Foreign trade and payments

Overview

External relationships again provided the greatest stimuli to economic growth in Germany in the second quarter of this year. The significant upward trend in exports prevailing for the past year continued to gain momentum between April and June 1997 and – despite the increase in imports at the same time – resulted in a surplus in Germany's trade balance which in the period under review amounted to just under DM 34 billion and thus DM 7 billion more, seasonally adjusted, than in the preceding quarter; the trade surplus had reached such proportions only once before, and that was during the export boom towards the end of the eighties. As there has also been another slight decline in the large deficits on invisibles recently, an unusally sharp "turnaround" for the better occurred simultaneously in the current account as a whole: compared with a seasonally adjusted deficit of just over DM 11 billion in the first quarter of this year, there was a surplus of DM 2½ billion in the second quarter – the first positive quarterly result since the end of 1990.

Current account in detail

Exports

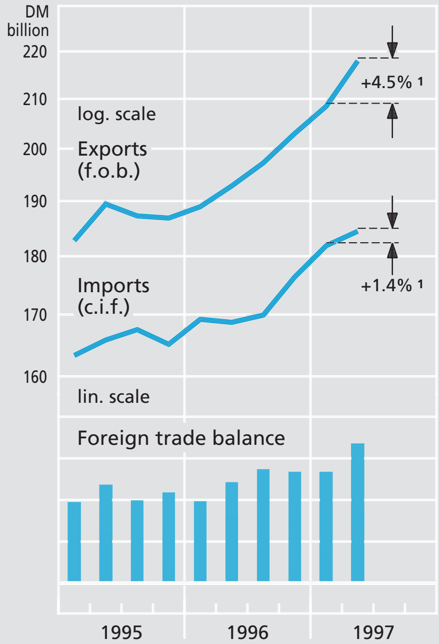
The seasonally adjusted value of German exports in the second quarter of 1997 was 4½ % higher than in the first quarter. This means that exports during the period under review were no less than 15 % higher in value than in the corresponding period last year. Even if the concurrent rise in export prices of just under 1½ % is taken into account, there was still a 13½ % growth in exports in real terms.

The sustained – and recently even accelerating – rise in exports apparently has a sound base. This is suggested not least by the fact that the rise encompasses the entire range of export goods on offer. According to the latest available information on the breakdown of German exported goods, which is available up to May this year, exports of products supplied by the capital goods industry and exports of the basic and producer goods sector rose in the first five months of 1997 by a seasonally adjusted 7 % and 8 ½ %, respectively, compared with the previous five-month period; at 5 ½ %, the rise in consumer goods was only slightly weaker. The orders received from abroad, which have risen even faster, also indicate that the general recovery in export business has a sound base. In seasonally adjusted terms export orders in manufacturing have increased sharply, particularly in recent months; in the second quarter their value exceeded the figure for the preceding quarter by 5 %.

This success illustrates, firstly, that the economic situation in major markets has been taking a turn for the better. Secondly, the international competitiveness of German exporters, in particular, has also improved considerably since the reduction of the distortions in the exchange rate pattern on the exchange rate side; thirdly, the strenuous efforts to increase productivity and reduce costs have strengthened their competitiveness on the cost side. In terms of the weighted real external value of the Deutsche Mark, which symbolises all of these influencing factors, the price competitiveness of German exporters has improved by approximately 10 % on a global average within the past two years. On that basis the real external value of the Deutsche Mark is almost exactly as it was towards the end of the eighties when the German economy found itself in an unmistakable export boom. Supported by such improvements in the business environment, German industry is now benefiting to a disproportionately high degree from the growth in world trade, which for 1997 as a whole is estimated to be growing overall at a rate of between 7 % and 8 %.

Foreign trade

Seasonally adjusted, quarterly



1 Change from previous quarter in %.

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Regional breakdown of exports

More detailed information on this can be obtained, in principle, from the regional distribution of German exports. However, these figures are available only up to May. Consequently, it is not yet possible to say precisely which markets were responsible for the accel-

Regional breakdown of foreign trade

January to May 1997, seasonally adjusted

Group of countries/ Country	Exports DM billion	Exports Change from Aug. to Dec. 1996 in %	Imports DM billion	Imports Change from Aug. to Dec. 1996 in %
Industrial countries	264.9	+ 4.5	230.3	+ 3.9
EU countries	195.4	+ 2.7	165.7	+ 2.2
of which				
Austria	18.5	– 4.6	11.7	+ 2.6
Belgium/ Luxembourg	20.9	– 4.1	18.5	– 2.6
France [1]	34.6	+ 0.0	30.0	+ 2.4
Italy	25.8	+ 6.2	24.1	+ 0.0
Netherlands	24.9	– 2.0	25.8	+ 2.8
Spain	13.2	+ 6.5	10.3	+ 4.0
United Kingdom	29.8	+ 9.6	21.2	+ 0.0
Other industrial countries	69.4	+ 9.5	64.5	+ 8.0
of which				
United States	30.3	+ 14.8	23.4	+ 9.3
Japan	9.0	+ 1.1	15.1	+ 11.0
Countries in transition	39.8	+ 9.0	38.7	+ 11.2
of which				
Countries in central and eastern Europe	35.4	+ 16.1	30.3	+ 13.5
China	3.7	– 32.7	8.5	+ 10.4
Developing countries	47.1	+ 7.8	36.5	+ 11.6
of which				
OPEC countries	7.8	+ 8.3	5.7	+ 3.6
Emerging markets in South-East Asia	20.5	+ 7.3	16.3	+ 11.6
All countries	352.4	+ 5.5	305.0	+ 5.2

1 Excluding aircraft.

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erated growth in exports in the second quarter. Nevertheless, the available data will probably provide some clues as to the essential structural features of the overall export momentum. As expected, they show that in the period from January to May 1997 the United States and the United Kingdom provided considerable stimuli to the trend in German exports compared with the period from August to December 1996. These two countries have long been enjoying vigorous economic growth while, at the same time, the relative strength of their respective currencies has been creating favourable competitive conditions for German enterprises. In terms of value and after seasonal adjustment the United States absorbed almost 15 % more German products than in the previous period mentioned; the United Kingdom purchased 9½ % more German products in the first five months of this year than in the previous period. The countries in transition in central and eastern Europe also made a considerable contribution to the growth in German exports (16 %); a faster rate of growth in exports was also achieved in trade with the developing countries, including the OPEC countries, and the emerging markets in South-East Asia (8 %). By contrast, exports to the member countries of the European Union in continental Europe were below average.

Imports

Growth in imports during the spring could not quite keep pace with the rate of expansion in exports. The seasonally adjusted value of imports rose by just under 1½ % in the second quarter of 1997 compared with the previous quarter; it was 11% higher than the level in the corresponding period a year earlier. As import prices also rose markedly over the year, in the second quarter of 1997 – mainly as a result of exchange rate differences brought about by the appreciation of the US dollar – by just under 3 % compared with the level a year earlier, the real increase in imports amounted to about 8 % compared with the corresponding period a year earlier. The appreciable rise in import prices is the downside, so to speak, of the improvement in international competitiveness of German exporters arising from the depreciation of the Deutsche Mark.

In view of the rather weak domestic demand overall, the momentum in exports, which triggered off a corresponding demand on the part of German manufacturers for foreign intermediate goods, raw materials and finished products, is an important driving force behind the growth in imports. The seasonally adjusted value of all imports of raw materials, semi-finished goods and intermediates rose by just over 5½ % in the first five months of this year compared with the previous five-month period; the value of imported finished products, however, rose even faster during the same period (by just over 7½ %). By contrast, there was virtually no rise in the value of energy imports. Their value had been inflated through steep price rises towards the end of last year.

Regional breakdown of imports

Of the industrial countries the United States and Japan – with (seasonally adjusted) growth of 9½ % and 11%, respectively, in the first five months of this year compared with the previous five-month period – benefited most – in terms of their respective growth rates provided by the regional data, which likewise are available only up to May – from the increase in German demand for imports. It is likely, however, that these values were largely due to exchange-rate-induced increases in import prices in terms of the Deutsche Mark. On the other hand, the rate of growth in imports from the group of EU countries was below average. Of the non-industrial countries it was notably the countries in transition in central and eastern Europe that showed significant increases in turnover in the trade with Germany (13½ %, seasonally adjusted). As far as the imports of raw materials are concerned, increases in the prices of these and the appreciation of the dollar each played an important role. Nevertheless, imports from the central and east European countries in transition have risen since the beginning of 1996 and in the first five months of this year were 20 % above the level during the corresponding period last year. There is no doubt that this must also be seen as an indication of the progress made in the integration of this country group into the world economy. Judging by the regional data on foreign trade, Germany is playing a central role in this context, both on the export and on the import side.

Invisibles

The deficit on invisible current transactions with non-residents, an area in which Germany continually records relatively large deficits, was restored in the second quarter of 1997 to something near its usual level following a sharp rise at the beginning of this year. The seasonally adjusted deficit fell by DM 6 billion to DM 30½ billion, which was the level it had reached during the same period

Major items of the balance of payments

DM billion

Item	1996 [1]	1997 [1]	
	2nd qtr	1st qtr	2nd qtr
I. Current account			
1. Foreign trade [2]			
Exports (f.o.b.)	192.5	202.6	221.2
Imports (c.i.f.)	169.2	178.2	187.8
Balance	+ 23.3	+ 24.5	+ 33.4
Memo item			
Seasonally adjusted figures			
Exports (f.o.b.)	193.4	209.1	218.6
Imports (c.i.f.)	169.2	182.4	185.0
2. Supplementary trade items [3]	– 1.2	– 1.6	– 1.0
3. Services			
Receipts	31.4	31.0	33.9
Expenditure	44.1	44.4	47.3
Balance	– 12.7	– 13.4	– 13.4
4. Factor income (net)	+ 1.2	– 5.1	– 0.8
5. Current transfers			
from non-residents	5.1	10.9	6.1
to non-residents	21.0	24.5	19.0
Balance	– 15.9	– 13.6	– 12.9
Balance on current account	– 5.3	– 9.2	+ 5.3
II. Capital transfers			
from non-residents	1.0	1.5	0.5
to non-residents	0.5	0.6	0.2
Balance	+ 0.5	+ 0.9	+ 0.4
III. Financial account (net capital exports: –)			
Direct investment	– 9.8	– 14.9	– 7.7
German investment abroad	– 6.6	– 15.5	– 6.2
Foreign investment in Germany	– 3.2	+ 0.6	– 1.5
Portfolio investment [4]	+ 19.9	+ 0.0	– 12.7
German investment abroad	– 10.5	– 43.7	– 46.5
Foreign investment in Germany	+ 30.4	+ 43.7	+ 33.8
Credit transactions [4]	– 2.6	+ 30.6	+ 34.8
Credit institutions	+ 5.0	+ 78.3	+ 18.0
Long-term	+ 5.4	+ 13.4	+ 6.6
Short-term	– 0.4	+ 65.0	+ 11.5
Enterprises and individuals	– 8.6	– 35.7	+ 17.9
Long-term	– 0.5	– 1.0	– 1.1
Short-term	– 8.1	– 34.7	+ 19.0
Public authorities	+ 0.9	– 12.0	– 1.1
Long-term	– 0.1	– 5.4	– 0.6
Short-term	+ 1.1	– 6.6	– 0.5
Other investment	– 0.7	– 0.7	– 0.7
Overall balance on financial account	+ 6.7	+ 15.0	+ 13.6
IV. Balance of unclassifiable transactions	– 2.8	– 8.6	– 19.7
V. Change in the Bundesbank's net external assets at transaction values (increase: +) [5] (I plus II plus III plus IV)	– 0.8	– 1.9	– 0.5

1 Figures subject to major uncertainty owing to changes in the method of data collection in foreign trade. — **2** Special trade according to the official foreign trade statistics. — **3** Mainly warehouse transactions for account of residents and deduction of goods returned. — **4** Excluding direct investment. — **5** Excluding allocation of SDRs and changes due to value adjustments.

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last year. Although the deficits in all subsections – services, factor income and current transfers – tended to decline, it was current transfers that were the deciding factor. Here alone the deficit declined by approximately DM 4 billion.

Services

During the period under review the seasonally adjusted deficit on service transactions with non-residents fell to DM 14 billion, which was almost DM 1½ billion less than in the previous quarter. This means that it exceeded the deficit in the corresponding period last year by no more than just over DM ½ billion, which was essentially due to the slight rise in the deficit on foreign travel, which makes up the "core" of the German service account with non-residents.

Foreign travel

At approximately DM 13 billion in the second quarter of 1997, Germany's traditionally large deficit on foreign travel exceeded the level in the corresponding period last year by no more than just under DM ½ billion. It is likely, at the same time, that the recent depreciation of the Deutsche Mark has made trips to some foreign destinations considerably more expensive for German travellers. This applies particularly to the countries within the "dollar area" given the fact that the Deutsche Mark was just over 11% lower in value against the US dollar in the second quarter of 1997 than it had been a year earlier. In real terms, that is to say, after adjustment to take account of the additional expenditure related to exchange rate movements and inflation, expenditure by German tourists and business travellers abroad in the second quarter of this year did not quite reach the level achieved in the second quarter of 1996. This becomes particularly clear if the regional breakdown of German foreign travel expenditure is also taken into account. For example, the greatest increases in the expenditure of German travellers abroad were to be found in countries whose currencies had sharply appreciated against the Deutsche Mark. This applies, for example, to German tourists' expenditure in the United States where in the second quarter of this year a 10½% increase was recorded compared with the same period last year. However, considerably more was also spent in Deutsche Mark terms on trips to Australia and New Zealand (+ 19½%) and to the United Kingdom (+ 10%). By contrast, some "classic" destinations such as Austria and Italy incurred losses during this period (– 4% and – 1 ½%, respectively) or, as in the case of Spain (+ ½%), were able to increase their receipts from German tourists only marginally.

Factor income

The deficit on factor income also declined from the first to the second quarter of 1997. At a seasonally adjusted DM 4 billion, the deficit in the second quarter was approximately DM ½ billion below the outcome in the previous quarter. The deficit on investment income, which fell from DM 4 billion, seasonally adjusted, to just under DM 3½ billion, was the main reason for this development. The relative strength of the dollar probably had a beneficial effect here in recent months because many of Germany's external assets are denominated in US dollars and therefore earnings in terms of the Deutsche Mark are correspondingly greater. By contrast, the deficits on current account and the associated reduction in Germany's net external assets tended to have a negative effect right into the early part of this year.

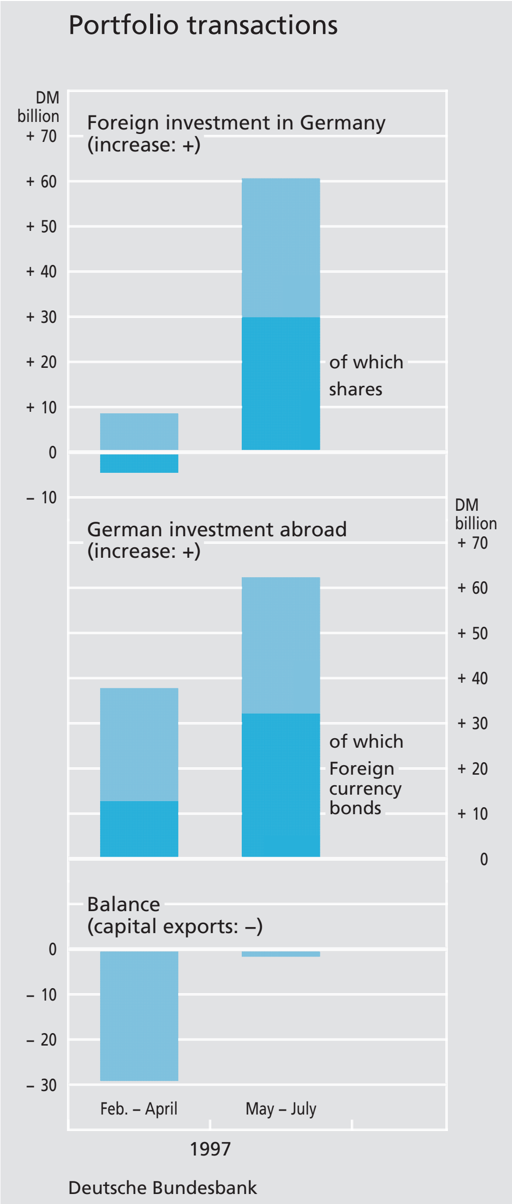
Unrequited transfers

There was a particularly marked decline in the deficit on current transfers to non-residents between the first and second quarters of 1997. This account ran a seasonally adjusted deficit of DM 12½%, which was approximately DM 4 billion lower than in the previous quarter. The main reason for this was the fact that the payments made as a result of the EU share in Germany's revenue from value added tax were considerably lower, at just under DM 3 billion, in the second quarter of 1997 than they had been in the first quarter (DM 8½ billion) because Germany had already made advance payments in the first quarter. The short-term fluctuations in the payment pattern naturally do not indicate the extent of Germany's actual burden from its contributions to the EU, which, in principle, is still considerable. Germany's regular net payments to the EU during the period under review amounted to DM 6½ billion. At a total of just over DM 4 billion, private transfers were the same as in the previous quarters, the remittances of foreign workers in Germany to their home countries (at just under DM 2 billion) being a particularly large component here.

Financial transactions and reserve movements

Trends in financial transactions

An unmistakably optimistic mood prevailed on the international financial markets in the early summer. Whereas widespread uncer-



tainty regarding interest rates and therefore, for a time, a wait-and-see attitude towards investment had still been determining sentiment during the early part of the year, a distinct upward trend set in on the international securities markets at the end of April. This resulted in a sharp rise in German financial transactions with non-residents in both directions. On the one hand, Germany's securities markets, and above all the equity market, benefited from the resurgence of international investor interest. On the other hand, investment by Germans in securities abroad also increased significantly, especially as a result of greatly increased purchases of foreign currency bonds. The capital movements through securities transactions with non-residents largely cancelled out over the entire period from May to July whereas in the previous three months – when gross flows were much lower on both sides of the financial account – fairly substantial outflows of funds from Germany's securities markets had been recorded. In the other sections of the financial account persistently substantial capital exports through direct investment were accompanied by extensive inflows through the credit transactions of non-banks with the result that the net external assets of the banking system, which – in the event of a relatively balanced current account – represent the balance-sheet counterpart to these developments, showed only a slight change.

Portfolio transactions

Foreign interest in German securities revived sharply following the change in mood on the international financial markets described above. Until then a fairly pronounced restraint on the part of non-residents had set the scene. Only DM 8 ½ billion net had been spent by non-residents in German securities markets in the three months from February to April this year whereas in the period under review, from May to July, non-resident investors purchased German securities worth DM 60 ½ billion.

Of the entire amount invested by non-residents in securities in Germany, German

Record investment by non-residents in German equity market

equities accounted for almost one-half, or DM 30 billion net. Between February and April international investors had reduced their German equity holdings worth DM 4½ billion. The recent development has to be seen primarily in connection with the change in international conditions, which had also given new impetus to prospects on the German equity market. The expected rise in the profitability of many German enterprises as a result of the distinct improvement which had emerged in their competitive position was the primary reason for this.

Foreign investment in the German bond market

In addition to the equity market, the German bond market benefited from the substantial sums invested by non-residents. At a time when German capital market interest rates were tending to fall and the yield advantage of dollar-denominated paper over equivalent bonds and notes in Deutsche Mark was becoming slightly less pronounced, inflows of foreign funds to the German bond market rose from DM 14½ billion from February to April to DM 28½ billion from May to July. As usual, foreign interest focused primarily on public bonds (DM 23 billion). Of these the two-year Federal Treasury notes, a major new issue of which had been launched in June, continued to be in great demand (DM 7 billion). Furthermore, foreign investors again purchased large quantities of foreign currency bonds issued by domestic credit institutions (DM 10 billion). By contrast, German money market paper enjoyed virtually no greater interest during the period under review.

German investment abroad

The rise in German purchases of securities abroad was a mirror image of the rise in foreign investment in Germany. At DM 62½ billion, German residents invested almost twice as much abroad between May and July as in the previous three-month period (DM 37½ billion). A further point is that the structure of German investment in securities abroad changed significantly. Whereas in earlier months Germans invested mostly in foreign equity markets (DM 21 billion), the interest in foreign equities ebbed considerably during the period under review (DM 7½ billion).

Large purchases of foreign currency bonds

Instead, German investors showed greater interest in foreign currency bonds. With a net investment of DM 32 billion net (compared with DM 13 billion in the previous period) Germans exceeded their relatively high level of investment at the end of the eighties, which was the last time German savers – albeit primarily for tax reasons – had purchased large amounts of foreign bonds and notes. The reason was that interest arising from claims against foreign borrowers was exempt from the withholding tax on interest income, which was then only in force for a short time.[1] German purchases of foreign currency bonds during the months under review concentrated on dollar-denominated paper (DM 7½ billion) and on lira-denominated paper (DM 16 billion), in particular. The Italian bond market evidently benefited to a greater extent from "convergence trading", which is essentially based on the expected market gains of previously high-yielding lira-denominated paper as a result of the conver-

1 The reason was that interest arising from claims against foreign borrowers was exempt from the withholding tax on interest income, which was then only in force for a short time.

Financial transactions

DM billion, net capital exports: –

Item	1996 May–July	1997 Feb.–April	1997 May–July
1. Direct investment	– 11.7	– 10.2	– 9.8
German investment abroad	– 9.6	– 8.9	– 13.0
Foreign investment in Germany	– 2.1	– 1.3	+ 3.3
2. Portfolio investment	+ 35.8	– 29.2	– 1.7
German investment abroad	– 9.4	– 37.7	– 62.3
Shares	+ 1.5	– 21.1	– 7.5
Investment fund certificates	– 1.5	– 2.6	– 4.1
Bonds and notes	– 6.1	– 14.8	– 38.9
Money market paper	– 2.9	– 1.3	– 2.6
Financial derivatives 1	– 0.4	+ 2.1	– 9.3
Foreign investment in Germany	+ 45.2	+ 8.5	+ 60.7
Shares	+ 15.6	– 4.6	+ 29.9
Investment fund certificates	– 1.1	+ 0.1	+ 0.7
Bonds and notes	+ 22.8	+ 14.3	+ 28.4
Money market paper	+ 7.8	+ 2.8	+ 0.9
Warrants	+ 0.1	– 4.2	+ 0.7
3. Credit transactions	– 30.3	+ 50.3	+ 11.0
Credit institutions	– 33.0	+ 50.7	– 1.6
Long-term	+ 6.4	+ 12.2	+ 2.1
Short-term	– 39.4	+ 38.5	– 3.7
Enterprises and individuals	– 0.5	+ 2.0	+ 18.4
Long-term	– 0.9	– 1.3	+ 0.4
Short-term 2	+ 0.4	+ 3.3	+ 18.1
Public authorities	+ 3.2	– 2.3	– 5.9
Long-term	+ 0.2	– 3.9	– 3.7
Short-term	+ 3.0	+ 1.6	– 2.1
4. Other investment	– 1.0	– 0.8	– 0.7
5. Balance of all statistically recorded capital flows	– 7.1	+ 10.1	– 1.2
Memo item Change in the Bundesbank's net external assets at transaction values (increase: +)	– 4.6	– 1.7	– 3.6

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 July 1997, which are not yet known.

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gence in interest rates in the European monetary union. The yield spread of, for example, ten-year lira-denominated government bonds actually declined from almost 2 percentage points to about 1 percentage point between the spring and the summer of this year.

In addition to the acquisition of foreign currency bonds, German investors purchased foreign Deutsche Mark bonds worth DM 7 billion (compared with DM 2 billion in the previous period) and foreign investment fund certificates worth DM 4 billion. In addition, relatively large amounts of funds were exported in connection with transactions in financial derivatives and warrants (DM 8½ billion net).

Direct investment

In contrast to what happened in portfolio transactions, substantial net amounts of capital continued to be exported as a result of direct investment. Between May and July German enterprises increased their participating interests in foreign firms by DM 13 billion compared with DM 9 billion in the previous three months. Since the beginning of the year a total of DM 30 billion in new investment capital has gone abroad. Consequently, the figure in the corresponding period last year (DM 22 billion) has been considerably overtaken. In the period under review the EU partner countries and the United States each absorbed just under one-third, or DM 4 billion, of total German direct investment. There was also substantial investment in Switzerland (DM 1½ billion) and in the countries in transition in central and eastern Europe (DM 1 billion).

According to their reports for the German balance of payments statistics, foreign enterprises, by contrast, increased their participating interests in Germany by no more than DM 3½ billion during the period under review. Between February and April they had actually reduced their investment by DM 1½ billion net. However, these figures must be interpreted very carefully. At all events, they are not consistent with more recent reports about a discernible increase in foreign interest in holding participating interests in enterprises and purchasing enterprises in Germany.[2]

Credit transactions of non-banks

Substantial outflows of funds (DM 12½ billion net) arose in the period under review as a result of the credit transactions of domestic non-banks with non-residents. This was mainly due to a reduction of DM 18 billion in the short-term (net) claims of domestic enterprises and individuals against non-residents. It is essentially inflows of funds from foreign banks to German enterprises, both as a result of borrowing and of reducing Eurodeposits. By contrast, the public authorities exported a total of DM 6 billion between May and July.

Credit transactions of banks

The credit transactions between domestic banks and non-residents virtually balanced out during the period under review. There were outflows of funds amounting to DM 1½ billion (net) between May and July. Small inflows of long-term financial resources were accompanied by an increase in the short-term net external assets of the credit institutions. This increase is to be seen essentially as a reflection of the trends in the other segments of the financial and current accounts mentioned above.

External position of the Deutsche Bundesbank

In contrast to the external position of the credit institutions, the net external assets of the Bundesbank declined – at transaction values – by DM 3½ billion between May and July. While the external liabilities remained virtually unchanged, the Bundesbank's foreign currency reserves decreased by approximately DM 3 billion as a result of commercial foreign exchange market transactions. The net external assets of the Bundesbank declined by a further DM 2½ billion in August. Taking the balance sheet rates at the end of 1996 as a basis, the net external assets of the Bundesbank amounted to DM 99 billon at the end of August compared with DM 105½ billion at the end of 1996.

Exchange rate trends

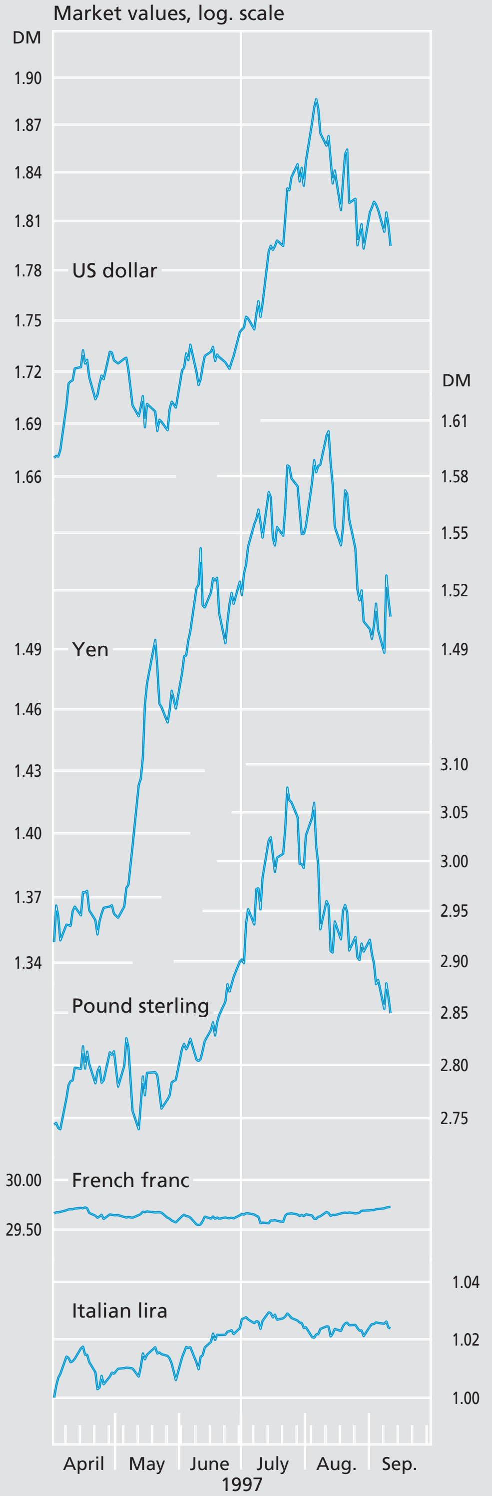
Dollar

The Deutsche Mark, which had largely stabilised on the world foreign exchange markets in the spring, lost ground again during the summer. The US dollar, in particular, received new impetus around the middle of the year with the result that within only a few weeks it

2 The data on corporate mergers and acquisitions rarely agree with the figures in the balance of payments statistics because these transactions are often not associated with cross-border payments or because the participating interests and takeovers are not counted, by definition, as direct investment because of the special nature of the participating interests and the legal domicile of the enterprises concerned. For the informative value of the direct investment figures and for the longer-term trend in international direct investment see Deutsche Bundesbank, Problems of international comparisons of direct investment flows, Monthly Report, May 1997, page 77 ff. and Deutsche Bundesbank, Development and determinants of international direct investment, Monthly Report, August 1997, page 63 ff.

Exchange rate trends
of selected currencies

Market values, log. scale



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appreciated to just under DM 1.90 whereas in the previous few months it had been moving in a relatively narrow band at approximately DM 1.70.

It was probably mainly the re-emergence of more favourable growth prospects for the US economy during the summer and the expectations on interest rates associated with this that gave rise to the increase in the dollar rate. However, the dollar appears to have benefited, too, from a certain revision of the global economic and political risks by market participants. At all events, this is suggested by the slight decline in the interest rate advantage of US government bonds over comparable German Federal paper. This decline was observed at the same time as the further strengthening of the US currency during the summer. In view of the difficulties involved in implementing the urgent reform plans in Germany and the uncertainty in connection with the planned introduction of European monetary union, the factors such as the large current account deficit and the savings disequilibrium illustrated by this, which had previously worked to the dollar's disadvantage, were apparently disregarded by investors for a time. The strong and largely tension-free economic growth in the United States may also have strengthened market confidence.

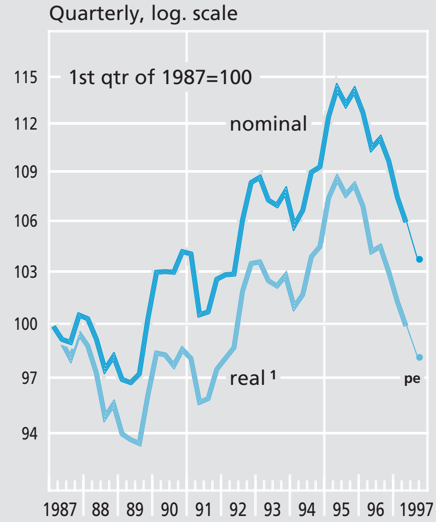
In addition to such changes in the assessment of the fundamental factors, however, certain exaggerations and overstatements may have contributed to the exchange rate trend in the summer. That is consistent, at least, with the fact that the implicit volatility of dollar options increased recently. It is presumably also an explanation for the fact that the dollar rate moved in the opposite direction throughout August after nervousness over interest rates in the Deutsche Mark area had increased discernibly and a wave of turbulence in the US financial markets had unsettled investors. The dollar was recently hovering at a level of about DM 1.80; when this Report went to press, it was being quoted at DM 1.78.

Yen

The yen also gained ground against the Deutsche Mark during the summer. This development had set in during the spring after prospects for economic growth in Japan had seemed to be improving appreciably and there had been a recurrence of record surpluses in Japanese foreign trade. After that, the Japanese currency appreciated against the Deutsche Mark, rising from about DM 1.35 in the spring to just under DM 1.60 in the second half of July. It then moved within a band between DM 1.54 and just over DM 1.60, its highest level since mid-1995. As in the case of the dollar, however, the upward movement in the yen ceased during the last few weeks before this Report went to press; indeed, the trend has gone into reverse. The Japanese currency seems to have been adversely affected by the uncertainty and tensions in some South-East Asian foreign exchange markets. These developments are the likely reasons for the downturn in Japan's foreign trade and for the greater difficulty in solving the structural problems in the Japanese banking system. Furthermore, the optimism in the spring about future economic trends has given way to a more sceptical outlook. When this Report went to press, the yen was being quoted at DM 1.47.

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; quarterly. — ● = Average between September 1 and 11, 1997.

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EU currencies

Of the EU currencies the pound sterling was the one which, largely in line with the dollar, gained the most ground against the Deutsche Mark during the summer. Underpinned by the robust economic growth in the United Kingdom and as a result of pressure from increasing inflationary risks which fuelled investors' expectations on interest rates, the British currency broke through the DM 3 threshold in July and, at DM 3.08, was as expensive as it had been in the summer of 1989. However – again in line with the dollar – a fairly rapid downward correction course began in August, with the result that, at the time this Report went to press, the pound sterling was again being traded at DM 2.86.

The Italian lira also tended to strengthen, and the interest rate differential between lira and Deutsche Mark assets again declined. Generally speaking, parity changes in the case of most other currencies participating in the exchange rate mechanism of the European Monetary System were strictly limited, by contrast. Almost all were being quoted at more or less their central rates at the time this Report went to press. Only the Irish pound again came under pressure to appreciate during the quarter under review – being carried along in the wake of the pound sterling.

Nominal and real external values

In the end the external value of the Deutsche Mark fell by 1% during the summer on a weighted average against the currencies of 18 industrial countries, primarily as a result of the strength of non-European currencies; at the time this Report went to press, the Deutsche Mark was being quoted at just over 4½% lower than it had been at the beginning of the year. After eliminating the differences in rates of inflation at home and abroad, however, the (real) depreciation of the Deutsche Mark on a weighted average of the currencies of all countries was somewhat weaker; the weighted real external value of the Deutsche Mark was approximately the same as it had been towards the end of the eighties. This means that Germany's export trade will probably continue to provide important stimuli for the German economy. On the other hand, the risks on the prices side associated with the exchange rate developments will have to be closely monitored.