Foreign trade and payments

Overview

The strong growth in German exports which has lasted for more than a year now continued during the third quarter of 1997 and therefore remained the main driving force behind the growth in the German economy. The main reasons for this were both the sustained upward trend in the world economy as a whole and the now fairly significant revival in west European economies, Germany's traditional export markets. However, German exporters would scarcely have been able to benefit from the buoyant export demand to the extent that they did had it not been for the fall in unit wage costs and the return of more favourable exchange rates, which improved their price competitiveness. The outcome was that once again Germany's seasonally adjusted trade surplus – of DM 36½ billion – clearly exceeded the result of the previous quarter, which itself had been a record, at DM 34 billion. With a total seasonally adjusted deficit of approximately DM 31½ billion the trend in the other transactions, which are included in Germany's current account with non-residents and which traditionally run relatively large deficits, at least stabilised. This means that after the elimination of seasonal factors Germany's current account again showed a surplus, which in the period from July to September amounted to DM 5 billion. That was just over DM 2½ billion more than in the previous quarter; in the corresponding period last year, by contrast, it had run a seasonally adjusted deficit of DM 4 billion.

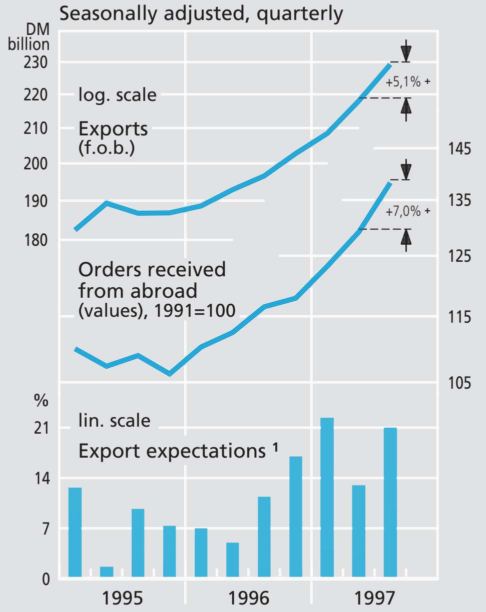
Current account in detail

Exports

The seasonally adjusted value of German exports rose by just over 5 % in the third quarter compared with the previous quarter; it therefore exceeded the result in the corresponding period of 1996 by just over 16½ %. Given the relatively moderate increase in export prices, the rate of growth was only slightly less in real terms, too, at 4½ % and 14 %, respectively, than it had been a year earlier. This means that, in terms of the growth in world trade, which international organisations estimate to be about 7 % in 1997, German exporters were evidently able to exploit the more favourable competitive conditions in export markets to consolidate and extend their position as well as to regain lost market shares.

Export trend

Seasonally adjusted, quarterly



1 Values taken from the ifo business survey. Balances from the positive and negative company reports. — + Change from previous quarter.

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There is a fair chance that this situation will not change fundamentally in the near future. The manufacturing sector is continuing to receive a spate of orders from abroad. The value of orders booked in the third quarter was 7 % higher – and in real terms 6 % higher – than in the previous quarter. According to the ifo business survey, export expectations have not been so high since the boom year of 1994. German exporters, however, cannot ignore the potential risks posed by the still unresolved crisis in South-East Asia and the possible knock-on effects on the industrial countries.

Regional breakdown of exports

The regional breakdown of export demand suggests that exports to the emerging economies in South-East Asia, which until the beginning of this year were showing highly dynamic growth rates, have moderated during 1997 so far without having any adverse effect on the momentum of German export business as a whole. The regional breakdown provided by Germany's foreign trade statistics, which, admittedly, cover the year up to August only, show that exports to that area of the world grew at a less-than-average rate of just over 1%, seasonally adjusted, between May and August compared with the preceding four-month period. Exports to Japan during the period concerned actually declined. By contrast, there was an extremely sharp increase in exports to China whereas in the first four months of the year exports to China had declined. Exports to the central and east European countries in transition, too, continued to rise sharply, at just over 6½ %. The significance of these countries for

German foreign trade is now considerable. They account for approximately 10 % of it. Exports to the OPEC group of countries grew even faster (+ 13 %) although their share of total exports, at just over 2 %, is fairly small.

The full effects of the South-East Asian crisis on German exports are being mitigated mainly by the fact that demand from EU countries, which account for more than one-half of German exports, increased significantly with a seasonally adjusted growth rate of 9½ % compared with the previous four-month period. Owing to the sustained cyclical recovery in west European partner countries, the demand from Germany's traditional export markets provided a significant counterweight to the curbing effect emanating from Asia. Exports to the United States, which account for approximately 8 % of German exported goods, also continued to be marked by considerable growth rates; in the four months from May to August 1997 there was a seasonally adjusted 4½ % rise here compared with the previous four-month period. The momentum with which exports to the United States grew between May and August becomes even clearer when compared with the corresponding period in 1996: the rate of increase amounted to no less than 24½ %.

Breakdown of exported goods

Germany's export trade benefits to an above-average extent whenever there is a revival in investment in a number of west European states and a continuing rapid expansion in investment in other regions. This is because of the relatively large proportion of capital goods in Germany's product range. Accordingly, exports of capital goods between May

Regional breakdown of foreign trade *

May to August 1997, seasonally adjusted

Group of countries/ Country	Exports	Imports	Balance in DM billion 1
	Change from January – April 1997 in %		May – August 1997
Industrial countries	+ 7.9	+ 7.4	30.4
EU countries	+ 9.5	+ 8.4	26.8
of which			
Belgium/Luxembourg	+ 8.4	+ 13.2	1.7
France 2	+ 7.4	+ 7.2	3.5
Italy	+ 10.4	+ 4.7	2.2
Netherlands	+ 10.8	+ 12.4	– 1.2
Spain	+ 10.7	+ 13.9	2.4
United Kingdom	+ 9.4	+ 10.3	7.5
Other industrial countries	+ 3.6	+ 4.7	3.7
of which			
United States	+ 4.5	+ 5.9	5.7
Japan	– 4.1	– 0.8	– 5.0
Countries in transition	+ 9.5	+ 4.5	2.3
of which			
Countries in central and eastern Europe	+ 6.7	+ 0.8	5.6
China 3	+ 32.1	+ 2.9	– 3.3
Developing countries	+ 5.1	+ 1.0	10.1
of which			
OPEC countries	+ 13.1	+ 2.2	2.3
Emerging markets in South-East Asia	+ 1.2	+ 2.3	3.3
All countries	+ 7.9	+ 6.3	44.4

* Countries attributed to individual groups of countries according to the latest position. — **1** The seasonally adjusted balances are subject to considerably greater uncertainty than the basic series from which they are drawn. Discrepancies in the totals are due to separate seasonal adjustments and to rounding. — **2** Excluding aircraft. — **3** Excluding Hong Kong.

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and August (more recent figures on the breakdown of goods are not yet available) showed a considerable increase (7½%, seasonally adjusted) compared with the previous period. Exports of road vehicles and of electrical equipment and apparatus rose particularly sharply. At just over 9½%, the rise in the exports of basic and producer goods was likewise very steep in the four months from May to August compared with January to April whereas export sales of consumer goods increased by no more than 3½%. In view of the orders received from abroad, it is likely that the trend outlined continued more or less unchanged in the third quarter as a whole.

Imports

Imports also gained momentum in the third quarter. The seasonally adjusted rise in the value of imports amounted to almost 5% compared with the previous quarter; if the accompanying rise in import prices during the third quarter is taken into account, however, the rise in real terms, at just under 3½%, was much lower. Consequently, imports exceeded their value in the corresponding period last year by 9% in real terms. Although this rate is appreciably lower than the corresponding increase of 14% in the case of exports, the rise is remarkably high both in terms of the growth in the domestic economy and in terms of total demand. This could be a reflection of the special nature of the breakdown of demand, which is possibly focused more than usual on industries with a lower degree of vertical integration, such as in the case of the motor industry with its closely integrated home and foreign production plant and, as a result, the greater importance of intra-industrial trade. To a certain extent, however, increased stocking of raw materials and primary products also appear to have played a part, not least in view of the rise in prices.

Breakdown of imported goods

At any rate, the breakdown of imported goods also suggests this even though here, too, the figures are available only up to August. These show a sharp seasonally adjusted increase in the purchases of raw materials and primary and semi-finished products in the period from May to August compared with the previous four months. It can also be assumed in the case of many goods which are statistically recorded as finished goods and which are likewise rising at a relatively faster rate that they are products which are destined to be incorporated as component parts into other products during the production process. Nevertheless, the sharp rise in the value of imports is probably also due to price changes as the prices of raw materials during the period under review rose considerably.

Regional breakdown of imports

Evidence from the regional breakdown of German imports (which, like the data on the breakdown of goods, is available only up to August) is also consistent with the account of a buoyant intra-industrial trade given above. For example, the imports from the other EU countries, with which there are close trading links, rose sharply. A typical feature in this connection is the rapid growth in imports from Spain, which is a major production location for the European car industry. Of the non-European industrial countries the United States increased its exports to Germany particularly sharply during the period from May

Current account

DM billion; seasonally adjusted

Item	1997 1st qtr	2nd qtr	3rd qtr
1. Foreign trade			
Exports (f.o.b.)	209.3	218.9	230.2
Imports (c.i.f.)	182.7	185.0	193.9
Balance	26.6	33.9	36.3
2. Services (balance)	– 15.3	– 13.8	– 13.0
of which Foreign travel (balance)	– 12.3	– 13.1	– 11.7
3. Factor income (balance)	– 3.8	– 3.9	– 1.2
of which Investment income (balance)	– 3.5	– 3.4	– 0.7
4. Current transfers (balance)	– 16.6	– 12.8	– 15.6
Balance on current account 1	– 10.7	2.3	5.0

1 Includes supplementary trade items.

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to August compared with the previous period. By contrast, imports from the emerging economies in South-East Asia and from China rose at a below-average rate during the period under review. Imports from the central and east European countries in transition during this period did not keep pace either with the growth rates in previous periods.

Balance on invisibles

The rapidly rising surpluses in the trade in goods were accompanied by large deficits on invisible current transactions with non-residents. These transactions include expenditure by German tourists and business travellers on foreign travel and transfer payments to non-residents. In the three-month period from July to September, which includes the main holiday period, the combined deficit – amounting to just over DM 39 billion compared with DM 28 billion in the previous quarter – was therefore larger for seasonal reasons. If the seasonal factors are eliminated, however, the aggregate deficit in the period under review was, at DM 31½ billion, just as large as it had been in the quarter before.

Services

Service transactions account for about one-half of this deficit. There was a seasonally adjusted deficit here of DM 13 billion in the period under review compared with one of just under DM 14 billion in the previous quarter. This means that, allowing for fairly minor fluctuations from quarter to quarter, the deficit has been virtually unchanged for the past three years now. This is mainly a reflection of the trend in foreign travel, which showed a deficit of just over DM 11½ billion after seasonal adjustment and therefore accounted for almost the whole of the deficit on services account. At DM 13 billion, the net expenditure of German travellers abroad in the previous quarter was slightly higher. Evidently German tourists abroad have either reduced their travel budgets somewhat in view of their more limited earning capacity and, depending on the country visited, the sometimes appreciable cut in purchasing power or they are switching to cheaper packages. This is suggested by the fact that the largest increases in expenditure by German travellers have been recorded in Portugal and Turkey, in some north African countries and in South-East Asian holiday destinations. By contrast, expenditure by German tourists in some major European holiday countries such as Italy, Spain and Austria in the third quarter of

1997 was distinctly below that in the corresponding period last year or, as in the case of France and Switzerland, just failed to reach last year's levels. On the other hand, destinations such as the United States continued to record substantial growth rates despite the considerable increase in prices incurred by German travellers as a result of the sharp appreciation of the dollar. This could indicate relatively low price elasticity but may also be explained by the time lags associated with price changes because in some cases there is a lengthy interval between the time of booking the journey and the time of travel.

Factor income

The seasonally adjusted deficit on factor income declined by DM 2½ billion to just over DM 1 billion in the third quarter. That is a distinct improvement on the result a year earlier when there had been a deficit of DM 5½ billion – a record for this section of the account. As usual, the reason for this was the trend in investment income, which in the period under review showed a deficit of only DM ½ billion compared with one of just over DM 5 billion a year earlier. Investment income receipts amounted to just over DM 30 billion, seasonally adjusted, and expenditure to just under DM 31 billion. This means that there was a 13 % increase in investment income generated abroad compared with the same period last year. The main contributory factor here was probably that, owing to the higher dollar exchange rate, Germany is now receiving rising investment income from its external assets denominated in dollars while the proportion of German external liabilities denominated in dollars and the interest expenditure associated with these are comparatively low. Another point is that total German expenditure on investment declined by 2½ % compared with the same period last year, primarily because German enterprises considerably reduced their dividend payments – which had risen sharply during the same period last year – to foreign shareholders in the period under review ahead of the widely expected tax reform. Since a decision on the planned reform has not yet materialised, this factor will probably become less important in the near future and will actually have the opposite effect for a time owing to the payment of the dividend backlog.

Current transfers

By contrast, Germany's traditionally large deficit on current transfers to non-residents increased further during the third quarter of this year. After the elimination of seasonal variations this deficit rose by almost DM 3 billion since the previous quarter to DM 15½ billion. It must be remembered here, however, that the result for the second quarter was particularly low owing to the change in the timing of contributions to the EC budget. Accordingly, public transfers alone rose by just over DM 3 billion to DM 12 billion; Germany's net current payments to the EC budget were DM 2 billion higher, at just over DM 8½ billion, in the period under review than they had been in the previous quarter. Private transfers, on the other hand, remained virtually unchanged; pensions and other maintenance payments to non-residents were also unchanged at DM 1.2 billion, and the remittances of foreign workers in Germany to their home countries amounted to just under DM 2 billion.

Financial transactions and reserve movements

Trends in financial transactions

The turbulences on the financial markets in Asia also affected the industrial countries and left their mark not least in the German capital account in the autumn. Investors' uncertainty about future developments in the emerging markets apparently resulted in many of them preferring to invest in domestic paper and curbed their interest in investing abroad. In the case of Germany these tendencies can be seen most clearly in portfolio transactions in which the financial flows in both directions declined discernibly between August and October 1997 compared with the previous three-month period. Securities transactions with non-residents closed with net outflows of DM 12 billion compared with DM 2½ billion in the previous period. A net amount of capital was also exported through direct investment. By contrast, a significant volume of funds was imported through credit transactions – mainly through short-term financial transactions on the part of the banks. These transactions were probably associated to a large extent with the liquidation of foreign securities investments on the German market. The net external position of the Bundesbank also declined slightly.

Portfolio transactions

Foreign investment ...

Owing to the growing uncertainty on the international financial markets, non-residents were noticeably hesitant in investing in German securities between August and October 1997. DM 19 billion net was imported in this way, which was only one-third of the funds that had flowed into Germany in the previous three-month period.

Major items of the balance of payments

DM billion

Item	1996 3rd qtr	1997 2nd qtr	1997 3rd qtr
I. Current account			
1. Foreign trade			
Exports (f.o.b.)	191.2	221.3	223.2
Imports (c.i.f.)	164.2	188.2	186.9
Balance	+ 27.1	+ 33.1	+ 36.2
2. Balance of invisibles 1	– 39.3	– 28.1	– 39.2
Balance on current account	– 12.2	+ 5.0	– 3.0
II. Balance of capital transfers	– 1.0	+ 0.4	+ 2.2
III. Financial account 2			
Direct investment	– 9.8	– 7.7	– 9.8
Portfolio investment 3	+ 29.6	– 12.7	+ 3.1
German investment abroad	– 11.3	– 46.5	– 48.8
Foreign investment in Germany	+ 40.9	+ 33.8	+ 51.9
Credit transactions 3, 4	+ 1.2	+ 34.2	– 11.3
Overall balance on financial account	+ 21.0	+ 13.7	– 18.0
IV. Balance of unclassifiable transactions	– 7.5	– 19.5	+ 12.2
V. Change in the Bundesbank's net external assets at transaction values (increase: +) 5 (I plus II plus III plus IV)	+ 0.2	– 0.5	– 6.5

1 Balance on services, factor income, current transfers and supplementary trade items. — 2 Net capital exports: –. — 3 Excluding direct investment. — 4 Including other official and private investment. — 5 Excluding allocation of SDRs and changes due to value adjustments.

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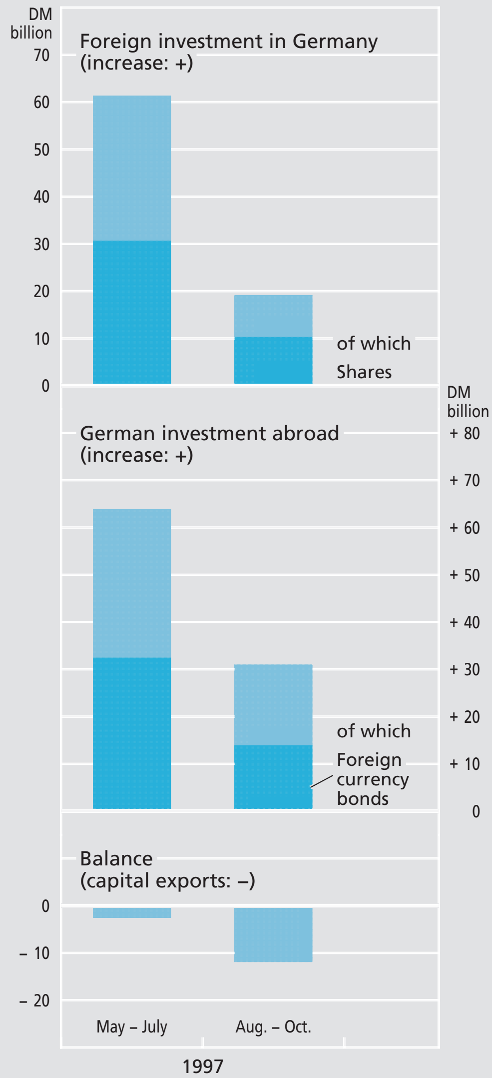
... on the equity market

In terms of the total amount of funds received through non-residents' investment in securities, however, their interest in German equities continued to be fairly high during the period under review. The inflows added up to a net DM 10½ billion; although that is much less than in the months from May to July (DM 30½ billion), it accounted for about one-half of total foreign investment in securities on the German market. This is quite remarkable in that the German equity market was also unable to escape the detrimental factors emanating from abroad and, in line with the general trend, incurred losses. Nevertheless, the profitability of German enterprises was apparently still regarded as favourable, an assessment which was probably due not least to the latest export successes.

... on the bond market

Foreign investment in the German bond market likewise moderated; net investment in the period under review came to no more than DM 16 billion compared with DM 28½ billion between May and July. Non-residents were interested not only in mortgage bonds but also in the foreign currency bond issues of domestic credit institutions – despite the appreciation of the Deutsche Mark against other major currencies. Paper denominated in US dollars and *inter alia* in French francs was in demand. On the other hand, there was selling pressure on government bonds and five-year special Federal bonds whereas the new issue of two-year Federal Treasury notes were well received, especially abroad. In all, non-resident investors purchased domestic bank bonds worth approximately DM 13½ billion and official paper worth DM 2½ billion.

Portfolio transactions



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... in other securities

Transactions by non-residents in the other segments of the German securities market were fairly modest, on balance. Inflows of DM 1½ billion net from the purchases of money market paper were accompanied by outflows of DM 6 billion from the sales of German investment fund certificates[1] and by

1 These are mainly intra-group transactions in connection with specialised funds.

payments (of DM 2½ billion) to non-residents in connection with warrants.

German investment in foreign securities

Following their very heavy portfolio investment abroad during the previous three-month period, German residents likewise cut back significantly on their acquisition of foreign paper between August and October, and DM 31 billion net, barely one-half of the amount invested in the previous period, went abroad as a result. Investment interest focused mainly on foreign bonds (DM 19 billion), especially those denominated in foreign currency (DM 14 billion). It was in this latter segment, however, that the greatest losses were recorded compared with the previous period (DM 32½ billion). The investment currencies in greatest demand from German residents were the French franc and, as part of the so-called convergence trade, the lira, with German credit institutions, among others, adding additional foreign currency bonds to their portfolios.

Bonds

Equities

In contrast to the still considerable foreign investment in the German equity market German residents were decidedly reluctant to invest in foreign equities during the period under review. No more than DM 2 billion was spent in this form of investment during the period. Probably it was not least the uncertainty about the effects of the serious exchange rate shifts in Asia as well as the sharp fall in prices on major foreign stock exchanges that made German investors more cautious, especially as they had purchased foreign equities worth approximately DM 38 billion during the first seven months of the year (the figure for the whole of 1996 was DM 21 billion).

Money market paper and investment fund certificates

At DM 1 billion, somewhat less capital flowed into foreign money market paper in the period under review than in the period between May and July (DM 2½ billion). The yen was the most favoured currency. Contrary to the general trends outlined, demand for foreign investment fund certificates increased during the period under review. German residents purchased certificates in foreign investment companies worth DM 8 billion (previous period: DM 4 billion); it was almost exclusively "traditional" funds that were involved here.

Direct investment

Transactions in the field of direct investment, which are usually not as susceptible to short-term movements in the financial markets as portfolio transactions, likewise declined between August and October compared with the previous three-month period. German direct investment abroad fell from DM 12 billion to DM 10 billion and foreign investment in Germany from DM 3 billion to DM 2 billion. However, the decline, at least in the case of German acquisitions of participating interests abroad, is probably due more to the customary monthly fluctuations than to a general about-turn in the considerable foreign investment of German enterprises. At any rate, German firms have invested more – at a total of DM 39 billion – in their foreign subsidiaries this year so far than they did in the corresponding period last year (DM 31 billion). Another factor suggesting that the strong interest in a further expansion of Germany's presence in foreign markets is continuing is the sharp increase in export business, which has

Financial transactions

DM billion, net capital exports: –

Item	1996 Aug. – Oct.	1997 May – July	1997 Aug. – Oct.
1. Direct investment	– 10.3	– 8.8	– 7.8
German investment abroad	– 9.2	– 11.9	– 9.9
Foreign investment in Germany	– 1.1	+ 3.1	+ 2.2
2. Portfolio investment	+ 22.7	– 2.6	– 11.9
German investment abroad	– 5.9	– 63.9	– 31.0
Shares	– 1.3	– 8.5	– 2.1
Investment fund certificates	– 0.1	– 4.2	– 7.8
Bonds and notes	– 1.8	– 39.2	– 19.0
Money market paper	+ 0.6	– 2.3	– 1.0
Financial derivatives 1	– 3.3	– 9.6	– 1.3
Foreign investment in Germany	+ 28.6	+ 61.3	+ 19.1
Shares	+ 1.2	+ 30.7	+ 10.3
Investment fund certificates	– 0.3	+ 0.7	– 6.2
Bonds and notes	+ 20.8	+ 28.3	+ 16.0
Money market paper	+ 4.8	+ 0.9	+ 1.7
Warrants	+ 2.1	+ 0.7	– 2.7
3. Credit transactions	+ 10.1	+ 7.9	+ 45.9
Credit institutions	– 2.7	– 1.6	+ 35.0
Long-term	+ 1.0	+ 2.1	– 10.7
Short-term	– 3.7	– 3.7	+ 45.7
Enterprises and individuals	+ 6.2	+ 17.1	+ 5.2
Long-term	+ 0.6	+ 0.5	+ 0.1
Short-term 2	+ 5.6	+ 16.6	+ 5.1
Public authorities	+ 6.6	– 7.6	+ 5.7
Long-term	+ 2.6	– 3.8	– 0.5
Short-term	+ 4.0	– 3.8	+ 6.2
4. Other investment	– 1.0	– 0.7	– 1.5
5. Balance of all statistically recorded capital flows	+ 21.4	– 4.2	+ 24.7
Memo item Change in the Bundesbank's net external assets at transaction values (increase: +) 3	+ 3.5	– 3.6	– 3.8

1 Securitised and non-securitised options as well as financial futures contracts. — **2** Excluding the changes in financial operations with foreign non-banks and in the trade credits for October 1997, which are not yet known. — **3** Excluding allocation of SDRs and changes due to value adjustments.

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proved in the past to be a major determinant of German direct investment. In the period under review the United States and Switzerland were the target countries most favoured for German corporate acquisition of participating interests.

Credit transactions of non-banks

As in the three months earlier, there were inflows of capital (amounting to about DM 11 billion) through the credit transactions of non-banks during the period under review. Enterprises and individuals as well as public authorities both drew to a small extent on their (short-term) bank balances in the Euromarket. By contrast, the long-term credit transactions of non-banks were almost completely in balance.

Credit transactions of the banks

There were two-way movements in the non-securitised credit transactions of the banks between August and October 1997. On the one hand, funds amounting to DM 10½ billion net were exported at the long end of the market for the first time in a while because the traditional borrowing of German banks abroad – for example, from their own financing subsidiaries – was more than offset by substantial cross-border loans. On the other hand, a significant volume of short-term funds (DM 45½ billion) accrued to German credit institutions from abroad whereas in the previous three months a deficit had been recorded in this segment of financial transactions. In the process domestic credit institutions increased almost exclusively their short-term external liabilities while their corresponding external assets hardly changed. The influx of funds is probably associated to some extent with the capital exports arising from portfolio transactions and from direct investment. The short-term net external assets of the credit institutions therefore declined significantly during the period under review. As observed above, however, the long-term and the securitised external assets of the banks increased with the result that the net external position of the credit institutions declined less sharply as a whole than is suggested by the short-term credit transactions.

External position of the Bundesbank

The net external position of the Bundesbank likewise declined, the reduction – at transaction values – amounting to approximately DM 4 billion. In contrast to the changes in the external position of the credit institutions, however, most of this arose from transactions on the assets side of the Bundesbank's balance sheet. There was a further fall in monetary reserves (– DM 3 billion) – especially as a result of sales of foreign exchange previously acquired outside the market. On the other hand, the Bundesbank's external liabilities rose by just under DM ½ billion. In November, however, there was again a slight improvement in the Bundesbank's external position. At balance sheet rates, it amounted to DM 98 billion at the end of November compared with DM 105½ billion at the end of 1996.

Exchange rate trends

Foreign exchange markets under strain worldwide

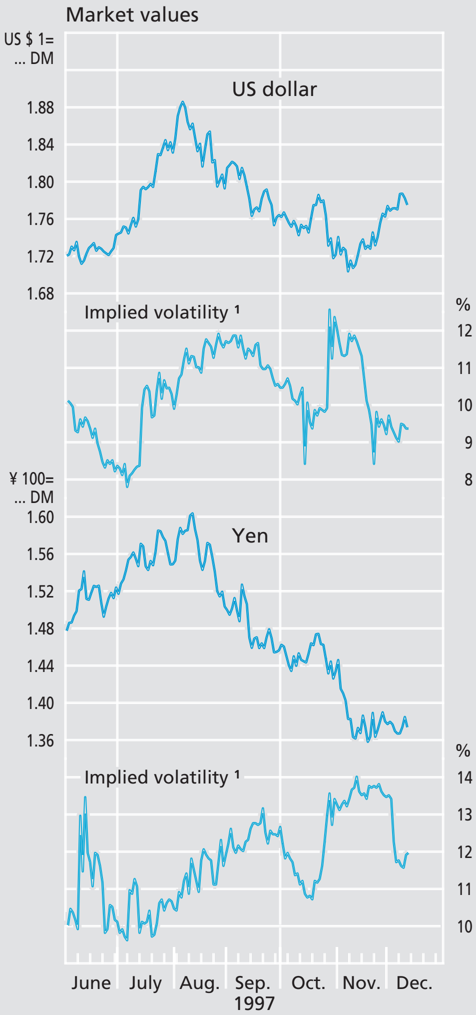
Developments on the global foreign exchange markets during the autumn were strongly influenced by the persistent crisis in the financial markets in South-East Asia. The considerable depreciation of a number of South-East Asian currencies and the marked downward revision of growth expectations in the region influenced the exchange rate trends of major world currencies to varying degrees. In view of the relatively minor links of the German economy with the crisis countries in Asia, the Deutsche Mark fared relatively well. As a result, its depreciation, especially against the dollar, which at the beginning of August had reached its highest point at approximately DM 1.90 to the dollar, was later partially reversed.

Dollar

The slight corrective movement was probably due mainly to the reassessment of growth prospects and inflation expectations as well as to the interest rate prospects for the US and the German economies resulting from this. In Germany as in Europe as a whole the economic situation looked increasingly more favourable than it had done earlier whereas the price climate had temporarily threatened to darken slightly. On the other side of the Atlantic, by contrast, the assessment subsequently spread that the risk of the US economy overheating further and the possibility of a preventative increase in US central bank rates had now probably become somewhat less likely. The consequent change in interest rate expectations in both countries checked the appreciation of the dollar in view of the exchange rate level reached in August and led to a certain degree of consolidation. At the same time the interest rate advantage of dollar assets over corresponding Deutsche Mark paper declined again somewhat.

At the time this Report went to press, the Deutsche Mark was being quoted at DM 1.76

Exchange rate trends of the US dollar and the yen



1 Implied volatilities of at-the-money options with a time to maturity of one month.

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against the US dollar. This means that the US currency had depreciated by about 6½% since the beginning of August; compared with the level at the beginning of the year, however, the appreciation against the Deutsche Mark was as much as 14%. Market participants now seem to regard the level reached as better founded; at any rate, the market's risk assessment, which is reflected in the implied volatility of dollar options, again improved considerably from the significant worsening of its risk assessment during the summer and in the past two months in connection with the further spreading of the currency crisis in South-East Asia.

Yen

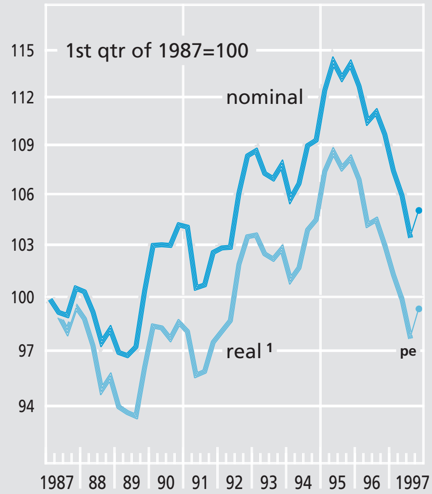
While the trend in the dollar rate during recent months, therefore, has probably to be seen primarily in connection with a certain revision in general growth and interest rate perspectives on both sides of the Atlantic, the yen became directly affected in the past few months by the currency turbulence, which began in Thailand but has since spread as far as South Korea. The substantial investment of Japanese business and the Japanese banks in this region has again exposed the structural weaknesses in the Japanese financial sector and given rise to corresponding pressure on the Japanese currency. At the time this Report went to press, the yen was being quoted at DM 1.36 and therefore about 15% below its record level of DM 1.60 at the beginning of August this year. At the beginning of the year the yen, at DM 1.34, had been a further 2% lower.

EU currencies

The pound sterling joined the dollar and the yen in losing ground against the Deutsche Mark in the late summer. In July, after a lengthy period of appreciation, the pound had reached its highest level – DM 3.08 – against the Deutsche Mark for seven years. However, the pound began to rise again in mid-October when the enduring strength of economic growth and increasing inflation risks reinforced market expectations that the Bank of England would raise central bank rates. The pound reached an exchange rate of approximately DM 2.95 at the beginning of December. In step with the UK currency the Irish pound, which for some time has been the most highly valued currency in the European exchange rate mechanism, likewise depreciated against the Deutsche Mark in the late summer. In contrast to the pound sterling, however, the Irish pound has largely stabilised since mid-October. Given its rate of about DM 2.60 when this Report went to press, the Irish currency has lost about 3 ½ % compared with its peak at the end of July. By contrast, the exchange rates of the other currencies participating in the European exchange rate mechanism continued to move in a very narrow corridor against the Deutsche Mark in the past few months.

Weighted external value of the Deutsche Mark *

Quarterly, log. scale



* Weighted against the currencies of 18 industrial countries. — 1 Nominal external value after adjustment for the differing movements in overall prices as measured by the prices of total sales. — ● = Average between October 1 and December 11, 1997.

Deutsche Bundesbank

Nominal and real external value

On a weighted average against the currencies of 18 industrial countries the (nominal) external value of the Deutsche Mark as a result of the weakening US dollar and the considerable depreciation of the yen rose by 2 ½ % between the beginning of August and the time this Report went to press. Although this means that the sharp depreciation of the Deutsche Mark, which reached its lowest point in the summer, was partly reversed, the Deutsche Mark – even after the elimination of differing price trends in the various countries concerned – was still being quoted around 3 ½ % lower than at the beginning of the year. Seen in this light, therefore, the competitive conditions under which German exporters operate have deteriorated little during the past few months. Instead, the somewhat firmer position of the Deutsche Mark in the world currency pattern and the "more balanced" exchange rates associated with this have clearly reduced the external price risks which for a time emanated from exchange rate trends and have thereby strengthened the longer-term prospects for the German economy.