Foreign trade and payments

Overview

World economic conditions deteriorated significantly in the autumn, and the growth stimuli which the German economy had been deriving from exports until the summer largely disappeared. The business impediments suffered as a result of the crises in South-East Asia, Latin America and some east European countries had now begun to have a discernible economic impact on almost all western industrial countries, and German exports in the fourth quarter of 1998 declined further in seasonally adjusted terms compared with the previous quarter. The restraining effects which this had on economic activity in Germany were somewhat moderated on the whole by the fact that imports had fallen at the same time. In real terms, however, the decline in imports was much less pronounced than that of exports. Nevertheless, as import prices had been falling more sharply than export prices, the seasonally adjusted value of the export surplus in the final quarter of last year decreased by only DM 2½ billion to DM 30 billion. There was a much larger deficit on invisibles than in the previous period, primarily because of the rise in investment income payments to non-residents. Consequently, the current account as a whole ran a seasonally adjusted deficit of DM 11½ billion in the fourth quarter of 1998 compared with a slight deficit of just under DM ½ billion in the third quarter.

Current account in detail

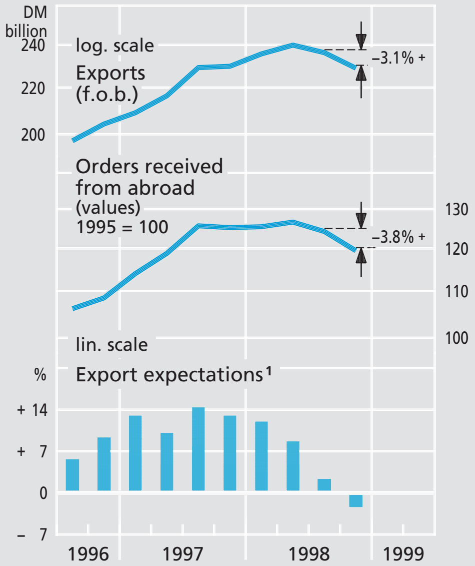
Exports

The seasonally adjusted value of German exports, which had already fallen by 1½% in the third quarter compared with the second quarter, declined by a further 3 % in the final quarter of the year. This means that the value of exports in the fourth period was only 1½ % above its level in the same period of 1997. It must be remembered, however, that export prices had declined by just over 1% in the 12-month period with the result that real export growth was correspondingly higher (at approximately 2½ %) compared with the same period a year earlier. However, the underlying downturn is considerable, a trend which can also be seen in the fact that the change from the previous year had been more than three times greater in the early summer. At that time, however, new business booked by German industry in foreign markets was already stagnating. It then declined further for the rest of the year with the result that during the period under review export orders received by the German manufacturing sector were significantly below their previous year's level both in terms of value and volume. According to figures taken from the ifo business survey, industry's export expectations likewise deteriorated; for the first time in almost five years pessimism predominated in the final quarter of 1998.

A number of factors contributed to this trend, and some of these combined to accentuate their unfavourable impact on German exports. The first of these factors were the financial crises in South-East Asia although the direct effects of these on Germany's foreign trade were held in check as a result of German exporters' limited integration with the group of countries concerned. However, the subsequent cumulation of risks to global economic growth, which had arisen from the unexpected deterioration in the performance of the Japanese economy, the uncertainty about future trends in the Chinese economy and the negative effects on confidence of the crises in Russia and Latin America, led to a discernible worsening of Germany's growth prospects and those of other industrial countries for 1998. Yet another detrimental factor was the weak demand from the oil-producing countries, which saw their spending capacity restricted as a result of the falls in oil prices. In the end, all of this could not fail to have an effect on the economic development of the western industrial countries, whose market growth up to the summer of last year had partially offset the decline in orders received from the developing countries and the emerging markets.

Export trend

Seasonally adjusted, quarterly



1 Values are taken from the ifo business survey and cover Germany as a whole. Balances are from positive and negative company reports. — + Percentage change from the previous quarter.

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Major items of the balance of payments

DM billion

Item	1997 4th qtr	1998 3rd qtr	1998 4th qtr
I. Current account			
1. Foreign trade			
Exports (f.o.b.)	238.9	r 231.5	242.0
Imports (c.i.f.)	205.8	r 198.9	209.1
Balance	+ 33.1	+ 32.6	+ 32.9
2. Balance of invisibles	– 25.8	– 40.9	– 36.0
Balance on current account 1	+ 5.5	– 8.5	– 3.7
II. Balance of capital transfers	+ 0.0	+ 1.8	+ 0.8
III. Financial account 2			
Direct investment	– 19.9	– 15.3	– 63.4
Portfolio investment 3	+ 6.5	+ 41.9	– 11.4
German investment abroad	– 20.1	– 43.4	– 73.6
Foreign investment in Germany	+ 26.6	+ 85.3	+ 62.2
Credit transactions 3, 4, 5	– 1.7	– 8.9	+ 53.8
Overall balance on financial account	– 15.1	+ 17.7	– 21.0
IV. Balance of unclassifiable transactions	+ 9.9	– 10.6	+ 28.7
V. Change in the Bundesbank's net external assets at transaction values (increase: +) 6 (I plus II plus III plus IV)	+ 0.4	+ 0.5	+ 4.8

1 Includes supplementary trade items. — 2 Net capital exports: –. — 3 Excluding direct investment. — 4 Including other official and private investment. — 5 Excluding the changes in financial operations of German non-banks with foreign non-banks and in the trade credits for December 1998, which are not yet known. — 6 Excluding allocation of SDRs and changes due to value adjustments.

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Regional breakdown of exports

Export weakness continues to be focused on the crisis regions. In the two-month period of October-November (more recent data are not yet available) German exports to the crisis countries in South-East Asia were 30½% below their level in the same period a year earlier; as a result, the share of this group of countries in Germany's export total fell from 5½% in 1997 to just 3½% in the period under review. Furthermore, the countries in transition in central and eastern Europe, which accounted for about 11% of German exports in the middle of 1998, reduced their imports from Germany by 1½% over the 12-month period. German exports to Russia actually more than halved (– 57%). Deliveries of German goods to Japan also fell sharply (– 7%). The OPEC countries, whose foreign exchange earnings slumped as a result of the decline in oil prices, likewise purchased fewer products from Germany (– 3 ½%). Demand from the EMU countries, which absorb approximately 44% of German exports, have always provided a certain degree of compensation for these sales losses. In October-November, too, these countries' imports from Germany were greater than a year earlier (by 7½%). German enterprises were likewise able to sell considerably more in the US market than a year earlier; when compared with their level in the previous few months, however, German exports to the United States were down in seasonally adjusted terms during the period under review.

Breakdown of goods

The deceleration in export growth has now become apparent in most sectors of German industry. However, the motor industry, which has been enjoying brisk demand both at home and abroad during the past two years, slightly increased its growth in export sales. It was able to look back on an export growth rate of just over 17 % compared with the previous year. Germany's mechanical and electrical engineering industries were particularly badly hit by the fall in demand from South-East Asia and in the months under review did not achieve the sales levels reached in the same period a year earlier. Some consumer industry sectors also sustained a slight fall in export business during the period under review when compared with the same period a year earlier.

Imports

The value of German imports declined less sharply than that of exports in the autumn; after seasonal adjustment, imports were just under 2½ % lower in the fourth quarter of 1998 than in the third quarter of the year whereas they exceeded their level in the fourth quarter of 1997 by 1½ %. However, these figures were influenced to a very large extent by the falling prices for imported petroleum and other raw materials. In terms of the price index for imported goods German imports in the last quarter of 1998 were, on average, almost 6 % cheaper than a year earlier. If these price movements are eliminated, German imports actually increased by approximately 7½ % in real terms compared with the same period a year earlier.

Regional breakdown of imports

According to the regional statistics, which admittedly are available only up to November, the seasonally adjusted decline in German imports in the last quarter of 1998 mainly concerned the EMU countries, from which Germany imported about 2½ % fewer goods in

Regional breakdown of foreign trade

October–November 1998

Group of countries/ Country	Exports		Imports	
	DM billion	Change from the previous year in %	DM billion	Change from the previous year in %
Industrial countries	127.9	5.7	103.4	– 2.4
EU countries	94.5	6.3	73.9	– 3.5
EMU countries	72.6	7.3	59.1	– 2.7
Austria	9.0	4.7	5.8	9.6
Belgium/ Luxembourg	9.5	6.9	7.9	– 6.6
Finland	1.9	32.8	1.4	6.3
France	19.3	12.5	15.0	0.0
Ireland	0.8	– 1.0	1.5	3.7
Italy	12.3	4.4	10.8	– 1.6
Netherlands	10.9	– 2.0	10.8	– 11.9
Portugal	2.0	13.1	1.6	9.5
Spain	6.9	12.8	4.3	– 5.0
Other EU countries	21.9	3.3	14.8	– 6.7
Denmark	3.0	7.9	2.2	– 22.3
Greece	1.3	10.2	0.5	6.5
Sweden	4.0	2.0	2.7	2.3
United Kingdom	13.6	2.1	9.4	– 5.3
Other industrial countries	33.4	4.2	29.5	0.3
of which				
United States	15.9	12.0	11.1	4.8
Japan	3.2	– 7.1	7.2	2.8
Countries in transition	19.2	– 3.2	18.9	4.9
of which				
Countries in central and eastern Europe	16.9	– 1.3	14.6	6.3
China 1	2.0	– 16.2	4.1	– 1.0
Developing countries	18.2	– 8.5	14.8	– 6.2
of which				
OPEC countries	3.4	– 3.6	1.8	– 27.5
Emerging markets in South-East Asia	5.7	– 30.4	7.3	– 0.6
All countries 2	166.5	3.3	139.1	– 0.6

1 Excluding Hong Kong. — **2** The totals for the comparative period of 1997 include annual revisions which are already broken down by region as well as revisions for the period from January to November 1998 which are not yet available in a regional breakdown.

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the period October-November than in the previous year. By contrast, imports from the United States again increased appreciably. However, it was the imports from the central and east European countries in transition which exceeded their previous year's level the most, given a rise here of almost 6½%. As a result of the growing intensification of its trade with this group of countries, Germany is continuing to make a very significant contribution to the economic stabilisation and modernisation of this region. The fact that the value of imports from Russia declined by almost 20% only appears to contradict that assertion: while structural deficiencies and delivery problems in that country do play a role, the main cause of the decline is the sharp fall in the prices for petroleum and natural gas, which are Russia's main exports. The sharp decline in imports from the OPEC countries was also mainly price-related. In view of the significant real depreciation of the currencies of the emerging markets in South-East Asia, it is likely that the prices of imported products from this region, too, have fallen considerably with the result that the slight downturn in imports (– ½%) is in no way to be interpreted as a corresponding decline in the real volume of imports from this region.

Imports by category of goods

Prices probably also distort sales figures for the major categories of goods. For example, the import values of German energy imports fell by 35½% compared with the same period a year earlier. The main reason for this was the dramatic fall in prices on the international oil markets. This reduced Germany's import bill for crude oil by 41% during this period. However, the value of imports of raw materials (other than energy) and intermediates and of food products also remained below the level in the previous year. By contrast, the value of imported finished goods was 3½% higher than a year earlier.

Invisibles

The fairly small surpluses in trade in goods in the fourth quarter were accompanied by substantially greater deficits in invisibles. The combined result of services, factor income and current transfers, which amounted to a deficit of just under DM 41 billion, exceeded the value of the previous quarter by DM 8 billion. Larger net payments to non-residents in respect of investment income were the most important reason for this while the deficit on current transfers hardly exceeded the level in the previous quarter.

Factor income

Germany's investment income account deteriorated considerably in the final quarter of 1998, with the seasonally adjusted deficit rising by DM 6 billion from the previous period to approximately DM 9½ billion. For one thing, this was a reflection of the continued large profits made by foreign subsidiaries in Germany and the larger amount of interest payable to non-residents for loans. For another, the investment income of German investors from their foreign participations and the interest received on loans to non-residents were comparatively low. If the net expenditure arising in cross-border factor income – which is subject to minor fluctuations – is taken into account, the factor income account ran a deficit of almost DM 10 billion (seasonally adjusted) in the final quarter of 1998 compared with one of DM 4 billion in the previous quarter.

Current account

DM billion; seasonally adjusted

Item	1998 2nd qtr	3rd qtr	4th qtr
1. Foreign trade			
Exports (f.o.b.)	241.4	237.7	230.3
Imports (c.i.f.)	207.5	205.2	200.4
Balance	33.9	32.5	29.9
2. Services (balance)	– 15.5	– 13.8	– 16.0
of which Foreign travel (balance)	– 13.0	– 13.0	– 14.4
3. Factor income (balance)	– 6.1	– 4.2	– 9.8
of which Investment income (balance)	– 5.5	– 3.5	– 9.3
4. Current transfers (balance)	– 10.8	– 14.8	– 15.0
Balance on current account 1	0.3	– 0.4	– 11.6

1 Includes supplementary trade items.

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Services

After eliminating seasonal factors, the deficit on cross-border services rose somewhat, at DM 16 billion, in the fourth quarter of 1998 (third quarter: just under DM 14 billion). Net expenditure on foreign travel, which increased more sharply in the fourth quarter than is usual for the time of year, accounted for the largest share of this. One of the factors which probably influenced this trend was the change in school holidays in North Rhine-Westphalia, the most populous Federal state; the lengthening of the autumn holidays for the first time apparently encouraged more people to travel abroad. Spending by German tourists, particularly in Spain, Italy, Greece and Portugal, increased sharply in the fourth quarter compared with the same period a year earlier whereas expenditure in some other EU partner countries fell slightly. German spending on travel to Switzerland also increased significantly whereas it largely stagnated in the case of the United States.

Current transfers

Current transfers to non-residents amounted to DM 15 billion net in the final quarter of last year. This means that they were much the same as in the previous quarter. Public credit transfers, including, as usual, Germany's contributions to the EU budget, accounted for the lion's share of this. However, private transfers such as the remittances of foreign workers in Germany to their home countries as well as pensions and other payments to non-residents also played a role.

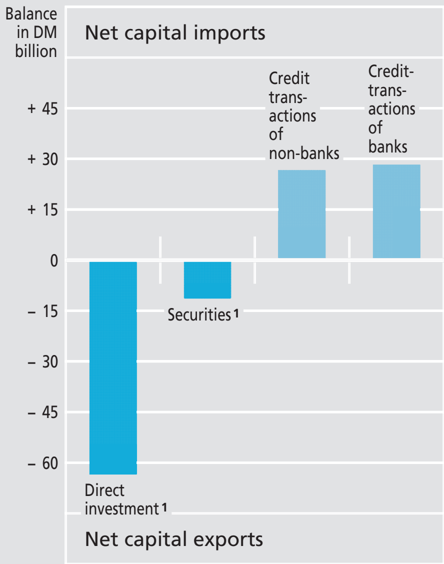
Financial transactions and reserve movements

Trends in financial transactions

The uncertainty on the international financial markets, which had resulted in large numbers of investors seeking refuge in safe havens during the summer, seems to have abated somewhat in the final quarter of 1998. At all events, major share markets, which had experienced a downturn for a time, were able to regain their previous record levels. Apart from a few exceptions, exchange rate fluctuations on the foreign exchange markets were fairly limited. Shifts in international portfolios resulted in net capital exports of DM 11½ billion in German portfolio transactions compared with inflows of DM 42 billion in the third quarter. The swing would actually have been much greater if the settlement of a large merger had not, in itself, led to an extensive influx of funds through portfolio transactions. This transaction was also the

Breakdown of financial transactions

Fourth quarter of 1998



1 Influenced by a large transaction in November.

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main cause of the unusually large deficit on direct investment (for details see the box on page 71). By contrast, there were fairly large net inflows of foreign funds as a result of unsecuritised lending business.

Portfolio transactions

The deteriorating trend in portfolio transactions was the result of a significant revival in German investors' interest in foreign paper and a downturn in non-residents' investment in the German market. Between October and December German investors bought foreign securities worth DM 73½ billion compared with DM 43½ billion in the previous quarter. Demand during the period under review was focused on bonds and notes, with total purchases amounting to DM 36½ billion, including DM 31 billion for foreign currency bonds alone. The expectation that interest rates in the EMU member states would converge further seems to have been the main motive behind investors' actions because no less than three-fifths of the funds concerned flowed into Italian, Spanish and Portuguese bonds. Looking back, their expectations were fulfilled: the differences in interest rates of public bonds in the EMU countries did not exceed 29 basis points at the end of 1998 whereas at the beginning of October they had been as much as 49 points in some cases.

German investment in foreign ...

... bonds and notes

... shares

As in the previous few quarters, foreign shares were the second most popular investment target. Although purchases of shares did decline in the period under review, they were, at DM 22½ billion, still fairly substantial compared with such investment in previous years. Evidently German investors were taking advantage of the temporarily lower price levels on major foreign stock exchanges following the financial market crisis in August to re-enter the market, especially as a fairly speedy recovery was emerging there – or, at least, faster than the recovery in Germany. Another factor influencing their decision to buy foreign shares may have been that in many cases yields on the bond market had fallen to a historic low and therefore savers – with the exception of those looking for a short-term speculative investment – apparently found them less attractive.

... money market paper and investment fund certificates

German investors also acquired foreign money market paper worth DM 6½ billion. Lira-denominated paper and short-dated yen-denominated paper were most in demand. In addition, just under DM 3 billion flowed into foreign investment funds.

Foreign investment in German ...

In contrast to their substantial purchases of securities in the third quarter of last year, non-resident investors were remarkably restrained with regard to new investment in Germany during the last three months of 1998. However, this development is not fully reflected in the published statistics, which show inflows of funds declining from DM 85½ billion to DM 62 billion. When interpreting the latest figures, however, it must be remembered that more than DM 50 billion of that sum was due to the single transaction mentioned above. If that transaction is excluded, net inflows of foreign funds were extremely modest during the period under review. Another contributory factor is presumably that some of the funds imported into Germany during the turbulence last summer were relocated as soon as the situation began to settle.

... bonds and notes

The change in investors' risk assessment is most clearly seen in fixed-interest securities. Whereas non-residents had spent DM 68 billion in purchasing this type of paper between July and September 1998, their net purchases amounted to only DM 20½ billion in the last three months of the year. The fact that the yield advantage of dollar-denominated bonds over Deutsche Mark paper increased discernibly towards the end of the year may also have had a detrimental effect.

... shares

The merger of the two industrial concerns explained in detail in the adjacent box had a considerable effect on the amount of shares recorded in the German balance of payments as purchases by non-residents during the period under review. When this transaction is included, these purchases amount to DM 38

Recording a large merger in November 1998 in the balance of payments

The merger of two large industrial enterprises had a considerable impact on the statistically recorded financial transactions with non-residents during the period under review. The merger was handled in such a way that the two existing enterprises were united to form a new German public limited company. The acquisition of the shares of the foreign enterprise was recorded in the balance of payments as German direct investment in the United States. In accordance with international guidelines on balance of payments statistics, this transaction was valued at market prices and amounted to more than DM 50 billion.

The claims of the former shareholders of the foreign enterprise were settled by the transfer of shares of the new company; this measure is not to be regarded as direct investment – there was still a participation threshold of 20 % of the capital or voting rights in this connection in 1998 – but, instead, is to be classified as portfolio transactions. Where the exchange of foreign share certificates for new German share certificates affected non-residents, the transaction was entered in the German balance of payments as US investment in German shares because a US bank was commissioned to settle the transaction. By contrast, the return of the shares held by German residents, which accounted for only a fraction of the equity capital of the US company, was entered in the German balance of payments as sales of foreign shares (to the United States).

The recording of the entire transaction therefore had no impact on the balance of the financial account as a whole. However, it did increase the total value of the balance of payments and resulted in considerable distortions in some subsections (direct investment and portfolio transactions). Owing to the unusual magnitude of the transaction, it will also have an effect on these areas in the annual accounts.

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Financial transactions

DM billion, net capital exports: –

Item	1997 4th qtr	1998 3rd qtr	1998 4th qtr
1. Direct investment	– 19.9	– 15.3	– 63.4
German investment abroad	– 16.6	– 17.1	– 70.8
Foreign investment in Germany	– 3.3	+ 1.8	+ 7.5
2. Portfolio investment	+ 6.5	+ 41.9	– 11.4
German investment abroad	– 20.1	– 43.4	– 73.6
Shares	– 10.3	– 31.8	– 22.5
Investment fund certificates	– 0.8	– 3.6	– 2.8
Bonds and notes	– 7.7	– 11.0	– 36.6
Money market paper	+ 0.8	+ 0.4	– 6.3
Financial derivatives 1	– 2.0	+ 2.4	– 5.5
Foreign investment in Germany	+ 26.6	+ 85.3	+ 62.2
Shares	– 2.3	+ 10.3	+ 38.1
Investment fund certificates	– 2.9	– 0.5	– 1.4
Bonds and notes	+ 30.2	+ 68.0	+ 20.5
Money market paper	+ 1.6	+ 7.1	+ 1.1
Warrants	+ 0.1	+ 0.5	+ 4.0
3. Credit transactions	– 0.9	– 5.4	+ 54.9
Credit institutions	– 26.6	– 11.2	+ 28.2
Long-term	– 19.1	– 12.3	+ 1.5
Short-term	– 7.5	+ 1.2	+ 26.7
Enterprises and individuals	+ 26.3	+ 3.0	+ 26.1
Long-term	+ 0.3	+ 7.0	+ 2.0
Short-term 2	+ 26.0	– 4.0	+ 24.1
Public authorities	– 0.6	+ 2.8	+ 0.6
Long-term	– 0.5	– 1.6	– 5.7
Short-term	– 0.1	+ 4.4	+ 6.3
4. Other investment	– 0.8	– 3.5	– 1.1
5. Balance of all statistically recorded capital flows	– 15.1	+ 17.7	– 21.0
Memo item Change in the Bundesbank's net external assets at transaction values (increase: +) 3	+ 0.4	+ 0.5	+ 4.8

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 December 1998, which are not yet known. — **3** Excluding allocation of SDRs and changes due to value adjustments.

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billion. If it is excluded, however, it emerges that foreign investors sold German shares on balance between October and December 1998 whereas in the spring and early summer of last year they had built up substantial positions in the German share market.

... investment fund certificates and money market paper

Non-residents were likewise net sellers (minus DM 1½ billion) in the case of German investment fund certificates during the final quarter of 1998; by contrast, they acquired German money market paper worth DM 1 billion.

Direct investment

As in portfolio transactions, there were net capital exports as a result of direct investment between October and December; these amounted to DM 63½ billion compared with DM 15½ billion in the three-month period earlier.

German investment abroad

In the period under review German enterprises acquired foreign participations worth a record DM 71 billion although, of course, the large merger mentioned, worth more than DM 50 billion, accounted for the greater share of this. If this transaction is excluded, German direct investment abroad during the period under review was roughly the same as in the previous quarter; at that time German enterprises had provided their foreign subsidiaries with DM 17 billion in investible funds. The outward investment of German enterprises and financial institutions was concentrated on the United States and on the partner countries within the EU.

Foreign investment in Germany

For their part, foreign firms, too, again increased their investment in Germany somewhat recently. At DM 7½ billion net, more funds flowed into Germany as a result of direct investment in the period under review than in the previous period (DM 2 billion). This was primarily due to intra-group credit management, which in the case of foreign direct investment in Germany traditionally has a greater weight – not least for tax reasons – than in the case of German investment abroad.

Credit transactions of ...

... enterprises and individuals

The unsecuritised credit transactions of German non-banks during the period under review were significantly affected by end-of-year operations. In line with the seasonal trend enterprises and individuals withdrew funds amounting to DM 26 billion net between October and December. The main reason for this was the sharp decline in short-term deposits with foreign banks; in the previous three months these had been increased discernibly. Some of the operations concerning bank balances in the Euro-market were obviously in connection with German direct investment abroad. Part of the reason for the decision to repatriate bank balances was possibly that the interest rate disadvantage (resulting from the minimum reserve requirement) of having assets in Germany, instead of in other EMU countries, has now disappeared and, owing to the remuneration of minimum reserve holdings, has at least become less significant in terms of competition with third countries; this might have been the cause of related relocations in the run-up to EMU.

... public authorities

The cross-border credit transactions of the public authorities almost cancelled out in net terms (+ DM 0.6 billion). In this case the influx of funds stemming from the reduction in balances held with foreign banks was largely offset by capital exports arising mainly from redemptions in respect of long-term loans previously raised abroad.

... banks

The unsecuritised credit transactions of the banks resulted in net capital imports of DM 28 billion in the last three months of 1998. Operations at the long end of the market largely cancelled out (+ DM 1½ billion). Considerably more significant from the point of view of the amount was the inflow of short-term funds (DM 26½ billion), which can be regarded as the counterpart to the outgoing payment in the other sections of the current and financial accounts.

External position of the Bundesbank

Unlike the external position of the credit institutions, the net external assets of the Bundesbank increased, at transaction values, by just under DM 5 billion in the final quarter of 1998 whereas in the previous three months they had shown comparatively little change. Part of the reason for the rise was the increase in external assets due to dollar interest income and inflows of dollars from US troops stationed in Germany; another factor was the decline in external liabilities as foreign monetary authorities withdrew part of their balances with the Bundesbank. Calculated at balance sheet rates applying at the end of 1998, the net external assets therefore amounted to DM 119 billion at the end of 1998 compared with DM 111 at the end of 1997.

Exchange rate trends

Start of EMU

At least as far as Europe is concerned, the almost perfect start to European monetary union was probably the most significant event on the world's foreign exchange markets during the winter. After the exchange rates of the participating currencies had progressively approached the central rates applying in the EMS, the Deutsche Mark and the national currencies of ten other member states of the European Union were absorbed into the euro, the new single currency. The final exchange rate of the Deutsche Mark against the dollar, which was fixed on December 31, 1998, was DM 1.6763. On that basis and taking into consideration the parity of 1:1 between the ECU and the euro agreed in the Maastricht Treaty, a (now irrevocable) exchange rate for the Deutsche Mark against the euro of DM 1.95583 was laid down. At the time that was equivalent to a value for the euro of $ 1.16675.

Dollar

During the last few months of 1998 the Deutsche Mark was already moving in a fairly narrow corridor against the dollar. Since the beginning of 1999 the euro has been moving against the dollar in a band of between $ 1.12 and $ 1.18. After an initial tendency to firm, the euro lost ground to the dollar. At the time this Report went to press, the euro was being quoted at $ 1.12, which was just over 3½% below its starting level. That could be seen, in particular, as a reflection of a certain market reassessment of growth prospects for the US economy and for Germany. The interest rate differential has also expanded in favour of the US currency. By contrast, potential adverse factors such as the large US current account deficit or the risks emanating from some Latin American markets seem to have receded somewhat more sharply into the background again when investors were making decisions during the period under review.

Yen

Despite the poor economic situation in Japan, the yen followed its exchange rate leap in October by firming further against the major world currencies. Its upward trend continued until well into January when it was checked for a time by *inter alia* foreign exchange market intervention by the Japanese central bank. Between the middle of October and the end of the year the Japanese currency appreciated by a further 5% against the Deutsche Mark, thus reaching an annual high. The yen has gained about 2½% in value against the euro since the beginning of the year. When this Report went to press, the euro was being quoted at ¥ 129.3. At ¥ 110 against the US dollar, the Japanese currency actually rose for a short time in January to its highest level against the dollar in almost two and a half years. This was probably due not only to technical factors but also to the large Japanese trade surplus (especially with the United States) and to the rise in long-term interest rates in Japan. In view of the persistent structural problems facing the Japanese economy, however, a considerable degree of uncertainty appears to be prevailing in the market. At all events, the implicit volatilities continue to be as high as in the autumn.

New exchange rate mechanism

In view of the exchange rate patterns in Europe outside the EMU, it must be emphasised that a new exchange rate mechanism (ERM II) replaced the previous exchange rate mechanism of the EMS at the beginning of January. The Greek drachma is taking part in this with the standard fluctuation margin of ± 15 %, and the Danish krone with a fluctuation band of ± 2 ¼ %. Both currencies are currently being quoted stronger than their respective euro central rate.

Pound sterling and Swedish krona

As a result of the less favourable growth prospects in the United Kingdom and the consequent expectations that interest rates there would fall, the euro was initially able to firm against the pound sterling; in view of the re-emergence of greater risks with respect to future economic developments in the euro area, however, the euro has now become just over 2 % weaker against the British currency than at the beginning of the year. The Swedish krona has also made a significant recovery. After losing about 6 ½ % in value against the Deutsche Mark in the last five months of last year, it firmed by a similar amount against the euro during January.

Brazilian crisis

The otherwise fairly placid development on the foreign exchange markets was overshadowed by the currency crisis in Brazil and the resurgence of worries with respect to the durability of the exchange rate link of the Chinese currency. After attempting to control the depreciation of the Brazilian real, the authorities, under persistent pressure, let the currency float in the middle of January and intervened only sporadically to support it. Since then, the Brazilian currency has lost about 35 % of its value against the euro. In view of the relatively minor significance of Brazil for German foreign trade (0.9 %), however, it is unlikely that the German economy will sustain all too great a loss directly from this.

External value of the Deutsche Mark and the euro

Dec. 31, 1998 = 100, daily rates, log. scale

Deutsche Bundesbank

External value of the Deutsche Mark and effective euro exchange rate

Generally speaking, the external value of the Deutsche Mark changed little against the currencies of 18 industrial countries in the last few months of 1998. After eliminating the differences in price movements, the real external value of the Deutsche Mark at the end of 1998 was at the same level as in 1987 and was therefore worth the equivalent of its multi-year average. It may therefore be concluded that, overall, there is a fairly wellbalanced exchange rate pattern against the currencies of the industrial countries. The trend in the effective exchange rate of the euro against the currencies of the major trading partners outside the single currency area since the introduction of Stage Three at the beginning of this year has continued this tendency. On a weighted average against the currencies of a group of 15 countries the euro has been moving since then within a narrow corridor with only slight fluctuations; at the time this Report went to press, it was just under 3 % lower than on the conversion date at the end of 1998.