gradually reduce the deficit to €10.5 billion by 2007.

3 July 2003
In its last meeting, the commission for the reform of local government finances is unable to agree on a tax reform concept.

16 July 2003
The Federal Cabinet decides to finance €2 billion of the Federal Government's pro rata additional shortfalls amounting to €7 billion arising from bringing forward the third stage of the tax reform through privatisation proceeds and thus to reduce net borrowing for 2004 vis-à-vis the draft budget.

13 August 2003
The Federal Cabinet adopts several draft laws concerning key reform projects. The Act Accompanying the 2004 Budget brings forward the third stage of the tax reform to 2004; on the other hand, lasting budget relief (from €7.7 billion in 2004 increasing to €15.2 billion in 2007) is planned – this principally comprises the abolition and/or reduction of various subsidies. The Act implementing the Federal Government's protocol declaration on the mediation committee's recommendations for the Act to Reduce Tax Subsidies (Basket II) contains measures to primarily stabilise corporation tax revenue. The Act Reforming Local Business Tax envisages extending the tax to self-employed professions and also stabilising municipal revenue through a higher local government share in turnover tax. With the Third and Fourth Act Promoting Modern Labour Market Services, labour market policy instruments are to be more efficiently designed, the Federal Labour Office is to be reorganised, unemployment assistance and social assistance for those able to work are to be amalgamated at the current social assistance level.

28 August 2003
The Commission for Achieving Sustainability in the Financing of the Social Security Systems (known as the "Rürup Commission") presents its final report. It suggests reducing the contribution rate to the statutory pension insurance scheme (to 22% up to 2030), in particular by incorporating a sustainability factor to limit pension adjustments and raising the statutory retirement age gradually between 2011 and 2035 to 67 years . It discusses two alternative reform approaches for the statutory health insurance scheme in the form of the flat-rate health premium and the "citizens' insurance model". In the long-term care insurance scheme it suggests the automatic adjustment of benefits and the harmonisation of benefit rates for in-patient and out-patient care; the contribution rate for employed persons is to be stabilised by a special contribution from pensioners and the building up of a capital stock.

8 September 2003
The Bundestag parties SPD, CDU/CSU and Bündnis 90/Die Grünen submit a joint draft Act Modernising the Statutory Health Insurance Scheme. The draft act is based on a jointly agreed summary paper presented on 22 July 2003 and envisages, besides the abolition of some benefits, greater cost involvement for insured persons, the tax financing of non-insurance-related benefits (by raising tobacco tax) and the application of the full contribution rate to supplementary pensions.

29 September 2003
The "Social Security" Commission (Herzog Commission) presents its proposals for reforming the social security systems. For the statutory pension insurance scheme, it suggests – like the Rürup Commission – raising the statutory retirement age to 67 and introducing a sustainability factor in the pension adjustment formula. Furthermore, it proposes taking greater account of child-rearing periods, reductions for surviving dependants without children and the right to claim a full pension after paying in contributions for 45 years. In the case of the statutory health insur-

Chronology of general economic and fiscal policy measures

(cont'd)

ance scheme, it supports the changeover to a funded system with flat-rate premiums from 2013. It proposes that the long-term care insurance scheme should likewise be changed to a funded system. Moreover, the insurance nature of the unemployment insurance scheme should be strengthened.

30 September 2003
The "Koch/Steinbrück Commission" presents a concept for the linear reduction of tax subsidies and financial assistance. An annual reduction of 4% is envisaged for the next three years; this should result in an annual budgetary relief of €10.5 billion from 2006 onwards once fully effective. In important respects, the proposals are laxer than those contained in the draft Act Accompanying the 2004 Budget.

23 October 2003
The Federal Cabinet approves the drafts of a Second and Third Act Amending the Sixth Book of the Social Security Code and other Acts aimed at stabilising the contribution rate to the statutory pension insurance scheme at 19.5% in 2004. This includes not increasing pensions in 2004 and reducing the minimum fluctuation reserve to 20% of a month's expenditure; furthermore, in future, pensioners are to pay the full contribution to the long-term care insurance scheme. Moreover, the time of pension payment for new retirees is put back from the beginning to the end of the month.

29 October 2003
The Federal Government approves a draft supplementary budget for 2003, which takes account of the tax shortfalls and additional labour market-related expenditure vis-à-vis the initial budget. As a result, the deficit goes up by €24.5 billion to €43.8 billion vis-à-vis the initial budget.

14 November 2003
In its 2003-04 Annual Report, the German Council of Economic Experts notes that the almost three-year stagnation of national economic output will come to an end in 2004. However, it also suggests that the expected cyclical recovery will remain subdued with GDP growth of 1.5% and that the macroeconomic production capacity will still not be fully utilised. As a result, employment will fall further on an annual average and unemployment will increase somewhat. In the Council's view, the economic slowdown is having an effect not least on public finances, which are significantly overshooting the deficit ceiling laid down in the Maastricht Treaty. The Council calls for action in this field after a series of bold and courageous reforms were introduced on the labour market and in the social security systems.

25 November 2003
When dealing with the deficit procedures initiated against Germany and France, the Ecofin Council does not follow the European Commission's recommendation to give the countries a formal warning and thereby to initiate the next stage of the excessive deficit procedure. According to the Ecofin Council's recommendations, which deviate from the envisaged procedure, the excessive deficit must be corrected in both countries only by 2005, and the scale of consolidation demanded for 2004 – namely to cut the cyclically adjusted deficit by 0.6% of GDP in Germany and by 0.8% of GDP in France – is likewise less rigorous than the Commission's recommendations.

3 December 2003
The Federal Government presents an updated stability programme, which anticipates a deficit ratio of 3½% for 2004 (after 4% in 2003) and consequently envisages a further breaching of the ceiling laid down in the Maastricht Treaty. Only in 2005 is the deficit ratio likely to fall below the ceiling (2½%) and then go down to 1½% in 2007. To this end, the general government expenditure ratio is to be reduced by 4½ percentage points (to 44½%) in the four years to 2007. The debt ratio will go up overall by 1½ percentage points to 65½% by 2005 before declining by 1 percentage point to 64½% in 2007; this will still considerably exceed the reference value laid down in the Maastricht Treaty. This is based on assumed real

economic growth of 1½% to 2% in 2004 and 2¼% in each of the subsequent years.

The Federal Cabinet approves a draft Act ensuring the sustainable financial bases of the statutory pension insurance scheme (Pension Insurance Sustainability Act). As suggested by the Rürup Commission, a sustainability factor is to be introduced according to which future pension adjustments will also depend on the development of the ratio of pensioners to contribution payers. Furthermore, the lowest age eligible for claiming early retirement is to be raised to 63, periods of college education are no longer to be counted towards pensions, and the statutory pension insurance reserves are to be increased.

Furthermore, the Federal Cabinet approves a draft Act reviewing the income tax treatment of contributions to and income from retirement pensions (Retirement Income Act), which complies with a ruling from the Federal Constitutional Court. In line with the recommendations from the expert commission charged with carrying out this review, there should be a progressive transition to the downstream taxation of pensions by 2040. In addition, the current tax privileges for endowment life insurance policies is to be abolished for new contracts from 2005 and the promotion of supplementary private pension plans ("Riester pensions") is to be simplified.

19 December 2003
The Bundestag and Bundesrat adopt, in particular, the following reform laws, some of which were extensively modified in the course of parliamentary mediation proceedings. The Act Accompanying the 2004 Budget envisages only the partial advancement of the third stage of the tax reform as well as smaller subsidy reductions vis-à-vis the original draft; on the other hand, it contains additional linear cuts in subsidies averaging 12% according to the "Koch/Steinbrück" list. The Act implementing the Federal Government's protocol declaration concerning the mediation committee's recommendation for the Act to Reduce Tax Subsidies (Basket II) imposes more moderate tax measures to tighten the rules on tax carryforward losses and debt financing through shareholders than envisaged in the draft. Moreover, special tax treatment is introduced for life and health insurance companies enabling them to offset book and disposal losses from equity holdings against tax (with a corresponding tax liability for gains). The Act Amending Local Business Tax largely leaves this tax in its current form; local government receives some relief from lowering the portion of business tax transferred. Whereas the Third Act Promoting Modern Labour Market Services is adopted in a largely unchanged form, the Fourth Act Promoting Modern Labour Market Services postpones the amalgamation of unemployment assistance and social assistance – compared with the draft – from the middle of 2004 to the beginning of 2005. The municipalities will in future have to fund the accommodation costs of the recipients and can opt to take over the other payments. In the Act to Reform the Labour Market, the threshold from which workers may claim employment protection is raised to companies with more than ten employees.

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, reforming the statutory health insurance scheme, short-term measures to stabilise the contribution rate to the statutory pension insurance scheme and a first part of the adopted labour market reforms.

14 January 2004
According to the preliminary outturn, the deficit recorded in the Federal budget for 2003 amounted to €39.2 billion, which was €4.6 billion below the amount provided for in the supplementary budget. This was due to additional tax receipts of €1.1 billion and lower expenditure of €3.5 billion, which primarily affected labour market-related spending, interest expenditure and guarantees.

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. Growth of 1.5% to 2% of GDP is expected for 2004 as a whole. This should lead to a turnaround on the labour market. Whereas unemployment may decline somewhat on an annual average, not least as a result of the labour market reform, 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
Another updated version of the German stability programme is presented which takes account of the outcome of the mediation committee; in particular it envisages a marginal downward revision (to 3¼%) of the expected deficit ratio for 2004.

11 March 2004
The Bundestag adopts the Pension Insurance Sustainability Act.

(b) Outlook for 2004

Recurrence of excessive deficit and violation of the Stability and Growth Pact

The Federal Government expects an excessive deficit in Germany for the third year in a row in 2004. Compliance with the ceiling laid down in the Maastricht Treaty has been postponed to 2005 with reference to the poor macroeconomic situation. Furthermore, the Ecofin Council did not follow the European Commission's recommendation to initiate the next step of the excessive deficit procedure. Instead, the excessive deficit procedure was held in abeyance for Germany; similarly, the reduction of the cyclically adjusted deficit by 0.6% of GDP demanded by the Council for 2004 was lower than the Commission's recommendation. In 2005 the deficit criterion is to be fulfilled.

Resultant problems

In the light of this approach, the threat of imposing sanctions in the event of a continued undesirable fiscal trend has lost credibility. In the medium and long term, risks may ensue from this for Germany (and the euro area as a whole). Debt financing may be made easier but this would simultaneously undermine public confidence in the prospect of achieving a sustainable government fiscal position. This damaging of the Pact also gives the wrong signals to the acceding countries. In addition, a prolonged larger demand for credit from government would result in higher capital market interest rates, which would impair the longer-term outlook for growth and employment. It would also make it more difficult for monetary policy makers to ensure a stable price level at low interest rates. By contrast, low government debt ratios would make it easier to overcome the challenges posed by demographic developments, which in Germany are particularly great. Moreover, refraining from taking more extensive consolidation measures can hardly be justified in Germany on cyclical grounds in the light of expected real economic growth of 1½% to 2% this year.

Plans for 2004

The plans for 2004 envisage a reduction of the general government deficit ratio to 3¼% based on the growth assumptions in the updated stability programme from January 2004. As things stand today, therefore, it seems likely that the deficit ceiling of 3% will be breached yet again, and the Federal Government's assumptions are subject to risks. Furthermore, another rise in the general government debt ratio, which already exceeds the 60% limit set in the Maastricht Treaty, is to be expected. As a result of the introduction of the second and the partial advancement of the third stage of the income tax cuts as well as the reduction in contributions to the statutory health insurance scheme envisaged as part of the health reform, the taxes and social security ratio will decrease this year. Other revenue is likely to decline, particularly as a result of the lower Bun-

General government debt Table 10

€ billion

Item	2002	2003 pe	2002	2003 pe
	Level at year-end 1		Year-on-year change 2	
Loans against borrowers' notes	423	430.5	– 12.7	+ 7.5
Securities	846.6	920	+ 67.6	+ 73.5
Other debt	8	7	– 1.2	– 1
Total debt	1,277.6	1,357	+ 53.7	+ 80
Central Government 3	725.4	767.5	+ 24.3	+ 42.5
State government (western)	328.4	355.5	+ 22.6	+ 27
State government (eastern)	63.8	68	+ 5	+ 4.5
Local government (western) 4	84.1	90	+ 1.9	+ 6
Local government (eastern) 4	16.7	17	– 0.3	+ 0.5
German Unity Fund	39.4	39	– 0.2	– 0.5
ERP Special Fund	19.4	19.5	+ 0.2	– 0
Indemnification Fund	0.4	0.5	+ 0.1	+ 0

1 In the definition relevant for compliance with the EMU convergence criterion, government indebtedness comes to €1,284 billion (2002) and €1,366 billion (2003). — **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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desbank profit. On the other hand, government expenditure growth will be dampened both by stringent budget management and – considerably – by the structural reforms which have been initiated. These will have an impact primarily in the form of savings in the statutory pension and health insurance schemes as well as reductions in personnel expenditure. The government expenditure ratio therefore looks set to decline significantly this year. On balance, this should represent a first step in the necessary process of reducing the structural government deficit. Further consolidation measures are, however, required in order to be able to fulfil national and international obligations.

4 Macroeconomic outlook and structural reforms

Outlook for 2004

The German economy, in the first quarter of 2004, is still in the initial phase of the recovery process which began in the second half of 2003. As yet, however, the economic recovery has only made moderate progress. The pace of the macroeconomic upswing is still well below the threshold at which investment in capacity expansions and new staff becomes necessary. This is another reason why it is still too early to speak of a self-sustaining upswing. Nevertheless, not only the generally optimistic expectations of the business sector, but also the overall improvement in the underlying conditions suggest that the recovery process will continue.

For example, the global economic recovery has developed into a robust and broadly-based upswing. The German economy is still coping with the current exchange-rate developments. Another reason for this is that the stimuli generated by world trade have become noticeably stronger and global economic growth this year may well be higher than originally expected. The German economy is likely to benefit from this, especially as the global pick-up in investment demand – which is in general comparatively price-inelastic – accords with the German economy's profile and is simultaneously apparent in different regions of the world. Moreover, the price competitiveness of the German economy, despite sustaining considerable exchange-rate-related losses compared with earlier high levels, may still be rated as being on a par with its multi-year average. Overall, the price climate in Germany remains decidedly consumer-friendly despite the increases in indirect taxes and administered prices. The cost trends continue to be moderate and the restructuring and modernisation measures of production enterprises are well advanced. The banking system has also made significant adjustment progress which, together with the low interest rates and abundant liquidity, provides a sound basis for more growth from both the monetary and the financial side.

Improved underlying conditions as a result of structural reforms ...

Moreover, the underlying conditions for the economy as a whole have improved as a result of the structural reforms agreed or initiated last year as part of the "Agenda 2010". These include labour market reforms, reforms in healthcare and old-age provision as well in the area of taxes and subsidies (see the box on page 87 for details).

... on the labour market, ...

Of particular significance are those measures aimed at considerably reducing the high level of structural unemployment. They are designed to strengthen the functioning of the labour market and reduce labour costs – especially non-wage labour costs – which are high by international standards. For example, the Act to Reform the Labour Market makes the hiring of new staff easier by relaxing the employment protection regulations for small businesses, by defining more clearly the social selection criteria in the case of compulsory redundancies and by considerably extending the possibilities for start-ups to take on temporary staff. Furthermore, the shortening of the maximum period of entitlement to unemployment benefit, which is lengthy by international standards, increases the

Major structural reform measures

1 Labour market

- Removal of restrictions in the Act on labour leasing (*Arbeitnehmerüberlassungsgesetz*).
- Revision of the arrangements for low paid part-time work (mini jobs).
- Introduction of subsidised one-person businesses ("Me Plc") and establishment of personnel service agencies.
- Reorganisation of the Federal Labour Office into a customer-oriented service provider with the aim of finding work for unemployed people more quickly.
- More efficient organisation of labour market policy instruments and simplification of benefits legislation, tightening up of the rules governing periods of ineligibility and the jobs which the unemployed can reasonably be expected to accept.
- Starting in January 2005 unemployment assistance and social assistance paid to persons able to work will be merged to create "unemployment benefit II", basically set at the same level as the former social assistance. Transitional arrangement following the maximum period of entitlement to unemployment benefit.
- Obligation to furnish proof of sufficient job-seeking efforts, all jobs deemed reasonable regardless of the person's qualifications. 30% benefit cut for three months if a job is refused.
- With effect from February 2006, period of entitlement to unemployment benefit shortened to 12 months, or 18 months in the case of unemployed persons over the age of 55.
- Starting in January 2004 relaxing of employment protection for new staff in firms with no more than ten employees.
- Changes to the present social criteria for selecting employees for dismissal in the case of compulsory redundancies in order to secure the continued employment of high achievers as well as a balanced staff structure. Employees granted the option of choosing between a statutory claim to severance payment and bringing an action for unlawful dismissal.
- Persons starting up in business may hire employees on a temporary employment contract of up to four years without the need to justify the time limitation.
- Restricting the requirement to be a master craftsman in order to operate a craft enterprise to crafts in hazardous areas and in areas necessitating in-depth training.

2 Statutory health insurance scheme

- Narrowing the range of benefits (abolition of death benefit, maternity payments, subsidised non-prescription drugs, taxi journeys, subsidised spectacles).
- Increase in patients' co-payments (up to a maximum level of 2% of the gross income), introduction of a surgery visit charge of €10 per quarter.
- Flat-rate financing of non-insurance-related benefits by raising tobacco tax.
- Higher health insurance contributions for pensioners.
- Extension of price discount scheme for patented pharmaceuticals, more rigorous assessment of pharmaceuticals' utility as of 2005.
- Further reduction of non-wage labour costs by shifting funding contributions from the employer to the employees by means of a separate insurance for dentures starting from 2005 and a special contribution of 0.5% by the employees starting in 2006.

3 Old-age provision

Short-term measures to stabilise the contribution rate in 2004.

- No pension increase in 2004.
- As of 1 April 2004, pensioners will pay the full (rather than the current 50%) contribution to the long-term care insurance scheme.
- Putting back the payment date for new pensions from the beginning to the end of the month beginning on 1 April 2004.
- Lowering the minimum fluctuation reserve from 0.5 to 0.2 month's expenditure.

Longer-term reform of the statutory pension insurance scheme (currently in the legislative process):

- Curbing pension increases from 2005 onwards by introducing a sustainability factor which takes into account the ratio of pensioners to contribution payers.
- Between 2006 and 2008, progressive increase in the statutory retirement age following unemployment and pre-retirement part-time work to 63 years.
- Periods of schooling and higher education no longer count towards pension payments.
- Raising the fluctuation reserve to up to 1.5 month's expenditure.

Amended tax treatment of retirement income (currently in the legislative process).

- Progressive changeover to the downstream taxation of pensions by 2040.
- Simplification of the promotion of supplementary private pension plans ("Riester pensions").

4 Taxation, financial assistance and other issues

- Bringing forward part of the third stage of the income tax reform to 2004 with a tax rate of between 16% and 45%.
- Reducing the grant to new homebuyers by almost one-third starting in 2004.
- Lowering the flat-rate commuter allowance to 30 cents per kilometre.
- Further cuts in subsidies in line with the "Koch/Steinbrück list" averaging 12% (including housing bonus, blanket deduction for income-related expenses for employees, savers' tax-free allowance, tax credits on employees' savings).
- Abolition of holiday pay and reduction of the Christmas bonus to 60% of a monthly salary for Federal civil servants (50% for retired civil servants).
- Cut in child-raising benefit primarily by lowering the income limit.
- Abolition of the "half-year rule" for depreciation allowances.
- Limitation of the loss-carry-forward facility to 60% of the total income over €1 million.
- Restrictions on corporate debt financing through shareholders.

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incentive to work, reduces the pressure on public finances from labour-market-related expenditure and opens up prospects of reducing social security contributions in the medium term. The merging of unemployment assistance and social assistance for beneficiaries able to work, which is planned as part of the "Hartz Acts" but is not due to come into effect until 2005, as well as the tightening up of the conditions for taking up work will also make a significant contribution in this respect.

... in the healthcare sector, ...

In the healthcare sector a package of measures was adopted for the statutory health insurance scheme. This package is designed to remedy the acute financial crisis in this social security sector, to curb non-wage labour costs and at the same time bring about a more efficient use of financial resources. Among the main measures are the curtailing of the range of benefits, higher co-payments by insured persons and a shifting of funding from employer to employees. While the demand for healthcare services will probably be dampened as a result of the increased supplementary charges for insured persons, competition among the service providers and the insurance institutions will hardly be increased by the current reform measures. The potential to lower the contribution rates is limited by the prior need to plug the existing funding gap and redeem part of the accumulated debt.

... in old-age provision ...

In the area of the statutory pension insurance scheme, short-term measures have been taken to stabilise the contribution rate, including not increasing pensions this year and lowering the minimum fluctuation reserve again. The latter measure, however, only provides this social security sector with a brief respite and, because of the associated renewed recourse to the reserves, will contribute to the likelihood that the general government deficit will once again exceed the Maastricht ceiling this year. Moreover, the Federal Government has passed an act containing further measures to curb the rise in contributions in the longer term, primarily by means of introducing a sustainability factor to lower pension adjustments. Starting next year a gradual changeover to the downstream taxation of pensions is also planned. This reform complies with a ruling from the Federal Constitutional Court and simultaneously makes a major contribution to the macroeconomic requirement of easing the levy burden shouldered by employed persons.

... and in reducing subsidies

Moreover, the Act Accompanying the 2004 Budget initiated the task of phasing out subsidies and tax breaks which have a distorting effect in terms of allocation. However, it falls well short of the original government plans. This applies particularly to the cut in the commuter allowance and the reduction of the grant to home-buyers. On the other hand, the additional first step towards a linear cut in subsidies pursuant to the "Koch/Steinbrück concept" is to be welcomed; it should be extended by further measures in the coming years. Conversely, some measures taken in the corporate sector as part of the "Basket II" of the Act to Reduce Tax Subsidies are not entirely without problems from a macroeconomic point of view. In particular, the limitation of the tax loss carry-forward facility will probably have a rather negative impact on the propensity to invest because it will make the full and timely fiscal recognition of losses required under the neutrality obligation even more difficult.

Further reforms required ...

Overall, this package of reforms nevertheless makes a significant contribution to overcoming the weak macroeconomic momentum. Additional efforts are, however, required to solve Germany's large structural problems constituted by the persistently high level of unemployment, the – by international standards – relatively short working year and life, the low growth potential, the high structural general government deficits and above all the unfavourable demographic outlook. This is all the more necessary given that at the summit in Lisbon in 2000 the EU member states undertook to make the European Union the most competitive and dynamic knowledge-based economic region in the world by 2010.

Only a sustained improvement in both the economy's and society's adaptability and innovative power will make achievement of these objectives possible. Only in this way will it be possible to absorb negative shocks without major friction and more swiftly recognise opportunities for the future. Much will hinge on the extent to which the labour market is modernised. The forthcoming enlargement of the European Union by ten member states on 1 May 2004 will increase the pressure to adjust even further.

... on the labour market, ...

Major and rapid increases in employment are not to be expected from the current package of labour market policy measures. Apart from the time lags during the preparatory and introductory phases, those involved will first need to gain practical experience of the instruments, some of which are new. Moreover, some changes do not come into force until 2005 or 2006. There is also considerable risk of bandwagon and rechannelling effects. Consequently, the net relief cannot be deduced from the number of assisted persons. It is true that the macroeconomic environment places tight constraints on the new labour market policy. However, if the economy continues to pick up steam, the employment opportunities could be exploited rapidly. This is borne out by the fact that the sluggish labour market stock figures mask considerable flow dynamics.

However, labour market reforms should not be primarily about creating new and permanent labour market segments by means of selective deregulation and special promotion programmes. The primary objective is to reduce the risk of unemployed people remaining in unemployment by increasing enterprises' willingness to recruit new staff. In addition to a general relaxation of employment protection regulations, greater use of lower starting pay rates would be very useful. There is still a need to reform the "favourability principle" which protects employees' interests by applying a broader definition which includes job-saving aspects. Furthermore, the inclusion of escape clauses in collective labour agreements permitting alternative solutions at plant level would widen businesses' action radius before a major contingency occurs. This would enable wages to fulfil their steering and market-clearing function more effectively. Furthermore, in the middle and higher income brackets adequate incentives for further training should be created by means of appropriate training yields. In the lower-skilled sector, remuneration must be aligned more closely to the jobs' productivity profile. The introduction of "unemployment benefit II" should make this easier.

... in the social security sector ...

In the social security field, the key task is to lastingly decouple the rising healthcare costs, which are caused by the demographic trend and the progress in medical technology, from wages. This is necessary in order to permanently curb non-wage labour costs and thus improve the conditions for generating employment. The additional measures which the Federal Government has introduced into the legislative process to reduce contributions to the statutory pension insurance scheme in the longer term may be conducive to this objective and, in addition, may help to achieve a more balanced intergenerational burden-sharing. Furthermore, the gradual raising of the statutory retirement age seems necessary given the rising life expectancy.

... and in central, state and local government

Fiscal consolidation at central, state and local government level is essential. Only if the government expenditure ratio is significantly reduced can sustainable progress be achieved in this area. In particular, the reduction of subsidies needs to be taken further. Only a budget position which is at least close to balance will also create a sound basis for the desired further tax cuts. In the light of the high fiscal deficits, priority must be given to the urgent task of greatly simplifying tax law, which is currently labyrinthine.

Ongoing policy of further reforms required as part of a coherent overall concept

The success of the reforms also depends on the extent to which they boost confidence in economic and fiscal policy and, at the same time, can lastingly improve the expectations of the private economic agents with regard to the economic outlook. To this end, an ongoing policy of further reforms should be pursued. These reforms should be part of a coherent and convincing overall strategy for progressively improving the underlying overall economic and financial policy conditions.

V European and global cooperation

1 European integration

(a) Damage to the Stability and Growth Pact

Sustainability of the government financial position not guaranteed in many countries

As of the beginning of 2003, the "Broad Economic Policy Guidelines" (the chief instrument for coordinating economic policy in the EU) will be fundamentally revised by the European Commission and the Ecofin Council only every three years as part of a more medium-term oriented strategy. In the meantime, reviews will focus on the member states' practical implementation of the economic policy recommendations. The Council laid down primary policy objectives in its revision of the Broad Economic Policy Guidelines in June 2003. These include reforms geared towards making the labour market more flexible and ensuring or restoring the sustainability of the government financial position. In the Council's view, the long-term sustainability of the government financial position is currently not guaranteed in half of the EU member states, including Germany. As economic performance in the EU was very disappointing in 2003, the fiscal situation continued to show mainly a year-on-year deterioration in the period under review, not least as a result of the automatic stabilisers. In 2003, only five member states achieved budgetary positions close to balance or in surplus as defined in the Stability and Growth Pact (SGP).

Excessive deficit procedure initiated against Germany and France

In January 2003, the Council, having already initiated an excessive deficit procedure against Portugal in November 2002, decided that there was an excessive deficit in Germany in 2002. The Council recommended corrective measures in the amount of 1% of GDP and, in accordance with the provisions of the SGP, called upon the Federal Government to correct the excessive deficit by 2004 at the latest. In June, the Council also initiated an excessive deficit procedure against France for breaching the reference value in 2002. The French government was recommended to pursue somewhat stricter fiscal consolidation than Germany, though likewise with the aim of correcting the excessive deficit by 2004.

Council responded to inadequate deficit reduction by suspending the regular procedure

Based on its autumn 2003 economic forecast, the European Commission concluded that the fiscal situation had continued to deteriorate during the year in Germany – even though the Federal Government had heeded the recommendations made by the Council in early 2003 – as well as in France and that a correction of the excessive deficits could no longer be expected in 2004, especially as tax relief measures were being prepared in both countries. As a result, the Commission advised the Council to intensify the deficit procedures against Germany and France, and presented recommendations along these lines in accordance with Article 104 (8) and (9) of the Treaty establishing the European Community to be a warning to the two countries as a last step before the imposition of sanctions. Germany and France would accordingly have been required to take additional consolidation measures. The Commission admitted though that the deadline for correcting the excessive deficit should be extended from 2004 to 2005 owing to significantly less favourable growth prospects. At the Council meeting in late November 2003, however, the vote on the Commission's recommendations to intensify the procedure did not reach the required majority. Instead, the Council adopted conclusions suspending the deficit procedures for the time being. However, both countries – in keeping with the commitments set out by the countries themselves and the Commission's recommendations – should make consolidation efforts with the aim of achieving the necessary deficit corrections by the end of 2005 at the latest. The Commission considered this to be an infringement of the agreed procedure. In order to establish clarity with regard to the present and future implementation of the SGP, the Commission filed an action at the European Court of Justice in January 2004 to verify the legality of the Council's approach.

Flexible interpretation of the SGP in the case of the United Kingdom too

As early as March 2003, the Council adopted a report which, whilst aiming to stabilise consolidation pressure (through obliging all governments to reduce their structural budget deficits by at least ½ percentage point each year), at the same time also allows country-specific circumstances to be taken into consideration in the evaluation of budget developments. The Commission used this scope for interpretation for the benefit of the United Kingdom in this year's round of examinations of the EU member states' stability and convergence programmes. Despite a planned government deficit of 3.3% of GDP in the 2004 fiscal year, the Commission announced that it would not recommend the initiation of an excessive deficit procedure owing to the fact that the reference value would be exceeded only temporarily and in view of the low level of debt and favourable growth prospects.

Modified application of the SGP damaged the very foundations of monetary union

Any events not in accord with the objectives and procedural rules of the SGP are a cause for major concern. As early as 1993, before the Maastricht Treaty came into force, the Federal Constitutional Court stipulated that Germany's participation in monetary union was dependent on the new regime being seen as a "stability union". The SGP of 1997 (whose provisions regarding the avoidance of excessive deficits, the surveillance of budgetary positions, the early warning system and the excessive deficit procedure refine the obligations set out under the EC Treaty and make them easier to apply) is intended to help to maintain monetary union's stability orientation on a permanent basis. In the Bundesbank's view, it is therefore an inherent part of the foundations. Without it, monetary union would probably not have started in 1999. At the aforementioned meeting in November 2003, the Council did not act in line with this fiscal basis, thus severely damaging it. In view of the upcoming EU enlargement, this has given the wrong signal to the acceding countries in particular. Evidently not every EU government is ready yet to accept the fact that they have relinquished a part of their sovereignty over budgetary policy through the Maastricht Treaty and the SGP.

SGP must be revived

The SGP is not an economic straitjacket but rather allows sufficient room for manoeuvre, which has to be created in the first place, however. Therefore, the problems which individual deficit countries are having in complying with the rules in the Treaty and the Pact are, above all, caused by domestic factors. Those countries which had excessive budgetary difficulties during the economic slowdown failed to embark on a consolidation path in a timely manner and to initiate comprehensive economic reforms at the same time. In order to restore the credibility of the Community's commitment to stability, it is necessary to revive the SGP, ie to interpret the existing set of rules in future in the strict manner promised by all of the parties when the SGP was agreed rather than to change it in one way or another. To limit the damage, the first step must be for Germany and France to fulfil the self-imposed commitments which they entered into in November 2003.

(b) Completion of preparations for EU enlargement

Treaty of Accession signed in April 2003

The EU's accession negotiations with ten countries (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) were successfully completed at the European Council meeting in December 2002 and the Treaty of Accession was signed in Athens in April 2003. The enlargement is scheduled to come into effect on 1 May 2004. This formally requires ratification of the Treaty by both the current and the new member states. Considerable progress has been made in this respect in the meantime and the ratification procedures are expected to be completed on time before the scheduled date of accession. Before ratification, referenda were held in all of the acceding countries apart from Cyprus. All of these countries voted in favour of accession, mostly with a large majority. Following the signing of the Treaty of Accession, the acceding countries have been integrated into the working structures of the Community. Prior to accession, they will have observer status (ie without a right to vote) in most Community bodies. They will also have a right to speak in some bodies, such as the General Council of the ECB.

Accession preparations well under way but still worrying gaps

Upon the conclusion of the accession negotiations, the Community expressed the hope that the acceding countries would completely fulfil the Copenhagen criteria of 1993 before the date of accession. This means, above all, that existing delays in the adoption of the *acquis communautaire* must be remedied. In its monitoring report of early November 2003, the Commission established that the acceding countries have made considerable progress in their preparations for accession and have already reached a very high degree of alignment with the *acquis*. However, the Commission also identified a number of areas of serious concern. They relate mainly to existing and considerable gaps which affect the functioning of the single market or which need to be closed so that EU funds can be delivered to beneficiaries in the new member states. The Commission will continue its monitoring activities until accession and, if necessary, is then determined to take all available measures to ensure that such problems are resolved rapidly.

Policy position of the Governing Council of the ECB of December 2003 on exchange rate issues in connection with enlargement

Upon accession to the EU, the economic and monetary integration of the acceding countries will also begin, although immediate accession to the euro area is out of the question. Although the introduction of the euro is an obligatory goal under the EC Treaty, the acceding countries must start by fulfilling the Maastricht critieria, which include the provision that new EU member states must first participate in the European Exchange Rate Mechanism (ERM) with satisfactory

Policy position of the Governing Council of the European Central Bank on the exchange rate policies of the acceding countries

In December 2003, the Governing Council of the ECB published a policy position on the exchange rate policies of the acceding countries. The policy position contains specific recommendations on participation in the European Exchange Rate Mechanism (ERM) and considers the interpretation of the convergence criteria for later entry into the euro area. The key points of this policy position can be summarised as follows.[1]

Main features of the ERM
The ERM is a system of fixed but adjustable exchange rates, which are defined in relation to the euro. The central rate and fluctuation bands are laid down in a multilateral arrangement. The normal fluctuation margin of the market rates is +/-15% but can be narrower in exceptional cases. The standard fluctuation band is appropriate for member states engaging in a convergence process. Flexible exchange rates, crawling pegs or pegs against currencies other than the euro are incompatible with the ERM. Currency board systems (ie totally rigid exchange rates) may be retained, in principle, as a unilateral commitment within the ERM. However, this arrangement must be assessed on a case-by-case basis.

The economic policies of the participating member states should, in principle, be guided by the requirements of any fixed exchange rate regime so as to avoid tensions as far as possible. If the market rates reach the boundaries of the fluctuation margin, interventions will, in principle, be automatic and unlimited unless they conflict with the primary objective of price stability in the member state or the euro area as a whole.[2]

Entry into the mechanism and length of participation
Participation in the ERM is voluntary, but membership is a precondition for the eventual adoption of the euro. No contractual preconditions have to be fulfilled to join the mechanism. To ensure trouble-free membership of the ERM, the new EU member states should undertake most of the necessary transformation or adjustment processes prior to participation in the mechanism. In particular, wherever necessary, fiscal policy should be set on a credible consolidation path.

The decision about the central rate is to be based on an assessment of a broad range of economic indicators and also take account of the market rate. However, there is no reason to presume that the initially agreed central rate will be the ultimate conversion rate for euro adoption. Realignments of the central rate should be made in a timely fashion in the event of a reassessment of the equilibrium rate. All of the parties, ie the member state concerned, the euro-area countries, the ECB and other member states participating in the ERM, can initiate a procedure aimed at reconsidering the central rate.

The Treaty establishing the European Community (the Treaty) sets out a minimum two-year period of participation in the ERM prior to the convergence assessment for the adoption of the euro. However, ERM membership should not be seen as merely a "waiting room" for the quickest possible entry into the euro area but rather as an independent intermediate phase which can help to further the convergence process. The length of participation in the ERM should be geared towards the ability to fulfil the convergence criteria on a sustainable basis.

Adoption of the euro
"Euroisation" (unilateral adoption of the euro as the national currency) would be incompatible with the multilateral nature of monetary integration. Instead, accession to monetary union is to be the outcome of an economic maturing process. According to the Treaty, new member states are expected to adopt the euro as soon as they fulfil the criteria relating to price stability, the sustainability of the government financial position, the convergence of interest rates and exchange rate stability ("nominal" convergence). Pursuant to Article 121 (1) of the Treaty, the sustainability of the degree of nominal convergence achieved, the current account situation and the development of unit labour costs and other price indices are also to be assessed. The convergence assessment will be carried out on the principle of equal treatment with the current member states. There will therefore be no relaxation of the criteria for the new member states. With regard to the exchange rate criterion this means that, prior to the convergence assessment, a member state must have participated in the ERM for a period of at least two years without a downward realignment of the central rate or severe tensions. The assessment of market exchange rate stability will focus – as in the past – on whether the exchange rate has been consistently close to the central rate without any tensions. The chosen width of the fluctuation band is irrelevant in this respect.

1 The policy position is available in full on the ECB's website (http://www.ecb.int). — **2** For details about the ERM, see Deutsche Bundesbank, Operational features of the new European exchange-rate mechanism, *Monthly Report,* October 1998.

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results for at least two years. Furthermore, it is not necessary for them to join the ERM immediately after their accession to the EU. Following intense discussions, the "Policy position of the Governing Council of the European Central Bank on exchange rate issues relating to the acceding countries" was published in December 2003. It gives the acceding countries recommendations on exchange rate policy and contains stipulations for future convergence assessments.

Entry into ERM advisable only after further progress towards convergence

According to the EC Treaty, there are no preconditions for joining the ERM. However, the central rate and the fluctuation band must be agreed multilaterally. To ensure that participation in the ERM is as trouble-free as possible, it appears necessary, however, for important economic transformation processes – such as price liberalisation – as well as the stabilisation of internal and external imbalances to already be well advanced. In particular, a credible consolidation of public finances should already have been initiated. Once achieved, ERM membership should be seen as an independent integration stage and not merely as a "waiting room" for joining monetary union as quickly as possible. Relatively narrow bands may be considered for a country which is generally viewed to be at an already very advanced stage of the adjustment process and could, therefore, be expected to align its policies with the monetary policy of the ECB without difficulties at any time. Apart from the fact that the convergence assessment for the adoption of the euro must be preceded by a minimum two-year period of participation in the ERM, the length of this intermediate phase should be geared solely towards the ability to fulfil the convergence criteria sustainably.

(c) Draft European Constitution still unsatisfactory

European Convention has presented draft Constitution

The Treaty of Nice entered into force in February 2003, thus largely completing the EU's institutional preparations for enlargement. Nevertheless, considerable shortcomings in the Community's institutional system still remained. The Intergovernmental Conference in Nice therefore also launched an in-depth debate on the future of the European Union. For this purpose, the European Council convened the European Convention by way of the Laeken Declaration in December 2001. The tasks of the Convention, whose meetings were open to the public, were to fully prepare a new Intergovernmental Conference and to pave the way for a Constitutional Treaty for Europe. The Convention was opened at the end of February 2002 and completed its work by submitting a draft Constitutional Treaty in July 2003.

Institutional strengthening of the European Union through the Convention's proposals

The first part of the Convention's draft Constitution contains provisions regarding the functioning of the European Union. For example, it codifies the Union's objectives, competences, institutions and financing mechanisms. The second part consists of a Charter of Fundamental Rights of the Union, whilst a further part deals with individual policies. Through this Constitution, the pillar structure of European integration created by the Maastricht Treaty would be replaced by a single legal framework with the intention, not least, of promoting citizens' awareness of the European Union. Furthermore, the division of responsibilities between the EU and its member states would be laid down more clearly than at present. More importantly, however, the draft Constitution includes a comprehensive reform of the Union's institutions and procedures, which would improve the EU's ability to function and make it more democratic. Thus, for example, the current weighting of votes in the European Council and the Council of Ministers for decisions by qualified majority would be replaced by a generally comprehensible redefinition of a qualified majority which is based on objective criteria and would not have to be altered in the event of further accessions. Under this system, a decision would be passed if it were made by the majority of member states representing at least three-fifths of the population of the European Union. In order to strengthen the Commission's key role as the driving force and guardian of the integration process, there are plans to reduce the number of members with a voting right to only 15 as of 2009. Moreover, in future, there would be a full-time President of the European Council elected for two-and-a-half years as well as a Union Minister for Foreign Affairs.

Convention's suggestions on EMU provisions extremely problematic

The draft Constitution envisages a number of changes to the provisions on Economic and Monetary Union (EMU), which are, however, extremely problematic with regard to the safeguarding of the Eurosystem's stability policy. Although there was initially a political consensus in the European Convention not to change the substance of the monetary constitution created by the Maastricht Treaty, the draft Constitution deviates from the current well-established provisions on several points. For example, the importance of price stability for steadying economic developments ("non-inflationary growth") is no longer emphasised as being one of the EU's general objectives. Instead "balanced growth" is envisaged. Only the ESCB would be obliged to maintain price stability. At the same time, the level of independence of the national central banks within the ESCB would be of only secondary importance to that accorded to the ECB. Moreover, the ECB would lose its special status as an institution *sui generis* and would become an EU body, which would accommodate latent wishes to include monetary policy in the governmental coordination procedures. The Bundesbank and the Governing Council of the ECB have publicly criticised these proposed amendments.[1] It is imperative to warn against including such changes in the final version of the Constitution. Any modification of the established Maastricht monetary constitution would run the risk of undermining public confidence in the lasting stability of the single European currency.

Intergovernmental Conference on the European Constitution has temporarily stalled

The Intergovernmental Conference, opened in October 2003 with the goal of reaching an agreement on the Constitutional Treaty, was overshadowed by two key political points of contention from the outset. One was that some countries refused to accept the new definition of a qualified majority suggested by the Convention, preferring to retain the weighting of votes in the Council agreed upon in Nice, which limits the influence of the larger countries to a greater extent. The other issue was that the smaller countries, in particular, were opposed to the suggested reduction in the size of the Commission; they wanted every country to continue to delegate one Commissioner to Brussels. The negotiations on a European Constitution have broken down temporarily owing, in particular, to these differences of opinion.

2 Functioning of the international monetary and financial system

(a) Exchange rate policy back in the international spotlight

Massive intervention by Asian countries

High US budget and current account deficits, which continued their rise in the year under review, put steady downward pressure on the US dollar as of March 2002; this caused exchange rate policy to come under renewed and increased international scrutiny over the course of 2003 as the US dollar's decline accelerated. Not entirely without some fundamental justification and partly to correct earlier depreciation, the euro rose (in terms of monthly averages) by 45% against the US dollar between February 2002 – immediately before the turnaround on foreign exchange markets – and February 2004. It went up by 21% as a weighted average against the currencies of the euro area's 12 most important trading partners. By contrast, the yen appreciated much less sharply. Over the same time-span, the yen rose against the US dollar and the currencies of 19 industrial nations by 25% and 4% respectively. In particular, the exchange rates of East Asian emerging market economies' currencies against the US dollar hardly moved. Many Asian countries resorted to unprecedented levels of foreign

1 For the Bundesbank's detailed opinion, see Deutsche Bundesbank, The monetary constitution under the Constitution for Europe, *Monthly Report*, November 2003.

Movement of Asian countries' foreign exchange reserves

Table 11

Country/group of countries [1]	US$ bn				as %		
	Holdings		Change		Annual percentage change		
	1998	2003	2003 versus 1998	2003 versus 2002	2001	2002	2003
Japan	203.2	652.8	449.6	201.3	11.7	16.4	44.6
Asian developing countries	575.2	1,255.3	680.1	287.5	11.1	22.9	29.7
of which							
China [2]	145.0	403.3	258.3	116.8	28.1	35.0	40.8
Hong Kong	89.6	118.4	28.8	6.5	3.4	0.7	5.8
India	27.0	97.6	70.7	30.6	21.4	48.1	45.7
Indonesia	22.4	34.7	12.3	4.0	– 4.4	13.7	13.0
Malaysia	24.7	43.5	18.7	10.2	3.4	12.5	30.6
Philippines	9.1	13.3	4.2	0.3	3.0	– 2.3	2.4
Singapore	74.4	95.0	20.6	13.6	– 6.1	8.7	16.7
South Korea	52.0	154.5	102.5	33.7	6.9	17.9	27.9
Taiwan	90.3	206.6	116.3	45.0	14.5	32.3	27.8
Thailand	28.4	41.0	12.5	2.9	1.3	17.6	7.7
Asia, total	778.4	1,908.1	1,129.7	488.8	11.3	20.8	34.4
Memo item							
Industrial countries excluding Japan	466.8	450.7	– 16.0	14.4	– 8.8	11.3	3.3
of which							
USA	36.0	39.7	3.7	5.9	– 7.2	16.7	17.5
Euro area [3]	284.4	188.5	– 95.9	– 27.3	– 4.9	3.8	– 12.6
Other developing countries	397.0	670.2	273.2	128.8	6.3	13.2	23.8
Africa	40.7	89.5	48.7	17.6	18.8	12.0	24.5
Europe [4]	101.0	249.6	148.6	62.8	10.3	33.8	33.6
Latin America and Caribbean	158.3	191.1	32.8	33.2	2.0	0.7	21.0
Middle East	97.0	140.0	43.0	15.1	1.9	6.0	12.1

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 if one takes into consideration that part of the 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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exchange market intervention to keep their currencies from appreciating in an effort to avoid impairing their economic activity. Japan's foreign exchange reserves rose by no less than US$201 billion over the course of 2003. The other Asian countries – especially East Asian economies with China at the forefront – added US$287 billion to their foreign exchange reserves. In this manner, Asia's central banks financed an estimated nine-tenths of the US current account deficit in 2003, certainly if one takes into account not only foreign currency inflows invested directly and identifiably in the United States (which show up in the US balance of payments as liabilities due to foreign monetary authorities) but also those official dollar purchases which are hidden as normal US capital imports (especially the counteritems to investment in financial centres outside the USA). The attendant purchase of US government bonds simultaneously served to dampen US capital market rates. This meant a dual impairment of the markets' role in the adjustment process – in the US case, the need for a broadly-based cheapening of the currency and the increase in the cost of capital. Owing to the euro's rise against Asian currencies as well as against the US dollar, Europe, in particular, has had to bear the brunt of the US twin deficits.

G7 countries call for greater exchange rate flexibility

At their meeting in late September 2003, the finance ministers and central bank governors of the Group of Seven (G7) nations called for greater exchange rate flexibility to strengthen the role of market forces in correcting balance of payments disequilibria. In contrast to its intended effect, however, this declaration put the euro under further appreciation pressure, whilst Japan sought to dampen the further appreciation of the yen by purchasing even more foreign currency and the Asian emerging market economies maintained their existing official or de facto exchange rate pegs. In its communiqué issued in early February 2004, the G7 expressly called on those countries which have thus far largely or completely frozen their exchange rates to introduce flexibility into their regimes. However, this G7 statement must not be construed as advising emerging economies generally to change over to freely floating exchange rates. On the whole, exchange rate flexibility is the appropriate complement to the largely free movement of capital. However, many emerging economies, especially China, have a long way to go in this respect since the establishment of lasting domestic stability, including sufficient financial sector stability, which is necessary for capital account liberalisation will still remain a major challenge for many years to come. Nevertheless, exchange rate policy in countries with fixed exchange rates can also contribute to global adjustment by changing parities, enlarging bands or pegging exchange rates to a basket of currencies instead of to a single major currency. A combination of these steps is also possible. However, it would be neither desirable nor sufficient to leave it up to exchange rate movements alone to make the necessary corrections in the global balance of payments structure. This must be strengthened by efforts on the part of deficit countries to increase their domestic saving (which, in the US case, primarily requires a return to a policy of sound public finances), while areas which have been experiencing sputtering growth, such as the euro area and Japan, should make vigorous efforts to enhance their growth potential through structural reforms in order also to revive imports.

Assuming global responsibility includes reviving the Doha Round

The increasingly interlinked nature of the world economy has meant significant prosperity gains, yet it has also made the world's individual economies increasingly interdependent. Unwelcome national developments can thereby escalate into "global imbalances" if major economies are affected. Living up to one's global responsibility means taking comprehensive and timely action with an eye to the global economic consequences. This also means not de facto turning one's back on the objective of open markets enshrined in the WTO. Following the breakdown of the WTO talks in Cancún, Mexico, last September, it is urgently necessary that everything be done to revive the Doha Round. Moreover, where possible, the increasing regional trade initiatives should (in line with WTO rules) involve further steps to liberalise trade with third countries instead of building external "walls". This is the best way to preserve the chances of achieving more growth and prosperity. Enhancing the international division of labour by no means benefits only rich countries. It is notably the fast-growing economies of Asia and the central and east European countries in transition which have been hugely successful in integrating into the world economy over the past few years, and they have consistently increased their share in world trade.

(b) Steps towards increased prudence in the granting of large IMF loans

Stricter requirements for exceptional access to IMF loans

The increasingly active role played by the IMF in resolving international financial crises, the risks hereby incurred by the Fund and considerations on the Fund's strategic role in crisis prevention and crisis resolution have culminated, since early 2002, in an in-depth debate on the requirements for granting large IMF loans. As early as September 2002, the IMF Executive Board approved stricter guidelines for access to IMF loans. Since then, in order to control the use of IMF resources during balance of payments crises, compliance with the following four criteria has been mandatory once the regular access limits (100% of the quota per year and 300% cumulatively) are to be exceeded.

– The member is facing acute and exceptionally high capital outflows which cannot be offset within normal access limits.

– A rigorous and systematic analysis indicates a high probability that total foreign debt will remain sustainable in the longer term.

– The member has good prospects of regaining access to the capital markets within the time Fund resources would be outstanding, so that the Fund's resources would serve only as a bridge.

– The member's policy programme agreed with the IMF is convincing not just on paper but is also politically feasible.

Moreover, stronger decision-making requirements were adopted in February 2003. They include an increase in the burden of proof on IMF staff in justifying the access level considered necessary, early notification of the IMF Executive Board on the status of programme negotiations and an ex post evaluation of the financial assistance within one year following the end of the arrangement. In addition, IMF management and the borrower countries' authorities are advised to exercise more prudence in making public pronouncements during programme negotiations.[1] This framework can make an important contribution to crisis prevention by driving home to private creditors and debtor countries the need to take primary responsibility for their own financial transactions. In practice, rigorous enforcement of the agreed criteria and procedural rules will be necessary in order to limit exceptionally large loans to a very few emergency cases in future and to make market participants change their behaviour accordingly. In other words, success will be possible only if individual decisions are not predominantly motivated by politics in future.

CCL expired on schedule

The IMF's Contingent Credit Line (CCL) facility expired on its scheduled sunset date of 30 November 2003; the vote in the Executive Board fell short of the 85% of votes needed for an extension. Reservations – not without some justification – among potential borrowers because of possible negative signals prevented the use of this facility, which was created in 1999 to avert the threat of contagion. All the same, the expiry of the CCL led to considerations about potential replacements. Particular thought is being given to modifying the IMF's existing precautionary arrangements to turn them into a general instrument of large-scale access to Fund resources for crisis prevention purposes. The debate on the pros and cons of such a strategy is still in progress. The Bundesbank has considerable misgivings about a policy of precautionary loans as this might thrust the Fund into the role of an "insurer" with a large burden of liability. The provision of massive precautionary credit could undermine efforts to limit the IMF's financing role, which are being made in the interests of the proper functioning of markets, not to mention the possible adverse consequences this could have for the IMF's liquidity and its potential risk. Any provision of large volumes of precautionary credit should be left to financial markets, which set risk-

1 For details concerning decisions on access criteria and access procedures see also IMF, *2003 Annual Report*, p 29.

adequate terms and thus provide less scope for market participants to commit moral hazard.

Simultaneously high and strongly concentrated credit exposure of IFIs requires increased risk provisioning

The simultaneously high and strongly concentrated credit exposure of the IMF and other international financial institutions (IFIs) has, in many cases, caused the share of multilateral liabilities in individual borrowers' total foreign indebtedness to rise to disturbing levels. These developments harbour considerable credit risk for public sector lenders. The IMF and the development banks therefore feel forced to provision adequately for risk. The reserves which the IMF has mobilised for this purpose up to now (currently just over SDR 6 billion, with plans to increase it to SDR 10 billion) seem rather meagre. A higher target value and an accelerated increase in available reserves would be desirable. In addition, the IFIs' share in individual borrowers' overall indebtedness should be reduced quickly.

(c) Progress and difficulties in improving crisis prevention and crisis resolution

IEO guidance on crisis prevention and crisis resolution

In May 2003, the IMF's Independent Evaluation Office (IEO) issued a report on the Fund's role in three recent capital account crises. The report identifies specific deficiencies in the Fund's surveillance activities, programme design and implementation, and internal governance in its management of the crises that struck Indonesia, Korea and Brazil in the late 1990s. In addition, the IEO gives specific recommendations for further action. They include improvements in the ongoing surveillance of member countries to ascertain the potential for crises. In this context, it would also be important to make more efficient use of country expertise available amongst the staff. The report also calls on the IMF to be more proactive in its role as a crisis coordinator. The IEO's report, which openly addresses numerous critical issues, was widely acclaimed. It leaves no doubt that Fund financial support by itself is insufficient to resolve crises. It is always urgently necessary for the country in question to make convincing adjustments. The IEO also recommends that this assistance be geared towards preventing the prolonged use of IMF resources. Long-term recourse to IMF resources at preferential rates especially undermines the revolving character of the foreign reserves available to the Fund.

Continued improvement in IMF surveillance

During the year under review, a number of concrete steps were taken to further improve the IMF's surveillance of world economic activity in line with the IEO's recommendations. They include the suggested expansion of vulnerability assessments of emerging market economies. Such assessments focus on a country's key indicators of its internal and external situation but are placing increasing emphasis on stress test scenarios which assume particularly adverse changes in the underlying framework, such as in commodity prices, exchange rates or interest rates. In addition, a decision was taken to streamline the Reports on the Observance of Standards and Codes (ROSCs) as well as the Financial Sector Assessment Programme (FSAP) reports. Moreover, these analyses are to be oriented more closely to conclusions and recommendations in order to better tackle identified deficiencies. Regular ROSCs will, in future, also address member countries' measures to combat money laundering and the financing of terrorism. The IMF, the World Bank and the OECD's Financial Action Task Force (FATF) are currently updating their joint strategy, on the basis of which a 12-month pilot project was successfully completed in 2003. The range of IMF documents published was also extended. Publication of IMF staff reports on economic policy consultations with member countries is now virtually expected. In cases of exceptional access to Fund resources, publication of key credit-related documentation by the borrower will even be mandatory in the future. Germany has supported these initiatives and is setting an example in their practical implementation. Notably, last year the Financial System Stability Assessment (FSSA) for Germany – written as part of Germany's Article IV consultation – was made available to the public. However, the Federal Government and the Bundesbank remain sceptical about continued calls to separate the IMF's surveillance and financial activities in the interests of greater objectivity. This could undermine the Executive Board's control function. In addition, it would mean that synergy effects from the general surveillance of economic policy and the monitoring of reform measures associated with credit would no longer be utilised.

G20 exchange of experiences on institutional basis for a stable and efficient financial sector

In 2003, the Group of Twenty (G20), an informal association of the world's most important industrial countries and emerging market economies, addressed the issue of how to reduce emerging market economies' vulnerability to crisis. From the beginning, the key element has been an exchange of experiences on the necessary institutional basis for a stable and efficient financial sector. During the Mexican presidency, this focal point was proposed jointly by the Bank of Mexico and the Bundesbank in order to learn some lessons from the most recent international debt crises. These crises have shown that countries with weak banking systems yet active in international capital transactions suffered a particularly severe real economic burden when struck by a crisis of confidence. Numerous G20 members (including all industrial countries, many emerging market economies, the ECB and the IMF) drew up case studies designed to facilitate identification of the priorities and modalities of a satisfactory institutional framework on the basis of their own experiences and those of their members. A crosssectional analysis showed that the following precautionary measures were necessary for establishing a stable and efficient financial sector: ensuring macroeconomic stability, legal certainty, sound supervisory structures and safe and efficient payment systems. There are plans to intensify this exchange of opinions in 2004 under the German G20 presidency.[1] Moreover, the G20 will discuss the preconditions for strengthening domestic capital markets, as this may show how emerging market economies could lower their dependence on high-risk foreign currency debt.

Breakthrough in introducing CACs as a market standard

Besides crisis prevention, the international debate continued to revolve around ways of improving crisis management. A breakthrough was achieved in incorporating collective action clauses (CACs) in new bonds issued under a foreign law, something which the international community has been recommending for a long time. Beginning in February 2003 with Mexico, numerous emerging market countries have since included CACs in their dollar-denominated bonds issued under New York law. The G10 countries and EU member states have supported this process by committing, in September 2002, to introduce similar practices. Although the details of the clauses used by emerging market economies differ, their bond issues, with just a few exceptions, all abide by two core recommendations contained in a report adopted by the G10 in September 2002. One recommendation was that the qualified majority of creditors needed for legally binding amendments of payment terms must not exceed 75% of outstanding principal. The other recommendation is to make the decision to accelerate a bond and to initiate litigation following a default contingent on a qualified minority of at least 25% of outstanding principal. This would prevent individual creditors from initiating pre-emptive litigation prior to decisions on restructuring, which would make debt restructuring difficult a priori. The G10 is currently studying the desirability of even greater harmonisation regarding these and other features of CACs as well as the feasibility of further official steps towards the development of a general market standard. Against this new background, it is especially important for Germany as a financial centre to be open to the concept of issuing foreign bonds with CACs, in contrast to previous practice. As a consequence of isolated doubts about the legality of such clauses, this is still not yet being done, despite public refutation by the Federal Government in cooperation with the Bundesbank as early as February 2000.[2] It is certainly

1 All of the aforementioned documents are available to the public on the G20's current website (http://www.G20.org).
2 See "Statement by the Federal Government on the admissibility of including collective action clauses in foreign sovereign bond issues subject to German law", reprinted in: Deutsche Bundesbank, *Annual Report 1999*, p 109.

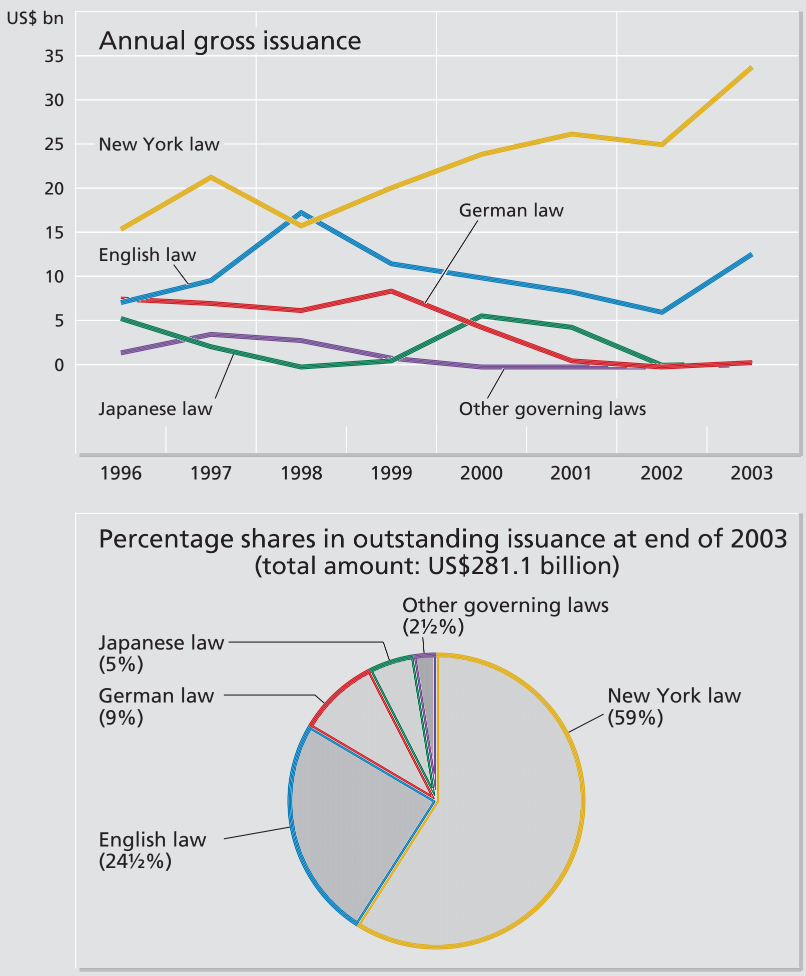
true that the volume of developing country sovereign bonds issued under German law has plummeted to virtually nil from its 1999 high (of US$8.6 billion) because former major issuers such as Argentina and Turkey have lost most or all of their access to the markets owing to crisis. However, future international borrowers will continue to keep sight of German investors' large capacity for absorption. The comprehensive revision of German debt securities legislation planned by the Federal Government, which is also supposed to pave the way for CACs in bonds governed by German law, should be carried out as quickly as possible so that Germany as a financial centre does not suffer any major disadvantages because of the emergence of the new market standard of having CACs in international bonds. This is an urgent matter because now bonds issued in the German currency – the euro – can also be issued under the governing laws of Germany's European neighbours.

Introduction of an SDRM deferred owing to insufficient political support

By contrast, the "Sovereign Debt Restructuring Mechanism" (SDRM) project proposed by the IMF in November 2001 – its goal being the creation of a sovereign foreign currency debt restructuring mechanism binding under international law – has been sidelined for the time being following a decision by the International Monetary and Financial Committee (IMFC), which should be regarded as the Fund's political controlling body. Despite major progress in the debate, already culminating in a detailed proposal, it became evident in April 2003 that such formal crisis resolution strategies were not going to find the necessary political support from several important member countries for the time being. However, Germany's attitude towards the SDRM project has always been positive. The Federal Government and the Bundesbank are in agreement that a legal framework which compels the debtor country and its creditors to undertake quick and fair negotiations in the event of a default may be regarded as a useful complement to the international financial architecture, comparable to the role of a national insolvency code. Resistance to the SDRM project has been fuelled primarily by concerns that debtor countries could abuse this mechanism as an easy way to avoid responsibility for correcting the consequences of economic policy failures of their own making. As a result of the international debate, however, the IMF went a long way towards addressing these concerns by envisaging rules under which creditors' rights to initiate litigation deemed necessary to assert their claims could be suspended only for a relatively short period and even then only with the approval of a qualified majority of creditors. Debtors would ultimately not have found it easy to resort to an SDRM, yet a procedure would still have been in place to achieve generally binding majority decisions among creditors in a relatively easy and reliable manner, something which cannot be

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

Chart 23



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

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achieved by the usual and recommended types of CACs. An SDRM would have tended to increase rather than impair the chances of reaching an agreement quickly and with maximum informality in a crisis event.

Discussions about introducing a code of conduct have reached an impasse

Since the SDRM project has been deferred and CACs are helpful only in restructuring individual bond issues, further proposals for a voluntary code of conduct have been presented. Such a code of conduct would be intended to facilitate the introduction of certain procedures and of a number of recognised principles for governing the very complex debtor-creditor relationship in the event of increasing market tension or acute crises. This code could serve both to keep crises from coming to a head and to make unavoidable debt restructuring run more smoothly. In November 2002, the G20 endorsed such projects and encouraged market participants to agree on relevant measures. This led to the beginning of talks in mid-2003, in which several G20 emerging market countries, the private sector, G7 countries and international agencies took part; however, key differences of opinion meant that these negotiations reached an impasse. Representatives of issuing countries fear that the consultation procedure with the private sector envisaged in the event of market tension could exacerbate the effects of crises. Reservations also exist concerning the idea of making real negotiations with creditors mandatory in a debt restructuring event instead of having the option of working with unilateral offers which would just be subject to a vote. In the light of this stalemate, in October 2003 the finance ministers and central bank governors of the G20 countries called on market participants to restart negotiations. It remains to be seen how much progress can be achieved in 2004.

3 International financial assistance

IMF credit at an all-time high

Outstanding IMF credit rose slightly once again during the 2003 calendar year (by SDR 1.4 billion) to an all-time high of SDR 71.9 billion (US$106.8 billion). The main reason was the increase in stand-by arrangements (SBAs), including drawings on the shorter-term supplementary reserve facility (SRF), which is designed to strengthen foreign exchange reserves. This contrasted with a decline in drawing on the longer-term extended fund facility (EFF). The focus of the Fund's lending continued to be on Latin America (accounting for just over half of all IMF loans) and Turkey. As mentioned earlier, the total credit volume was focused on a handful of countries. The Fund's five largest borrowers received nearly 80% of total credit. In addition, more than 40% of outstanding credit is now based on disbursements exceeding normal access limits, underscoring the need for reform in the IMF's lending policy.

Precautionary credit to Brazil fraught with problems

In the Brazilian case, in December 2003 the IMF entered uncharted and therefore difficult waters by extending and augmenting the existing SBA. It is extremely difficult to reconcile this credit with the agreement in September 2002 to curtail exceptional access – which is predicated on acute and extreme capital outflows. Even the Brazilian authorities did not see any financing need when the credit was granted. On the contrary, the good progress made in implementing the programme and the gains in confidence on the markets had created all

IMF credit: purchases, repurchases and total amounts outstanding

Table 12

SDR billion

Item	1999	2000	2001	2002	2003
Purchases	10.7	7.7	24.6	26.6	21.1
Repurchases	20.0	15.8	14.1	16.0	19.7
Net purchases	– 9.3	– 8.2	10.6	10.6	1.4
Total IMF credit outstanding 1	57.5	49.3	59.9	70.5	71.9
of which					
Exceptional access 2	1.2	2.4	14.1	24.4	28.7
Type of credit/facilities					
Credit tranches 3	26.2	20.8	34.8	46.5	49.6
Extended Fund Facility (EFF)	16.1	15.7	15.0	14.6	13.9
Compensatory Financing Facility (CFF) 4	3.0	3.0	0.8	0.6	0.2
Poverty Reduction and Growth Facility (PRGF) 5	6.5	6.4	6.5	6.9	6.9
Other facilities	5.7	3.4	2.8	2.0	1.3
Regional breakdown 6					
Africa	6.6	6.5	6.2	6.1	5.5
The Americas	14.9	6.8	19.0	28.2	32.1
Asia	17.9	18.6	12.4	10.3	9.9
Europe	17.4	16.7	21.6	25.2	23.8
Middle East	0.7	0.6	0.6	0.6	0.6

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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the conditions necessary for reducing Brazil's huge burden of debt to the Fund. This large loan, approved by some Directors only with considerable reservations, can be seen as a "grandfather" case for which the new rules tightening the access criteria did not have to be applied. Moreover, this new loan was classified as a precautionary arrangement, ie at present the Brazilian authorities have no intention of drawing on the funds. As already mentioned, however, this idea of a precautionary credit line with large access, about which no fundamental consensus has been reached within the IMF's Executive Board, runs counter to other efforts to instil a greater awareness of their own responsibility into market participants, thereby motivating them to improve their own risk assessment.

Multilateral development banks' overall lending commitments largely stable

Lending by the World Bank (IBRD and IDA), at US$18.5 billion, was barely lower in their 2003 reporting year (July 2002 to June 2003) than in the same period of the preceding year (US$19.5 billion). In 2003, Latin American countries accounted for half of new commitments. The commitments of the African Development Bank (AfDB) in the 2003 calendar year, at US$2.6 billion, were likewise largely unchanged from the previous year (US$2.8 billion). This meant that the temporary transfer of AfDB headquarters from Abidjan, Côte d'Ivoire, to Tunis, Tunisia – on account of the civil war – hardly impeded its business activities. The new lending commitments of the European Bank for Reconstruction and Development (EBRD), which amounted to €3.7 billion in the last calendar year (€3.9 billion in 2002), likewise remained virtually unchanged. Of this, just under 30% went to Russia. By contrast, the Inter-American Development Bank (IADB), which saw its lending commitments plummet in the 2002 calendar year owing to stagnant investment activity in recipient countries, raised its lending by a distinct margin in 2003 (US$6.8 billion following US$4.6 billion a year earlier). This is attributable not least to a total of US$3.2 billion worth of emergency loans to Argentina, Colombia and Paraguay. The effect of such loans, however, can also be to further impair the ability of those countries to service their debts.

Enhanced efforts to achieve the Millennium Development Goals

Last year, the development policy debate was strongly geared towards achieving the Millennium Development Goals (MDGs). Enshrined in the UN Millennium Declaration in 2000, these MDGs include specific poverty-fighting objectives which are to be achieved by the year 2015. They call upon developing countries to continue their efforts to make more effective use of their own resources, as well as those donated by foreign public and private sector agencies. However, they also call on donor countries to make good their promise to grant more generous assistance, to provide debt relief and to improve market access for exports from developing countries. The reaction has been positive insofar as international donors – since the UN Conference on Financing for Development in Monterrey, Mexico, in March 2002 (if not already before then) – have become increasingly convinced that public development aid would have to be increased by around US$50 billion annually in order to achieve the MDGs on schedule.

Proposal on establishing an IFF still controversial

Against this background, in January 2003, the UK Treasury presented a proposal to create an "International Finance Facility" (IFF). Based on long-term donor commitments for development aid against which donors would issue bonds to raise funds, the goal is to increase the amount of official development aid from its present level of just under US$60 billion to around US$100 billion per year. With an eye to this proposal, the joint IMF/World Bank Development Committee decided, in autumn 2003, to call on the World Bank, in particular, to examine various financing facilities through which substantial additional financial resources could be mobilised within a foreseeable timeframe. The Bundesbank, however, sees capital market-related and development policy-related problems with regard to the IFF. Since it is doubtful whether donor countries' budgets would even allow them to make such financing commitments over a relatively long period, it is unclear whether IFF issues would actually have the desired first-class credit rating and whether the interest costs could be kept accordingly low.

It also appears questionable whether recipient countries' willingness to reform and ability to absorb could keep pace with a doubling of development assistance. These reservations underscore the fact that a further dismantling of trade barriers would be a better and especially effective form of development assistance.

Strengthening the influence of developing countries in international institutions

Following the Monterrey financial conference, at which the international community also agreed to help developing countries participate more effectively in shaping the world economy, the IMF and World Bank took initial steps to give developing countries a greater say in these institutions. One was to expand the organisational office capacities of Directors representing countries from sub-Saharan Africa. In addition, last autumn, the Development Committee called on both institutions to look into taking additional measures. It welcomed plans to establish an "Analytical Trust Fund" designed to support sub-Saharan Directors in the implementation of research projects on developmental issues. The options for increasing developing countries' voting rights in international financial institutions appear relatively limited, however. A reasonable alternative would be to increase the basic votes in the decision-making bodies of the IMF and World Bank, since the developing countries' share in the total number of votes has decreased distinctly following multiple quota and capital share increases. Increasing the number of basic votes would mean amending both institutions' Articles of Agreement, but that would not constitute an insurmountable hurdle. The Bundesbank, however, believes that a country's IMF quota or capital share should continue to accurately reflect its relative strength in the world economy and that its influence should be commensurate with this strength. Quota changes motivated entirely by politics and shifts in capital shares would ultimately weaken these institutions.

Operations of the Deutsche Bundesbank

I Structural reform

1 Objectives of the structural reform and a look back

Objectives of the structural reform

Major objectives of the activities in connection with the structural reform, which were begun in 2002 and continued in the reporting year, are a more operationally efficient performance of tasks and maintaining the functionality of Germany's central bank in the European context.

Legal basis adopted and internal strategy phase concluded in 2002

The institutional foundation stone for an organisation with short reporting and decision-making lines was laid in March 2002 with the amendment of the Bundesbank Act and the creation of a new, streamlined management structure with an eight-member Executive Board. A strategy for putting in place the underlying statutory conditions was finalised and adopted by the Executive Board in 2002.

2 Establishment of a new organisational structure at the Bundesbank

Large parts of the new organisational structure in place as early as mid-2003

A major feature in 2003 was work on implementing the new organisation and the extensive internal changes which this entailed. This affected mainly Central Office and the nine regional offices of the Bundesbank. Large parts of the new organisational structure were already in place by mid-2003. The loss of the autonomous powers of the former Land Central Banks and a now clear definition of tasks – dealing with policy issues at Central Office and with operational tasks at the regional offices – means that duplication of work and time-consuming coordination of activities will be avoided in future.

New uniform structure of the regional offices

The new uniform organisational structure at the regional offices also plays a part in enhancing the efficiency of operations. Since mid-2003, all regional offices have been organised into regional divisions: the "In-house operations" division, the "Banking and Financial Supervision" division, and the "Banking Operations" division or "Banking Operations" sections at the Leipzig and Frankfurt Regional Offices respectively.

Thirteen service centres took up full operation in 2003

Thirteen of the total 22 planned service centres, each of which concentrates and performs tasks for the Bank as a whole at a single location, went into full operation during 2003. This included the Service Centre for Procurement (Buy-ing) in Frankfurt. The other nine service centres have already begun making preparations for operation and are likely to start full operation in 2004.

3 Further streamlining of the branch network

Continuation of adjustments in the branch network

Following on from the 1992 Central Bank Council decision to reduce the number of branches, the Executive Board decided in May 2002 to convert the former 52 sub-branches into dependent operating units with effect from 1 April 2003 and to close them within a period of five years (by no later than 30 April 2007). With this decision, the number of locations was reduced to 66 branches. An additional need for consolidation was already in prospect in 2002 owing to changes in the underlying conditions, such as rapidly advancing automation of bank services, concentration in the banking industry and far-reaching changes in central bank refinancing following the transfer of monetary policy powers to the European Central Bank and the resulting need for streamlining the range of services provided by the Bank (particularly in cash payments).

Further consolidation of the branch network

In order to provide the parties involved in cash handling with a longer-term planning horizon, the Executive Board decided at the end of 2003 to close 19 more branches within a time-frame up to the end of 2007. This decision put in place the final major building block of the Bundesbank's structural reform and established the branch network for the foreseeable future.

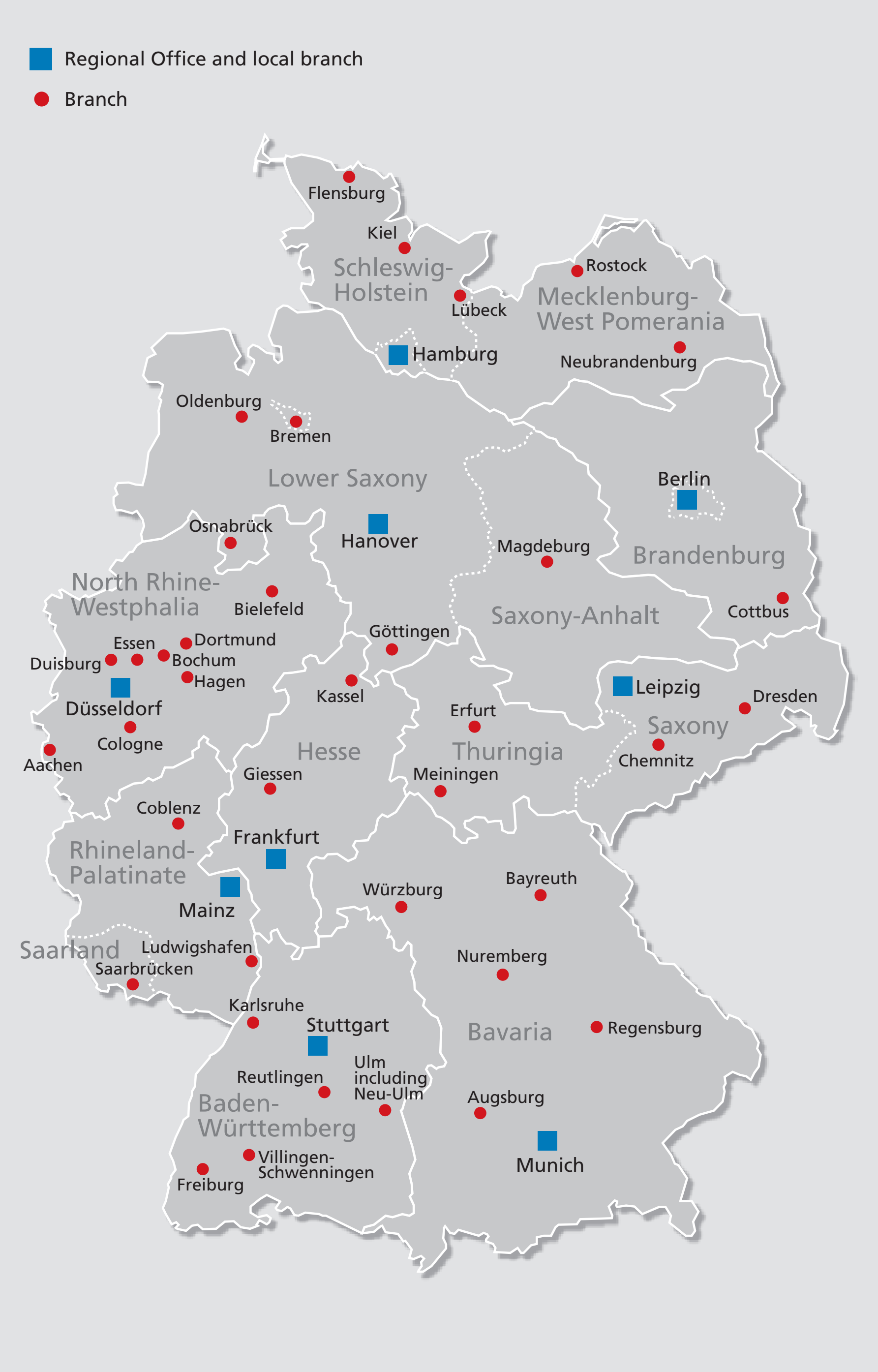
Concentration on 47 locations makes it possible to process cash much more cost-effectively, while simultaneously cutting back excessive capacity which is no longer needed. Although this decision means that the branch network will be less dense than before, the Bundesbank's nationwide presence will essentially be retained and the supply of central bank services ensured.

Parallel implementation of the earlier Executive Board decisions

With effect from 1 April 2003, all the former sub-branches were converted into dependent operating units with the number of operating units simultaneously being reduced to 34. Owing to business developments over the past few years, it is envisaged that a total of 12 further operating units, ie five locations more than originally planned, will be closed by 31 March 2004. The closure of the other 22 operating units will take place in stages in the next few years.

Bundesbank branch network following the implementation of the Executive Board decisions

Chart 24



Deutsche Bundesbank

4 Concrete steps taken to implement the 2002 decision on restructuring the range of services provided in cash operations

As long ago as 2002, the Executive Board adopted a number of far-reaching decisions of principle for the strategic repositioning of the Bundesbank in cash operations. In the reporting year, further steps were taken to implement those decisions.

Key points of the restructuring in cash operations

The Bank remains committed to participating in banknote processing in future for the sake of assuring the existing standard of quality. The Bank will continue to guarantee the purity of the stock of banknotes in circulation by taking counterfeits and unfit notes out of circulation. The Bundesbank's involvement in coin processing is limited to the issuance of newly minted coins, meeting marginal stock requirements, processing counterfeit coins, replacing damaged and/or mutilated coins, taking unfit coins out of circulation and carrying out random quality checks.

The Bundesbank's cash operations are concentrated on the standard service portfolio defined in the Eurosystem. These standard services are provided free of charge and primarily comprise the inward and outward delivery of banknote bundles and packets as well as the inward and outward delivery of machine-packed rolls of coins in packs and containers.

Besides these decisions taken in autumn 2002, the Bundesbank held discussions in summer 2003 with the parties involved in cash handling, following which it decided to provide (starting in 2004) the following additional services for banknotes subject to a fee: the customised portioning of outpayments and the acceptance of mixed and leftover packets.

Adjustment process facilitated by offering additional services for coins for a limited period

With regard to coins, the Executive Board of the Bundesbank, following the outcome of the discussions held with the parties involved in cash handling, decided to offer the following additional services subject to a fee for a transitional period of one year (from 1 January 2004): the inward and outward delivery of loose coins in bags as well as the acceptance of rolls of coins which do not conform to the Bundesbank's requirements. This means that the Bundesbank's business customers will have sufficient time to adapt to the new conditions pertaining to coins. Furthermore, in view of the fact that the coin container will be the standard packaging unit from 2007, it was agreed that the Bundesbank should observe the process of inpayments and outpayments of coins for a period of one and a half years and hold further supplementary discussions with the parties involved in cash handling. On this basis, the Bundesbank will subsequently examine whether a packaging unit smaller than a coin container should be provided as a standard service.

5 Impact on the number of staff and costs

Forecast development in staffing levels

The implementation of the structural reform, the streamlining of the branch network and the other operational policy decisions imply a considerable potential for savings. Given the present conditions and the uncertainties associated with such an estimate, the number of staff employed by the Bundesbank, as things stand at present, is likely to fall by almost 30% (compared with the level at the beginning of 2003) from around 15,800 to 11,100 by the end of 2007.

Prospective saving potential from 2008

In the next few years, the initial synergies of the structural reform will still be masked by the costs of the changeover. The overall prospective savings in staff and material costs are likely to be in the order of €280 million per year from 2008.

II Processing cash payments and cashless payments

1 Cash payments

Euro currency in circulation in the Eurosystem

During 2003, the volume of euro banknotes in circulation issued by the Eurosystem increased fairly sharply by 21.6% to €436.1 billion. The volume of coins in circulation rose by 13.1% to €14.1 billion. At the end of 2003, 96.9% of euro currency in circulation issued by the Eurosystem consisted of banknotes, and 3.1% of coins.

In 2003 the Bundesbank distributed 13.9 billion euro banknotes representing a value of €419.6 billion and 17.4 billion euro coins representing a value of €8.4 billion. During the same period, it took in from its customers 13.3 billion euro banknotes with a value of €382.2 billion and 14.0 billion euro coins with a value of €7.8 billion for processing.

Euro currency in circulation

Table 13

Trend

€ million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation 1
2002	370,968	358,535	12,433
2003	450,198	436,131	14,067

Pattern at the end of 2003

Banknotes in circulation			Coins in circulation 1		
Notes of €	€ million	Percentage of total	Coins of €	€ million	Percentage of total
500	119,237	27.3	2.00	5,610	39.9
200	27,086	6.2	1.00	4,120	29.3
100	80,977	18.6	0.50	1,895	13.5
50	144,819	33.2	0.20	1,133	8.1
20	41,075	9.4	0.10	661	4.7
10	16,846	3.9	0.05	376	2.7
5	6,091	1.4	0.02	174	1.2
			0.01	98	0.7
Total	436,131	100.0	Total	14,067	100.0

1 Circulation of euro coins excluding commemorative coins.

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Besides the coins in circulation, euro commemorative coins were issued in all participating countries; these were only legal tender in their respective country of issue. In Germany issues of German euro commemorative coins amounted to a total value of €199.5 million.

Deutsche Mark currency in circulation

As a result of the wide acceptance of measures to reduce the amount of national Deutsche Mark currency in circulation ahead of the changeover date in 2001 and subsequent considerable flowback of Deutsche Mark cash in 2002, the amount of Deutsche Mark currency was reduced from DM290 billion at the end of 1999 to DM16.9 billion by the end of 2002. Following the sharp declines in the previous years, the Deutsche Mark currency in circulation went down by only DM1.1 billion to DM15.8 billion in 2003. Specifically, the value of Deutsche Mark banknotes in circulation decreased by DM951 million and the value of coins by DM105 million. With regard to the Deutsche Mark coins which have not been returned, it is to be remembered that this figure includes commemorative coins of DM10 and DM5 and that a fairly large percentage of Deutsche Mark coins in circulation – particularly of the smaller denominations – is likely to be irretrievably lost.

DM currency in circulation

Table 14

Trend

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
1999	289,972	274,133	15,839
2000	278,143	262,089	16,054
2001	162,205	149,755	12,450
2002	16,876	9,383	7,492
2003	15,819	8,432	7,387

Pattern at the end of 2003

Banknotes in circulation			Coins in circulation		
Notes of DM	DM million	Percentage of total	Coins of DM	DM million	Percentage of total
1,000	1,993	23.6	10.00	2,415	32.7
500	654	7.8	5.00	2,068	28.0
200	404	4.8	2.00	766	10.4
100	2,691	31.9	1.00	837	11.3
50	992	11.8	0.50	488	6.6
20	776	9.2	0.10	468	6.3
10	791	9.4	0.05	171	2.3
5	131	1.6	0.02	73	1.0
			0.01	101	1.4
Total	8,432	100.0	Total	7,387	100.0

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In 2003, particularly from bank stocks, around 10.7 billion Deutsche Mark coins worth DM5.1 billion were recycled.

Destruction of banknotes

After the large volume of the past few years, destruction of Deutsche Mark banknotes decreased sharply in the year under review. Besides the banknotes of all denominations continuing to flow back from circulation, it was primarily reserve holdings of DM500 and DM1,000 which were shredded.

Destruction of DM/euro banknotes

Table 15

Item		1999	2000	2001	2002	2003
DM banknotes	Number (millions)	795	782	1,781	2,426	95
	DM billion	43.0	85.1	260.9	246.5	44.1
Euro banknotes	Number (millions)	–	–	–	137	310
	€ billion	–	–	–	3.3	6.9

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The destruction of rejected euro banknotes increased sharply, as was to be expected, and was more than twice as high as the level in 2002. Even so, the vol-

Counterfeits detained in payments as recorded by the Bundesbank

Table 16

	Banknotes		Coins	
Year	Number	€ thousands	Number	€ thousands
2002	13 698	872	1 032	2
2003	50 205	3 402	16 500	33

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ume of destroyed euro banknotes was still considerably lower than the average DM volume of earlier years. This was due to the influence of euro cash being issued for the first time and shows that the average quality of euro banknotes in circulation – especially of the higher denominations – is currently better than the average quality of DM banknotes over a multiyear period.

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. In making this comparison, it should be borne in mind that only relatively small quantities of counterfeit banknotes and coins were produced during the euro's introduction phase.

The €50 banknote was the most frequently counterfeited denomination (32,746 items), followed by the €100 note (11,920 items). Taken together, these two denominations make up almost 90% of all counterfeit banknotes. The counterfeit coins were almost exclusively of the €2 denomination (16,090 items).

2 Cashless payments

Slight increase in the volume of payments via the Bundesbank

The number of domestic and cross-border payments made through the Bundesbank in 2003 showed a slight increase on the year. Overall, around 2.2 billion credit transfers and collection orders to the value of €134,489 billion were settled in the year under review, signifying a rise of 1.5 % in the number of items submitted and an increase of 2.0% in the total amount.

Since autumn 2001, the processing of payments as well as communications with customers in the Retail Payment System (RPS) have been continuously im-

Further developments in RPS for national transactions …

proved applying a multistage strategy developed in consultation with the banking industry (for example, by extending the evening submission times or by establishing new communication standards). Since the implementation of the third and final stage in early April 2003, credit institutions have been able to submit items arising from transactions on the current business day (such as transactions at payment terminals and ATMs during the evening) to the Bundesbank by data telecommunication even up to the morning of the next business day. These submissions are then processed and sent out on the same day. At the request of the banking industry, the morning submission times were extended from 06.00 to 07.00 starting on 1 July 2003.

… and cross-border credit transfers

The Regulation of the European Parliament and of the Council of 19 December 2001 on cross-border payments in euro (EU pricing regulation) allocated specific obligations to the European credit institutions as from 1 July 2003. Customers' cross-border credit transfers in euro to another EU member state with a value of up to €12,500 (from 1 January 2006: €50,000) are to be settled according to domestic conditions. Credit institutions may, however, request that their customers provide the recipient's International Bank Account Number (IBAN) and Bank Identifier Code (BIC). In order to make such standardised credit transfers more efficient, the European Banking Association (EBA) – a private-law organisation of larger credit institutions which is domiciled in Paris – developed the STEP2 procedure. So as to allow smaller and medium-sized credit institutions the opportunity to have competitively neutral access to European retail payments, on 3 November 2003 the Bundesbank linked up with this STEP2 procedure on both the input and output side via RPS. With its direct participation in this standardised settlement system, the Bundesbank is making a major contribution to reducing the time and cost of settling cross-border credit transfers within the EU.

Concentration of retail payments settlement

As part of the structural reform, the Executive Board of the Deutsche Bundesbank decided to concentrate the settlement of retail payments on the "Computer Centre/Retail Payment System – Operations" service centre set up in Düsseldorf. After completing extensive preparatory work, the activities which had previously been carried out in eight other regional computer centres (for example, conversion of cheques) started to be moved to Düsseldorf towards the end of the year under review. This process of concentration and rationalisation will be completed by the end of the first quarter of 2004.

Cashless payments of the Deutsche Bundesbank

Table 17

Item	2002 Number (million)	2002 € billion	2003 Number (million)	2003 Percentage change	2003 € billion	2003 Percentage change
Retail payments						
RPS						
Direct debits, cheques	1,284.8	1,226	1,265.2	– 1.5 %	1,127	– 8.1 %
of which Conversions	34.1	715	28.0	– 18.0 %	621	– 13.1 %
Prior 3 payments	871.9	886	923.1	5.9 %	975	10.0 %
of which Conversions	2.0	13	1.8	– 10.7 %	11	– 19.0 %
Total	2,156.8	2,112	2,188.3	1.5 %	2,101	– 0.5 %
MASSE 1 (cross-border)	4.6	2	4.8	4.5 %	2	13.3 %
STEP2 via RPS 2 (cross-border)	–	–	0.0	–	0	–
Total	4.6	2	4.8	4.8 %	2	14.0 %
Grand total	2,161.3	2,114	2,193.1	1.5 %	2,104	– 0.5 %
Large-value payments						
RTGS^{plus} 3						
– national	27.6	91,818	28.2	2.2 %	92,710	1.0 %
– cross-border via TARGET 4	4.3	32,966	4.6	7.0 %	35,833	8.7 %
AZV 5 (cross-border)	0.2	28	0.2	– 3.2 %	37	33.1 %
Other 6	3.0	4,970	2.6	– 12.9 %	3,806	– 23.4 %
Grand total	35.1	129,781	35.6	1.4 %	132,386	2.0 %
Cashless payments	2,196.4	131,895	2,228.7	1.5 %	134,489	2.0 %

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

Deutsche Bundesbank

RTGS^{plus} – important within Germany...

The real-time gross system of the Bundesbank, RTGS^{plus}, with a daily national volume of €360 billion (and an average of 110,000 payments) has established itself as an individual/large-value payment system which is of crucial importance for the stability of the German financial system.

... and successful in the European TARGET association

Besides national large-value payments, more than 18,000 cross-border credit transfers are submitted to RTGS^{plus} every working day and then transmitted 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

Payment systems oversight makes a major important contribution to the stability of the financial system and to the efficiency of payment operations. During the year under review, the Bundesbank acknowledged the increasing importance of payment systems oversight by creating a separate operational unit to carry out this task. This enables the ongoing oversight activities to be intensified. For example, a survey on correspondent banking was conducted in 2003. For this purpose, discussions were held with individual banks in order to undertake a more accurate analysis of the risks associated with this business. Future work in payment systems oversight will include analyses of the innovative design of electronic payment procedures and of changes in the payments structure in Germany. Dealing with the issue of the standardised, secure and efficient operation of existing procedures – including those offered by the Bank itself – will likewise be a focus of payment systems oversight. This is all taking place in close association with the traditional payment systems policy and organisational activities of the Bundesbank and is, moreover, embedded in the ESCB and G-10 framework regulations and agreements.

3 Developments in the European setting

Discussion about TARGET2

The year under review was characterised by intense political debate concerning the next generation of the TARGET system (TARGET2). The Governing Council of the ECB adopted the main principles of the new system in 2002. According to this decision, the individual central banks of the European Union still have the option of operating their own real-time gross settlement systems. In the future, however, there has to be greater harmonisation of the performance features and the cost recovery principle has to be stringently observed. Alternatively, the central banks of the European Union have the option of using a common platform on a voluntary basis, in which case all the interested central banks must agree on a single common platform during the first three years.

Outcome of the TARGET2 consultation procedure

As part of a public consultation, market participants were invited by the ESCB to give their opinion on the TARGET2 plans. The joint opinion of the European banking associations and the European Payments Council (EPC) attracted particular attention. The European banking industry ultimately indicated a strong preference for a TARGET2 system with only a single platform. They regard this as a necessary adjunct to the banks' work in creating a "Single European Payments Area". A further requirement was that TARGET2 significantly improve liquidity management for the European banks and enable cost-effective participation through a large degree of harmonisation and use of state-of-the-art technical standards.

Bundesbank's cooperation with Banca d'Italia and Banque de France ("3G")

Since the onset of the discussion about TARGET2, the Bundesbank has continuously supported the idea of a single TARGET2 platform and, by developing RTGS^{plus} into a client-based common system, has sought to promote the consolidation of the fragmented TARGET structure. However, it became clear that this strategy would be unable to take due account of the political circumstances and the differing interests of the various countries. Alternatives therefore had to be sought to speed up the predictably difficult process of discussion and decision-making at the European level. In-depth discussions with the Banca d'Italia and the Banque de France followed. The upshot of these talks was that in October 2003 all three central banks (known as the "group of three" or "3G") took a decision to submit a joint bid to the ESCB to develop and operate the common TARGET2 platform. At the same time, Germany, France and Italy affirmed their intention to give up their existing real-time gross settlement systems and to start using the common platform with the launch of TARGET2. Thus, the 3G initiative is not only significant from the supply point of view but also in terms of demand. Together, the three countries represent – in terms of the number of payments – approximately 70% of the TARGET volume.

Fundamental elements of the joint 3G proposal

The rationale behind the joint solution is that the common TARGET2 platform can be created through the ongoing development and integration of existing function modules. The advantages of this over a completely new development are greater cost-effectiveness, faster implementation and a reduced development risk. Overall, the new system has the following objectives.

– Meeting the requirements of the European banking industry.

– Compliance with the neutrality principle. The new system may not lead to competitive distortions between the individual countries or market infrastructures.

– Safeguarding the principle of decentralisation within the ESCB. The participating central banks have to retain responsibility for conducting business with their customers.

– Implementation by 1 January 2007, one aim being to provide the countries acceding to the European Union with a secure planning basis.

– High degree of flexibility in order to accommodate the various interests of the participating national central banks.

However, a common platform only makes economic sense if a high level of standardisation can be achieved. Consequently, there is little room for implementing specific national features which few market participants would use and which would considerably increase the complexity of the design. A certain ability to compromise is therefore required from the European banks. Nevertheless, flexibility will be achieved by offering individual central banks additional, optional standard modules.

Response within the ESCB to the 3G proposal

The 3G joint initiative was received positively by the other central banks. However, the EU central banks still have to reach final agreement on whether TARGET2 will be based solely on this platform from the outset. The 3G will have a workable project organisation in place at the end of the first quarter of 2004 so that the technical realisation of the project can be started. This approach is based on a division of labour, which is the first of its kind in the Eurosystem. It provides an opportunity to bring about a significant improvement to a key component of the European payments infrastructure in the foreseeable future.

Significance of TARGET2 for the German banking industry

The German banking industry will also benefit from the common TARGET2 platform. In addition to the well-established performance elements which are familiar from RTGS^{plus}, the German banks will also be able to use new features. Technical consolidation will also open up new prospects for the German market participants as the separate liquidity flows in Europe can be merged into one system. This will help to enhance transparency and improve efficiency in payment processing. Moreover, the benchmark-setting contingency provisions can substantially increase security against failure. As things currently stand, the intention is to provide the credit institutions with the necessary specifications at the end of 2004 so that they can prepare their internal systems for participation in the common platform. Customer tests are expected to start around mid-2006.

EMSSO report on electronic money...

The Electronic Money System Security Objectives (EMSSO) report, which was published in May 2003 and supplements the 1998 ECB Report on Electronic Money, details the Eurosystem's expectations concerning the technical security of e-money systems.

… as a yardstick for technical security…

The EMSSO report was published in the light of the Eurosystem's interest in fostering both the soundness and the efficiency of payment systems. The security objectives set out in the report will be used by the Eurosystem to assess the overall reliability and technical security of e-money systems and are also designed to increase public confidence in such systems. These objectives are designed to level the regulatory playing field for the different systems. Furthermore, they have the potential to facilitate the interoperability of e-money payment systems.

… creating a new environment

There is an awareness within the Eurosystem that new initiatives in the field of e-money systems are bringing about changes in the underlying conditions and, furthermore, that market expertise in such a standardised and detailed security framework is sometimes lacking. This calls for prudence and pragmatism in assessing compliance with the security objectives.

E-money in Germany still "on standby"

The use of e-money in Germany is still stagnating at a relatively low level in terms of the volume of transactions. It remains to be seen whether increased use, in particular, at ticket machines and other vending machines can help to achieve a breakthrough in the use of electronic money in the future.

4 Activities at the G10 level

Work within the CPSS

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.

Central banks in retail payments

In March 2003 the CPSS published its report on "Policy issues for central banks in retail payments". It describes how the central banks of the G10 countries, as providers of payment services, act as catalysts in the evolution of payment systems and as overseers of retail payments. The Bundesbank plays a comparatively active part in retail payments and regards its operative role, particularly in settlement services and in terms of providing the Retail Payment System (RPS) for nationwide interbank clearing, as a supplement to the bilateral clearing of the banking industry. The report also identifies current trends in retail payments which could affect their efficiency and security and examines the issues this raises for the central banks. It specifies four goals which the central banks and, in some cases, other public authorities should pursue in order to maintain and promote efficient and secure retail payments. These relate to (i) the legal and regulatory framework, (ii) market structure and performance, (iii) standards and infrastructure and (iv) central bank services. Furthermore, the report looks into what part central banks could play in achieving these goals and identifies a range of possible measures. These measures emphasise the importance of market analysis and of a cooperative and advisory approach by central banks towards both the private and public sectors.

Role of central bank money in payment systems

In August 2003 the CPSS published a report on the role of central bank money in payment systems. This report analyses the complex interplay of competition and cooperation among central and commercial banks in the payments architecture of modern economies. Among other things, the report addresses the following questions. First, who should maintain an account at a central bank? Second, which service should be offered to this account holder? Third, what payments or payment systems are or should be settled in central bank money or – if this is not practicable – what would be the alternatives without giving rise to credit and liquidity risks? Fourth, what would be the advantages and drawbacks of concentrating payment flows on a small number of banks and how might central banks respond to this? The report details the various approaches taken by the individual central banks, including the Bundesbank, regarding the use of central bank money. It does not contain any policy recommendations; however, the common objectives and the underlying philosophy of the G10 central banks are summarised in ten propositions.

Foreign exchange settlement risk

In the year under review the CPSS took another close look at the settlement risk in foreign exchange transactions, focusing on the Continuous Linked Settlement (CLS) System, a privately operated global system for the clearing and settlement of foreign exchange transactions. This system, which went into operation in September 2002, largely eliminates the settlement risk by settling forex transactions on a payment-versus-payment (PVP) basis. In September 2003 the number of CLS-eligible currencies was increased from seven (Australian dollar, Canadian dollar, euro, pound sterling, Swiss franc, US dollar and yen) to eleven. Transactions in Danish and Norwegian krone, Swedish krona, as well as Singapore dollars, can now be settled in CLS. In terms of operations, appropriate security precautions and the cooperation of all the parties involved have meant that so far it has been possible to prevent disruptions in the CLS environment from having widespread implications.

Cooperative oversight of CLS

The Federal Reserve System has primary responsibility for the oversight of CLS. However, as envisaged in the 1990 Lamfalussy Report on interbank netting schemes, the other central banks (including the Bundesbank), whose currencies are settled via CLS, are also involved in the cooperative oversight. This oversight is exercised by a working group set up by the CPSS. This working group analyses and assesses the operational and liquidity risks which come to the fore with participation in CLS and monitors the residual settlement risks in the market and the way in which they are managed.

Trends in individual payments and oversight of payment and securities settlement systems

In June 2003 the CPSS established two new working groups. One is analysing recent trends in individual payments, for example, the introduction of liquidity-saving elements as in the case of RTG^{plus}. The results of this are due for publication in 2005. The other working group has been given the mandate to analyse the oversight of payment and securities settlement systems. Its purpose is to compare the aims and methods of the G10 central banks, to identify common features and make the implications of differences transparent. The work, which is not, however, aimed at a joint approach to oversight, should be completed by the end of 2005.

Core Principles for systemically important payment systems…

In January 2001 the governors of the G10 central banks approved the Core Principles for systemically important payment systems. These principles are intended to promote the design and operation of secure and efficient payment systems and thus make a significant contribution to maintaining and strengthening financial stability. Furthermore, they set out the central banks' responsibilities, which include a requirement for them to disclose their aims and their role in payments and to ensure that the systems which they operate comply with the Core Principles.

…and compliance with them in RTGS^{plus}

The Governing Council of the ECB subsequently decided that, when performing its oversight function, the Eurosystem should be guided by the Core Principles and that all systematically important payment systems in the euro area shall be examined to ensure that they comply with the Core Principles. In line with this requirement, the Bundesbank carried out its own analysis of RTGS^{plus}. The IMF, which audited the German financial system in the first half of 2003 as part of the Financial Sector Assessment Program (FSAP), confirmed the favourable finding of this analysis and the compliance of RTGS^{plus} with the Core Principles.

III Securities clearing and settlement

Role of the Bundesbank

The Bundesbank's oversight function for payment systems also covers securities clearing and settlement. Moreover, through its participation in various national, European and international bodies, the Bundesbank makes a major contribution to the efficiency and security of securities clearing and settlement.

Positive FSAP assessment by the IMF...

The assessment methodology developed in 2002 by the G10 central banks and the International Organization of Securities Commissions (IOSCO) for applying the CPSS/IOSCO recommendations for securities settlement systems was used by the IMF as a basis for its audit of the German infrastructure as part of the Financial Sector Assessment Program (FSAP). A major emphasis was placed on the settlement system of the positively assessed German central securities depository (CSD), Clearstream Banking AG. This CSD forms the backbone of the German securities settlement system.

... not least owing to a new settlement model for the German market

The positive outcome was due, not least, to the new monetary settlement model, introduced in November 2003, which was developed by Clearstream Banking AG and the Bundesbank in close cooperation with market players and the relevant associations. Central bank liquidity, which had hitherto not been exploited overnight, is now used for securities settlement. This enhances both the efficiency and security of settlement. This meant, in particular, the elimination of the unwinding risk in overnight processing (even though it has never actually materialised), thus making a major contribution to the stability of the German financial market.

Guarantee model for foreign remote participants

The "guarantee model", introduced as part of the new system, is a groundbreaking solution, developed by the Bundesbank together with other central banks, for giving foreign participants access to overnight processing. Bilateral guarantees between the participating central banks mean that credit institutions that do not have a branch in Germany can use their refinancing facilities at their home central bank for overnight processing. This flexible procedure is unique in Europe at present.

Draft CPSS/IOSCO recommendations for central counterparties

Having due regard to the stability of the global financial system, the Bundesbank remains committed to its involvement in the CPSS/IOSCO working group. This group is currently drawing up recommendations for central counterparties. These take on the role of mediating parties in the contractual relationship between the buyers and sellers of securities and derivatives, thereby assuming the original rights and obligations in the relationship between the two trading parties. In Germany, this function is performed by Eurex Clearing AG. Its operations used to be confined mainly to the Eurex futures and options market but were extended to equity trading at the Frankfurt Stock Exchange in March 2003.

European developments: implementation of the CPSS/ IOSCO recommendations by the ESCB and CESR

For the purpose of implementing the CPSS/IOSCO recommendations for securities settlement systems in the European Union, a joint working group of the ESCB and the Committee of European Securities Regulators (CESR) put forward draft minimum standards for public consultations in August 2003.The standards are intended to form the basis of oversight of the European securities settlement systems and help achieve harmonisation and greater efficiency in cross-border settlement.

IV The Bundesbank's money market and refinancing operations as part of the Eurosystem

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 Germany the number of these institutions went down in 2003 (as in the preceding years) from 2,363 to 2,225 as a result of ongoing mergers in the banking industry. Consequently, at the end of the year Germany accounted for around 35% of the 6,600 or so counterparties in the euro area.

... for regular open market operations, ...

In order to have access to monetary policy operations, counterparties must also satisfy certain operational requirements. The number of German institutions entitled to participate in the regular open market operations decreased last year from 1,387 to 1,272 (in the Eurosystem as a whole, there were some 2,150 such institutions at the end of 2003). Specifically, an average of 169 bidders from the Bundesbank's area participated in the weekly main refinancing operations last year, with 95 taking part in the monthly longer-term refinancing operations (Eurosystem: 267 and 133 respectively). Hence participation in the standard tenders fell both in Germany and in the Eurosystem as a whole last year (in Germany in 2002 there were 200 bidders in the main refinancing operations and 133 bidders in the longer-term refinancing operations; in the Eurosystem as a whole, the respective figures were 307 and 186). The persistent decline in participation in the main refinancing operations is probably mainly due to the consolidation process in the banking sector. Moreover, the banks have been finding the main refinancing operations less attractive now that the volatility of the interbank money market rates has tended to decline since the changeover to variable rate tenders and the frequently narrow gap between allotment rates on open market lending and money market rates has made arbitrage less profitable. Finally, many credit institutions had ample liquidity last year, resulting from huge inflows of deposits and the fact that loan demand was only moderate. For refinancing purposes, the banks resorted more to the highly developed (collateralised and uncollateralised) money market.

... for standing facilities ...

Access to the two standing facilities – the marginal lending facility and the deposit facility – is open only to institutions which fulfil their minimum reserve requirements themselves, that is to say, which do not use an intermediary institution to do so. The number of institutions with access to the marginal lending facility fell from 1,836 to 1,653 in the course of the year (in the Eurosystem as a whole, there were around 2,600 such institutions at the end of 2003). During 2003 access to the deposit facility in Germany declined from 2,187 to 2,074 institutions (Eurosystem as a whole: just under 3,100 institutions at the end of 2003).

... and for fine-tuning operations

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 40 counterparties for money market operations and 15 for foreign exchange market operations (Eurosystem as a whole: 142 and 72 institutions respectively at the end of 2003).

Main refinancing operations

The main refinancing operations (main tenders) continue to be the key monetary policy instrument used by the Eurosystem for its money market management. These operations are conducted at weekly intervals and, on an annual average, meet around 81.5% of central bank money requirements. In 2003 a total of 52 main refinancing operations with maturities of two weeks were conducted as variable rate tenders in the form of American auctions and with a minimum bid rate. In 9 operations the minimum bid rate was 2.75%, in 13 it was 2.50% and in 30 2.00%. In addition to the operations with maturities of two weeks, the ECB offered three operations with maturities of one week (two operations with a minimum bid rate of 2.50% and one operation with a minimum bid rate of 2.00%). These operations were conducted in order to bring the amounts allotted in the ongoing main tenders into line with each other.

The amount outstanding in the Eurosystem averaged €197.5 billion over the year, just over half of which (€103.3 billion) was accounted for by German banks. The large German share was mainly due to the relatively high demand for banknotes at the Bundesbank.

Longer-term refinancing operations

To provide basic refinancing, longer-term refinancing operations with three-month maturities were offered at monthly intervals. A total of 12 "basic tenders" each with a pre-announced volume of €15 billion were conducted in 2003. The transactions were executed as American-style variable rate tenders. The volume outstanding in the Eurosystem averaged €45 billion over the year, ie around 18.5% of the aggregate refinancing needs. The German share averaged around 70%.

To take account of the expected higher need for liquidity in the euro-area banking sector in 2004, the Governing Council of the ECB decided to increase the amount allotted in all longer-term refinancing operations carried out in 2004 from €15 billion to €25 billion.

Fine-tuning operations

To absorb unexpected excess liquidity arising from high levels of recourse to the marginal lending facility, a liquidity-absorbing collection of time deposits was conducted on 23 May 2003. The operation had a maturity of three days and was offered at a fixed rate of 2.50%.

Marginal lending facility

Use of the marginal lending facility enables the counterparties to create overnight liquidity at any time on their own initiative, provided that they have sufficient collateral available. The overnight credit thus obtained is supplied at a rate higher than the allotment rate in the main refinancing operations. Consequently, as a daily average last year recourse to the marginal lending facility was only €0.3 billion for the Eurosystem as a whole and €0.2 billion for the Bundesbank. Average recourse to this facility thus remained virtually unchanged since 2002. High levels of recourse on certain days were mostly due to attempts to overcome liquidity shortages just before the end of the reserve maintenance period, such as on 23 December (€11.6 billion, the largest level of recourse in 2003, of which the Bundesbank accounted for €5.0 billion) and on 21 and 22 May (€9.0

billion and €1.8 billion respectively, almost all of which was accounted for by the Bundesbank). In rare cases, however, recourse amounting to billions also occurred in connection with technical disruptions to interbank payment transactions, for example on 3 July and 1 December.

Deposit facility

The deposit facility allows credit institutions to deposit unlimited amounts of liquidity with the Eurosystem overnight. Owing to the relatively low rate of interest paid, the credit institutions use the deposit facility only when they have unexpected liquidity excesses, generally at the end of a reserve maintenance period. Large amounts of excess liquidity were recorded, for example, on 23 September (€7.4 billion, the highest level of recourse to the deposit facility in the Eurosystem in 2003, of which €1.8 billion was accounted for by the Bundesbank) and on 23 January (€5.6 billion; Bundesbank: €1.9 billion). However, certain credit institutions occasionally also resorted to the deposit facility in the evening in order to set aside overnight the funds needed to make interbank payments scheduled for the following morning or to settle securities transactions early the next day, which is what led to considerable levels of recourse on 2 June and 16 September for instance. As a daily average in 2003, €0.2 billion was lodged with the Eurosystem's deposit facility (Bundesbank: €0.2 billion). This means that the level remained as in 2002.

Changes in the operational framework

Following a public consultation procedure, the Governing Council of the ECB decided on 23 January 2003 to make some changes to the Eurosystem's monetary policy framework; these were implemented in the first quarter of 2004. Since 10 March 2004 the reserve maintenance period has started 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. Changes in the interest rates on the standing facility rates will, as a rule, be implemented on the first day of the new maintenance period. The maturity of the main refinancing operations was shortened from two weeks to one; the first one-week main refinancing operation was allotted on 9 March 2004. Moreover, since 25 February 2004 the allotment of the longer-term refinancing operations has taken place on the last Wednesday in the calendar month.

Range of assets eligible as collateral for refinancing operations

Assets which the Bundesbank deems eligible for the Eurosystem's monetary policy operations are divided into two categories: "tier one assets" comprise only marketable debt instruments which satisfy uniform, euro-area-wide eligibility criteria laid down by the ECB. "Tier two assets" comprise additional marketable debt instruments plus non-marketable debt instruments. The eligibility criteria for these assets are determined by the national central banks on the basis of minimum standards laid down by the ECB. The Bundesbank's list of eligible tier two assets includes mainly non-marketable debt instruments which take the form of trade bills and bank loans. The residual maturity of such assets, when accepted by the Bank, may not be less than one month; it may not exceed six months in the case of bills of exchange, or two years in the case of bank loans. The debtors of the bills or loans must be business enterprises in the non-financial sector or self-employed persons and be domiciled in Germany. Eligibility for central bank refinancing is verified by the Bundesbank primarily by referring to their annual accounts.

List of eligible assets

The list of assets eligible as collateral for refinancing operations is published on the ECB's website. The list gives details of each type of (marketable) eligible asset. At the end of December 2003, the volume outstanding of such marketable eligible assets was some €7,300 billion. Roughly 35% of that sum was accounted for by assets held in Germany.

Volume of assets pledged to the Bundesbank

At the end of 2003 counterparties had eligible assets totalling €438 billion pledged in their collateral pools at the Bundesbank as cover for refinancing operations (and intraday loans in the context of payment settlement). That figure included €164 billion of assets held in another member state and made available across national borders for refinancing purposes at the Bundesbank.

Some 42% of the assets pledged to the Bundesbank were covered bank debt securities (Pfandbriefe). Government bonds and uncovered bank debt securities each accounted for one-quarter. Compared with the preceding year, that signifies a shift in favour of uncovered bank debt securities and away from Pfandbriefe. Less than one-tenth of the total was made up of other marketable assets and lending to the private sector (approximately 10,500 bills of exchange and 4,500 bank loans, amounting to €6.2 billion in all).

Public consultation procedure to improve the Eurosystem's collateral framework

In the summer of 2003 the Eurosystem carried out a public consultation procedure on measures to improve its collateral framework. The proposal presented to market players for their comments envisages gradually replacing the two-tier collateral framework by a single-tier list of eligible assets. The tier one assets already accepted as loan collateral by the Eurosystem would be included in the single list. The types of tier two assets currently accepted as eligible assets will be reviewed to establish whether or not they should be included in the single list. Furthermore, the possibility of including debt instruments issued by a G10 country which is not established in the EEA in the list of eligible assets is also being examined.

Respondents' opinions

The market players took a lively interest in this consultation procedure and were largely in favour of the proposal to progressively introduce a single list of eligible securities throughout the euro area. This was said to favour an equal playing field for the counterparties in the Eurosystem and to enhance transparency. Most of those taking part in the consultation procedure were in favour of extending the current list of tier one and tier two assets in order to cover a greater, and still growing, need for collateral in the international money and capital markets as well as in payment transactions and securities settlement.

Support for bank loans

Against the background of this increased need for collateral, there was support for including bank loans in the single list of eligible assets. Some participants were keen to see a broadening of the current definition of bank loans and to allow not only "pools of loans" but also bank loans denominated in foreign currency, loans to the public sector and borrowers' notes. The participants were unanimous in their rejection of the introduction of fees in connection with bank loans. This was seen as putting bank loans at a disadvantage compared with other types of collateral.

Positive attitude to including equities

In principle, respondents viewed the inclusion of equities in a positive light although some do not see a strong business case for doing so. Respondents also expressed the view that the inclusion of equities should not hinder the inclusion of other types of assets – such as bank loans – in the single list.

Other collateral

The respondents in the consultation procedure were generally in favour of including other marketable tier two assets. There was clear support for including euro-denominated debt instruments issued by G10 countries that are not in the EEA. Moreover, many respondents called for debt instruments denominated not only in euro but also in all G10 currencies to be included in the list of eligible assets.

Implementing the measures

Implementing a revision of the Eurosystem's collateral policy is expected to mean that both Eurosystem central banks and the Eurosystem's counterparties will need to adapt their operational systems and procedures. In addition, the likely introduction of some categories of assets will make it necessary for some countries to adapt their legislation. For these reasons, the revision of the collateral framework, if and when decided, will need to be implemented gradually over several years.

V The Bundesbank's involvement in the issuance of Federal securities and in asset management

As the Federal Government's fiscal agent, the Bundesbank carries out various tasks relating to the issue and settlement of Federal securities. In 2003 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 effected price regulation operations and sales of the amounts set aside for market management operations through the German stock exchanges. Since May 2002, however, sales through electronic trading systems of the amounts set aside for market management operations have been executed by the German Finance Agency.

Moreover, the Bank continues to be represented on the Committee for Public Sector Credit Issues, on which the bond-issuing requirements of central, state and local government are coordinated and questions concerning issuing techniques are discussed. In addition, it is still involved in the Central Capital Market Committee and in a number of other national and international committees in which capital market and stock market matters in the broader sense are addressed.

Bund Issues Auction Group

Since 1998 Federal bonds (Bunds), five-year Federal notes (Bobls), Federal Treasury notes (Schätze) and Treasury discount paper (Bubills) have all been issued by auction through the Bund Issues Auction Group. Membership of this group is conditional on sufficient placing power. That condition is deemed to be met if at least 0.05% of the issue volume allotted by auction in a calendar year, weighted by maturity, is taken up. When determining a member's placing power, the weighting factors should reflect the differing capital commitments and interest rate exposures associated with the various maturities. In 2003 the weighting factors were 1 for Bubills, 4 for Schätze, 8 for Bobls, 15 for 10-year Bunds and 25 for 30-year Bunds; the same factors will continue to apply in 2004.

Bund Issues Auction Group
List of members, ranked according to their shares in the weighted amounts allocated in 2003

Table 18

Ranking		Ranking	
1	Deutsche Bank AG	21	HSBC Trinkaus und Burkhardt KGaA
2	ABN AMRO Bank (Deutschland) AG	22	WestLB AG
3	Dresdner Bank AG	23	DZ Bank AG Deutsche Zentral-Genossenschaftsbank
4	Morgan Stanley Bank AG	24	Deutsche Postbank AG
5	Barclays Bank PLC Frankfurt Branch	25	HSH Nordbank AG
6	Bayerische Landesbank	26	Lehman Brothers Bankhaus AG
7	Crédit Suisse First Boston (Europe) Ltd Niederlassung Frankfurt	27	Norddeutsche Landesbank Girozentrale
8	Goldman, Sachs & Co oHG	28	Baden-Württembergische Bank AG
9	Merrill Lynch Capital Markets Bank Limited Zweigniederlassung Frankfurt am Main	29	Bayerische Hypo- und Vereinsbank AG
10	Citigroup Global Markets Limited Zweigniederlassung Frankfurt	30	Nordea Bank Finland Plc Niederlassung Deutschland
11	UBS Investment Bank AG	31	Landesbank Baden-Württemberg
12	BNP Paribas Niederlassung Frankfurt am Main	32	Bremer Landesbank Kreditanstalt Oldenburg – Girozentrale
13	ING BHF-Bank AG	33	SEB AG
14	The Royal Bank of Scotland Frankfurt Branch	34	Landesbank Sachsen Girozentrale
15	Commerzbank AG	35	Nomura Bank (Deutschland) GmbH
16	JP Morgan Securities Ltd. Frankfurt Branch	36	Stadtsparkasse Köln
17	Bankgesellschaft Berlin AG	37	Reuschel & Co KG
18	Landesbank Hessen-Thüringen Girozentrale	38	SANPAOLO IMI SpA Filiale Frankfurt am Main
19	Société Générale SA Zweigniederlassung Frankfurt am Main	39	Hesse Newman & CO (AG & Co) Kommanditgesellschaft
20	DekaBank Deutsche Girozentrale		

New members not included in the ranking list: Crédit Agricole Indosuez Niederlassung Frankfurt am Main, Danske Bank A/S Zweigniederlassung Hamburg and Svenska Handelsbanken AB (publ) Niederlassung Frankfurt.

Deutsche Bundesbank

In 2003 €174.5 billion worth of Federal securities were issued through the Auction Group in 35 auctions (2002: €157.7 billion in 28 auctions). At the end of each year the German Finance Agency publishes a list of Auction Group members, ranked according to their shares in the maturity-weighted allotment volume. At the beginning of 2003 there were 41 members in the Auction Group. During the course of the year, three new members joined and at the end of the year two members were withdrawn due to insufficient placing power, meaning that the number of members went up to 42 at the beginning of 2004.

Issues of Federal bonds (Bunds) in 2003

Table 19

Issue	Auction date	Amount issued (€ billion) Total	Amount allotted by auction	Market management amount	Terms Weighted average price (%)	Average yield (% pa)
4.50% Bund of 2003 (2013)						
ISIN DE0001135218	8 Jan	8.0	7.1	0.9	101.63	4.30
Increase	5 Mar	7.0	5.6	1.4	105.09	3.87
Increase	23 Apr	7.0	5.1	1.9	102.53	4.17
Increase	27 May	2.0	–	2.0	–	–
		24.0				
4.75% Bund of 2003 (2034)						
ISIN DE0001135226	29 Jan	6.0	5.1	0.9	102.90	4.57
Increase	23 July	4.0	3.5	0.5	97.47	4.90
		10.0				
3.75% Bund of 2003 (2013)						
ISIN DE0001135234	2 July	8.0	6.0	2.0	98.55	3.93
Increase	6 Aug	7.0	6.6	0.4	96.48	4.19
Increase	10 Sep	7.0	6.4	0.6	95.86	4.27
		22.0				
4.25% Bund of 2003 (2014)						
ISIN DE0001135242	29 Oct	8.0	7.8	0.2	99.66	4.29

Deutsche Bundesbank

Issues of five-year Federal notes (Bobls) in 2003

Table 20

Issue	Auction date	Amount issued (€ billion) Total	Amount allotted by auction	Market management amount	Terms Weighted average price (%)	Average yield (% pa)
4.25% Bobls series 141 of 2002 (2008)						
ISIN DE0001141414	5 Feb	6.8	6.3	0.5	104.51	3.25
Increase	12 Mar	7.0	4.1	2.9	105.48	3.02
		1 13.8				
3% Bobls series 142 of 2003 (2008)						
ISIN DE0001141422	14 May	7.0	5.0	2.0	99.67	3.07
Increase	11 June	7.0	5.4	1.6	101.56	2.65
		14.0				
3.50% Bobls series 143 of 2003 (2008)						
ISIN DE0001141430	8 Oct	7.0	6.4	0.6	100.13	3.47
Increase	12 Nov	7.0	5.9	1.1	98.75	3.78
		14.0				

1 Total amount issued: €14 billion.

Deutsche Bundesbank

Federal bond issuance

As part of the auctions conducted by the Bundesbank, €64.0 billion of Bunds were issued in 2003 (2002: €58.0 billion). By reopening issues, issue volumes of up to €24.0 billion were reached.

Stripping

The volume of bonds whose principal and interest may be separated ("stripped") amounted to €389.4 billion at the end of the year; approximately €5.4 billion of these were held in stripped form.

Five-year Federal notes

The issue concept and issue pattern for Bobls were changed in 2003. The sale of Bobls as tap issues was abolished in February 2003. Accordingly, starting with series 142, the biannual lead time for sales as tap issues was discontinued before the first auction; the maturity of Bobls was consequently reduced from 5½ years to 5 years. Furthermore, three series – instead of two – were issued by auction in 2003. New issues took place in February, May and October and each were increased in the following month. Since February 2003 individuals and non-profit institutions have been able to purchase – as a replacement for the discontinued tap issues – the most recent listed Bobls directly for no extra charge from the Federal Securities Administration *(Bundeswertpapierverwaltung)*. The volume of Bobls issued in 2003 amounted to €41.8 billion (2002: €38.0 billion).

Federal Treasury notes

In 2003 a total of €48.0 billion worth of Schätze were issued at quarterly intervals (in March, June, September and December) and increased in the following month (2002: €45.0 billion).

Treasury discount paper

July 2003 was the first time amounts set aside for market management operations were introduced for Bubills issued at monthly intervals by the Federal Government with maturities of six months. Sales of amounts set aside for market management operations are executed by the German Finance Agency as part of their secondary market activities. Including amounts set aside for market management operations, the volume of Bubills issued in 2003 was €65.3 billion (2002: €48.6 billion).

Market management operations

Again in 2003 some amounts raised by the issue of Federal securities were set aside for market management operations: €10.8 billion in the case of Bunds, €8.7 billion in the case of Bobls, €5.4 billion in the case of Schätze and €5.6 billion in the case of Bubills. A total of €31.4 billion was raised from the sale of market management stocks (2002: €21.4 billion).

Issues of Federal Treasury notes (Schätze) in 2003

Table 21

Issue	Auction date	Amount issued (€ billion)			Terms	
		Total	Amount allotted by auction	Market management amount	Weighted average price (%)	Average yield (% pa)
3% Schätze of 2002 (2004)						
ISIN DE0001137008						
Increase	15 Jan	[1] 5.0	4.6	0.4	100.57	2.69
2.50% Schätze of 2003 (2005)						
ISIN DE0001137016	26 Mar	7.0	6.4	0.6	99.83	2.59
Increase	30 Apr	5.0	4.1	0.9	100.07	2.46
		12.0				
2% Schätze of 2003 (2005)						
ISIN DE0001137024	25 June	7.0	6.2	0.8	100.02	1.99
Increase	16 July	5.0	4.4	0.6	99.48	2.28
		12.0				
2.50% Schätze of 2003 2nd issue (2005)						
ISIN DE0001137032	24 Sep	7.0	6.3	0.7	100.13	2.43
Increase	22 Oct	5.0	4.4	0.6	99.699	2.66
		12.0				
2.75% Schätze of 2003 (2005)						
ISIN DE0001137040	10 Dec	7.0	6.2	0.8	99.979	2.76

1 Total amount issued: €14 billion.

Deutsche Bundesbank

Issues of Treasury discount paper (Bubills) in 2003

Table 22

Issue / ISIN	Auction date	Amount issued (€ billion)			Terms	
		Total	Amount allotted by auction	Market management amount	Weighted average price (%)	Average yield (% pa)
January 2003 / DE0001114510	6 Jan	4.9	4.9	–	98.611	2.68
February 2003 / DE0001114528	10 Feb	4.9	4.9	–	98.762	2.48
March 2003 / DE0001114536	10 Mar	5.0	5.0	–	98.802	2.31
April 2003 / DE0001114544	14 Apr	4.9	4.9	–	98.804	2.39
May 2003 / DE0001114551	12 May	5.0	5.0	–	98.877	2.25
June 2003 / DE0001114569	16 June	4.6	4.6	–	99.079	1.91
July 2003 / DE0001114577	14 July	6.0	5.0	1.0	99.012	1.97
August 2003 / DE0001114585	11 Aug	6.0	4.9	1.1	98.937	2.05
September 2003 / DE0001114593	15 Sept	6.0	4.9	1.1	98.968	2.06
October 2003 / DE0001114601	13 Oct	6.0	5.5	0.5	98.936	2.05
November 2003 / DE0001114619	10 Nov	6.0	5.2	0.8	98.935	2.13
December 2003 / DE0001114627	8 Dec	6.0	4.9	1.1	98.917	2.09

Deutsche Bundesbank

Issues of Federal savings notes in 2003 Table 23

Issue	Sales period 2003	Sales (€ million)			Nominal interest rate (% pa)	Final yields (% pa)	
		Total	Federal savings notes, Type A	Federal savings notes, Type B		Type A	Type B
2003 / 1 and 2	2 Jan-28 Feb	375	305	70	2.00 – 5.00	3.12	3.42
2003 / 3 and 4	28 Feb-30 May	243	189	54	1.50 – 4.75	2.71	3.03
2003 / 5 and 6	30 May-5 Aug	137	109	28	1.00 – 4.75	2.53	2.88
2003 / 7 and 8	5 Aug-31 Oct	246	188	58	1.25 – 5.25	2.94	3.31
2003 / 9 and 10	31 Oct-31 Dec	168	115	53	1.25 – 5.50	3.02	3.42

Deutsche Bundesbank

Price regulation operations

As in previous years, the Bundesbank carried out price regulation operations (for the account of the issuers) for securities which are officially listed on the German stock exchanges and issued by the Federal Government, its special funds, the Treuhand agency and Deutsche Ausgleichsbank (DtA) and for securities which were issued prior to 1997 by KfW *(Kreditanstalt für Wiederaufbau)*. The Bundesbank also conducted price regulation operations for bonds issued by the German federal state of Lower Saxony and listed on the stock exchanges in Frankfurt am Main and Hanover, and for Deutsche Bundespost securities listed on the Frankfurt stock exchange.

Federal savings notes and Federal Treasury financing paper

Securities business with external safe custody and counter customers via the branches of the Bundesbank was discontinued on 31 December 2002. However, in the year under review the Bundesbank continued to be involved, through credit institutions, in selling Federal savings bonds and Federal Treasury financing paper issued on tap. In 2003 €1.2 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-making institutions (2002: €2.4 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 €0.8 billion (2002: €1.4 billion).

Pension reserves of central and state governments

Given the evident demographic changes, pension payments to civil servants are set to rise sharply in the future. In order to safeguard these payments, Parliament, in adopting the 1998 Pension Reform Act *(Versorgungsreformgesetz)*, decided to accumulate central and state government pension reserves in the form of special funds based on contributions from the recipients of civil service pay and pensions. The Act on a Federal Government Pension Reserve *(Gesetz über eine Versorgungsrücklage des Bundes)* based on the Pension Reform Act entered into force at the beginning of 1999; in order to safeguard pension expenditure, this Act provided for a special fund called the Federal Government pension reserve *(Versorgungsrücklage des Bundes)* to be established under the jurisdiction of the Federal Ministry of the Interior. Taking account of the 2001 Pension Amendment Act *(Versorgungsänderungsgesetz)*, which entered into force on 1 January 2002, these resources are to be used over a period of 15 years from 2017 onwards to progressively ease the burden of pension payments. The management of the resources in this special fund was entrusted, under the Act on a Federal Government pension reserve, to the Bundesbank.

Total transfers of resources to the Federal Government pension reserve amounted to €180 million in 2003. In accordance with the investment guidelines laid down by the Federal Ministry of the Interior and the Federal Ministry of Finance, in agreement with the Federal Ministry of Labour and Social Affairs, the Bundesbank invested those resources in marketable Federal debt securities. At the end of 2003, the market value of this special fund was approximately €625 million.

State governments are also required to accumulate pension reserves in the form of special funds. On the basis of a number of different regulations, the management of the funds in such pension reserves has been assigned to specific Regional Offices of the Bundesbank.

Monetary Stability Foundation

In 2001, pursuant to the Act concerning the Minting of a DM1 Gold Coin and the Establishment of the Monetary Stability Foundation of 27 December 2000, the Bundesbank issued gold coins with a face value of DM1. Of total net receipts from sales of those gold coins (€94.3 million), €51.1 million was transferred to the Monetary Stability Foundation, which was established on 1 January 2002. The remainder accrued to the Prussian Cultural Heritage Foundation and is earmarked for the refurbishment of Museum Island in Berlin. One of the objectives of the Monetary Stability Foundation is to support economic and juridical research, especially in the fields of monetary and currency systems, in order to maintain and enhance the public's awareness of the significance of monetary stability.

The assets of the foundation are managed by the Bundesbank, the aim being to generate the highest possible returns as regularly as possible so as to finance the foundation's expenditure, while at the same time maintaining the real value of the foundation's assets. In line with these principles, the assets are invested in blue-chip, euro-denominated, fixed interest securities and equities. At the end of 2003, the market value of the foundation's assets was approximately €52.5 million.

Central bank service

In consultation with the European Central Bank, the Bundesbank is currently restructuring the services it offers to foreign central banks and supranational institutions in the area of reserve management. This restructuring is a response to the growing interest among these particular customers in increasing their investment in euro-denominated assets.

Euro portfolio

Furthermore, towards the end of the year under review, the Bundesbank took an initial step towards establishing its own securities portfolio. This portfolio is made up of investments in euro-denominated, fixed interest, AAA-rated securities which serve as an asset-side counterpart to the Bundesbank's pension provisions.

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

1 International harmonisation of banking supervision

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

Basel II: third consultative paper

In the year under review, the Basel Committee on Banking Supervision continued its work on revising the Basel Capital Accord (Basel II). It published a third consultative paper at the end of April 2003. This was followed by a three-month consultative period. Numerous credit institutions and their associations as well as other interest groups used this opportunity to voice their opinions and submitted comments.

Main issues in the opinions on the third consultative paper

The opinions commended the progress made in comparison with the second consultative paper and made it clear that most of the new framework is widely supported. At the same time, they highlighted areas in which there is still a need for adjustment. The opinions focused on the following topics: partial application of the new rules, possible pro-cyclical effects, the planned bank-specific capital requirements, home country/host country issues (above all regarding the USA), the treatment of securitisation and holdings, and the recognition of insurance in operational risk measurement approaches. The Basel Committee has examined the opinions in detail and agreed to make adjustments concerning the capital requirement for expected and unexpected losses, the capital requirement for credit card commitments, simplification of the treatment of certain types of securitisations and changes to certain credit risk mitigation techniques, such as credit derivatives. Once the relevant details have been clarified, the consultations on the new Capital Accord are to be concluded by mid-2004.

Third Quantitative Impact Study

The effect of Basel II on the minimum capital requirements of credit institutions has been examined in various "Quantitative Impact Studies". The most recent of these, the Third Quantitative Impact Study, was aimed at determining whether adjustments to the risk weight functions were needed to maintain the level of equity capital available within the banking system before the third consultative paper was published in April 2003. This Impact Study was conducted by the Basel Committee's working groups on the "Quantitative Impact Study" and "Overall Capital" in cooperation with credit institutions from 43 countries.

"Quantitative Impact Study" and "Overall Capital" working groups

In Germany, 57 banks took part in the Impact Study, a large number by international standards. In addition to being responsible for the German institutions, the Bundesbank, in providing comprehensive technical support, was able to make an important contribution to the evaluation of the results from the participating countries both in Basel and at the EU level. At its meeting in October 2003, the Basel Committee decided to fundamentally change the risk weight functions. The average expected losses from credit risk have therefore been removed from the risk weight functions.

Research Task Force

As the importance of quantitative methods in banking supervision has increased, the Basel Committee's Research Task Force – in which the Bundesbank is also represented – has been able to provide a significant impetus for the advancement of international banking supervision through its own research projects. In the year under review, the importance of market information as an indicator of risks within the banking system and the causes of bank failures were examined, the latter on the basis of case studies. One working group, which is chaired by the Bundesbank, deals with the validation of internal ratings systems.

Working Group on the Validation of Internal Ratings Systems

Accord Implementation Group

The Bundesbank and BaFin (the Federal Financial Supervisory Authority) are represented in the Basel Committee's Accord Implementation Group (AIG). The AIG was established in 2002 with the intention of creating a forum for discussing implementation issues regarding Basel II in an intensive exchange of information with the banks and associations. The reasons for this lie in the wide scope of implementation which the risk-oriented approach of Basel II has created for the institutions and supervisors, leading to a need for international coordination. Through promoting cooperation between the supervisory authorities and an exchange of information, for example with regard to the relevant supervisory approaches or the planned structure of national options in the Accord, the AIG's goal is to help to strengthen the level playing field and to reduce the implementation costs for internationally operating institutions.

Accounting: IAS 32 and IAS 39

The Basel Committee on Banking Supervision was intensively involved in the discussions on the revision of the International Accounting Standards (IAS), in particular IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement). The International Accounting Standards Board (IASB) presented the amended versions of IAS 32 and IAS 39 on 17 December 2003. These did not yet include the amendments regarding the possible accounting treatment of modern risk management procedures to hedge the banks' interest rate risk for an entire portfolio (macrohedge accounting). However, the IASB presented a modification proposal based on consultations and subsequent discussions with the European banking industry. The Basel Committee has criticised this proposal, especially the IASB's intention to include prepayments in the definition of ineffectiveness within the hedging relationship. In its own opinion, the Bundesbank advocates the inclusion of core deposits in a hedged net liability position given their proven long-term duration. However, this has been rejected by the IASB up to now. The IASB intends to publish the amendments to the macrohedge accounting provisions of IAS 39 in the first quarter of 2004.

Disclosure as an aspect of international accounting

In view of the planned changeover to IAS/IFRS (International Financial Reporting Standards) for the consolidated accounting of publicly traded companies within the EU as of 2005, the further development of these standards is of special interest. The accounting standards IAS 30 (Disclosures in the Financial Statements of Banks and Similar Financial Institutions) and IAS 32, which are of particular informational relevance, were developed further in 2003. Whilst both standards govern the general disclosure of information in financial statements, IAS 30 – as the sector-specific standard – has up to now applied only to banks and similar institutions. As the debate now stands, it is to be expected that IAS 30 will be developed into a new standard, applicable to all enterprises, governing the disclosure of risks arising from financial instruments. The disclosure requirements pertaining to equity capital and internal and external capital requirements are to be expanded in IAS 1 (Presentation of Financial Statements). In future, IAS 32 is to contain provisions which enable the various IAS 39 valuation categories to be identified within the balance sheet and the income statement, and require a separate breakdown of these different valuation categories' contribution to profits. However, a more detailed breakdown of the balance sheet and the income statement will be needed for statistical and prudential supervisory purposes. In order to avoid inconsistencies, care must continue to be taken in revising the IAS/IFRS to ensure that they are harmonised as far as possible with Pillar 3.

International aspects of auditing annual accounts

The Bundesbank's participation in the Basel Committee has also involved addressing international issues regarding the auditing of annual accounts. The objective is to attain uniform, high-quality auditing standards on a global scale. Not least because of the EU's plans to implement the International Standards on Auditing (ISAs) with binding force for all financial statements within the EU as of 2005 (Communication from the Commission, Official Journal C 236 of 2 October 2003), the Basel Committee has joined other international financial market regulators in advocating the establishment of an independent public oversight board based at the International Federation of Accountants (IFAC). The privately organised IFAC – the global organisation for the accountancy profession – and its International Audit and Assurance Standards Board (IAASB) are responsible for drawing up the ISAs. In order to ensure that supervision is independent, the IFAC has agreed that all of its activities of public interest will, in future, be monitored by a supervisory body – the Public Interest Oversight Board (PIOB) – composed of representatives of the international financial market regulators. The IFAC Council, IFAC's decision-making body, approved these oversight plans on 14 November 2003, which means that the ten-member PIOB can be expected to start its work in the course of 2004.

(b) Harmonisation and cooperation in the European Union

Revision of the European capital requirements

The task of revising the capital requirements for credit institutions and securities trading firms remained a focal point of the European Commission's harmonisation efforts in 2003. In close harmony with the work of the Basel Committee, the European Commission is pursuing a concept based on minimum capital requirements, a supervisory review process and increased market discipline. In July, the European Commission published the draft capital requirements in a third consultative paper. As things stand at present, these requirements are to be implemented by means of directives amending the Codified Banking Directive and the Capital Adequacy Directive.

Adaptation of the banking sector's committee organisational structure to the Lamfalussy approach

At the beginning of November 2003, the European Commission put forward a proposal to establish a new financial services committee organisational structure (COM/2003/0659 final). In response to changes on the financial markets and in the financial services sector, at the Stockholm European Council in March 2001 the Heads of State or Government called not only for the full implementation of the Financial Services Action Plan by the end of 2005, but also for the organisational structure of the committees with their advisory and comitology functions, which include the EU's enlargement to 25 member states, to be adapted to the new conditions in accordance with the recommendations of the Lamfalussy group. Until now, the Banking Advisory Committee, which was set up by way of the First Council Directive (77/780/EEC) on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, carried out both functions in the banking sector. In future, the European Banking Committee ("level 2") is to advise the Commission on the development of legislation and act as the comitology committee for the adoption of implementing legislation by the Commission. Moreover, the Committee of European Banking Supervisors (CEBS) ("level 3"), which is based in London, has been set up to promote the convergence of member states' supervisory practices, serve as a forum for the exchange of confidential information and advise the Commission on technical matters, particularly the preparation of implementing legislation. The EU's national central banks are also represented on the Committee of European Banking Supervisors irrespective of whether they are involved in banking supervision or not. Only the European Banking Committee's comitology function is to be included in the Codified Banking Directive (2000/12/EC) in future; the two new committees' advisory functions, however, are based on a Commission Decision of 5 November 2003. The legislative procedure is to be completed under the Irish Presidency before the European Parliament elections in the summer of 2004.

(c) Cooperation within the European System of Central Banks

The Banking Supervision Committee (BSC) helps the ESCB to fulfil its task laid down in the Treaty on European Union of contributing to the stability of the

European financial system. Furthermore, the Committee promotes the exchange of banking supervisory information among its members, ie the central banks and the supervisory authorities of the (at present) 15 EU member states. The Committee's work focuses on analysing the stability of the European banking systems and assessing structural changes in the banking sector. The results of this work have been presented to the Governing Council of the ECB, the supervisory fora in Europe and elsewhere, and the supervisory authorities and central banks of the European Economic Area. In 2003, the Committee published two stability reports and a report on structural developments in the banking sector. The analyses benefited from the synergy effects of combining the information and knowledge of the supervisory authorities and central banks in the BSC.

Further analyses of the stability of the EU banking systems and structural developments in the banking sector

Use of synergy effects between supervisory and central bank functions

Two memoranda of understanding regarding the flow of information between the European credit registers (see page 157) and between EU supervisory authorities and central banks in the event of a crisis have been signed to improve the cooperation and exchange of information between supervisory authorities and the central banks within the EU.

Multilateral agreements to improve the exchange of information

2 Changing and developing the national prudential supervisory standards

Enforcement of accounting rules

Until now the only examination of enterprises' accounting practices has been during the annual audit carried out by the statutory external auditor. Unlike in other countries, a separate monitoring procedure does not exist in Germany. The only activities that may be said to represent sovereign enforcement are those of the court of registration (*Registergericht*). In 2003, the high-level Working Group on the Auditing of Annual Accounts and Corporate Governance examined the question of the introduction of enforcement in Germany. Some proposals from the working group's final report, which was forwarded to the Federal Ministry of Justice on 31 July 2003, have since been included by the Federal Government in a draft Act on enforcing compliance with corporate reporting requirements (*Gesetz zur Kontrolle von Unternehmensabschlüssen: Bilanzkontrollgesetz* in short) published on 8 December 2003. This bill envisages the introduction of a two-stage enforcement procedure. Pursuant to existing plans, in the first stage, a private enforcement body shall perform compliance audits of listed enterprises' accounting practices, both in the event of actual suspicion and in the form of random checks. In the second stage, BaFin shall be given sovereign authority to act if individual enterprises refuse to cooperate in the first stage, or if the irregularities found in the first stage have not been rectified. The costs of enforcement will be passed on to the audited enterprises on a cost allocation basis. In the case of specific audits carried out in the second stage, however, the enterprise concerned shall be billed separately.

Quality of annual accounts audits

The Working Group on the Auditing of Annual Accounts and Corporate Governance also considered how the quality of audits could be improved, focusing on ways to increase the independence of external auditors. The Bundesbank participated in this debate as, in the ongoing monitoring of institutions, it uses documents drawn up by the external auditors of the supervised institutions. Some of the working group's proposals on auditor independence were incorporated into a Federal Government draft Act on international accounting standards and audit quality (*Gesetz zur Einführung internationaler Rechnungslegungsstandards und zur Sicherung der Qualität der Abschlussprüfung*) published on 15 December 2003. The intention is to extend the list of circumstances under section 319 of the German Commercial Code which suggest auditor partiality. This essentially concerns the provision of certain non-auditing services by the same external audit firm which audits the annual accounts. A revised section 319a of the German Commercial Code shall list further grounds for doubting impartiality with regard to the auditing of "public interest enterprises". Moreover, specific details on the audit fee will be made mandatory in the annex to the audit report.

Corporate governance

In addition, the working group examined corporate governance issues. It specifically called for a strengthening of the supervisory board's or the audit committee's role in appointing external auditors and cooperating with them. Other suggestions by the working group concerned the personal independence of the chairman of the audit committee, who should not be a former member of the company's management board, as well as an obligation on the part of the supervisory board to explain the expertise of all the members of the audit committee. In the view of the working group, the proposals should be incorporated into the German Corporate Governance Code. The public debate on corporate governance addressed various other topics, including the obligations to disclose the individual salaries of management board members, the introduction of personal liability of management and supervisory board members, and the improvement of minority shareholders' rights to assert an action against the managers. At the EU level, the European Commission presented a corporate governance action plan in 2003. The action plan did not envisage common European rules, but rather adequate coordination of existing national corporate governance codes.

Money laundering prevention act

The German Banking Act was amended several times in the year under review. The new section 25b of the Banking Act came into force on 1 July 2003. This provision was incorporated into the Banking Act by passage of the Act to improve the combating of money laundering and to combat the financing of terrorism, abbreviated to "Money Laundering Prevention Act" (*Geldwäschebekämpfungsgesetz*), of 8 August 2002 and specifically regulates the organisational obligations of those institutions which conduct giro business or provide money transmission services. These obligations are part of the good governance requirements.

Law on customs administration

The second Act to amend the law on customs administration (*Zweites Gesetz zur Änderung des Zollverwaltungsgesetzes*) came into effect on 31 October 2003 and is now reflected in the new section 6a of the Banking Act. The purpose of this provision is to create a legal basis for financial sanctions to combat the risks arising from the funding of terrorism. It authorises BaFin to impose restrictive measures on institutions which are supervised pursuant to the Banking Act and their managers, as well as to prohibit the execution of banking activities or financial services and related financial transactions. A precondition of this is that circumstances exist to suggest that funds or other financial assets are being used to fund terrorist activities.

Law on the reorganisation and winding up of credit institutions

With the coming into force of the Law on the reorganisation and winding up of insurance undertakings and credit institutions (*Gesetz zur Umsetzung aufsichtsrechtlicher Bestimmungen zur Sanierung und Liquidation von Versicherungsunternehmen und Kreditinstituten*) on 10 December 2003, new provisions were incorporated into the Banking Act in sections 46d to 46f. These require BaFin to inform the competent authorities in other countries within the European Economic Area (EEA) before it orders restructuring measures to be carried out at a deposit-taking credit institution or an e-money institution. Pursuant to the revised section 46b of the Banking Act, "imminent illiquidity" now also constitutes grounds for opening insolvency proceedings. The Banking Act defines imminent illiquidity as the probable inability to fulfil existing payment obligations upon maturity. In future the relevant authorities or courts of the home country will be solely responsible for opening insolvency proceedings against the assets of a deposit-taking credit institution or an e-money institution in the EEA. However, the proceedings will be recognised by the other states. The office of the insolvency court has to forward the order to open proceedings to BaFin immediately. In turn, BaFin informs the competent authorities in the other EEA host states that proceedings have been instigated. Furthermore, BaFin is entitled to request information at any time from the insolvency court and the insolvency administrator on the status of the proceedings. These provisions are supplemented by the obligation in the new section 24 (1) No 8a of the Banking Act for institutions to notify BaFin and the Bundesbank of their intention to request the opening of insolvency proceedings against their assets.

Country Risk Regulation

The Regulation governing information on loans to foreign borrowers pursuant to the Banking Act (Country Risk Regulation) was amended by means of the Regulation to amend the Country Risk Regulation of 30 July 2003 (Federal Law Gazette I 2003, page 1602). The amendment had become necessary as a result of changes in statutory regulations in connection with the Sixth Act amending the Banking Act and the Regulation governing large exposures and loans of three million Deutsche Mark or more. The reporting cycle, formerly on a half-yearly basis, is now on a quarterly basis to provide banking supervisors with greater insight into foreign loans granted by German credit institutions. The reporting threshold per institution was reduced from DM50 million to €10 million and the reporting threshold per country was increased from DM1 million to €1 billion, while the reporting threshold per country ceased to be coupled to the liable capital. The reporting requirement now relates to loans to borrowers whose registered office is outside the European Union and other contracting states of the EEA agreement, as well as outside Switzerland, the United States, Canada, Japan, Australia and New Zealand. Moreover, disclosure obligations concerning loans that are merely passed on by the borrowers were extended in order to record the ultimately relevant country risk.

Minimum requirements for the credit business of credit institutions

A Bundesbank and BaFin working group was set up to establish an audit concept in preparation for audits of compliance with the "Minimum requirements for the credit business of credit institutions" (*Mindestanforderungen an das Kreditgeschäft der Kreditinstitute,* or *MaK*), which were published on 20 December 2002. The audit concept was developed with three objectives in mind. First, both the audit and the audit findings must fulfil certain minimum quality standards in order to meet the high requirements of a banking supervisory audit. Second, audits of compliance with the minimum requirements for the credit business of credit institutions should be consistent in terms of form and content so that, as well as delivering findings on the individual institutions, they enable well-founded comparisons between institutions. A further aim is to ensure that audits are performed efficiently in a way which conserves the existing audit resources and is cost-effective. The work was completed at the end of 2003. As part of the expert sub-committee on the "Minimum requirements for the credit business of credit institutions", which was set up in 2003, the Bundesbank participated in the debate on how to deal with the institutions' problems with the "Minimum requirements". The results of the expert sub-committee's work provide significant impetus for the audits of compliance with the "Minimum requirements", which are scheduled to commence in the latter half of 2004 and which will initially deal only with the first stage of the implementation of the "Minimum requirements". The institutions have until the end of December 2005 to implement the IT requirements (second stage).

Working Group on the implementation of Basel II

In the context of the Working Group on the implementation of Basel II established in October 2003, BaFin and the Bundesbank discussed the national implementation of Basel II with the credit institutions and the associations of the German banking industry. In order to enhance the operational efficiency of the working group, expert sub-committees were set up to support it by examining the individual issues in depth. The planned expert sub-committees on the internal ratings based approach (IRB), credit risk mitigation techniques, operational risk, asset-backed securities (ABS), disclosure and the supervisory review process (SRP) were all established in the fourth quarter of 2003.

Approval of internal rating systems

Specification tests for internal ratings based systems (IRB systems) are being prepared by a Bundesbank and BaFin working group. The objective is to decide all applications for certification of an IRB system by the time Basel II comes into force. According to a joint Bundesbank-BaFin survey of German credit institutions, roughly 550 of the approximately 1,500 institutions that responded are currently planning to use an IRB approach to capital requirements for credit risk. In preparation for the IRB approval tests, the Bundesbank and BaFin are planning to commence initial assessments of the methodological concepts of the IRB procedures in 2004. Subject to examination at a later date, banks and associations can have existing rating systems, or rating systems which are about to be implemented, appraised to see how the documented rating developments comply with the third consultative paper on the Basel Accord.

Preparation for the SRP

A key part of the new Basel Capital Accord is Pillar 2, the supervisory review process (SRP). This is a new, comprehensive review process which places greater significance on audits of banking operations and to which the new rules on cooperation between the Bundesbank and BaFin will apply. A key element of the

SRP is the assessment of institutions' capital adequacy and risk management processes. The exact structure of the supervisory review process in Germany has not yet been determined. Supervisors will, however, integrate the existing "Minimum requirements for the credit business of credit institutions" and the "Minimum requirements" for the trading activities of credit institutions, into the supervisory review process. However, auditing principles and methods as well as assessment criteria must be harmonised across all risk areas and a coherent concept for the SRP developed by 2005 at the latest. This is essential if the risk situation, internal processes and capitalisation of a bank are to be definitively, consistently and completely recorded in the SRP.

3 Ongoing banking supervision operations

Further decline in the number of credit institutions ...

At the end of 2003, the Bundesbank had registered 2,469 domestic credit institutions for supervisory purposes,[1] including 47 securities trading banks. The net decrease of 146 institutions indicates that the concentration process in the German banking sector was slower in 2003 than in earlier years (net decrease of 257 institutions in 2000, 213 in 2001 and 164 in 2002). A total of 177 credit institutions closed down, mostly owing to mergers. This figure includes 96 credit cooperatives and 32 savings banks. The decrease was somewhat offset by 31 newly registered institutions, mainly branch offices of banks domiciled in another European Economic Area country, regional banks and securities trading banks.

... and financial services institutions

In the year under review, the number of domestic enterprises with licences to provide financial services pursuant to section 1 (1a) of the Banking Act likewise went down even further. The number of financial services institutions that are audited as part of the ongoing supervision operations and, in particular, are obliged to comply with the notification and reporting requirements laid down in the Banking Act slipped from 906 in 2002 to 831 at the end of 2003.

Minimum requirements for the trading activities of credit institutions

During 2003, the Deutsche Bundesbank performed nine audits of internal market risk models on the basis of section 44 of the Banking Act read in conjunction with section 10 (1c) and section 32 (3) sentence 2 of said act. At the end of 2003, a total of 15 institutions were using risk models approved by banking supervisors. In 2003, the Bundesbank, for the first time, supervised all audits of

1 Definition according to section 1 (1) of the Banking Act as well as institutions that are being wound up, in liquidation or dormant.

Ongoing banking supervision operations

Table 24

Number of operations conducted

Item	2001	2002	2003
Individual reports pursuant to sections 13 to 14 of the Banking Act	[1] 207,363	[1] 212,026	188,911
Single borrowers included in the summary reports submitted pursuant to sections 13 to 14 of the Banking Act	[1] 2,176,552	[1] 2,233,209	2,193,886
Reports pursuant to sections 24 and 24a of the Banking Act	40,597	47,585	44,561
Monthly returns pursuant to section 25 of the Banking Act	43,931	42,992	40,918
Reports on the volume of foreign lending (country risk) pursuant to section 25 (3) of the Banking Act	265	270	370
Audit reports on annual accounts	3,490	3,378	3,263
Reports on the auditing of safe custody accounts	700	614	483
Routine, special and deposit guarantee fund audit reports	1,894	1,887	1,755
Audits pursuant to sections 44 and 44c of the Banking Act	74	69	79
Audit reports on the special funds of investment companies	970	1,431	1,309
Reports from investment companies on their activities	6,655	6,635	6,891
Reports under Principle I	34,579	32,846	29,923
Reports under Principle II	33,118	31,617	28,990
Audits of internal risk models	10	8	9
Reports under the Basel Capital Accord	84	76	76

1 Revised from last year.

Deutsche Bundesbank

market risk models. BaFin is involved as an observer in every audit pursuant to the cooperation agreement of 30 October 2002 between the two institutions. For the most part, these were follow-up audits and on-site audits of modified versions of models that had already been approved by supervisors. Only one model was reviewed for the first time. During 2003, the Bundesbank performed a total of 64 audits of compliance with the "Minimum requirements for the trading activities of credit institutions" (*Mindestanforderung an das Betreiben von Handelsgeschäften* or MaH). Such audits are based on the minimum requirements for the trading activities of credit institutions and BaFin (formerly BaKred[1]) circulars 4/1998 and 5/2001. The Bundesbank's risk-oriented audits focused on risk controlling, risk management and the separation of functions as stipulated by the MaH. Pursuant to section 15 (2) of the Act concerning the Integrated Supervision of Financial Services, which came into force in 2002, the costs of all audits of the minimum requirements for the trading activities of credit institutions and market risk models in 2003 were transferred to the institutions. As in previous years, the audits also covered major foreign branches of institutions.

Transfer of audit costs to the institutions

1 Short for *"Bundesaufsichtsamt für das Kreditwesen"*, or Federal Banking Supervisory Office, it merged with two other supervisory offices to form BaFin on 1 May 2002.

Credit register of loans of €1.5 million or more

Table 25

Third quarter	Volume of loans of €1.5 million or more: € billion	Volume of loans of €1.5 million or more: Change (%)	Number of loans of €1.5 million or more reported: Number	Number of loans of €1.5 million or more reported: Change (%)	Number of reporting: insti-tutions 1	Number of reporting: financial enterprises	Number of reporting: insurance enterprises
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

1 Credit institutions and financial services institutions.

Deutsche Bundesbank

The number of loans of €1.5 million or more to be reported quarterly pursuant to section 14 of the Banking Act fell in the 12 months from 30 September 2002 to 30 September 2003 by just over 2% to around 514,400 reports. The total volume of reported loans of €1.5 million or more went down during this period from €7.2 trillion to almost €7.0 trillion on the reporting date of 30 September 2003 (the table above shows the figures since 1998). At this date, 2,624 institutions, 1,174 financial enterprises and 633 insurance enterprises had submitted reports on loans of €1.5 million or more.

Credit register of loans of €1.5 million or more

The Bundesbank's central credit register ascertains each borrower's aggregate debt on the basis of the reports submitted and reports this figure to the individual lending institutions. The number of borrowers notified to lenders on the reporting date of 30 September 2003 amounted to 387,007. Around two-thirds of the borrowers were amalgamated into a total of 79,909 single borrower units pursuant to section 19 (2) of the Banking Act. At the end of September 2003, 144 borrowers/single borrower units had debts exceeding €1.5 billion; the aggregate indebtedness of those borrowers amounted to almost €500 billion, which represents 7.1% of reported total borrowing. At €4.1 trillion, around 59% of reported total borrowing was taken up by domestic borrowers.

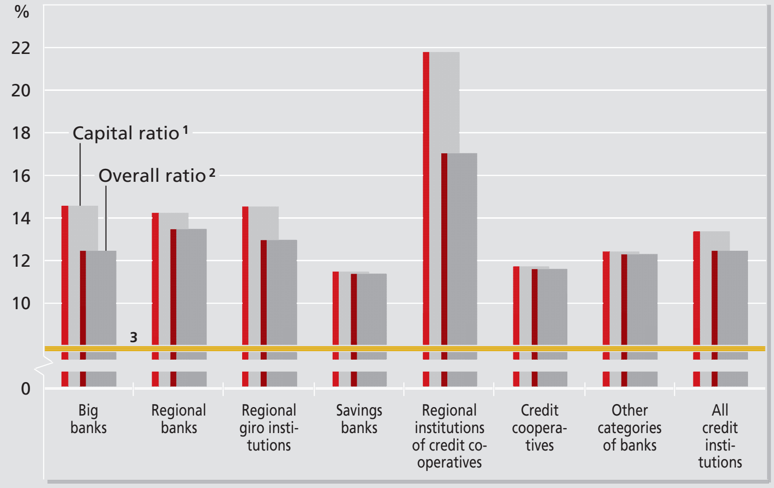
Insolvencies

In 2003, the credit register recorded a total of 2,770 insolvencies of enterprises and individuals which or who, at the time of their insolvency being announced, had outstanding loans of €1.5 million or more pursuant to section 14 of the Banking Act. This was 237 cases fewer than in 2002 (-9.2%). The volume of loans of €1.5 million or more reported for insolvent borrowers amounted to around €11.9 billion, which was just over half the amount for 2002.

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

Chart 25

End-2003 levels



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

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International cooperation between European credit registers

The signing of a Memorandum of Understanding by the governors of the central banks of seven EU countries – Austria, Belgium, France, Germany, Italy, Portugal and Spain – in February 2003 created the legal framework for a cross-border exchange of information between the credit registers of the aforementioned countries. The aim of this exchange of data between the EU credit registers is to give commercial banks access to the information on their borrowers' indebtedness stored by the other European credit registers. The Working Group on Credit Registers, which reports to the Banking Supervision Committee (BSC), is currently establishing the organisational and IT infrastructure for the planned 2005 launch of the cross-border data exchange.

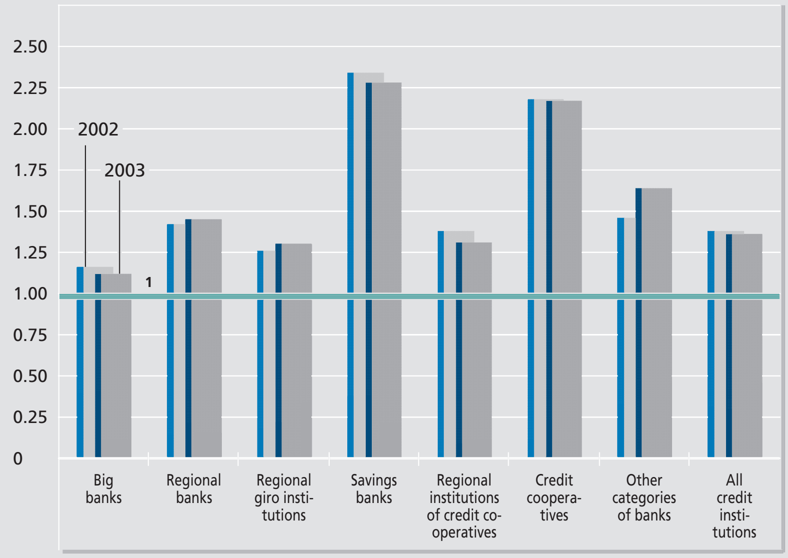
Principle I

Principle I pursuant to sections 10 and 10a of the Banking Act specifies the rules governing the minimum capital requirements for credit institutions and financial services institutions at national level. It stipulates that the own funds (liable capital plus eligible tier 3 funds) of individual institutions as well as of groups of institutions/financial holding groups must amount to at least 8% of the relevant credit, counterparty or market price risks. Credit risks or counterparty risks, which are classified and weighted in individual standardised creditworthiness categories, are to be backed by liable capital (core capital and additional capital).

Liquidity ratio of individual institutions submitting Principle II reports *

Chart 26

End-of-year levels



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

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When calculating the capital charge for market risk positions using either various standardised procedures defined by supervisors or accepted internal risk models, tier 3 funds can also be included.

Capital ratios

On 31 December 2003, the capital ratio – which reflects the ratio of weighted risk assets to liable capital – of single institutions was 13.4% on average (2002: 12.7%). Groups of institutions/financial holding groups submitting Principle I reports on a consolidated basis had an average ratio of 12.7% (2002: 11.3%). 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 12.5% on 31 December 2003 (2002: 11.9%). Groups of institutions/financial holding groups had an average overall ratio of 11.5% (2002: 9.7%). Credit risks accounted for the bulk (92%) of risk positions to be backed by capital. The average capital ratios and overall ratios of various German banking categories are shown in the chart on the previous page.

Principle II

In accordance with the supervisory liquidity standard Principle II, credit institutions are obliged to match their payment assets with their payment liabilities according to residual maturity by grouping them into four different maturity bands. An institution is deemed to satisfy the prudential liquidity requirements if its monthly liquidity ratio – the ratio of the institution's funds available in the following month to its potential liquidity outflows – is greater than or equal to 1.

Liquidity ratios

On 31 December 2003, the average liquidity ratio of German banking institutions was 1.36 (2002: 1.38). The chart on the preceding page shows the average liquidity ratios of various German banking categories on 31 December 2003 and a comparison with 2002. When comparing the liquidity ratios of different banking categories, it should be noted that a lower liquidity ratio or significant differences in the ratio level do not necessarily indicate liquidity problems within the banking category, but instead could be the result of structural differences in the refinancing operations of each individual banking category.

4 Cooperation projects on banking supervision issues

The increasing complexity of banking business...

The growing complexity of banking and financial business as well as the international standardisation of banking regulations require the Bundesbank, in its supervisory activities, to devote more and more attention to quantitative issues and model theory. The Bundesbank is fulfilling this requirement not least by initiating cooperation projects with universities and other research institutions.

...requires dialogue and cooperation with universities and research institutions

The more macro-prudential projects that were carried out during the period under review focused, amongst other things, on the role of German banks in the transmission of financial crises as well as the implications of new capital rules for banks proposed in the third consultative paper of the Basel Committee (Basel II) on German banks' international lending. Furthermore, they examined the question as to what extent the minimum capital requirements and ensuing regulatory pressure influence risk and capital decisions. At the micro-prudential level, risk modelling projects played an important role. One project, for example, looked into whether or not the contribution of a loan to portfolio diversification is affected by the size and creditworthiness of the enterprise. Another project, which was particularly significant in the light of the forthcoming prudential recognition of internal rating based approaches to measuring borrowers' credit risk, focused on identifying efficient statistical methods for assessing the quality of banks' IRB procedures.

Working papers on banking supervision issues

To encourage dialogue between economists, foreign supervisory authorities and credit institutions, a new series of discussion papers on banks and financial supervision was initiated. During the period under review, two papers were published in this series.

VII Financial stability analyses

International organisations focus on financial stability

In the past few years central banks and international organisations have increasingly focused their attention on maintaining financial stability as the basis for the efficient allocation of capital and risks within the financial system. Several factors have contributed to the growing importance of financial system stability. For example, strong growth of the financial markets – also in traditionally bank-based financial systems – has been observed. Furthermore, the increasing internationalisation of financial transactions and the incorporation of many emerging markets in the international financial sector have contributed to greater integration of the financial systems. At the same time, however, the risk of international contagion has also increased. In addition, the striking innovations in the areas of financial instruments and infrastructure have led to an increase in both the volume and pace of transactions. The increasing capabilities of the financial markets bear a potential risk of an increase in susceptibility to sudden volatility and the impact on real economic developments.

FSAP

In the course of 2003 the International Monetary Fund, as part of the Financial Sector Assessment Program (FSAP), assessed the stability of the German financial system, the quality of supervision and regulation of the financial sector and the observance of international standards and codes of practice in this field. The aim of a review of this kind is to identify potential weaknesses in the structures of a country's financial sector and to develop suggestions for their improvement. The Bundesbank supported the IMF's efforts through discussions at the expert level, by carrying out stress tests on the stability of the German banking sector and by providing data on the German financial system.

Cooperation on CGFS and in FSF ...

At the international level, the Bundesbank is active on a number of committees which deal with subjects related to financial stability. As part of the Basel platform of the G10 central banks, the Bundesbank contributes its expertise on the Committee on the Global Financial System (CGFS). One of this Committee's primary tasks is to monitor the global financial system, in particular with a view to identifying potential weaknesses in a timely manner. In the past year, the Committee also focused on the analysis of foreign direct investment in the financial sectors of the emerging markets and a study of the role played by rating agencies, in particular in the area of structured finance. Above and beyond that the Bundesbank works together in the Financial Stability Forum (FSF) with a number of international organisations and national authorities from countries with major financial centres. This forum encompasses a wide range of participants and focuses on the exchange of information on weaknesses in the financial system. In the year under review the following topics were also discussed in depth: weaknesses in corporate governance, including accounting and auditing as well as conflicts of interest involving financial market players, credit risk transfers in the financial system, transparency in the reinsurance sector and the stability of offshore financial centres.

... as well as on the EFC and BSC

Within the institutional framework of the European Union, the Bundesbank participates in the Financial Stability Table (FST) of the Economic and Financial Committee (EFC). One focal point of the past year's work was to pursue progress made in implementing the recommendations of the Brouwer reports on financial stability and the management of financial crises. Within the European System of Central Banks the Bundesbank participates in the stability analyses of the Banking Supervision Committee (BSC), on which, beside the central banks, the national supervisory authorities within the EU are also represented. In 2003 the Eurosystem published two BSC reports on the stability of the European banking sector. In addition, in the year under review the subjects of crisis management and structural developments in the EU banking system, in particular, were discussed at length. The current focus is on the analysis of credit risk transfers.

First German stability report in December

The Bundesbank's December 2003 *Monthly Report* included the first publication of a report on the stability of the German financial sector. The report dealt, in particular, with developments in the real economy, international financial markets and the system relevant intermediaries or groups of intermediaries. From now on, the Bundesbank will publish its assessments of financial stability and potential risks on a regular basis.

VIII UN/EU financial sanctions: new developments

Basic principles

Of the restrictions on the movement of capital and on payments (financial sanctions) currently in force in Germany, some are based on United Nations requirements while others have been enacted directly by the European Union. They are regularly part of directly applicable rules under Community law and generally freeze the funds of the listed natural and legal persons and other groups and entities and prohibit funds from being made available to these entities.[1]

UN sanctions against Usama bin Laden, the Taliban and the Al-Qaida network

The list of persons and entities associated with Usama bin Laden, the Al-Qaida network and the Taliban, against whom financial sanctions are in force,[2] was amended 17 times during the period under review.[3]

Moreover, the addition of interest or other earnings due on blocked accounts is expressly permitted, among other things. This interest and these other earnings are frozen in the same manner as the account to which they are added. An option of permitting certain exceptions in the case of specifically defined payments was added to the Regulation[4]; however, it has not been of any practical relevance yet.

UN sanctions to combat terrorism

UN sanctions have been implemented in the Community by means of Council Regulation (EC) No 2580/2001 of 27 December 2001 on specific restrictive measures directed against certain persons and entities with a view to combating terrorism.[5] The persons and entities to which this Regulation applies are determined separately by the Council – most recently in its Decision of 22 December 2003.[6] The competent authorities in the member states – in Germany, the Deutsche Bundesbank – may grant authorisations to use funds. This option has not been used in practice so far.

UN sanctions against Iraq

UN financial sanctions against Iraq were changed following the second Gulf War and regime change in Iraq. Sections 52 and 69e of the Foreign Trade and

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1 Further details on the structure of the regulations and the legal basis, as well as key contents of these legal acts, may be found in the Deutsche Bundesbank's Annual Reports for the years 2001 (pp 170-174) and 2002 (pp 158-160) as well as in the Deutsche Bundesbank's *Monthly Report* for April 2003 (pp 69-75).
2 Council Regulation (EC) No 881/2002 of 27 May 2002, OJ L 139 p 9.
3 Last amended by Commission Regulation (EC) 2157/2003 of 10 December 2003, OJ L 324 p 17.
4 Council Regulation (EC) No 561/2003 of 27 March 2003, OJ L 82 p 1.
5 OJ L 344 p 70.
6 2003/902/EC, OJ L 340 p 63.

Payments Regulation were repealed with effect from 27 August 2003. They made, in particular, access to bank accounts, safe custody deposits or other assets managed or held in safe custody with resident credit institutions and belonging to Iraq, official bodies in Iraq or their authorised representatives, access by these bodies to assets held with non-resident credit institutions, and payments specified in section 69e of the Foreign Trade and Payments Regulation subject to authorisation by the Bundesbank.

Council Regulation (EC) No 1210/2003,[1] which implements UN Security Council Resolution 1483 (2003), imposed restrictions on financial relations with Iraq for the first time in Community law.

The restrictions under Community law initially provide for the freezing of all funds and economic resources of the Government of Iraq and public bodies, corporations or agencies located outside Iraq on 22 May 2003. The affected bodies are listed in Annex III of the Regulation.[2]

Moreover, funds belonging to former President Saddam Hussein, senior officials of his regime, immediate members of their families or legal persons, bodies or entities owned or controlled directly or indirectly by the aforementioned persons or by any natural or legal person acting on their behalf or under their direction, are to be frozen. Annex IV of the Regulation lists these persons, bodies and entities. No funds are permitted to be made available, directly or indirectly, to or for the benefit of the persons mentioned above.

Frozen assets may be unfrozen only for the purpose of their transfer to the Development Fund for Iraq held by the Central Bank of Iraq under the conditions set out in UNSC Resolution 1483 (2003). In a derogation, the competent national authorities may, in accordance with the change in the sanctions pursuant to Council Regulation (EC) No 1799/2003[3] and under the specific conditions listed, authorise the release of frozen funds if they are the subject of a judicial, administrative or arbitral lien or judgement. No use has been made of this option so far.

1 Of 7 July 2003, OJ L 169 p 6, last amended by Commission Regulation (EC) No 2204/2003 of 17 December 2003, OJ L 330 p 7.
2 The public bodies, corporations and agencies and natural and legal persons, bodies and entities of the previous government of Iraq listed in Annex III were named for the first time in Commission Regulation (EC) No 2119/2003 of 2 December 2003, OJ L 318 p 9.
3 Of 13 October 2003, OJ L 264 p 12.

UN sanctions against Libya

No decision has yet been taken on lifting the UN financial sanctions against Libya (section 69n of the Foreign Trade and Payments Regulation). These were suspended with effect from 5 April 1999.

EU sanctions against the Federal Republic of Yugoslavia

The financial sanctions against the Federal Republic of Yugoslavia[1] continue to apply unchanged. They were limited to Slobodan Milosevic and 12 other persons on 21 June 2001.[2] The European Commission alone may grant exemptions for humanitarian purposes. No practical use has been made of this option yet.

EU sanctions against Zimbabwe

The EU financial sanctions imposed on Zimbabwe pursuant to Council Regulation (EC) No 310/2002[3] continue to apply unchanged; this Regulation's period of application was extended until 20 February 2004.[4] The Bundesbank may grant exceptions in respect of the Zimbabwe sanctions. No use has been made of this option so far.

EU sanctions against Burma/Myanmar

The list of persons affected by the EU sanctions imposed on Burma/Myanmar[5] was most recently amended by Commission Regulation No 2297/2003.[6]

Financial Sanctions service centre

On 1 July 2003 the Bundesbank restructured its operations regarding financial sanctions and established a Financial Sanctions service centre based at Munich Regional Office. The Financial Sanctions service centre is the banking sector's main point of contact for all matters pertaining to the implementation of UN and EU financial sanctions.

IX Economic Research Centre

Last year the Economic Research Centre continued to promote academic research at the Bundesbank and to present the results to the public. This is testimony to the willingness to use new scientific methods to analyse economic developments and to answer unresolved questions. Thus, the Bundesbank's eco-

1 Council Regulation (EC) No 2488/2000 of 10 November 2000, OJ L 287 p 19.
2 Council Regulation (EC) No 1205/2001 of 19 June 2001, OJ L 163 p 14.
3 Of 18 February 2002, OJ L 50 p 4, last amended by Commission Regulation (EC) No 1643/2002 of 13 September 2002, OJ L 247 p 22.
4 Council Regulation (EC) No 313/2003 of 18 February 2003, OJ L 46 p 6.
5 Council Regulation (EC) No 1081/2000 of 22 May 2000, OJ L 122 p 29.
6 Of 23 December 2003, OJ L 340 p 37.

nomic research aims to improve the basis for monetary policy decisions over the long term.

Discussion papers on wide range of topics

The Economic Research Centre published 18 discussion papers during the year under review. The vast majority were written by Bundesbank staff. Some of the authors were visiting scholars working at the Bundesbank for a limited period. The discussion papers provide an insight into research work at the Bundesbank and are generally intended as a basis for articles published in economics journals. They covered a wide range of topics, although monetary issues naturally took centre stage. These included several papers on the Bundesbank's monetary policy stance prior to the launch of European monetary union. One finding was that the Bundesbank apparently, and with good reason, attached great importance to developments in the money stock when taking its decisions. Many research papers had cast doubt on this assertion in previous years. Other discussion papers contributed to an improved understanding of events on the financial markets. The money market and the behaviour of commercial banks during the central bank's open market operations were subjects of particular interest. In addition, other financial markets of importance to the transmission channels of monetary policy and to the stability of financial systems were also analysed. The apparent increase in volatility on the German share market was studied, as was the question of how much the previous sharp swings in the DAX can be attributed to a decrease in rational behaviour on the part of market participants.

For some time now, the Economic Research Centre has sought to explain the determinants and consequences of foreign direct investment. Foreign direct investment has grown especially rapidly and can have an increasing impact on the economy of the host country and on that of the investor's home country alike. For this purpose, among other things, a database with relevant micro data was established. A number of researchers have been working with these data since last year, and in 2003 two discussion papers from this field of research were published.

Extensive conference programme

During the year under review the Economic Research Centre held or co-hosted three conferences. The fifth spring conference was dedicated to the topic of "Monetary policy: How relevant are other policymakers". Theoretical papers on the relationship between monetary policy and fiscal policy were presented, and the consequences for an optimal economic policy were discussed. This fundamental issue is also interesting in the light of the economic policy debate about the European Stability and Growth Pact. In addition, the pros and cons of the international coordination of economic policy in general and of monetary policy in particular were discussed. In the autumn the Economic Research Centre, together with the University of Frankfurt's Center for Financial Studies, organised a conference on "Expectations, learning and monetary policy". It also co-hosted a conference on "The Euro area as an economic entity" with the Summer Institute of the Centre for Economic Policy Research.

Various contacts with other research institutions

Contacts between the Economic Research Centre and other researchers were also strengthened through various other channels. The Economic Research Centre hosted two regular series of seminars, one of which jointly with the research department of the European Central Bank and the University of Frankfurt's Center for Financial Studies. Conversely, Bundesbank staff took part in similar events held by other organisations. Bundesbank staff need to be constantly and systematically learning new methods and their application in order to maintain and improve their high standards of research and scholarship. The Economic Research Centre has therefore organised a variety of further training courses. In addition, researchers from the Bundesbank are active in a joint programme run by the European System of Central Banks with the purpose of analysing the inflation process in Europe. Finally, a number of German and foreign researchers spent time at the Economic Research Centre doing research as visiting scholars.

Applications of the macro-econometric model

The Economic Research Centre is also involved with econometrics, and this includes the Bundesbank's multi-country model. The model assists with the development of macroeconomic projections for Germany and is needed to provide a quantitative assessment of the impact of economic policy measures and of exogenous shocks. In the past year the Bundesbank's model was used within the ESCB both for forecasting and for simulating the impact of economic policy measures. In addition, various economic policy scenarios were simulated in cooperation with staff of the German Council of Economic Experts for the Assessment of Overall Economic Trends.

X Technical central bank cooperation

Last year, the Bundesbank's activities within the framework of technical central bank cooperation again meant that it worked closely with central banks from

Technical central bank cooperation: main areas of activity

Chart 27

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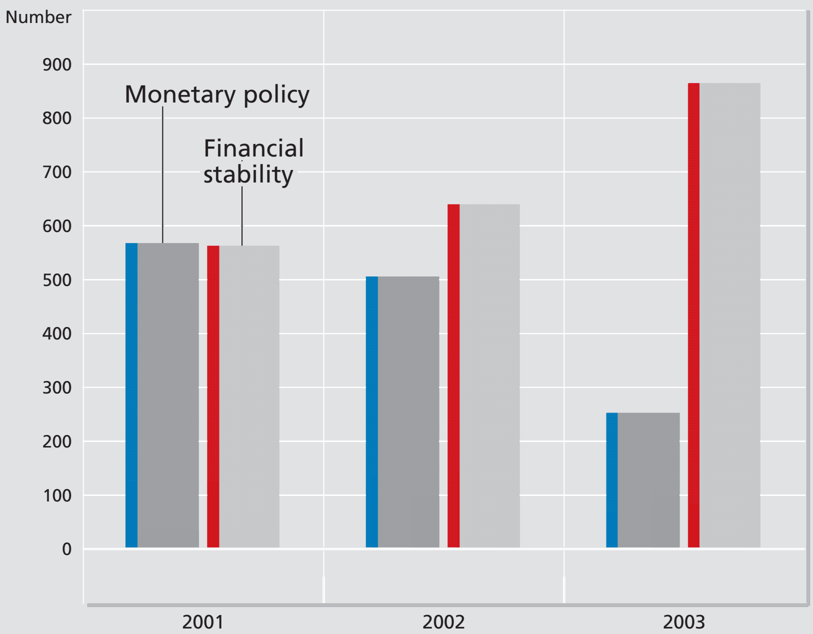
developing countries, emerging market economies and transition countries. The fundamental concern was the setting up of market-oriented central bank systems as a basis for stability and growth throughout the world. In all, some 2,100 central bank employees from 70 countries took part in around 200 training activities in Germany and abroad in 2003. As in previous years, the focus was on the EU acceding countries as well as on Russia and China. Hence, despite the internal strains associated with the reorganisation of the Bundesbank, the level of activities in 2002 was not only maintained but, encouragingly, was slightly increased. Nevertheless, as in previous years, the Bundesbank was not fully able to meet the continuing high demand for technical central bank cooperation services.

In terms of content, technical central bank cooperation covers the entire economic, operational and legal area of modern central banking business issues. Recently, the professional focus has increasingly shifted from monetary policy problems towards issues in connection with financial stability and practical central bank topics.

Number of participants in main topic areas covered by Technical Central Bank Cooperation Division

Chart 28



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The Bundesbank has a wide range of instruments at its disposal for implementing technical central bank cooperation and it tailors these to the needs of each of its partner central banks. The monthly international central banking seminars on certain key areas are primarily directed at fairly young, well-trained junior members of staff who are meant to gain some initial international experience to add to the knowledge they have already acquired. The Technical Central Bank Cooperation Division organises specialist seminars on specific central banking topics for smaller groups of central bank staff in Germany and abroad. Specific issues can be clarified in greater detail during specialist visits by foreign central bank employees to the relevant Bundesbank departments or through consultancy programmes abroad involving Bundesbank experts. These activities mostly form a part of individually tailored projects.

Since 1992, over 15,000 specialists from all over the world have taken part in around 1,600 Bundesbank training events. The international demand for the Bundesbank's technical central bank cooperation services seems set to continue in 2004.

XI Organisation and staff

Further substantial cut in core staff owing to structural measures

The changes in the organisation of operations, the new branch strategy and the change in business policy regarding cash services had a perceptible impact on the Bundesbank's staffing during the year under review. The number of core staff has fallen by 1,184 (or around 7.8%) to 14,029, mainly affecting the branches. Staff were relocated from the Regional Offices to the Central Office, but this was largely the result of a change in organisational allocation and did not constitute a mass migration of staff. There was one distinct feature at the end of 2003 in that the short-term employment contracts in the branch network expired on 31 December and, for this reason, the actual reduction in staff numbers in the end was approximately 10%.

Personnel management measures accompanying the Bundesbank's structural reform

As a result of the organisational restructuring of the Bundesbank, increased demands are being made on the flexibility of many employees. In order to reduce any social hardship arising from this restructuring process, the Executive Board and the staff representative bodies agreed a series of accompanying measures. Instruments to promote mobility and encourage the acquisition of appropriate specialist qualifications for the new areas of work were used to ensure that employees are transferred from surplus areas of work to those which hold more promise for the future.

Number of training positions fall owing to reforms

Owing to the fact that fewer staff will be needed in the future, far fewer trainee civil servants began career training during the year under review than in previous years (272 compared with 347 the previous year).

By contrast, the number of business training vacancies remained at a high level (288 compared with 274 in 2002). This means that, in order to make a contribution to reducing youth unemployment, the Bundesbank again offered a much higher number of training positions to school leavers in the year under review than would be consistent with the number of junior members of staff it requires itself.

Bundesbank staff at European Central Bank

At the end of the year under review 76 members of the Bundesbank's staff were on secondment to the European Central Bank (ECB). Some of these secondments date back to the time of the European Monetary Institute (EMI), the ECB's predecessor. Most of the seconded members of staff at the ECB are employed at professional and managerial levels.

Bundesbank staff on 31 December 2003 *

Table 26

Item	Staff numbers 1				Changes from previous year			
	Total	Regional offices 2	Branch offices	Central Office 2	Total	Regional offices 2	Branch offices	Central Office 2
Civil servants	6,374	1,806	2,791	1,777	– 93	– 546	– 265	+ 718
Salaried staff	7,557	1,720	4,067	1,770	– 1,057	– 532	– 804	+ 279
Wage earners	658	214	297	147	– 95	– 18	– 71	– 6
Total	14,589	3,740	7,155	3,694	– 1,245	– 1,096	– 1,140	+ 991
of which Trainee civil servants/other trainees 3	560	151	220	189	– 61	– 55	– 54	+ 48
Core staff	14,029	3,589	6,935	3,505	– 1,184	– 1,041	– 1,086	+ 943
of which Staff with permanent contracts	13,607	3,565	6,566	3,476	– 855	– 1,019	– 780	+ 944
Staff with temporary contracts	422	24	369	29	– 329	– 22	– 306	– 1
Memo item Core staff pro rata	13,194.1	3,384.5	6,448.2	3,361.4	– 1,151.6	– 1,041.0	– 1,034.7	+ 924.1

	End-2003	End-2002
* Not included:		
Members of staff on secondment for 12 months or more	119	121
Members of staff on unpaid leave	612	656
Members of staff in the second phase of the age-induced part-time employment scheme	374	330
1 *Of which* part-time employees	1,965	2,019
2 In the course of the restructuring, staff from the Regional Offices were relocated to the Central Office		
3 Other members of staff undergoing training: civil servants changing their career path	31	70

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Part-time work

The Bundesbank endeavours to comply as far as possible with the wishes of its employees regarding part-time work. At 14%, the ratio of part-time employment was slightly up from the previous year (13.3%). Part-time employees work on average around 58% of the hours worked by full-time employees. 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 13,194 full-time employees (in 2002, the number was 14,346; there was a fall of approximately 8%).

Age-induced part-time work

The regulations governing age-induced part-time work agreed in the wage settlement for public sector employees in 1998 are also widely applied at the Bundesbank. On 31 December 2003, 899 members of staff were engaged in age-induced part-time work. 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. Three hundred and seventy-four employees have now entered the second pre-retirement phase.

Training activities accompanying structural reform strengthened

During the year under review, training at the Bundesbank was focused on qualifying staff for the reorganised work procedures and functions associated with the structural reform. A large proportion of the training took the form of project-accompanying training sessions in, for example, standardising bank-specific SAP applications, account management and cash management.

Managers in a process of change

A further focus in the year under review was on management training. Some 250 managers from the branches, Regional Offices and the Central Office devised ideas for successful self-management and constructive solutions for individual leadership situations in the current process of change with external trainers in three-day seminars.

Basel II qualification programme intensified

Employees continued to be intensively trained during the year under review in preparation for future tasks in connection with the Basel Capital Accord, "Basel II". Sixty-three seminars with around 1,050 participants took place in all for Bundesbank and Federal Financial Supervisory Agency staff to prepare for the Supervisory Review Process.

Annual accounts of the Deutsche Bundesbank for 2003

I Balance sheet of the Deutsche Bundesbank as at 31 December 2003

Assets

				31.12.2002
			€ million	€ million
1	Gold and gold receivables		36,533	36,208
2	Claims on non-euro-area residents denominated in foreign currency			
	2.1 Receivables from the IMF	7,609		(8,272)
	2.2 Balances with banks, portfolio investment, external loans and other external assets	32,538		(40,525)
			40,147	48,797
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	129,912		(87,094)
	5.2 Longer-term refinancing operations	32,279		(36,144)
	5.3 Fine-tuning reverse operations	—		(—)
	5.4 Structural reverse operations	—		(—)
	5.5 Marginal lending facility	89		(2,241)
			162,280	125,479
6	Other claims on euro-area credit institutions denominated in euro		2	1
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	1,225		(1,225)
	9.2 Claims arising from the transfer of foreign reserves to the ECB	12,247		(12,247)
	9.3 Claims related to the allocation of euro banknotes within the Eurosystem (net)	—		(—)
	9.4 Other claims within the Eurosystem (net)	4,221		(5,036)
			17,693	18,507
10	Items in course of settlement		34	26
11	Other assets			
	11.1 Coins	458		(380)
	11.2 Tangible and intangible fixed assets	1,977		(2,039)
	11.3 Other financial assets	2,494		(2,454)
	11.4 Off-balance-sheet instrument revaluation differences	—		(—)
	11.5 Accruals and prepaid expenses	722		(1,027)
	11.6 Sundry items	359		(425)
			6,010	6,325
			267,439	240,083

Liabilities

				31.12.2002
			€ million	€ million
1	Banknotes in circulation		121,369	104,543
2	Liabilities to euro-area credit institutions related to monetary policy operations denominated in euro			
	2.1 Current accounts	44,523		(44,791)
	2.2 Deposit facility	75		(47)
	2.3 Fixed-term deposits	—		(—)
	2.4 Fine-tuning reverse operations	—		(—)
			44,598	44,838
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	58		(43)
	4.2 Other liabilities	497		(598)
			556	640
5	Liabilities to non-euro-area residents denominated in euro		7,650	7,128
6	Liabilities to euro-area residents denominated in foreign currency		8	11
7	Liabilities to non-euro-area residents denominated in foreign currency		2,785	1,848
8	Counterpart of special drawing rights allocated by the IMF		1,426	1,570
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)	44,590		(29,129)
	9.3 Other liabilities within the Eurosystem (net)	—		(—)
			44,590	29,129
10	Items in course of settlement		1	1
11	Other liabilities			
	11.1 Off-balance-sheet instruments revaluation differences	—		(—)
	11.2 Accruals and income collected in advance	154		(152)
	11.3 Sundry items	4,388		(90)
			4,543	242
12	Provisions		5,603	5,506
13	Revaluation accounts		29,063	34,191
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 (at 31.12.2002 Distributable profit)		248	5,437
			267,439	240,083

II Profit and loss account of the Deutsche Bundesbank for the year 2003

				2002
			€ million	€ million
	– Interest income	4,867		(6,038)
	– Interest expense	– 1,586		(– 1,882)
1	Net interest income		3,281	4,156
	– Realised gains/losses arising from financial operations	544		(2,058)
	– Write-downs on financial assets and positions	– 2,328		(– 64)
	– Transfers to/from provisions for general risks, foreign exchange risks and price risks	274		(68)
2	Net result of financial operations, write-downs and risk provisions		– 1,511	2,062
	– Income from fees and commissions	58		(54)
	– Expense relating to fees and commissions	– 11		(– 12)
3	Net income from fees and commissions		47	42
4	Income from participating interests		201	639
5	Net result arising from allocation of monetary income		– 91	41
6	Other income		54	60
7	**Total net income**		1,982	7,000
8	Staff costs		1,000	1,021
9	Other administrative expenses		263	316
10	Depreciation on tangible and intangible fixed assets		172	192
11	Banknote printing		82	68
12	Other expenses		217	79
13	**Profit for the year**		248	5,324

Frankfurt am Main, 18 February 2004

DEUTSCHE BUNDESBANK

Executive Board

Ernst Welteke   Dr Jürgen Stark

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

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

Auditor's report

We have audited the annual financial statements, together with the bookkeeping system, of the Deutsche Bundesbank for the financial year from 1 January 2003 to 31 December 2003. 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 § 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 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, 17 March 2004

Ernst & Young		PwC Deutsche Revision	
Aktiengesellschaft		Aktiengesellschaft	
Wirtschaftsprüfungsgesellschaft		Wirtschaftsprüfungsgesellschaft	
Graf von Treuberg	Havas	Kütter	Borgel
Wirtschaftsprüfer	Wirtschaftsprüfer	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 cost 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, as last amended by the Seventh Act amending the Bundesbank Act of 23 March 2002 (Federal Law Gazette I, page 1159), 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 2000 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 whereas the remaining 92% has been allocated to the 12 NCBs. The Bundesbank has a 27.8% share in accordance with the banknote allocation key. This is equivalent to 92% of the Bundesbank's share (30.2%) in the paid-up capital of the ECB. 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 NCB in accordance with the banknote allocation key and the value of the euro bank-

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).

notes that it actually puts into circulation also gives rise to remunerated intra-Eurosystem balances.[1] If the value of the euro banknotes 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 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 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 2003 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 31 December

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).

2003. The interim profit distributed for 2003 has therefore been transferred back to the ECB.

Change in ECB capital key on 1 January 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. On 1 January 2004 a corresponding adjustment was made for the first time since the establishment of the ECB. A further adjustment to the capital key will be made on 1 May 2004 in connection with the accession of the ten new countries to the EU. Based on the EU Council Decision of 15 July 2003 on the statistical data to be used for the adjustment of the key for subscription to the capital of the European Central Bank, the Bundesbank's share in the ECB capital key is reduced from 24.5% up to 31 December 2003 to 23.4% from 1 January 2004. The shares of the 12 national Eurosystem central banks in the ECB's fully paid-up capital will also be adjusted in this connection; accordingly, the Bundesbank's share in the fully paid-up capital is reduced from 30.2% up to 31 December 2003 to 29.4% from 1 January 2004. The following are the main effects that this will have on the Bundesbank balance sheet from 1 January 2004: the "Participating interest in the ECB" shown in asset sub-item 9.1 declines by €54 million to €1,170 million owing to the repayment of part of the deposited capital; the Bundesbank's euro-denominated claims arising from the transfer of foreign reserves to the ECB decline from €12,247 million to €11,702 million (asset sub-item 9.2). The reduction in the contribution of capital and in the claims arising from the transfer of foreign reserves were settled with the ECB as TARGET payments at the beginning of January.

Preparation and auditing of annual accounts

The Executive Board drew up the Bundesbank's annual accounts for the financial year 2003 on 18 February 2004. The annual accounts were audited by Ernst & Young Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Frankfurt am Main, and PwC Deutsche Revision Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Frankfurt am Main, which the Executive Board had appointed as external auditors on 18 December 2002 in accordance with section 26 (3) of the Bundesbank Act. The Federal Court of Auditors, the Governing Council of the ECB and the Council of the European Union were party to the appointment. The auditors confirmed without qualification on 17 March 2004 that the Bundesbank's annual accounts for 2003 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, on 24 March 2004, approved the transfer of the Bundesbank's profit to the Federal Government and the publication of the annual accounts.

V Notes on the individual balance sheet items

1 Assets

Gold and gold receivables

At the end of 2003 the Bundesbank's holdings of fine gold (ozf) amounted to 111 million ounces. The gold was valued at market prices at the end of the year (1 ozf = €330.364). In the year under review the gold holdings declined by 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 €7,609 million (SDR 6,459 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 (€15,323 million) and the euro balances amounting to €9,254 million (SDR 7,856 million) at the disposal of the IMF at the end of the year. In 2003 there was a net increase of SDR 227 million in the holdings of drawing rights on the IMF, mainly as a result of the euro withdrawals and repayments of other member countries.

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. The level of special drawing rights held at the end of 2003 amounted to €1,540 million

Receivables from the IMF

Table 27

Item	31.12.2003 SDR million	31.12.2003 € million	31.12.2002 SDR million	31.12.2002 € million	Change from previous year SDR million	%	€ million	%
Drawing rights within the reserve tranche (net)	5,152	6,069	4,925	6,384	+ 227	+ 4.6	– 315	– 4.9
Special drawing rights	1,307	1,540	1,456	1,888	– 149	– 10.2	– 348	– 18.4
Total	6,459	7,609	6,381	8,272	+ 78	+ 1.2	– 663	– 8.0

Deutsche Bundesbank

(SDR 1,307 million) compared with €1,888 million (SDR 1,456 million) on 31 December 2002. Increases totalling SDR 81 million, mainly as a result of interest credited, were accompanied by decreases amounting to SDR 230 million arising from voluntary sales.

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 2003.

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 = €1.1780).

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 €32,538 million at the end of 2003 compared with €40,525 million on 31 December 2002. These are almost exclusively US dollar holdings amounting to US$40,332 million (= €31,934 million), representing a decline of US$1,478 million from the previous year. This sub-item also contains holdings in yen (¥80,869 million = €599 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$36,818 million. Last year the Bundesbank reduced its net US dollar position by US$3,068 million. 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$1.263 (compared with €1 = US$1.0487 at the end of the previous year).

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

Table 28

Item	31.12.2003	31.12.2002	Change from previous year	
	€ million	€ million	€ million	%
Current account holdings and overnight deposits	735	660	75	11.3
Claims arising from reverse repurchase agreements (reverse repos held in US dollars)	3,706	4,103	– 397	– 9.7
Fixed-term deposits and deposits at notice (held in US dollars)	5,210	5,755	– 545	– 9.5
Marketable securities	22,762	29,861	– 7,099	– 23.8
of which: amount held in US dollars	22,551	29,537	– 6,986	– 23.7
Other	125	146	– 21	– 14.3
Total	32,538	40,525	– 7,987	– 19.7

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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 €36,801 million higher than on 31 December 2002.

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 two-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 bidding rate. At the end of the year the main refinancing operations amounted to €129,912 million, which was €42,818 million more than the level on 31 December 2002 (€87,094 million). On a daily average the main refinancing operations amounted to €103,322 million (2002: €65,764 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 €32,279 million at the end of 2003 and was therefore €3,865 million below that of the previous year. On a daily average of the year the volume of longer-term refinancing operations amounted to €32,214 million (2002: €37,092 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 2003 had declined by €2,152 million since the previous year to €89 million. The extent to which it was being used on a daily average of the year amounted to €205 million (2002: €188 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 Maastricht 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 within the Eurosystem, both on the ECB and on the other central banks participating in the Eurosystem, are combined in this item.

Sub-item 9.1 "Participating interest in the ECB" is the Bundesbank's participating interest in the ECB. Pursuant to Article 28 of the ESCB Statute, the national central banks are the sole subscribers to the capital of the ECB. Subscriptions depend on capital shares, which are fixed in accordance with Article 29 of the statute and are revised and adjusted every five years (see the explanatory notes in *General information on annual accounts* regarding the change to the capital key). On 31 December 2003 the Bundesbank had a 24.5% share (€1,225 million) of the ECB's capital of €5 billion. This was equivalent to a 30.2% share of the total capital paid in by the 12 national central banks in the Eurosystem.

Sub-item 9.2 "Claims arising from the transfer of foreign reserves to the ECB" 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. On 31 December 2003 the Bundesbank's share of the foreign reserves transferred was unchanged at €12,247 million. As the transferred gold does not earn interest, the claim is 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 banknote allocation key. As at the end of 2002, the Bundesbank again had no claims at the end of the 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. At the end of the year the Bundesbank obtained from its assets and liabilities net claims amounting to €4,474 million (2002: €4,811 million). The TARGET settlement balances are remunerated at the current main refinancing rate. This item also contains the liabilities arising from the allocation of monetary income amounting to €91 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 €161 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).

Tangible and intangible fixed assets

Table 29

€ million

Item	Purchase/ production costs 31.12.2002	Additions	Disposals (net)	Accumulated depreciations	Book value 31.12.2003	Book value 31.12.2002	Depreciation 2003
Land and buildings	3,186	91	– 16	– 1,457	1,768	1,795	– 102
Furniture and equipment	814	31	– 2	– 632	197	228	– 59
Computer software	91	7	– 0	– 84	12	15	– 10
Total	4,091	128	– 18	– 2,173	1,977	2,039	– 172

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Other assets

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

Sub-item 11.2 "Tangible and intangible fixed assets" amounted to €1,977 million compared with €2,039 million in 2002; it comprises the Bundesbank's land and buildings, furniture and equipment and computer software.

Sub-item 11.3 "Other financial assets" amounting to €2,494 million contains the Bundesbank's fixed-interest euro assets (€2,442 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, Frankfurt am Main, amounted to €38 million. The 30% participating 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.

After the redistribution of shares in accordance with the constitution during the year under review 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 2003. These chiefly consist of interest income which is due in the new financial year from securities denominated in US dollars, loans and other assets which were acquired or transacted 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 2003, the Bundesbank had a 27.8% share of the value of all euro banknotes in circulation. In the year under review the total value of banknotes in circulation within the Eurosystem rose significantly, namely from €358,519 million to €436,240 million. Accordingly, the Bundesbank shows holdings of euro banknotes worth €121,369 million at the end of the year (compared with €99,745 million at the end of 2002). As the value of the euro banknotes actually issued by the Bundesbank in the year under review increased disproportionately sharply from €128,874 million to €165,958 million and was therefore more than the allocated amount, the difference of €44,590 million (2002: €29,129 million) is shown in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)". From 2003 the value of Deutsche Mark banknotes still in circulation is shown in liability item 11 "Other liabilities".

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

Sub-item 2.1 "Current accounts" contains the deposits of the credit institutions, amounting to €44,523 million (31 December 2002: €44,791 million), which are used to meet the minimum reserve requirement and settle payments. The main criterion for including these deposits in this sub-item is that the respective business partners appear in the list of institutions which are subject to the minimum reserve regulations in the Eurosystem. On a daily average the current account deposits amounted to €37,909 million (2002: €38,052 million).

Sub-item 2.2 "Deposit facility" (€75 million) contains overnight deposits at a predetermined interest rate (standing facility). On a daily average the deposit facility amounted to €169 million (2002: €151 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 2003 general government deposits amounted to €58 million in all (31 December 2002: €43 million).

The deposits of enterprises and individuals are the main items shown in sub-item 4.2 "Other liabilities". At the end of 2003 these deposits amounted to €497 million compared with €598 million on 31 December 2002.

Liabilities to non-euro-area residents denominated in euro

This balance sheet item, amounting to €7,650 million (31 December 2002: €7,128 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$3,513 million (€2,782 million) compared with US$1,932 million (€1,843 million) in 2002, which have arisen from repurchase agreements (repos).

Counterpart of special drawing rights allocated by the IMF

The counterpart of the special drawing rights allocated by the IMF free of charge and shown as sub-item 2.1 "Receivables from the IMF" on the assets side of the balance sheet corresponds to the allocations of SDRs to the Federal Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,211 million.

Intra-Eurosystem liabilities

The Bundesbank's liabilities within the Eurosystem, both 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. There were no such issues during the year under review.

Sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)" contains the liabilities arising from the application of the banknote allocation key. At the end of the year these liabilities amounted to €44,590 million (2002: €29,129 million) (see liability item 1 "Banknotes in circulation").

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. The net liabilities balance together with the very small settlement balances arising from the traditional correspondent banking operations within the Eurosystem would be shown in sub-item 9.3 "Other liabilities within the Eurosystem (net)". At the end of the year the Bundesbank incurred a net claim arising from these assets and liabilities, and this is shown on the asset side under sub-item 9.4 "Other claims within the Eurosystem (net)".

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 2003. These consist essentially of interest expenditure and payments which are due in the new financial year and which arose in the financial year just ended.

Sub-item-11.3 "Sundry items" consists mainly of the Deutsche Mark banknotes which are still in circulation and which were shown in liability item 1 "Banknotes in circulation" until the end of the financial year 2002. Although Deutsche Mark banknotes have not been legal tender since 1 January 2002, the Bundesbank has publicly undertaken to redeem Deutsche Mark banknotes that are still in circulation for an indefinite period. On the balance sheet date Deutsche Mark banknotes still in circulation amounted to €4,311 million (compared with €4,798 million at the end of 2002).

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 €274 million decline in the provisions is due mainly to the year-on-year reduction in the euro value of

Provisions Table 30

Provision for ...	31.12.2003	31.12.2002	Change from previous year	
	€ million	€ million	€ million	%
General risk	2,490	2,764	– 274	– 9.9
Pension commitments	2,590	2,524	65	2.6
Pre-retirement part-time work	87	89	– 2	– 2.3
Staff restructuring schemes	116	8	108	1,344.4
Other	321	121	199	164.6
Total	5,603	5,506	97	1.8

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the US dollar position (see asset item 2.2 "Balances with banks, security investment, external loans and other external assets").

Following an increase of €33 million, the Bundesbank's provisions for direct pensions amount to €2,201 million; they are 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 €389 million on 31 December 2003 (2002: €356 million).

A provision for pre-retirement part-time work was made for the first time in 1999. It was reduced by €2 million on 31 December 2003 for actuarial reasons. 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 2003 by €108 million to €116 million.

The other provisions were created primarily for losses on disposals arising from the closure of branches and places of business and for unrealised holidays as well as for doubtful liabilities and other expenditure.

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 2003 (revaluation items "new").

Revaluation items "old"

The revaluation items "old" show the difference between the gold position and the US dollar position at their market values on 1 January 1999 and at their

Revaluation accounts

Table 31

Item	Revaluation items "old" € million	Revaluation items "new" € million	Total 31.12.2003 € million	31.12.2002 € million	Change from previous year € million	%
Gold	19,113	9,289	28,402	28,062	340	1.2 %
US dollars	–	–	–	4,396	– 4,396	– 100.0 %
Other foreign exchange	–	0	0	0	– 0	– 3.9 %
Securities	–	661	661	1,734	– 1,073	– 61.9 %
Total	19,113	9,950	29,063	34,191	– 5,129	– 15.0 %

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respective lower values according to the valuation method valid prior to that date. In the balance sheet on 31 December 1998 the values for gold were 1 ozf = DM143.8065 (€73.5271) and for the US dollar US$1 = DM1.5629 (€1 = US$1.2514) while the market values on 1 January 1999 were 1 ozf = €246.368 and €1 = US$1.1668.

Although the valuation gains arising from the initial valuation are not eligible for distribution, they are available for offsetting valuation losses. Besides a dissolution in the case of valuation losses, a dissolution takes place only in the case of reductions in the corresponding assets. In the course of an annual revision all disposals in the year under review are first offset against the acquisitions in that year. A proportionate dissolution of the revaluation items "old" concerned is undertaken only if the end-of-year holdings are below their lowest end-of-year level since the beginning of 1999.

The reduced holdings of US dollars and gold resulted in dissolution amounts of €111 million and €35 million respectively in the year under review. The dissolution amounts are included in the profit-and-loss item 2/sub-item "Realised gains/losses arising from financial operations".

The valuation on 31 December 2003 resulted in valuation losses of €3,781 million on the US dollar item. These losses exceeded the remaining revaluation item "old" amounting to €2,079 million after the dissolution resulting from disposals. Consequently, there was a complete dissolution of this item at the end of the year (see profit and loss item 2/sub-item "Write-downs on financial assets and positions").

The revaluation items "old" were reduced by a total of €2,225 million to €19,113 million.

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 2003 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 €330.364, with the result that the market value of the gold position exceeded its acquisition value and a revaluation item amounting to €9,289 million arose (2002: €8,914 million). In the case of the US dollar position the market value at the end of the year (€1 = US$1.263) was lower than the acquisition value (€1 = US$1.1164), with the result that there was no revaluation gain (2002: €2,205 million) but, instead, a valuation loss as in the case of the yen and SDRs (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 €634 million arose from the valuation of US-dollar-denominated securities; there were also valuation gains of €26 million arising from the valuation of euro portfolios.

Capital and reserves

In accordance with the Bundesbank Act (last amended on 23 March 2002) the liable capital amounts to €2.5 billion. The reserves amount to the statutorily fixed upper limit, which is likewise €2.5 billion.

Profit for the year

The profit and loss account for the year 2003 closed with an annual surplus of €248 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 much lower than in the previous year, falling by €875 million to €3,281 mil-

Interest income

Table 32

Item	2003 € million	2002 € million	Change from previous year € million	Change from previous year %
Interest income in foreign currency				
IWF	96	134	– 38	– 28.0
Current account holdings and overnight deposits	2	3	– 1	– 44.9
Reverse repo transactions	57	90	– 33	– 36.7
Fixed-term deposits and deposits at notice	65	96	– 30	– 31.7
Marketable securities	930	1,655	– 725	– 43.8
Other	9	23	– 14	– 59.3
Total	1,160	2,001	– 841	– 42.0
Interest income in euro				
Main refinancing operations	2,405	2,197	208	9.4
Longer-term refinancing operations	812	1,249	– 437	– 35.0
Fine-tuning operations	–	6	– 6	– 100.0
Marginal lending	7	8	– 1	– 10.9
TARGET balances in the ESCB	95	81	14	17.8
Transfer of foreign reserves to the ECB	244	345	– 101	– 29.2
Net claims related to the allocation of banknotes	–	91	– 91	– 100.0
Financial assets	89	4	85	2,201.2
Other	56	57	– 1	– 2.1
Total	3,707	4,037	– 330	– 8.2
Grand total	4,867	6,038	– 1,171	– 19.4

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lion. Of this total amount, €1,135 million was in foreign currency (primarily foreign reserves) while the euro holdings amounted to €2,146 million (primarily income from bank refinancing less expenses for minimum reserves).

Interest income in foreign currency declined by €841 million from the previous year. This was due primarily to the lower rate of interest on US dollar assets on an annual average. The weaker US dollar and the smaller volume of assets invested also contributed to the fall in interest income.

Interest income in euro declined by €330 million from the previous year. Despite the sharp increase in the volume of the main refinancing operations (increase from €66 billion to €103 billion on an annual average), income from the refinancing of credit institutions (€3,223 million) fell by €236 million. The main reasons for this development were the interest rates for the main refinancing operations and for the longer-term refinancing operations, both of which dropped from 3.3% to 2.3% on an annual average, and the year-on-year decline to €32 billion in the annual average volume of longer-term refinancing operations (2002: €37 billion).

Interest expenditure

Table 33

Item	2003	2002	Change from previous year	
	€ million	€ million	€ million	%
Interest expenditure in foreign currency				
Repo agreements	24	36	– 11	– 31.8
Other	0	0	0	31.0
Total	24	36	– 11	– 31.8
Interest expenditure in euro				
Minimum reserves	884	1,250	– 366	– 29.3
Deposit facility	2	3	– 1	– 35.9
Fixed-term deposits	143	200	– 57	– 28.4
TARGET balances in the ESCB	102	292	– 191	– 65.2
Net liabilities related to the allocation of banknotes	420	87	333	382.5
Other	11	14	– 3	– 24.3
Total	1,561	1,847	– 285	– 15.4
Grand total	1,586	1,882	– 296	– 15.8

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Interest expenses

Interest expenditure declined year on year by €296 million to €1,586 million, essentially as a result of the €285 million fall in interest paid in euro terms. Expenditure on remunerating the minimum reserve volume, which was almost unchanged from the previous year, declined by €366 million as a result of the lower average interest rate of 2.3% (2002: 3.3%). In the case of settlement payments in the Eurosystem interest expenditure related to TARGET balances decreased by €191 million; by contrast, expenditure on remunerating intra-Eurosystem liabilities arising from the allocation of euro banknotes increased by €333 million owing to the sharp rise in the euro banknotes in circulation (see *General information on annual accounts*).

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

The sub-item “Realised gains/losses arising from financial operations” amounted to €544 million compared with €2,058 million in 2002. In the year under review there were realised gains arising from the disposal of gold (€48 million), US dollars (€5 million net) and securities (€584 million) whereas in the case of SDRs and the yen there were realised losses of €92 million and €1 million respectively. The disposals of US dollars and gold resulted in a dissolution of part (€111 million and €35 million respectively) of the revaluation items “old” created on 1 January 1999 (see liability item 13 “Revaluation accounts”). These are included in the realised gains.

Fees and commissions

Table 34

Item	2003	2002	Change from previous year	
	€ million	€ million	€ million	%
Income				
Securities trading and safe custody account business	9	14	– 5	– 33.1
Cashless payments	35	31	3	11.1
Cash payments	10	7	3	44.7
Other	5	2	2	111.1
Total	58	54	4	8.2
Expenditure				
Securities trading and safe custody account business	7	7	0	– 2.1
Other	5	5	– 1	– 14.5
Total	11	12	– 1	– 7.5
Grand total (net income)	47	42	5	12.8

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Most of the valuation losses of €2,328 million recorded in the sub-item "Write-downs on financial assets and positions" occurred in the US dollar position (€1,702 million net), the SDR position (€552 million) and the yen position (€51 million). Owing to the necessary write-down of €3,781 million in the US dollar position, the existing revaluation item "old" amounting to €2,079 million for the US dollar position after dissolution because of disposals was completely cancelled, resulting in a net expenditure of €1,702 million (see liability item 13 "Revaluation accounts").

The sub-item "Transfers to/from provisions for general risks, foreign exchange risks and price risks" contains the reduction in the provision for general risks (€274 million), 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

Net income from fees and commissions rose by a total of €5 million to €47 million compared with the previous year. Whereas the income arising from securities trading and safe custody account business declined, income from the handling of cash and cashless payments rose.

Income from participating interests

This item contains the Bundesbank's profit from its participating interests in the Liquiditäts-Konsortialbank GmbH, the Bank for International Settlements and the European Central Bank. The fall of €438 million in income to €201 million is due almost exclusively to the reduced distribution of profits by 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 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. 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 taken together. 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 €91 million for the Bundesbank (2002: a net claim of €41 million). This liability was due to the difference between monetary income, amounting to €2,438 million, which the Bundesbank paid into the common

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).

pool and the sum, amounting to €2,347 million, reallocated to the Bundesbank corresponding to its share in the paid-up capital of the ECB.

Other income

The remaining income declined year on year by €6 million to €54 million.

Staff costs

Expenditure on staff, which includes the changes in the provisions relating to this item, decreased by a total of €22 million (2.1%) to €1,000 million in 2003. If the additions to and deductions from the provisions are excluded, overall expenditure declined year on year by no more than €14 million (1.6%) despite a discernible fall in the number of staff. The fact that this decline in expenditure was less than what would have been consistent with the reduction in staff was due primarily to 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 as well as to payments already made in connection with staff restructuring schemes in 2003.

Payments to serving members of the Executive Board, former members of the Bank'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 €12,303,461.80 in the year under review.

In the year under review a total of €195 million was spent on retirement pensions including the transfers to provisions for pensions (2002: €257 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 €53 million (16.8%) to €263 million. Most of the reduction in other administrative expenses was due to the reduced expenditure on the maintenance of buildings and on computer hardware and software as well as to the cessation of expenditure on work relating to the introduction of euro banknotes and coins.

Depreciation on tangible and intangible fixed assets

The depreciation of land and buildings, of furniture and equipment and of computer software is shown under asset sub-item 11.2 "Tangible and intangible fixed assets".

Banknote printing

Expenditure on banknote printing increased by €14 million (20.0%) from the previous year because the sharp rise in the number of euro banknotes in circulation in the year under review led to an additional demand for new banknotes.

Other expenses

Other expenses increased by €138 million to €217 million year on year. This was due mainly to the fact that the further streamlining of the branch network in the course of the structural reform necessitated a transfer to the provision for losses on disposals arising from the closure of branches and places of business (see liability item 12 "Provisions").

Branches and operating units of the Deutsche Bundesbank

on 1 April 2004

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]	
830	Gera	L
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]	
	Neumünster[2]	
860	Leipzig	L
545	Ludwigshafen	MZ
230	Lübeck	HH
240	Lüneburg	H
810	Magdeburg	H
	Halberstadt[2]	
550	Mainz	MZ
670	Mannheim	S
840	Meiningen	L
490	Minden	D
310	Mönchengladbach	D
	Krefeld[2]	
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]	
	Ravensburg[2]	
694	Villingen-Schwenningen	S
510	Wiesbaden	F
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