Foreign trade and payments

Overview

The dynamic growth stimuli which export business had been providing right into the late summer moderated somewhat in the autumn. Firstly, the demand for German exports, which had been rising at an unexpectedly high rate until last September, levelled off. Secondly, the fairly brisk flow of imports in the autumn curbed the growth stimuli exerted by exports on the domestic economy. After the elimination of seasonal factors, however, the export surplus in October-November 1997 still amounted to DM 22½ billion and was therefore only slightly below the particularly large surplus (DM 24 billion) in the previous two-month period. With a deficit of just over DM 25 billion, invisible current transactions, too, showed a less favourable result in the two-month period under review than they had done in the previous two months (DM 20½ billion). Consequently, the German current account recorded a seasonally adjusted deficit of DM 3½ billion in the period under review (October-November 1997) compared with a surplus of DM 2½ billion in August-September.

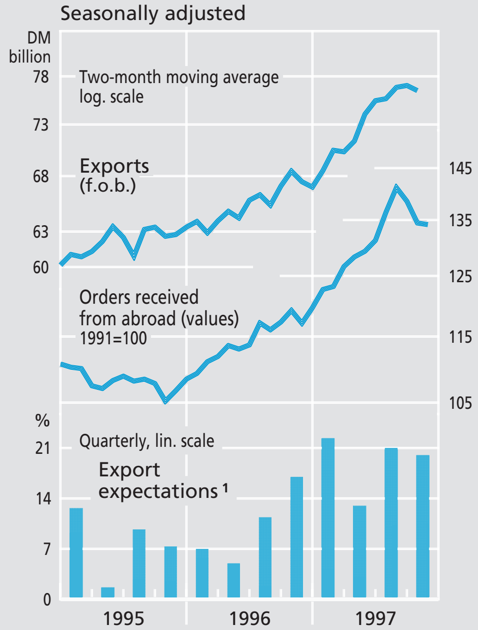
Current account in detail

Exports

The level of exports in October-November 1997 was approximately the same as the level reached during the extraordinarily buoyant trend in German exports in the spring and summer. The seasonally adjusted value of exports in October-November was only slightly below (– ½ %) the value in the two previous months. That means, however, that they were still as much as 11½ % above their level in the same period of 1996. The trend in the orders received by German industry presents a similar picture. While these orders had reached record levels in August and September, as a result of the bunching of large contracts, for example, in mechanical engineering and industrial equipment, they declined somewhat during the following two months. The possibility that the crisis situation in East Asia had played a part here cannot be ruled out.

More precise assessments of the effects of the crisis in East Asia cannot be made for the time being, however, as the regional breakdown of German foreign trade for the two months under review is still not available. Nevertheless, it may be assumed that the adverse effects sustained directly by German foreign trade during the months under review as a result of the crises in Asia were relatively minor because German business as a whole is not very active in the group of countries concerned; the seven crisis countries directly involved[1] account for only just under 5 % of German exports. However, the situation may be quite different in the case of individual economic sectors in Germany. After all, approximately 10 % of Germany's mechanical engineering products were exported to that region in 1996. Consequently, more serious repercussions cannot be ruled out in the longer term if the weaker market growth in Asia results in a substantial downturn in orders and it becomes even more difficult for German exporters to win new business in these markets because the dramatic depreciation of Asian currencies has given local suppliers competitive advantages.

Export trend



1 Values taken from the ifo business survey. Balances from the positive and negative company reports.

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By contrast, a certain degree of relief is expected from the economic trend in the industrial countries, which has tended to be favourable until now, especially as Germany's competitive position with respect to this group of countries has now improved discernibly. The exchange rate relationships have relaxed appreciably, and the moderate wage settlements and the successful rationalisation efforts of the past few years are again providing German enterprises with new opportunities in traditional export markets.

Regional breakdown of exports

According to the data on the regional breakdown of exports, which are available up to October, the trend in exports is, in any case, clearly marked by the demand from the in-

1 Thailand, Malaysia, the Philippines, Indonesia, Taiwan, Hong Kong and South Korea.

dustrial countries, which account for approximately three-quarters of German exports. The most dynamic stimuli by far are still exerted by the US market, which has been growing strongly for the past few years and in which German suppliers are enjoying a certain price advantage over their competitors as a result of the sustained strength of the dollar. In the two-month period of September-October 1997 sales of German products in the United States exceeded the level in the corresponding period of 1996 by no less than 30 %. The comparable growth rate for German exports to EU countries, at just under 11%, was appreciably lower; owing to the enormous importance of the European industrial countries (which absorb just under 55 % of German exports), the revival in growth which this reflects greatly contributed to the trend in German exports of goods. By contrast, exports to Japan declined by 8 % compared with the same period of the previous year, which is an indication of the persistent impediments to growth in Japan.

Of the regions outside the group of industrial countries, the central and eastern European countries in transition have long been recording above-average growth rates (September-October 1997 compared with the previous year: 36 ½ %). This means that the importance of this region for Germany's export trade has risen further; about 11% of German exports were absorbed by these countries recently. This group of countries is now considerably ahead of the emerging economies in South-East Asia, whose imports from Germany in September-October 1997 exceeded those in the same period of 1996

Regional breakdown of foreign trade

September-October 1997

Group of countries/ Country	Exports		Imports	
	DM billion	Change from the previous year in %	DM billion	Change from the previous year in %
Industrial countries	119.6	13.4	100.0	9.8
EU countries	86.8	10.9	71.0	7.2
of which				
Austria	8.3	0.1	4.7	– 3.5
Belgium/ Luxembourg	8.9	0.3	8.4	2.6
France	16.7	13.4	14.2	16.3
Italy	11.6	13.7	9.7	0.8
Netherlands	11.0	3.7	10.9	6.0
Spain	5.9	24.1	4.1	13.0
United Kingdom	12.8	22.4	9.5	12.4
Other industrial countries	32.8	20.7	29.1	17.0
of which				
United States	14.8	29.8	10.4	22.9
Japan	3.6	– 7.9	6.7	20.1
Countries in transition	19.9	31.1	18.0	22.4
of which				
Countries in central and eastern Europe	17.4	36.3	13.7	21.7
China	2.1	2.5	4.2	24.1
Developing countries	21.4	18.0	16.5	19.5
of which				
OPEC countries	3.7	21.5	2.6	12.7
Emerging markets in South-East Asia	8.7	9.8	7.7	21.0
All countries	161.4	16.0	134.7	12.5

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by 10%. In the two-month period under review German enterprises increased their exports to the group of developing countries by a total of 18% compared with the same period a year earlier; this was due mainly to the demand from Latin America and the OPEC states.

Breakdown of goods

Virtually all sectors of German industry benefited from the strong demand from abroad. Manufacturers of capital goods, who increased their exports in September-October 1997 by 17½% compared with a year earlier, benefited most. The appreciable success of the German motor industry, which had the highest turnover in the capital goods sector, was the main contributory factor here. There was also strong demand abroad for other products, notably electrical engineering products as well as office and data processing equipment, whereas German mechanical engineering products, despite double-digit growth rates, achieved only below-average sales. Exports by the basic goods and producer goods sectors rose by 14½% in the months under review compared with the same period of 1996, while the increase in export sales of consumer goods was 11½%. Although there are still no figures on the breakdown of total German exports in the subsequent period, the somewhat more moderate trend in these exports already suggests that this growth rate was not sustained.

Imports

Compared with the trend until the late summer of last year, the growth in imports during the autumn slowed down somewhat, but the seasonally adjusted value of imports in October-November 1997 rose by just under 1% as against August-September. There was a growth rate of just over 11% as against the same period of 1996, which means that it was much the same as that of exports. In contrast to what happened in the case of the latter, however, much of the rise in the value of imports was due to increases in the prices of German imports of goods which were mainly exchange-rate-related. In terms of the index of import prices the price differential between October-November 1997 and the same period of 1996 amounted to just over 3%, which meant that during the period under review imports were "only" about 8% higher in real terms than they had been a year earlier. Compared with the significantly weaker trend in domestic demand, however, this rise is still striking.

Imports by category of goods and by region

A not inconsiderable proportion of the growth in imports should probably be seen more in connection with the buoyancy in exports, which, owing to the high degree of international industrial integration, had resulted in a growing demand for intermediates and semi-finished products from other countries. According to the data on the breakdown of goods, which is available up to October, imports of intermediates and semi-finished goods rose by almost 10% in September-October compared with the corresponding period a year earlier, while the value of imports of energy and other raw materials rose at a rate which was far below average (just under 4%).

However, the countries of the European Union, which delivered 7% more goods to Germany in the two-month period under review than in the same period of 1996, had only a below-average share of the rise in the import demand from German business. By contrast, imports from the United States were 23 % up on the previous year. However, much of this increase was probably a reflection of the 15 % appreciation of the dollar, compared with the same period in 1996. The imports from the emerging economies in South-East Asia, many of which may also be invoiced in dollars, likewise rose at an above-average rate, namely 21%. The value of goods purchased from the countries in transition in central and eastern Europe rose by 22 % – a sign of the growing integration of this group of countries into the international division of labour.

Current account

DM billion; seasonally adjusted

Item	1997 June – July	Aug. – Sep.	Oct. – Nov. p
1. Foreign trade			
Exports (f.o.b.)	151.5	154.3	153.6
Imports (c.i.f.)	126.8	130.2	131.3
Balance	+ 24.7	+ 24.0	+ 22.3
2. Services (balance)	– 8.7	– 9.3	– 10.9
of which Foreign travel (balance)	– 7.7	– 8.2	– 8.9
3. Factor income (balance)	– 1.2	– 0.9	– 2.8
of which Investment income (balance)	– 0.8	– 0.6	– 2.6
4. Current transfers (balance)	– 9.5	– 10.5	– 11.5
Balance on current account 1	+ 4.5	+ 2.5	– 3.7

1 Includes supplementary trade items.

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Invisibles

The primary reason for the slight deficit on current account in October-November was the larger deficit on invisible transactions with non-residents, which comprise services, factor income and current transfers. Contrary to the usual trend at this time of year, which is marked above all by a sharp decline in expenditure on foreign travel, the deficit on these invisible transactions rose slightly in October-November. If such seasonal effects are eliminated, the deficit in this sector rose to just over DM 25 billion, compared with DM 20½ billion in August-September and DM 21½ billion a year earlier.

Services account

Almost one-half of this was due to the deficit on services, which rose by just over DM 1½ billion, seasonally adjusted, to just under DM 11 billion in October-November compared with August-September. As usual, foreign travel accounted for the greatest share of the deficit by far (almost DM 9 billion). However, the increase is due mainly to larger adverse balances, notably in payments for patents and licences, and in expenditure on the construction work by foreign companies in Germany, on publicity and trade fairs and on engineering and other technical services. Outside the field of foreign travel, the deficit on cross-border service transactions rose by DM 1 billion to DM 2 billion.

Foreign travel

Net expenditure on foreign travel, by contrast, hardly increased in seasonally adjusted terms during the period under review. The stagnation in real incomes, which has persisted for some time now, is probably the main reason why there is limited scope for changes in spending here. According to the data on the regional breakdown of foreign travel expenditure, which are available, admittedly, only up to the third quarter of 1997, the "classical" European holiday countries such as Italy, Spain and Austria were hit particularly hard by the reluctance to spend. By contrast, numerous non-European countries, especially the United States, Australia and New Zealand, recorded substantial growth in the third quarter of 1997 compared with the same period a year earlier. However, this was probably essentially due to exchange-rate-related increases in prices rather than to any real increase in demand.

Factor income

Other contributory factors to the increased deficit on invisibles were larger factor payments to non-residents as a result of cross-border employment and the possession of property abroad. In the period of October-November the deficit on factor income rose by DM 2 billion over that of the previous two-month period (August-September) to just under DM 3 billion. The rise is mainly due to larger investment income payments to non-residents; income payments to non-residents arising out of direct investment in Germany rose particularly sharply during the period under review because enterprises domiciled in Germany had initially postponed their dividend payments to foreign shareholders in anticipation of the planned tax reform in the autumn. The resultant "backlog" in dividend payments seems to be disappearing now that the reform plans probably cannot be put into effect for the time being.

The interest and dividend payments arising from portfolio investment likewise showed a large deficit in October-November, although

Major items of the balance of payments

DM billion

Item	1996 Oct. – Nov.	1997 Aug. – Sep.	1997 Oct. – Nov.
I. Current account			
1. Foreign trade			
Exports (f.o.b.)	r 145.2	145.0	161.6
Imports (c.i.f.)	r 123.2	121.3	137.1
Balance	r + 22.0	+ 23.7	+ 24.5
2. Balance of invisibles	– 21.8	– 24.5	– 25.3
Balance on current account 1	r – 0.6	– 1.7	– 1.6
II. Balance of capital transfers	– 0.1	+ 1.6	+ 0.1
III. Financial account 2			
Direct investment	– 9.2	– 5.7	– 4.6
Portfolio investment 3	+ 22.5	+ 4.8	– 9.8
German investment abroad	– 3.7	– 20.2	– 18.3
Foreign investment in Germany	+ 26.2	+ 25.0	+ 8.5
Credit transactions 3, 4	– 0.9	+ 2.8	+ 16.4
Overall balance on financial account	+ 12.5	+ 1.9	+ 2.0
IV. Balance of unclassifiable transactions	r – 9.8	– 5.0	– 1.0
V. Change in the Bundesbank's net external assets at transaction values (increase: +) 5 (I plus II plus III plus IV)	+ 2.0	– 3.1	– 0.6

1 Includes 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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this deficit was no greater than the one in the previous two-month period. It is now becoming even more apparent that income – in Deutsche Mark terms – from dollar-denominated financial and capital investment abroad, which accounts for a relatively large share of German external assets, rose as a result of the appreciation of the dollar, whereas the dollar plays a much less significant role in Germany's external liabilities. Seen in this light, the appreciation of the US currency is having a positive effect on the German investment income account. By contrast, the deficits on current account and the associated decline in Germany's net external assets are still having a negative impact, although this decline has recently slowed down again.

Current transfers

The deficit on current transfers remained at DM 11 billion in October and November. Seasonally adjusted, however, it likewise rose somewhat (by just under DM 1 billion to DM 11½ billion). The main reason for this was that, at DM 6½ billion, German contributions to the EC budget were somewhat greater than in the two previous months. By contrast, other public and private sector transfer payments in the two-month period were virtually unchanged at DM 4½ billion net. Pensions and other maintenance payments accounted for just over one-half of this, and the remittances of foreign workers in Germany to their home countries for the rest.

Financial transactions and reserve movements

Trends in financial transactions

Events in the international financial markets were characterised by continuing uncertainty about how the crises in Asia would develop in the fourth quarter of 1997. While as a result of the reassessment of earnings and risk prospects many equity markets sustained significant losses, bonds and notes tended to remain favourable in the autumn owing to the overall improvement in inflation prospects. These general trends were also reflected in Germany's capital account, which revealed a certain reluctance on the part of international investors to make new investments, especially in the German equity market. As German residents reduced their demand for foreign paper at the same time, however, German portfolio transactions with non-residents still had a surplus of DM 6½ billion in the fourth quarter of 1997, compared with one of DM 3 billion between July and September. Net capital imports also occurred through the credit transactions of non-banks during the period under review; by contrast, substantial amounts of funds were exported by way of direct investment and as a result of the credit transactions of the banks.

Portfolio transactions

The high degree of volatility on the financial markets was reflected in sharply fluctuating flows of securities in the fourth quarter of 1997. This is particularly true of the behaviour of foreign investors in the German market, who suddenly switched to selling in October following substantial investment during the summer and then in the following two months – taken together – again invested heavily in German paper. Nevertheless, no more than DM 26½ billion was imported between October and December, compared with DM 52 billion in the third quarter.

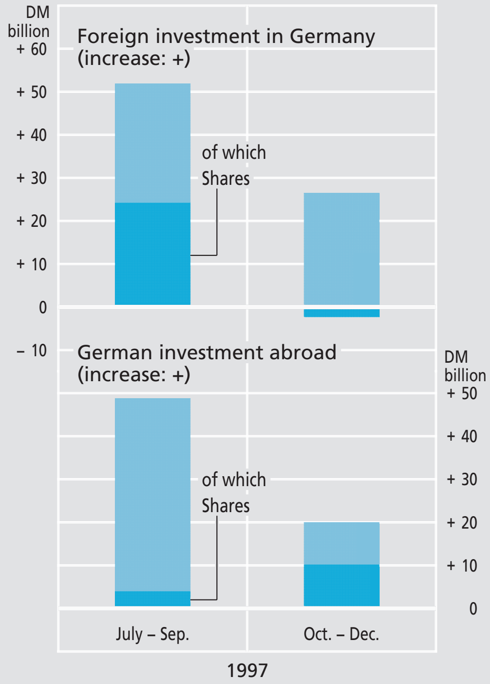
Foreign investment in German equities

The main reason for this decline was the diminishing interest of non-residents in the German equity market. Whereas foreign investors had acquired equities for as much as DM 24 billion between July and September, they sold equities worth DM 2½ billion net following the sudden fall in prices in October and the persistent price volatility in the final quarter of 1997.

... bonds and notes

On the other hand, foreign investment in German bonds and notes remained brisk. Inflows of DM 32 billion in the third quarter were followed by net inflows of DM 30 billion in the fourth quarter; foreign interest focused on bonds issued by the public sector (DM 23½ billion), notably Federal Government bonds and two-year Federal Treasury notes. By contrast, sales of bank bonds were distinctly lower (DM 6½ billion) during the period under review. The strong demand for Deutsche Mark bonds (in contrast to equities) may have been encouraged by changes in the risk assessment of the emerging markets. In times of great uncertainty international investors often seek out the security of safe havens; this is something the German market had already profited from in the past. Evidently the crises in Asia also had a dampening effect on inflation expectations. At all events, the overall decline in bond yields in the industrial countries during the final quarter of 1997 could suggest this interpretation.

Portfolio transactions



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... money market paper and investment fund certificates

As far as non-residents' transactions in other German securities are concerned, in the fourth quarter of 1997 the acquisition of money market paper (DM 1½ billion) was accompanied by sales of investment fund certificates (DM 3 billion).

German investment abroad

German residents were even more circumspect when investing in foreign securities during the period under review than foreign investors were. The demand for foreign securities, which had been extremely strong right into the summer months, declined discernibly towards the end of the year. Overall, residents bought no more than DM 20 billion worth of foreign paper between October and December. That was less than one-half of net purchases in the preceding three months (DM 49 billion). This was principally due to the much

Bonds and notes

lower interest in foreign bonds and notes. After spending DM 30½ billion in the previous period, German residents spent no more than DM 7½ billion on foreign debt instruments in the final quarter of 1997, with most of the buying being done by the banks. The demand for foreign currency bonds issued abroad declined particularly sharply.

The declining interest in foreign currency bonds not only reflects the uncertainty surrounding future price movements on the international financial markets, which may have led generally to a lower propensity to invest abroad but also the diminishing attractiveness of "convergence trading" in the run-up to European monetary union. Now that the gap between the yields in countries potentially participating in EMU has narrowed significantly – at least at the long end of the market – any false hopes that there will be further price increases in formerly high-yielding currencies will probably have largely disappeared. Whereas, for example, Germans had invested as much as DM 13½ billion in lira-denominated paper in the third quarter of 1997, this paper accounted for only just over DM 3 billion of the funds invested in the final quarter of 1997. Accordingly, dollar-denominated issues replaced those denominated in lire as the favourite; at DM 4½ billion, however, purchases here, too, were lower in the fourth quarter than they had been in the late summer months (DM 7½ billion).

Foreign equities

In contrast to foreign bonds and notes, foreign equities again aroused greater interest on the part of German investors during the final quarter of 1997. DM 10½ billion net

Financial transactions

DM billion, net capital exports: –

Item	1996 4th qtr	1997 3rd qtr	1997 4th qtr
1. Direct investment	– 16.2	– 9.8	– 16.0
German investment abroad	– 13.7	– 15.9	– 13.2
Foreign investment in Germany	– 2.5	+ 6.1	– 2.7
2. Portfolio investment	+ 16.8	+ 3.1	+ 6.4
German investment abroad	– 13.9	– 48.8	– 20.1
Shares	– 10.1	– 4.1	– 10.3
Investment fund certificates	– 0.1	– 7.8	– 0.9
Bonds and notes	– 3.9	– 30.3	– 7.7
Money market paper	– 3.2	– 3.9	+ 0.8
Financial derivatives [1]	+ 3.3	– 2.7	– 2.0
Foreign investment in Germany	+ 30.8	+ 51.9	+ 26.5
Shares	+ 5.8	+ 24.2	– 2.3
Investment fund certificates	– 1.8	– 3.2	– 2.9
Bonds and notes	+ 28.5	+ 31.7	+ 30.1
Money market paper	+ 4.6	+ 1.8	+ 1.5
Warrants	– 6.5	– 2.8	+ 0.1
3. Credit transactions	– 19.2	– 9.6	– 13.2
Credit institutions	– 21.2	– 7.0	– 26.0
Long-term	+ 3.2	– 5.9	– 18.6
Short-term	– 24.4	– 1.2	– 7.4
Enterprises and individuals	+ 0.8	+ 0.1	+ 11.7
Long-term	– 3.0	+ 0.7	– 0.0
Short-term [2]	+ 3.8	– 0.6	+ 11.7
Public authorities	+ 1.2	– 2.7	+ 1.1
Long-term	+ 2.4	– 3.4	– 0.6
Short-term	– 1.2	+ 0.7	+ 1.7
4. Other investment	– 1.8	– 1.7	– 0.6
5. Balance of all statistically recorded capital flows	– 20.4	– 18.0	– 23.4
Memo item: Change in the Bundesbank's net external assets at transaction values (increase: +) [3]	– 2.0	– 6.5	+ 0.4

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 December 1997, which are not yet known. — **3** Excluding allocation of SDRs and changes due to value adjustments.

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flowed into foreign equities in the period under review, compared with DM 4 billion in the third quarter. German investors were apparently using the lower price level to (re)enter the market and – at least in some cases – thereby continued the efforts observed in the first half of 1997 to internationalise their equity portfolios. In the other segments of the trading in securities, by contrast, there was generally a decline in interest. Sales predominated in the case of foreign money market paper, and purchases of foreign investment fund certificates were extremely limited (DM 1 billion).

Direct investment

The inflows of funds as a result of portfolio transactions were accompanied between October and December by net capital exports of DM 16 billion through direct investment. German enterprises increased their participation abroad by DM 13 billion, compared with DM 16 billion in the previous quarter; the EU was the preferred target region. Outflows of funds (DM 2½ billion) likewise predominated in the case of direct investment in Germany in the period under review, whereas in the previous quarter foreign enterprises had invested DM 6 billion in their German subsidiaries. However, the results were recently largely determined by a fairly high degree of restructuring in the insurance sector.

Credit transactions of the non-banks

In the non-securitised credit transactions of the non-banks, outflows of funds (DM 13 billion) predominated in the period under review, as is usual at the end of the year. This was primarily due to the short-term transactions of enterprises which – presumably to improve the appearance of their balance sheets, in the main – repatriated a discernible amount of their bank deposits in the Euromarket. These funds are normally exported again in January. The public sector, too, imported a small amount of funds in the fourth quarter.

Credit transactions of the banks

In contrast to the non-banks, the banks exported funds as a result of their credit transactions. In the process German credit institutions increased their long-term lending by DM 18½ billion net. In addition, a total of DM 7½ billion was exported in the form of short-term funds – most of this sum probably being a reflection of the aforementioned repatriation at the end of the year of bank deposits held by domestic enterprises abroad.

External position of the Bundesbank

Unlike the external position of the credit institutions, the net external assets of the Bundesbank remained virtually unchanged in the final quarter of 1997. They rose by DM ½ billion at transaction values after declining by DM 6½ billion in the previous period. Dollar interest receipts and dollars from US troops stationed in Germany were almost completely channelled back into the market during the period under review. By contrast, the dollar amounts made available under the IMF credits to assist the East Asian countries did not affect the external position of the Bundesbank because they resulted in a similar rise in the SDR claims on the International Monetary Fund. Calculated at the balance sheet rates applying at the end of 1996, the net external assets therefore amounted to DM 100 billion at the end of December 1997 compared with DM 105½ billion at the turn of 1996-7. In January the net external assets of the Bundesbank declined at transaction values by DM ½ billion.

Exchange rate trends

Global foreign exchange markets

The crises in Asia and possible knock-on effects on the global economy again characterised developments in the foreign exchange markets during the winter months. In the wake of the steep downward trend in a number of "fairly small" East Asian currencies, those of larger newly industrialising countries such as South Korea began to totter, which, in turn, seriously affected the Japanese financial sector and the yen for a time.

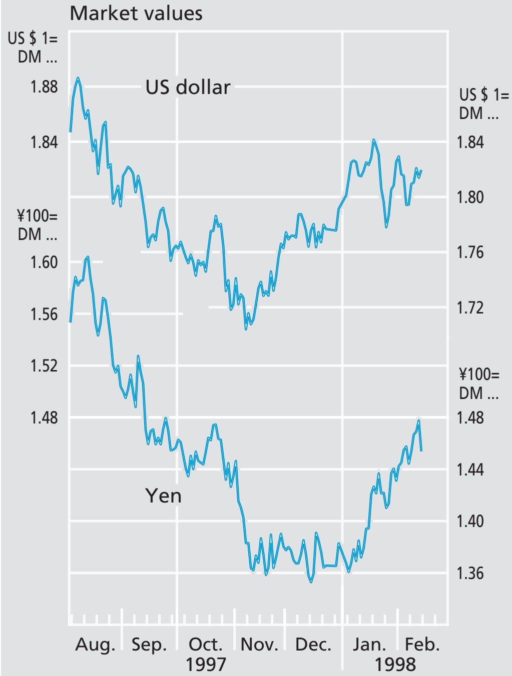
Yen

Within only a few weeks the Japanese currency fell to DM 1.35 per ¥ 100 by the middle of December, or almost back to its level of February 1997, its lowest level that year. It was not until the Japanese government announced measures to strengthen the banking sector and foster economic growth that the yen recovered. At the time this Report went to press, it was being quoted at DM 1.45; that was similar to its rate in October before the obvious deterioration of the situation as a result of the collapse of one of Japan's major financial institutions.

Dollar

The depreciation of the yen against the US dollar was particularly pronounced at the turn of the year. After a period of consolidation in November, however, the US currency also firmed once more against the Deutsche Mark in the ensuing period in connection with the spread of the financial crises in East Asia. At the end of the year the dollar almost reattained the DM 1.80 mark. With the exception of temporary interruptions this trend continued after the turn of the year. At just under DM 1.85, the quotations for the US currency actually came fairly close for a time to the dollar's peak of last summer; the rate of DM 1.82 as this Report went to press was likewise only marginally below that. It has increasingly appeared in the past few months that interest rate speculation, once the driving force behind the dollar trend, has receded into the background and has been replaced by major portfolio shifts to the dollar as a safe haven. In any case, the interest rate differential between dollar and Deutsche Mark assets has changed very little, and, owing to the curbing influences, which are probably somewhat stronger in the case of the United States, the growth prospects for the United

Exchange rate trends of the US dollar and the yen



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States and for Europe have tended to become more similar. Incidentally, the Deutsche Mark and the other European currencies closely linked to it have also benefited from the reorientation of internationally operating investors – but apparently not to the same extent as the dollar.

EU currencies

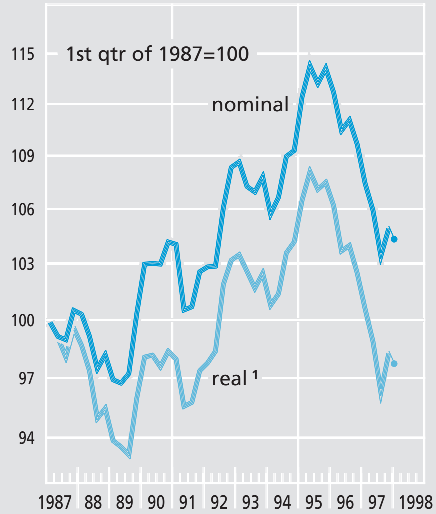
By contrast, exchange rate movements vis-à-vis most EU currencies were very limited. That is particularly true of the currencies which are participating in the EMS exchange rate mechanism and which, with the exception of the Irish pound, have been moving within a narrow fluctuation margin at around their bilateral central rates to the Deutsche Mark virtually since the autumn of last year. The ever growing conviction of foreign exchange market players that monetary union will start as planned has certainly contributed a great deal to this development.

British and Irish pounds

For some time now, by contrast, the British and Irish pounds have been moving in a different direction. This has mainly resulted from the faster growth rates of these two countries over those in continental Europe and the close integration of their economies. The British pound, which does not participate in the exchange rate mechanism of the European Monetary System, has been continually appreciating – albeit with minor fluctuations – against the Deutsche Mark during the past few months and exceeded the DM 3.00 mark for a short time in mid-January 1998. This was primarily due to the continued strong economic growth in the United Kingdom and the raising of central bank rates by the Bank of England at the beginning of November.

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 January 1 and February 12, 1998.

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The latter measure increased the interest rate advantage of the pound sterling over the Deutsche Mark to 4 percentage points at the short end of the market. With the approach of European monetary union, the British currency is apparently also benefiting from its status as an investment alternative to those European currencies which will be replaced by the euro. When this Report went to press, the pound sterling was being quoted at DM 2.98.

The approaching starting date for European monetary union has also been affecting the exchange rate of the Irish pound recently – even if its impact here may have been different from that on the pound sterling. After the Irish currency, which is included in the exchange rate mechanism of the EMS, had appreciated largely in line with the English pound until the end of last November, it subsequently deviated markedly from the trend in the British currency and has since moved towards its DM central rate. As this Report went to press, the Irish pound was being quoted at DM 2.51. This means that the gap in its bilateral central rate to the Deutsche Mark has been reduced from 8 % to 4 % compared with the level reached at the end of November (DM 2.61).

Nominal and real external values of the Deutsche Mark

On a weighted average against the currencies of 18 industrial countries, the (nominal) external value of the Deutsche Mark changed very little between the beginning of October 1997 and the time this Report went to press – despite the substantial shifts in the rates between individual currencies. Even after eliminating the differences in price movements in Germany and abroad, the (real) external value of the Deutsche Mark remained stable against the currencies of the industrial countries; it was approximately 5 % below its level of a year earlier. There is virtually no change in this picture if the currencies of the crisis countries in East Asia are included in the calculation of the real external value of the Deutsche Mark. Owing to the relatively minor role which these countries play in Germany's foreign trade, there is still a real depreciation even when using this extended definition. Nevertheless, one cannot overlook the fact that the positive effects of the improved competitiveness of German exporters, which has been achieved in the past two years as a result of the correction in the previous appreciation of the Deutsche Mark and the cost-cutting measures at home, may be impaired by the crises in East Asia. That is another reason why, despite recent export successes, the safeguarding of the quality of Germany as an industrial base must continue to be a major priority.