Report of the Deutsche Bundesbank

for the Year 1978

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Note: In order to expedite publication of the English version of this Report the following sections contained in the German original have been omitted:

Part A	Bank supervision, domestic and external monetary and foreign exchange policy regulations of the Deutsche Bundesbank
Part C	Fund for the Purchase of Equalisation Claims
Appendices to Parts B and C	Nos. 1, 3, 4 and 5

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Part A: General part

The currency and the economy in 1978

I. Economic developments and central bank policy

In 1978 the Bundesbank pursued a monetary policy that was directed towards achieving several objectives at the same time. On the one hand, it sought to bring about monetary conditions that would facilitate the development of the expansionary forces in the German economy, in order to improve the chances of reaching a high level of employment and thus reducing unemployment. On the other hand, it had to take care not to ease monetary conditions to such an extent that additional scope for price and cost rises was created. In relation to these overall objectives, the outcome in 1978 appears quite satisfactory. After a slow start, which owed something to the severe winter and labour disputes, economic activity gathered pace quite generally in the course of the year. It was mainly fuelled by domestic demand, the stimulus imparted by foreign demand this time — in contrast to earlier upswings — being small. In the end the growth of overall production (as measured by the real gross national product), at 3 1/2 %, came up to the target originally envisaged for 1978. As business activity strengthened, the situation in the labour market improved perceptibly; the size of the labour force rose for the first time since 1973, so that it was able to absorb those who wished to start work and a reduction in the level of unemployment became possible.

Even though economic activity picked up strongly, particularly in the second half of the year, and a number of major sectors of the economy began to approach the limits of their capacity, the situation on the price front remained quiet for long periods of last year. In 1978 price rises were again smaller than in the preceding year, except in the construction market. Industrial producer prices increased on average by no more than 1.3 % during the year, and consumer prices went up by 2.6 %; these were the lowest growth rates since the end of the sixties. The slackening pace of price rises was admittedly due in part to a number of influences which are unlikely to recur soon, such as the steep appreciation of the Deutsche Mark and the fall in agricultural prices. But this progress towards stability could not have been made if wage settlements had not been in keeping with these tendencies.

When assessing monetary developments in 1978 it must be borne in mind that the Bundesbank's room for manoeuvre in the monetary field was greatly constricted at times by external developments. Both at the beginning of the year and in the autumn new monetary unrest associated with the temporary weakness of the U.S. dollar, and to some extent also with tensions in the European narrower margins arrangement (the "snake"), resulted in a rapid appreciation of the Deutsche Mark in international foreign exchange markets. In order to slow down this upward movement, which far exceeded the price and cost differential between Germany and other countries, and at the same time to mitigate the dampening effect of an excessive appreciation on domestic activity, the Bundesbank took considerable amounts of foreign currency out of the market; indeed, as far as weak currencies in the European narrower margins arrangement were concerned, it was obliged to do so. In these circumstances the Bundesbank was forced to adhere to a relatively easy domestic monetary policy. Both factors — the massive inflows of funds from abroad and the stance of domestic monetary policy — led to an expansion of the money stock in Germany that greatly overshot the Bundesbank's original monetary growth target for 1978. As long as the trend of business activity remained fairly flat (as in the early part of last year) and as the sharp appreciation of the Deutsche Mark automatically restrained the increase in domestic costs and prices, it was possible to tolerate the faster expansion of liquid funds in Germany; in fact, any application of the monetary brakes during that period would probably have had an adverse effect on the economy as a whole. But after the upswing had gathered appreciable momentum in the second half of 1978 and the upward movement of the Deutsche Mark had ceased — and indeed given way to a slight weakness in the foreign exchange markets — following the U.S. monetary policy measures of last November, the Bundesbank had to apply stricter standards to its policy. This was clearly reflected in its announcement of a monetary growth target for 1979 in mid-December last year. It underlined this decision by lowering the banks' rediscount quotas at the same time. Since then it has further reduced bank liquidity, and it finally affirmed this turnaround in its policy by raising the discount and lombard rates. By these measures the Bundesbank is trying to play its part in ensuring the favourable development of the economy. The maintenance of price stability, which has nearly been achieved after difficult years involving many sacrifices, is an essential precondition for this.

Economic growth

Percentage change on previous year

Year	Gross domestic product 1	Productivity 2	Total number of man-hours worked	Persons employed in Germany	Gross domestic product 1 per inhabitant	**Compare** Gross domestic product per inhabitant, all OECD countries 3
1961–1969 4	+ 4.6	+ 5.2	– 0.6	+ 0.1	+ 3.6	+ 3.9
1970–1973 4	+ 4.4	+ 4.6	– 0.1	+ 0.4	+ 3.6	+ 3.5
1974–1978 4	+ 1.8	+ 3.7	– 1.8	– 1.2	+ 2.1	+ 1.7
1974	+ 0.5	+ 3.6	– 2.9	– 1.9	+ 0.4	– 0.3
1975	– 2.0	+ 3.0	– 4.9	– 3.4	– 1.6	– 1.4
1976	+ 5.0	+ 4.8	+ 0.2	– 0.9	+ 5.5	+ 4.4
1977	+ 2.8	+ 3.6	– 0.8	– 0.2	+ 3.0	+ 2.9
1978	+ 3.1	+ 3.8	– 0.7	+ 0.3	+ 3.2	+ 2.9
Memo item						
1976–1978 4	+ 3.6	+ 4.0	– 0.4	– 0.3	+ 3.9	+ 3.4

1 At 1970 prices. – **2** Gross domestic product at 1970 prices per man-hour worked. – **3** On a U.S. dollar basis; 1961–1973: at 1970 prices and exchange rates; 1974–1978: at 1975 prices and exchange rates. – **4** Annual averages. – The figures from 1976 onwards are provisional.

1. Economic recovery in the course of the year

Increase in the real gross national product in line with the target

Economic activity in the Federal Republic of Germany increased considerably in the course of 1978. After the output of goods had been reduced noticeably in the first few months by labour disputes in the metal and printing industries and by production losses in the construction sector owing to the relatively severe winter, the expansionary forces preponderated again before the middle of the year. From then onwards output rose sharply. Over the whole of 1978 the real gross national product was 3 1/2 % larger than a year earlier.

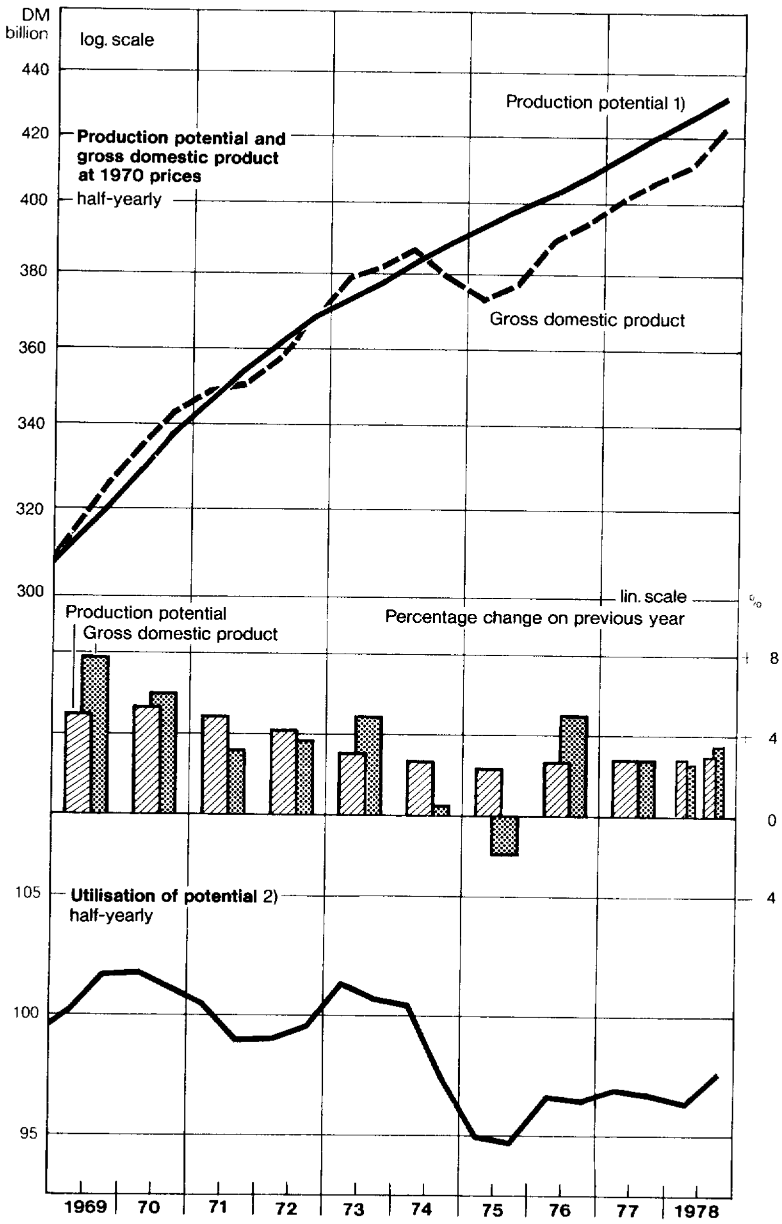
Differing developments in the individual economic sectors

However, developments in the individual economic sectors differed greatly in 1978, as in the preceding years. In the construction industry the upswing was particularly pronounced. Despite growing labour bottlenecks, output in this industry in 1978 was 7 1/2 % larger than a year before. On the other hand, the expansion of production in the manufacturing sector in 1978 was below the average (+2 %), even though some industrial branches (chemicals, iron and steel) which had not benefited from the economic upturn in 1977 were able to make up considerable leeway last year. Other industries, especially those facing particularly keen competition from foreign suppliers in domestic and foreign markets as a result of the higher external value of the Deutsche Mark (for instance the textile and clothing industry and the precision instruments and optical goods industry), were not always able in 1978 to maintain the level of output of the preceding year. In the first few months of 1979, under the impact of the exceptionally severe winter, there has probably been little or no increase in overall production.

4 % annual growth of the gross domestic product per inhabitant between 1976 and 1978

Since the recession of 1975 Germany's real gross national product has grown at an average annual rate of 3.7 %. It should be borne in mind, however, that the resident population has decreased slightly in the past few years. Calculated per inhabitant – this is a better indicator of the development of the standard of living than the gross national product itself – the expansion of production in Germany has come to 4 % per annum in the last three years; both over time and by international standards this is a considerable increase. In the OECD countries the real gross domestic product per inhabitant rose by only 3 1/2 % per annum between 1976 and 1978. In the sixties, by contrast, the growth of the real gross domestic product per inhabitant in Germany, at 3 1/2 % a year, had been below the average for all OECD countries (4 %). The output of goods went up slightly more than production potential in 1978, particularly in the second half of the year; it had also done so in 1976, but not in 1977. Production potential, which is intended to reflect the output possible in the economy if the utilisation of all the factors of production is running at a "normal" level, grew by an estimated 3 % a year between 1976 and 1978. In 1978 the utilisation of the potential is likely to have amounted to just over 97 % of "normal" compared with not quite 95 % in 1975. However, this average figure for 1978 masks widely differing conditions in individual sectors. In the motor industry, for example, ca-

Production potential and national product



1) Calculated by the Bundesbank.- 2) Potential = 100.

pacities were in effect fully utilised throughout the year, and the construction industry approached full utilisation rapidly as the year progressed, but in shipbuilding, the steel industry and parts of the capital goods sector, for instance, capacity was idle in 1978, although there too the degree of utilisation increased in some cases. However, economically utilisable capacity in branches of economic activity with structural sales problems cannot be measured very accurately. There are undoubtedly sectors which, given the existing level of exchange rates and the domestic cost situation, are hardly competitive any longer, at least as far as specific products are concerned, and which therefore cannot avoid running down their capacities. In these sectors the volume of physically available production capacity does not in itself mean very much, since the only assets which can realistically be regarded as part of the production potential are those which can be utilised economically in the medium term under the prevailing cost and price conditions. The statistics enable only rough allowance to be made for the phasing out, owing to a long-term decline in sales, of assets which are physically still available — i.e. have not yet been scrapped — but are no longer economically utilisable.

Low productivity rate as a result of under-utilisation of capacities . . .

In 1978 output per man-hour worked in Germany increased by almost 4 %. The rise in productivity was thus roughly as great as a year earlier. It appears, however, that the rate of growth has generally slowed down in the last few years after having remained remarkably constant in the sixties, at just over 5 % a year, if cyclical variations are disregarded. There are several reasons for this. One significant factor is that the utilisation of overall production capacity has been lower than "normal" in the last few years on cyclical grounds, as already noted. But even if the cyclical fluctuations in economic activity are eliminated, productivity is found to have improved distinctly more slowly in the medium term; in 1978 the "cyclically adjusted" increase in productivity (i. e. the increase possible if capacities were better utilised) was approximately 1 percentage point smaller than in the early seventies and not quite 1 1/2 percentage points lower than in the sixties. This is mainly because "productive" investments, i. e. particularly private net investments (excluding housing), continue to be smaller than they used to be relative to the gross national product.

. . . and changes in underlying economic conditions

Moreover, in the producing sector — traditionally an area where the scope for rationalisation is great and productivity accordingly high — the expansion of output has been hampered more than in other sectors in the past few years. The appreciation of the Deutsche Mark since the end of 1972 has increased competition with foreign suppliers, both in Germany and abroad. Furthermore, the sharp wage rises have shifted overall income relationships to the disadvantage of enterprises, without the input of labour being fully adjusted to the changed pattern of costs. Structural shifts were unavoidable in these circumstances; they were reflected in a medium-term decline in the share of the producing sector in the real gross domestic product. On the other hand, particularly the service sectors, which are generally less exposed to international competition, and the government in its capacity as a producer of services gained some ground with respect to net value added and employment in the same period. However, the scope for rationalisation in these sectors is not as great as in industry, and the improvement in their productivity was correspondingly smaller. Since this trend will probably continue in the longer run, and certainly not be reversed, the overall increase in productivity (as measured per man-hour worked) is not very likely to return to its previous pace in the medium term. This should not be regarded as a purely negative development. On the contrary, it opens up the possibility of approaching the goal of full employment even if overall economic growth is smaller than in earlier years. The first signs of this were discernible last year. The level of employment was raised quite sharply although, as noted, the real gross national product went up by "only" 3 1/2 %, whereas many longer-term forecasts which are based too mechanically on past patterns still assume that there will be an increase in employment that simultaneously results in a decrease in unemployment only if the real growth of the gross national product in Germany amounts to more than 4 % per annum.

Improvement in the situation in the labour market . . .

. . . although the high level of unemployment persists

On the whole the situation in the labour market improved in the course of 1978. After the manpower reserves which enterprises still possessed as a result of the slack business activity (sometimes in the form of short-time working) had largely been used up, the demand for additional labour rose noticeably. Altogether, the average number of employees in 1978 was about 140,000 larger than a year earlier. Nevertheless, the number of unemployed registered at the labour exchanges last year still averaged nearly one million, i. e. 37,000 fewer than in 1977. In relation to the dependent labour force (the criterion used in the official German statistics) the seasonally adjusted unemployment ratio stood at 4.1 % at the end of 1978. If, in accordance with international practice, the total labour force is used as a yardstick (this appears to be justified in so far as some of the unemployed were previously self-employed), the unemployment ratio came to 3.7 % at that time. In March 1979, after the severe winter weather had ended, the seasonally adjusted unemployment ratio declined to 3.9 % and 3.5 %, respectively.

Structural influences become more and more apparent

It is becoming increasingly evident that the upturn in economic activity is favourably affecting the labour market but only gradually reducing the structural problems of unemployment. Between the recession year of 1975 and 1978 the number of unemployed men registered at the labour exchanges decreased by an annual average of about 134,000 or just over one fifth; in particular, the employment prospects of persons between 20 and 59 years of age and of young persons (those below 20 years of age) improved. By contrast, the number of women registered as unemployed increased sharply (by roughly 52,000) between 1975 and 1978 because, on the one hand, many women were looking

Basic economic data in the Federal Republic of Germany

Item	Unit	1975	1976	1977	1978	1975	1976	1977	1978
						Percentage change on previous year			
Aggregate demand									
Private consumption	DM billion	576.5	623.1	666.6	709.5	+ 9.3	+ 8.1	+ 7.0	+ 6.4
Public consumption	DM billion	215.3	227.4	240.3	256.1	+ 11.0	+ 5.6	+ 5.7	+ 6.6
Fixed capital formation	DM billion	214.5	231.9	249.1	276.5	— 0.9	+ 8.1	+ 7.4	+ 11.0
Machinery and equipment	DM billion	82.3	90.7	99.9	110.4	+ 7.7	+ 10.2	+ 10.2	+ 10.5
Buildings	DM billion	132.2	141.2	149.3	166.1	— 5.5	+ 6.8	+ 5.7	+ 11.3
Expenditure on stocks	DM billion	— 2.3	+ 9.7	+ 9.1	+ 5.8	.	.	.	.
Domestic expenditure	DM billion	1,004.1	1,092.1	1,165.1	1,247.9	+ 6.4	+ 8.8	+ 6.7	+ 7.1
External surplus 1	DM billion	29.8	29.6	28.6	34.8	.	.	.	.
Exports	DM billion	272.5	311.8	329.3	347.0	— 1.3	+ 14.4	+ 5.6	+ 5.4
Imports	DM billion	242.7	282.2	300.7	312.3	+ 4.3	+ 16.3	+ 6.5	+ 3.9
Gross national product at current prices	DM billion	1,033.9	1,121.7	1,193.7	1,282.6	+ 4.8	+ 8.5	+ 6.4	+ 7.4
Memorandum items									
Orders received by manufacturing	1970 = 100	135.9	154.7	156.1	164.0	— 2.2	+ 13.8	+ 0.9	+ 5.1
Domestic orders	1970 = 100	127.9	139.5	142.5	150.3	+ 2.6	+ 9.1	+ 2.1	+ 5.5
Foreign orders	1970 = 100	162.2	204.5	199.6	208.9	— 12.2	+ 26.1	— 2.4	+ 4.6
Orders received by construction	1971 = 100	96.2	90.3	104.4	128.6	+ 6.9	— 6.2	+ 15.6	+ 23.2
Production									
Gross national product at 1970 prices	DM billion	751.5	789.8	810.0	837.3	— 1.9	+ 5.1	+ 2.6	+ 3.4
Productivity 2	1970 = 100	122.1	127.9	132.5	137.5	+ 3.0	+ 4.8	+ 3.6	+ 3.8
Output in the producing sector (excluding construction)	1970 = 100	105.0	112.7	116.0	118.7	— 5.7	+ 7.3	+ 2.9	+ 2.3
Construction output	1970 = 100	92.4	95.2	95.2	102.4	— 11.2	+ 3.0	0.0	+ 7.6
Employment									
Employed persons	Millions	25.3	25.1	25.0	25.1	— 3.4	— 0.9	— 0.2	+ 0.2
Wage and salary earners	Millions	21.4	21.3	21.3	21.5	— 3.5	— 0.5	+ 0.3	+ 0.7
Foreign workers	Millions	2.1	1.9	1.9	. . .	e — 11.5	— 6.6	— 2.7	. . .
Memorandum item									
Total number of man-hours worked	1970 = 100	90.6	90.8	90.1	89.5	— 4.9	+ 0.2	— 0.8	0.7
Unemployed persons	Thousands	1,074	1,060	1,030	993	+ 84.4	— 1.3	— 2.9	— 3.6
Unemployment ratio 3	%	4.7	4.6	4.5	4.3	.	.	.	.
Prices									
GNP deflator	1970 = 100	137.6	142.0	147.4	153.2	+ 6.7	+ 3.2	+ 3.8	+ 3.9
Memorandum item									
Unit labour costs in the economy as a whole 4	1970 = 100	144.2	146.6	152.2	155.3	+ 6.1	+ 1.7	+ 3.8	+ 2.1
Cost of living index for all households	1970 = 100	134.7	140.8	146.3	150.1	+ 6.0	+ 4.5	+ 3.9	+ 2.6
Producer prices of industrial products	1970 = 100	135.5	140.7	144.5	146.3	+ 4.7	+ 3.9	+ 2.6	+ 1.3
Overall construction price level	1970 = 100	133.7	137.8	143.9	152.6	+ 2.4	+ 3.1	+ 4.4	+ 6.0
Producer prices of agricultural products	1970 = 100	133.2	149.0	142.3	p 137.0	+ 13.3	+ 11.9	— 4.5	p — 3.7

1 Balance of merchandise and service transactions with the rest of the world (including GDR). — **2** Gross domestic product at 1970 prices per man-hour worked. — **3** Unemployed persons as a percentage of the dependent labour force. — **4** Index of gross wages and salaries per employee divided by index of real GNP per employed person. — The figures from the national accounts from 1976 onwards are provisional.
p Provisional. — **e** Estimated.

for employment while, on the other, the demand for female labour did not keep pace with the growing supply. The placement of unemployed women (about 475,000 at the end of September 1978) was complicated by the fact that one in three of them stated that she was only interested in a part-time job; 90 % of them also said that they were only willing to be placed in their home region, which necessarily keeps the unemployment ratio high in districts with an unfavourable economic structure.

A further indication of structural shifts in the labour market is the fact that certain enterprises are having more and more difficulty in finding suitable skilled and in some cases even unskilled labour despite the large number of persons registered as unemployed. This applies particularly to many construction firms, which in the preceding years of sluggish construction activity released many employees whom they now urgently need. Parts of the manufacturing sector and some service fields (e. g. the hotel and catering trade) also found it very hard to meet their personnel requirements last year. In addition, there are regional differences in the pace of the economic recovery. Whereas there was virtually full employment in large areas of southern Germany in 1978, in northern and western Germany, and also in south-western Germany, the unemployment ratios were mostly above the average.

Labour reserves often overestimated

There is strong evidence that last year Germany came nearer to the goal of a high level of employment than is suggested by some calculations of the size of the unutilised labour potential. It is of course correct to assume that there are persons — especially women — who are not registered as unemployed but who would accept a job if one was offered to them in the desired region and on acceptable terms. But it is also known — though not adequately demonstrable in figures — that some members of the labour force (for instance those who are approaching pensionable age) are virtually unplaceable during the period in which they are registered as unemployed. Estimates of the size of so-called "hidden" labour reserves — i. e. persons who could be incorporated into the labour force in addition to those registered as unemployed — differ greatly. The number of employees that might perhaps be mobilised may easily be overestimated, particularly if it is assumed that the increase in the employment of women of working age will continue at the same pace as at the beginning of the seventies, when excessive demands were made on the labour market. A weighty argument against this idea is the fact that last year's economic upswing soon revealed in some sectors of the economy labour bottlenecks which could be overcome neither by the placement of unemployed persons nor by the recruitment of manpower from the "hidden" reserves. A rate of economic growth such as would be required to mobilise the "hidden" reserves ascertained by this estimation procedure would, if it could be achieved at all, again place an excessive strain on the labour market, with all the concomitant adverse consequences.

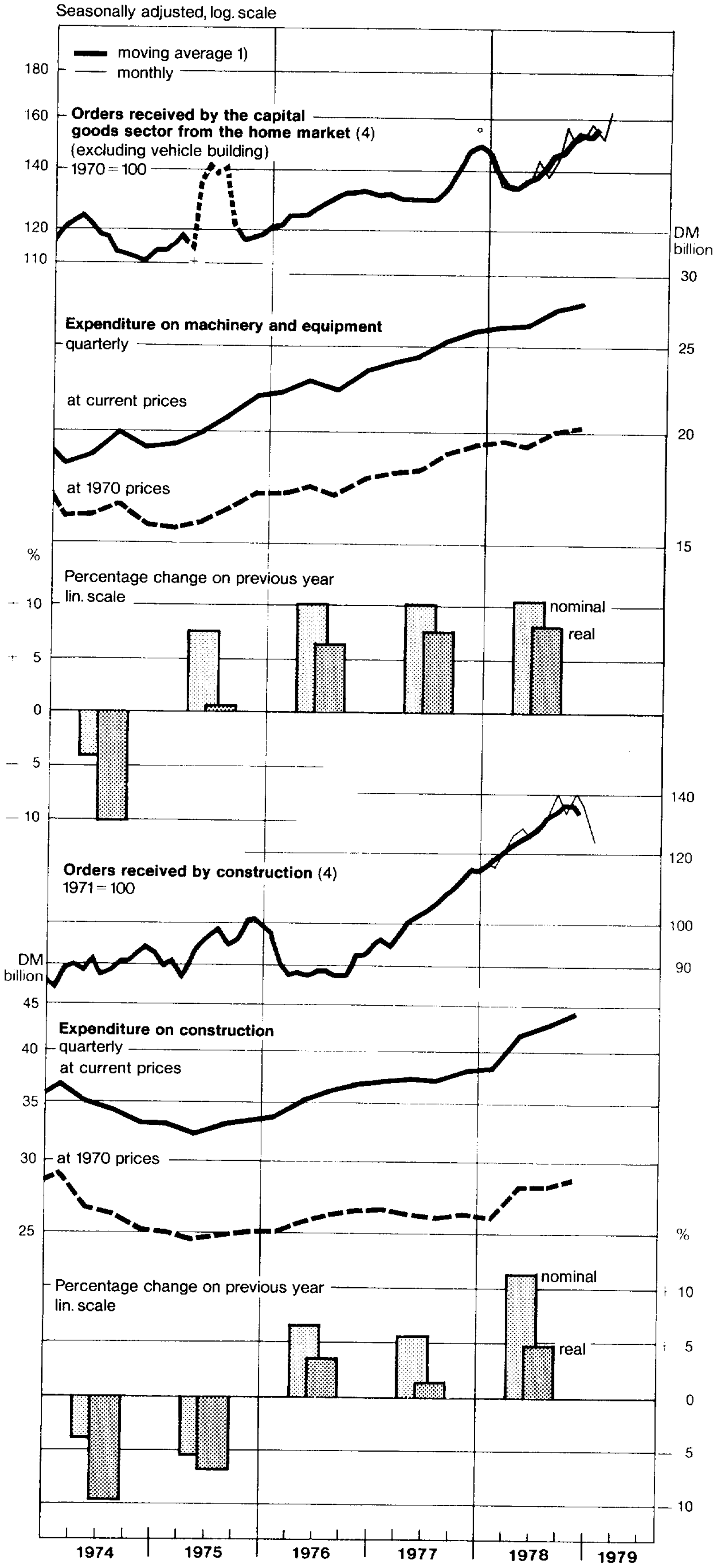
Capital investment the main driving force of the upswing

In the course of last year private capital investment developed into the principal driving force of the economic upswing. In 1978 enterprises (excluding housing) spent 10 ½ % more than a year before on machinery, equipment and buildings; at constant prices this represented an increase of 7 %. The surveys of investment intentions in industry carried out by the Ifo Institute last summer showed that enterprises — particularly in the capital goods industry and construction — were distinctly more willing to invest. The significant rise since then in the domestic orders received by the capital goods industry and the persistently large imports of capital goods suggest that these plans are now being realised swiftly. From the present perspective heavy capital investment by the business community therefore seems likely in 1979 as well.

Investment for the purpose of increasing capacity gains ground

It is particularly noteworthy that, among the motives for capital investment, the enlargement of capacity again gained ground relative to the renewal of plant and rationalisation. Among other things, this meant that last year trade and industry spent considerably more than in 1977 on construction, without which it is often impossible to expand capacity. Furthermore, as a result of the long period of low capital investment a considerable need to replace plant has built up in some parts of the business community and is now having to be met. Finally, quite a number of investments have recently been prompted by new production techniques or stricter regulations on environmental protection.

Demand for capital goods



1) The length of the moving average (in months) is indicated in brackets beside each curve.- + In the specially marked part of the curve the moving average is influenced by special factors in June 1975.- ° Influenced by large-scale orders.

Greater propensity to invest owing to higher earnings and favourable financing conditions

The main reason for the greater willingness to invest was the distinct improvement in enterprises' profitability last year. In addition, the fiscal policy decisions of the last few years[1] resulted for enterprises as well as for employees in certain tax cuts, which will be followed by further relief at the beginning of 1980. This tended to enlarge the scope for self-financing, which had already expanded noticeably in earlier years (albeit at that time on account of relatively weak capital investment). According to provisional calculations, enterprises (excluding housing and financial institutions) last year financed practically all — 99% — of their sharply increased capital expenditure with internal resources (consumption of fixed capital, net retained income, investment grants from other sectors); in 1977 the self-financing ratio had been considerably lower.[2] In all, enterprises' capital expenditure last year was only DM 2 billion larger than their new internal resources (against DM 20 billion in 1977). Another beneficial influence on the investment climate was the fact that the necessary outside funds were readily available and could be obtained at favourable interest rates. Both these factors helped to place capital investment on a sound basis. Any answer to the question as to whether the upswing in the economy has now become "self-sustaining" must begin at this point. By historical standards the conditions for this are good at present: sales are growing, earnings are increasing and enterprises' financial circumstances, which were previously under pressure in some cases, have strengthened. The fact that sales and earnings prospects have generally become more favourable also fits into this picture, although certain risks in foreign business cannot be overlooked. The improvement in the conditions for capital investment admittedly owed something to government action (namely tax cuts and the expansion of public demand for goods and services), but at the moment new economic policy measures do not appear to be required; on the contrary, it is now possible and to some extent necessary to leave economic developments more to the decisions of the private sector.

Steep increase in expenditure on housing

A very strong stimulus to economic activity was imparted by housing construction last year. In 1978 10 1/2% more than a year earlier was spent on residential buildings, both the construction of new dwellings and the modernisation of old ones being of great importance. Promotional measures by the government, favourable terms of finance — at times mortgage loans on residential real estate could be obtained at effective interest rates of 6% per annum in 1978, the lowest level since the end of the sixties — and also a certain fear of new increases in construction prices caused demand for construction work to rise steeply. Over the whole of 1978 the orders for residential buildings received by the construction industry went up by roughly one third, and the number of dwellings whose construction was approved was about one fifth larger than a year before. If the number of dwellings completed in 1978 nevertheless failed to regain the 1977 level (−10%), this was largely because production was severely hampered by the bad weather in the first few months and towards the end of last year and because capacity bottlenecks increasingly prevented output from growing during the rest of 1978; the number of dwellings under construction therefore rose sharply. Public authorities also placed sizable construction orders in 1978. As described on page 16, the central, regional and local authorities awarded orders under the programme of future investments at a relatively brisk pace last year. Altogether, demand for construction work expanded much more than construction output could be raised, so that order backlogs in the construction industry increased considerably.

Private consumer demand remains a mainstay of economic activity

Households' demand for consumer goods also boosted economic activity significantly last year. In 1978 private consumption expenditure was 6 1/2% higher than a year before. Compared with 1977 (7%) the expansion of consumption thus slowed down in nominal terms, but not in real terms. As the pace of price rises moderated in 1978, real private consumption in that year was 4% larger than a year earlier (against 3% in 1977). The growth of consumption was mainly due to the sustained sharp increase in disposable income. Although average earnings from wages and salaries grew distinctly more slowly in 1978 than a year before, the number of employees went up, as already noted. Moreover, employees benefited from the tax cuts that entered into force at the beginning of 1978. Total net income from wages and salaries therefore rose quite sharply, namely by 6 1/2%, in 1978. The amount available to households in 1978 from pensions and assist-

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1 See the following section.
2 For further details see Monthly Report of the Deutsche Bundesbank, Vol. 31, No. 3, March 1979, p. 20.

Income

Year	National income	Gross income from wages and salaries	Gross entre-preneurial and property income	National income	Gross income from wages and salaries	Gross entre-preneurial and property income
	DM billion			Percentage change on previous year		
1961–1969 **1**	352.2	230.0	122.3	+ 7.6	+ 8.7	+ 5.7
1970–1973 **1**	622.6	432.0	190.7	+11.7	+13.6	+ 7.7
1974–1978 **1**	875.9	630.0	245.9	+ 6.7	+ 6.9	+ 6.4
1974	772.4	560.6	211.8	+ 7.1	+10.0	+ 0.1
1975	805.6	583.6	222.0	+ 4.3	+ 4.1	+ 4.8
1976	874.8	626.4	248.4	+ 8.6	+ 7.3	+11.9
1977	929.3	669.9	259.4	+ 6.2	+ 6.9	+ 4.4
1978	997.7	709.7	288.1	+ 7.4	+ 5.9	+11.1

1 Annual averages.

ance payments was roughly 6% larger than a year earlier, the postponement of the pension adjustment (from July 1, 1978 to January 1, 1979) tending to reduce the expansion of this income. Including private withdrawals from entrepreneurial income and all households' property income (which declined slightly compared with the preceding year), total disposable income increased in line with private consumption, i. e. by 6 1/2%, in 1978. Accordingly, the saving ratio remained virtually unchanged last year, at just over 13 1/2% of disposable income.[1]

Distinct shift in the distribution of income in favour of entrepreneurial income

The strength of domestic demand, and particularly the further relative increase in capital investment, owed a great deal to the fact that the distribution of income shifted in favour of enterprises last year. While national income rose by 7 1/2%, gross entrepreneurial and property income grew by 11%. Its share in national income went up to 29%, which roughly corresponds to the share at the beginning of the seventies after adjustment for the changes of the past few years in the structure of employment. Despite the comparative imprecision of this figure,[2] it may be concluded that, on the earnings side, enterprises taken as a whole last year regained some of the ground they had previously lost in the years of pronounced profits squeeze. The significance of the more favourable earnings position as a stimulus to capital investment has already been pointed out in a different context. It is to be rated all the higher as the improvement in profitability was primarily due not to sharply rising sales prices (which would have been detrimental to other social groups) but to a combination of favourable developments on the cost side. For one thing, the appreciation of the Deutsche Mark and the relatively low prices of raw materials in world markets resulted in a perceptible reduction in the prices paid by enterprises for imports. For another, the rises in pay rates agreed upon between management and labour in 1978 were much smaller than a year before; moreover, their impact on unit labour costs was softened by an increase in productivity of about the same proportions as in 1977.

Yet real wage and salary income still rises strongly

Despite the improvement in enterprises' earnings, wage and salary earners did not have to forgo an appropriate share in the growth of overall output. Quite the contrary, in fact. The increase in gross income from wages and salaries, at 6%, was admittedly much smaller than that in entrepreneurial and property income, but as the rise in consumer prices slowed down at the same time this represented a price-adjusted wage and salary expansion of over 3%. Aided by the cuts in wage tax, net income from wages and salaries went up by as much as 4% in real terms last year; this was the largest rise since 1971. However, this was partly because consumers also benefited from the relatively low

1 For methodological reasons the saving ratio of households as ascertained here is about 1 percentage point higher than that published by the Federal Statistical Office. The reason for this is the differing treatment of employees' claims arising from company pension commitments. The Federal Statistical Office likewise regards the increase in such claims as part of the acquisition of financial assets, but it records this process not in the context of saving from disposable income but as a capital transfer by enterprises to households.
2 Entrepreneurial and property income is a very heterogeneous variable which includes the income of agriculture, housing, members of the professions, banks and insurance enterprises, the Federal Railways and the Federal Post Office as well as the profits income of trade and industry. It also includes the property income of all households.

prices of imports; to this extent the above-mentioned favourable trend in the relative distribution of income was attributable to an influence which will probably not recur; indeed, it is likely to give way to a development in the opposite direction this year. But even if this special factor in 1978 is taken into account, the increase in income from wages and salaries in real terms last year may be regarded as an encouraging sign of the success of a strategy which relies on the effect on employment of a wage policy consistent with overall economic requirements and which at the same time succeeds in strengthening real mass purchasing power. Understanding of these relationships, which the discussion between the Council of Economic Experts and other representatives of economic science has helped to spread, has apparently increased in the meantime. After a sharp wage dispute in the steel industry at the beginning of this year's wage round, management and labour in the metal-working industry agreed on a wage settlement which (including all fringe benefits) resulted in a rise of about 5% in hourly pay rates; by and large, this appears appropriate to the situation in the affected sectors. Wage settlements of similar size were then reached in other industrial wage bargaining areas and in the public service. Further economic developments will be favourably influenced by the sense of economic responsibility shown by management and labour in the recent wage negotiations.

Export growth not very strong

During 1978, after a rather sluggish start in the first few months, foreign business again gave a certain stimulus to domestic economic activity, although last year foreign demand on the whole played a much smaller part in the recovery than at comparable stages of earlier economic cycles. The main cause of the upturn in exports in the second half of the year was the slight improvement in business activity in Germany's principal European partner countries. Towards the end of the year this was reflected in a distinctly larger inflow of foreign orders to exporters. Over the whole of 1978 the foreign orders received by the manufacturing sector exceeded the 1977 level by 4 1/2% in value and by not quite 3 1/2% in volume. According to the surveys of the Ifo Institute, at the turn of 1978/79 enterprises were viewing export prospects with greater optimism than in the middle of last year. Their expectations were, however, dampened by new uncertainties connected with the political developments in Iran. Partly because of the difficulties arising from the appreciation of the Deutsche Mark, German exports, which grew by 4% in real terms, were unable to maintain their share in world trade in 1978, even though the high quality of the products, their prompt availability and the flexible adjustment of exporters to new market conditions offset various price disadvantages in world markets.

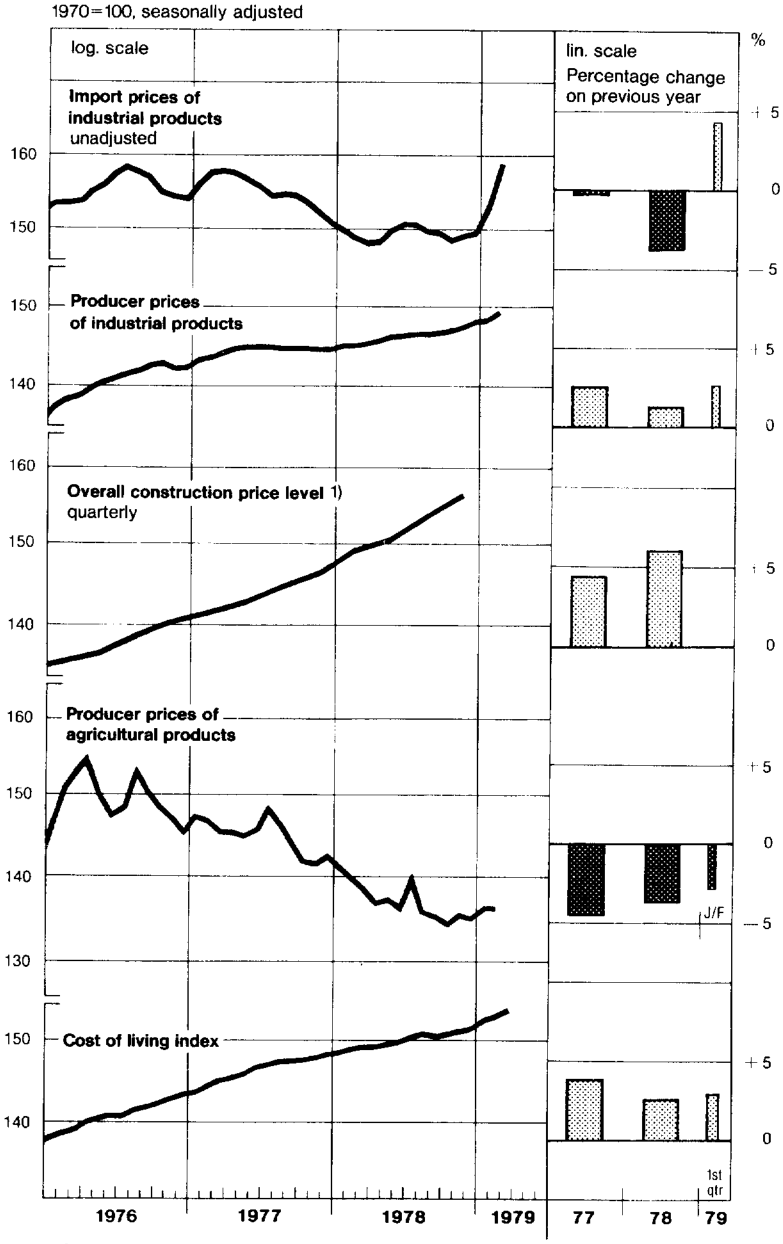
Increased foreign competition in domestic markets

Another consequence of the appreciation of the Deutsche Mark was that the competitive pressure of foreign suppliers in domestic markets continued to increase in 1978. In real terms, imports of goods rose last year by 7 1/2%, and thus just over twice as much as the real gross national product (3 1/2%). The share of imported goods in total domestic sales in Germany (calculated at 1976 prices) went up from 17 1/2% in 1970 to not quite 24% last year. The failure of the German trade surplus to decrease in 1978 despite the strong demand for imports is attributable (as explained in more detail on page 20) to the marked decline in import prices on account of the appreciation, which resulted in the value of imports growing less than that of exports. But the underlying tendency of real foreign trade flows is undoubtedly towards a reduction in the trade surpluses. In 1978 the price-adjusted surplus on Germany's external merchandise and service transactions, as defined in the national accounts (and at 1970 prices), went down to DM 23 billion compared with DM 26.5 billion a year before. As import prices have been rising sharply (more so, indeed, than export prices) since the turn of the year, this tendency will no doubt soon be reflected in a decrease in the nominal value of the surpluses on merchandise and service accounts.

Further progress in the stabilisation of prices in 1978

In 1978 the upward movement of prices in Germany again slowed down distinctly, after noticeable progress towards greater price stability had already been made in the preceding years. The sustained tendency of the Deutsche Mark to appreciate once more contributed significantly to this trend. It enabled importers to compete with German producers in domestic markets by offering a low-priced range of goods. Imported products again cost trade and industry less than a year before. Under the impact of increasing foreign competition in the field of finished goods and aided by inexpensive imports of raw materials and primary products, the industrial producer prices of goods sold in the home market went up only a little during long periods of last year. On an average, the

Prices



1) Calculated by the Bundesbank.

prices of industrial products rose, as noted, by no more than 1.3% in 1978, which was the lowest rate of increase in the last ten years.

Ample supply of agricultural products . . .

The consistently favourable movement of the prices of agricultural products played a major part in the curbing of price rises last year. Large crops of fruit and vegetables and an ample supply of animal products caused agricultural sales prices to decline almost continuously; on an average they were just over 3 1/2% lower in 1978 than a year previously. In the longer term — i. e. over a period of ten years — the producer prices of agricultural products have thus risen by 3% a year, while those of industrial products have gone up by 4 1/2% per annum. The moderating effect of agricultural prices on the overall price trend was also felt at the consumer level. Increases in food prices averaged no more than 1% in 1978 as compared with the preceding year. The other consumer prices were raised by roughly 3%, so that the overall cost of living index went up by an annual average of 2.6%. This was the smallest increase in the cost of private consumption since the end of the sixties. The progress achieved last year in slowing down the pace of

. . . helps to curb price rises at the consumer level inflation is to be valued all the higher as the rate of value-added tax was raised by 1 and 1/2 percentage point (to 12% and 6%, respectively) at the beginning of 1978. In the case of industrial goods and agricultural products this additional fiscal burden could not all be passed on in prices because of the keen competition in the markets. But in the service sector, where price competition with other countries is of minor significance, some of the price increases were relatively steep; in this field the average annual rate of price rises came to nearly 4%.

Faster rise in construction prices

In the course of 1978 prices went up sharply in the construction industry. This owed relatively little to the raising of value-added tax at the beginning of the year; the main causes seem to have been the sustained heavy demand on the one hand and the fact that supply was sometimes approaching capacity limits on the other. In 1978 the overall construction price level — comprising the prices of civil engineering work, office and industrial buildings, and housing — was on average no less than 6% higher than a year before, although the extent of the increase no doubt differed from region to region. In road construction alone prices in the fourth quarter of 1978 were about 7 1/2% higher than they had been a year earlier. The improvement in the costs-earnings ratio due to these price adjustments is likely to have enabled some construction firms to strengthen their capital base, which was rather weak in many cases.

Unfavourable price movements at the beginning of 1979

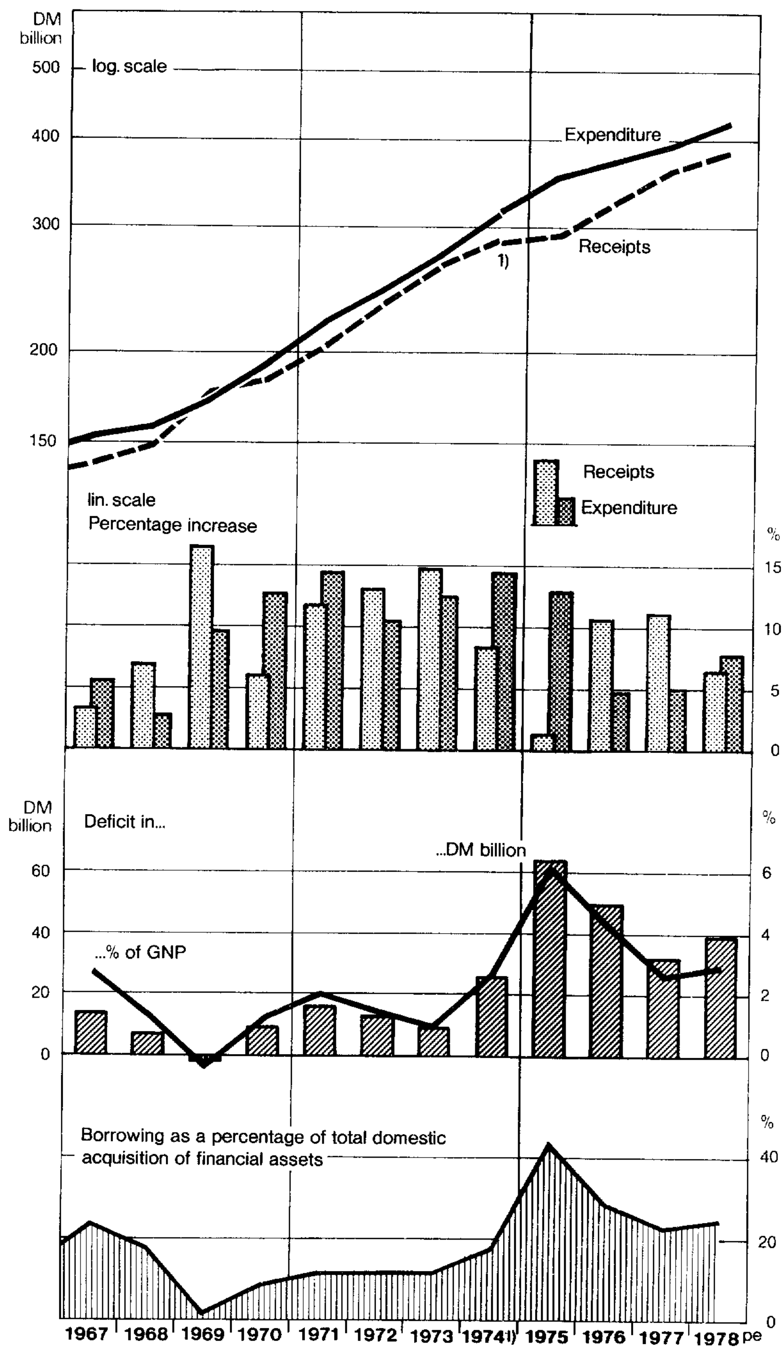
Around the turn of 1978/79 there were signs of a reversal in the movement of prices in some sectors. Uncertainties about the oil supply following the political developments in Iran and the long, severe winter caused the demand for energy to rise more steeply than before; there were also sharp price increases in some international raw material markets. Moreover, concern was aroused by the stronger inflationary tendencies in major industrial countries, as reflected in the fact that the rate of inflation at the consumer level there came to about 8 1/2% compared with roughly 3% in Germany; the difference thus rose to nearly 6 percentage points against just over 4 percentage points twelve months earlier. Repercussions on the price level in Germany were inevitable. Domestic producer prices started moving upwards, especially those of import-dependent products. In addition, at the consumer level the "administrative" prices charged for the services of the Post Office and the broadcasting stations and third-party car insurance premiums were raised significantly. Furthermore, food prices went up more than usual at that time of the year as a result of the severe winter weather. The increase in the cost of living index consequently gathered pace in the first few months of 1979; by March the year-on-year growth rate had accelerated to over 3%. On the other hand, domestic costs — particularly wage costs — hardly triggered faster price rises after management and labour, as noted, generally agreed on relatively moderate increases in pay rates at the beginning of this year. Nevertheless, the vigilance and joint action of all those involved directly or indirectly in the process of price formation will be required if the upward tendency of prices is to be contained and the progress so far achieved in the field of price stability safeguarded.

2. Further government stimuli to economic activity

Fiscal stimuli imparted primarily by means of tax cuts

In 1978 fiscal policy contributed to the strengthening of private demand for consumer and capital goods, but it was not the only source of major stimuli. The way had been prepared for last year's fiscal policy during 1977, when, in view of the signs of weakness then evident in the economy, the public authorities had switched to a more expansionary course and given priority to tax reliefs in order to create — also in the medium term — more favourable underlying conditions for an economic expansion supported primarily by the private sector. In the Report for 1977 attention was drawn to the fact that the measures then taken were beginning to exert a positive influence on the economic climate in that year, even though this was not yet being reflected in cash receipts and expenditure; to this extent the relatively sharp decline in the deficits, which moreover was concentrated in the first half of 1977, conveyed a distorted picture of the impact of the public authorities on economic activity in 1977. The Tax Amendment Act of summer 1977 introduced cuts motivated by growth policy considerations in direct taxes and improvements in children's benefits as from the beginning of 1978, and at the same time limited the long-planned increase in value-added tax to 1 (or 1/2) percentage point; in terms of revenue this package of measures was thus roughly neutral. Greater significance attached to the tax measures adopted in the autumn of 1977 "to promote economic growth and employment". The beginning of 1978 thus saw the entry into force of

Finances of the central, regional and local authorities



1) As from 1974 including special-purpose associations. - pe Partly estimated.

tax cuts (especially the raising of the basic allowance and the introduction of a so-called general allowance, and also the improved tax treatment of "provident expenditure") which primarily increased the disposable income of households and therefore tended to encourage private consumption. These tax cuts, from which wage and salary earners benefited most, were accompanied by tax relief specifically for enterprises, notably the extension of depreciation allowances and the lowering of property tax rates. In the aggregate, the tax measures approved during 1977 reduced the receipts of the central, regional and local authorities by almost DM 10 billion in 1978. Private income also profited from the raising of children's benefits from the second child onwards, which placed an additional burden of DM 1.75 billion on public budgets in 1978. The extra demand generated by the central, regional and local authorities themselves was less significant than the above-mentioned measures, even though, taken by itself, it also gave a consid-

Record of economic policy measures

1978	**I. Domestic and external monetary policy**
January 4	The Bundesbank grants the U.S. Treasury a credit line which may be drawn on for the purpose of intervening in the dollar market. This credit line supplements the existing swap arrangement between the Bundesbank and the Federal Reserve System.
January 19	As from March 1 the banks may deduct domestic legal tender from the required minimum reserves, while the privileges granted to banks located in places without a Bundesbank office are abolished. To compensate for the relief associated with the deduction of cash balances, the minimum reserve ratios on liabilities to residents are raised by 8 %.
February 10	The Norwegian krone is devalued by 8 % within the European narrower margins arrangement with effect from February 13.
March 10	The Bundesbank again buys trade bills (up to June 16) to stabilise the money market on condition that the banks repurchase them after ten days (interest rate: 3 1/4 %).
March 13	The Bundesbank and the Federal Reserve System agree to increase their existing reciprocal swap arrangement by \$ 2 billion to a total of \$ 4 billion. At the same time the U.S. Treasury arranges for the sale of SDR 600 billion to the Bundesbank in order to purchase Deutsche Mark.
May 18	The minimum reserve ratios on external liabilities are lowered with effect from June 1 and brought into line with the lower ratios on domestic liabilities. The minimum reserves on the growth of external liabilities are abolished as from the same date. In addition, the reserve ratios on domestic and external liabilities are lowered across the board by 7 %. These measures release about DM 4.5 billion of liquidity.
June 1	The Bundesbank re-examines its monetary growth target for 1978. It announces that the target originally set can no longer be achieved and explains the reasons for the expected overshooting.
June 29	The banks' rediscount quotas are raised by DM 3 billion with effect from July 1. At the same time the assessment of the quotas is linked more closely than before to the size of the individual banks' bill portfolios in order that the quotas may be utilised more effectively.
July 6–7	At its meeting in Bremen the European Council discusses a scheme for closer monetary cooperation, with the objective of creating a zone of monetary stability in Europe (European Monetary System).
October 15	Exchange rates in the European narrower margins arrangement are realigned with effect from October 16; the Deutsche Mark is revalued by 4 % and the Netherlands guilder and Belgian franc are revalued by 2 % each.
October 19	The minimum reserve ratios on the banks' domestic and external liabilities are raised by 9 % with effect from November 1 (neutralising about DM 4.5 billion of liquidity).
November 1	The United States announces a comprehensive programme to strengthen the dollar and restore orderly conditions in the foreign exchange markets. The package of measures provides among other things for the acquisition of Deutsche Mark by the United States through drawing on the IMF and selling special drawing rights to the Bundesbank and through raising loans denominated in Deutsche Mark in the German capital market. Moreover, the Bundesbank and the Federal Reserve System agree to increase their reciprocal swap arrangement by a further \$ 2 billion to a total of \$ 6 billion.
December 5	The European Council resolves to establish a European Monetary System (EMS). The provisions governing the EMS are to enter into force at the beginning of 1979 and are to be consolidated into a final system after a transitional period lasting two years. (Because of differences in the field of agricultural policy over the question of border compensation in the European Communities, however, the EMS is not put into effect on January 1, 1979 as originally planned.)
December 6	As part of its programme to strengthen the dollar, the United States for the first time raises loans in the German capital market against Treasury Notes denominated in Deutsche Mark (DM 3 billion). (It raises a further DM 2.5 billion of such loans in the German market in February 1979.)
December 12	The Norwegian krone withdraws from the European narrower margins arrangement.
December 14	The Bundesbank announces a monetary growth target for 1979. The expansion of the central bank money stock between the fourth quarter of 1978 and the fourth quarter of 1979 is to be kept within a range of 6 to 9 %. Whether monetary policy aims at the lower or upper limit of this range will depend on future domestic and external economic developments. The banks' rediscount quotas are lowered by about DM 5 billion with effect from January 1, 1979.
1979	
January 1	The International Monetary Fund resumes its allocations of new special drawing rights (SDRs), which last took place in 1972. In the first tranche about SDR 4 billion is allocated in all, Germany receiving SDR 224 million (equivalent to DM 534 million). Further allocations, each of SDR 4 billion, are to follow in 1980 and 1981.

January 18	The Bundesbank raises the lombard rate from 3 1/2% to 4% with effect from January 19. In addition, the minimum reserve ratios on the banks' domestic and external liabilities are raised by 5% as from February 1.
March 13	The European Monetary System enters into force.
March 29	The Bundesbank decides to raise the discount rate from 3% to 4% and the lombard rate from 4% to 5% with effect from March 30. The banks' rediscount quotas are also raised by DM 5 billion with effect from April 1.
1978	**II. Economic and fiscal policy**
January 1	The 1977 Tax Amendment Act and major parts of the Act to Reduce Taxes and Promote Capital Investment come into force. The measures include the raising of the basic allowance and the introduction of a general allowance in the case of income tax, cuts in property and trade tax and improvements in children's benefits. On the other hand, value-added tax is raised to 12% or 6%. On balance these measures burden the budget with about DM 10 billion in 1978.
January 26	In its Annual Economic Report the Federal Government states that safeguarding a self-sustaining, durable economic upswing remains the central problem for 1978. This is an essential precondition for the creation of a sufficient number of jobs and hence for a gradual reduction of unemployment. Capital investment plays a key role in this context; if it is to be strengthened, the increase in costs and prices must be curbed and the profitability of enterprises improved. Considering the position at the beginning of 1978, the Federal Government regards an average annual economic growth rate of about 3 1/2% in real terms as being within reach.
January 27	The Bundestag approves the 1978 Federal budget, which totals DM 188.5 billion and shows a financial deficit of DM 31 billion.
March 8	The Federal Government adopts measures to consolidate the finances of the pension insurance funds. The increase in pensions in 1979 is limited to 4 1/2% and that in the next two years to 4%. The contribution rate is to be raised by 1/2 percentage point in 1981.
June 14	The Bundestag approves a supplementary budget embodying expenditure totalling DM 0.9 billion (mainly to assist the coal and steel industry); this extra expenditure is offset in full by cuts in other items.
June 22	The Bundestag approves the amendment to the Housing Modernisation Act, which comes into force on July 1, 1978 (programme to conserve energy totalling DM 4.35 billion). Under this programme, investments that save heat are encouraged by means of grants or tax relief.
July 17	In the course of the economic summit meeting in Bonn, the German delegation announces measures totalling up to 1% of the gross national product as a contribution to counteracting the worldwide disturbance of economic equilibrium.
July 28	To give effect to the commitment entered into at the economic summit meeting in Bonn, the Federal Government approves cuts in income tax and trade tax, improvements in children's benefits and other expenditure measures which are to come into force mostly in 1979 but partly not until 1980. To reduce the burden on the budget, the rate of value-added tax is to be raised by 1 or 1/2 percentage point as from July 1, 1979. At the same time the Federal Government adopts the draft budget for 1979, which totals DM 204.5 billion and shows a financial deficit of DM 36 billion.
November 17	After agreement has been reached in the Mediation Committee, the Bundestag approves the package of tax cuts and additional expenditure. The children's benefits for second children are to be raised six months earlier than envisaged in the draft and the provisions on trade tax are modified (additional relief being planned from 1981 onwards). The burden placed on the budget by this package is estimated at DM 13.5 billion in 1979 and DM 15 billion in 1980.
November 23	The Council of Economic Experts, in its Annual Report, notes a distinct improvement in the economic climate. It sees no further need for action by the economic authorities beyond the measures already adopted. It emphasises the necessity of consolidating government budgets "judiciously" in the medium term. The Council advocates the continuation of a wage policy designed to adjust the level of costs by degrees.
1979	
January 24	The Federal Government presents the 1979 Annual Economic Report. It regards the progressive raising of the level of employment, while avoiding any new risk of inflation, as the central problem of economic policy. In the present year it sees reason to expect further gradual progress, provided that no major external disturbances occur and that decisions on the distribution of income are consistent with overall economic requirements. On these conditions the Federal Government considers an average annual economic growth rate of about 4% in real terms to be attainable in 1979.
January 26	The Bundestag approves the 1979 Federal budget, which totals DM 204 billion and shows a financial deficit of just under DM 32 billion.
February 14	The Federal Government approves a programme to promote the establishment of private businesses.

erable boost to economic activity. These authorities concentrated on accelerating the start of public capital projects under the programme of future investments, which was in principle intended as a medium-term scheme, although some private capital projects were also assisted. In 1978 further orders worth DM 6 to 7 billion were placed under this programme alone. The overall construction orders awarded by the central, regional and local authorities last year were 23% larger than in 1977, during which they had already substantially increased the level of their orders.

Economic climate improved by further tax reductions

At the end of July 1978 the Federal Government, acting in accordance with the agreements reached at the conference of the heads of government of the seven major industrial countries ("economic summit meeting"), approved a further package of measures "to strengthen demand and improve economic growth", which was then expanded slightly in the course of the parliamentary deliberations. The emphasis was again on tax cuts; wage and salary earners will benefit most from them, especially from the renewed raising of the basic allowance and the elimination of the "jump" in the tax scale at the beginning of 1979. In addition, further relief from trade taxes for enterprises is planned from 1980 onwards. The new shortfalls in tax receipts are to be offset in part by a further increase in value-added tax as from the middle of 1979. Tax policy has thus moved another step towards shifting the main weight of the tax system slightly more from direct taxes (whose share in total revenue had risen sharply until 1977) to indirect taxes, in order to ease the burdens resulting from the progressive tax scale and hence to render the tax system more "performance-oriented" again. On the expenditure side, children's benefits were raised once more; besides a number of other socio-political improvements, the promotion of innovations and of capital investment in trade and industry was increased. This programme, which, as stated, was devised in July 1978 on the basis of the unfavourable economic data up to May, had a beneficial influence on the economic climate in the further course of 1978, although it did not begin to affect the cash position — to the extent of over DM 13 billion, or about 1% of the gross national product — until 1979. The resultant tendency towards an increase in the deficit in 1979 is being counteracted by a number of factors, particularly the recovery of domestic economic activity since the early summer of 1978, which is causing receipts to flow in slightly faster than had been assumed; this automatic adjustment is desirable as regards both its origin (the economic upswing) and its medium-term effects (the reduction of public sector borrowing).

Slower growth of tax revenue despite unexpected extra receipts

In 1978 the cash trend of the central, regional and local authorities was largely determined by the measures initiated in the preceding year. Under the impact of the substantial tax cuts, receipts rose by 7 1/2% in 1978 and thus much less than in the previous two years (+11% each). Nevertheless, the growth of receipts was stronger than had been expected at the beginning of the year. Tax revenue was over DM 7 billion larger than had been forecast in the official tax estimate of February 1978; most of this increase was due to higher revenue from the assessed taxes on income. In 1978 assessed income tax (for natural persons) yielded 5 1/2% more than a year before, whereas at the beginning of the year it had been assumed that the deductibility of the tax already paid on dividends of corporations would have a stronger effect and that receipts would therefore rise only a little. Corporation tax revenue also grew surprisingly sharply, at 18%; for one thing, quite considerable final payments for earlier years flowed in and, for another, the regular advance payments were raised appreciably during the year in view of the development of profits. Appraisal of the financial prospects of the central, regional and local authorities is complicated by the fact that a wide margin of error has emerged in recent years in forecasts of the assessed taxes. This is partly because the effects of changes in tax legislation on the cash figures can only be estimated roughly, especially if, as in the case of the corporation tax reform, a modification of the system is involved and there is no past experience to draw on. Moreover, as has often been deplored, no up-to-date figures are available on the state of assessments and the adjustment of advance payments. In 1978 receipts of wage tax, unlike those of the assessed taxes, developed in conformity with the expectations entertained at the beginning of the year. Owing to the numerous cuts, wage tax revenue grew by only 1 1/2%. The yield of value-added tax, by contrast, went up very sharply (by 17%), mainly because of the raising of the tax rate by 1 (or 1/2) percentage point — i. e. by one eleventh — and of the favourable trend of consumption

Finances of the public authorities

Item	1975	1976 **p**	1977 **p**	1978 **pe**	1975	1976 **p**	1977 **p**	1978 **pe**
	DM billion				Percentage change on previous year			
Central, regional and local authorities								
Expenditure								
Personnel expenditure	117.7	124.1	132.2	140	+ 8.6	+ 5.4	+ 6.5	+ 6
Current expenditure on materials	53.1	56.5	60.4	65	+ 7.9	+ 6.3	+ 6.9	+ 7.5
Expenditure on transfers **1**	103.1	108.9	113.8	122.5	+ 30.6	+ 5.7	+ 4.5	+ 7.5
Interest expenditure	14.8	18.2	21.2	22.5	+ 16.7	+ 22.8	+ 16.8	+ 5.5
Fixed investments **2**	47.4	45.2	45.4	49.5	+ 0.1	− 4.5	+ 0.4	+ 9
Indirect investments **3**	22.6	23.5	22.3	28.5	+ 6.7	+ 3.7	− 4.9	**7** + 27.5
Total	358.6	376.3	395.3	428	+ 12.9	+ 4.9	+ 5.1	+ 8
of which								
Federal Government	164.2	171.7	179.2	197	+ 18.8	+ 4.6	+ 4.5	+ 10
Länder Governments	145.1	153.0	161.0	176	+ 9.6	+ 5.4	+ 5.2	+ 9.5
Receipts								
Tax receipts	242.2	268.1	299.4	319	− 0.0	+ 10.7	+ 11.7	+ 6.5
Other receipts	52.9	58.5	63.4	70.5	+ 6.4	+ 10.6	+ 8.5	+ 11
Total	295.1	326.6	362.9	389.5	+ 1.1	+ 10.7	+ 11.1	+ 7.5
of which								
Federal Government	130.1	141.5	157.0	171	+ 1.6	+ 8.7	+ 11.0	+ 9
Länder Governments	125.0	137.6	152.4	163.5	+ 0.0	+ 10.1	+ 10.8	+ 7
Cash deficit (−) **4**	− 64.6	− 49.6	− 32.1	− 38.5	.	.	.	.
of which								
Federal Government	− 34.0	− 30.1	− 22.2	− 25.5	.	.	.	.
Länder Governments	− 21.2	− 15.1	− 8.3	− 12	.	.	.	.
Social security funds								
Expenditure	177.5	193.7	209.4	222	+ 17.8	+ 9.1	+ 8.1	+ 6
Receipts	174.0	193.6	204.9	219.5	+ 13.1	+ 11.2	+ 5.9	+ 7
Cash surplus (+) or deficit (−) **5**	− 3.4	− 1.0	− 4.5	− 2.5	.	.	.	.
Public authorities, total								
Expenditure **6**	508.9	542.0	577.4	617	+ 13.4	+ 6.5	+ 6.5	+ 7
Receipts **6**	441.9	492.1	540.5	576	+ 3.7	+ 11.4	+ 9.8	+ 6.5
Cash deficit (−)	− 68.0	− 50.6	− 36.5	− 41	.	.	.	.

1 Including transfer of the EEC share in taxes. — **2** Cash expenditure is recorded here, whereas the production of public capital goods is shown in the government account of the national accounts. — **3** Expenditure on investment grants and loans to third parties, and the acquisition of participations. — **4** The differences between the balance of receipts and expenditure and the cash deficit are due to special transactions. — **5** Based on the change in financial assets, which differs slightly from the balance of booked receipts and expenditure. — **6** After adjustment for payments of the central, regional and local authorities to the social security funds. — **7** Overstated owing to changes in the method of assessment. — **p** Provisional.
pe Partly estimated.
Discrepancies in the totals are due to rounding.

and the sharp increase in spending on residential buildings and public capital formation.[1] In the aggregate, tax receipts grew by 6 1/2 %; the overall tax ratio thus declined slightly from the peak it had reached in 1977 (25 %).

Steeper rise in expenditure, particularly capital expenditure

The expansionary stance of fiscal policy was also reflected in a steeper rise in public expenditure. Spending by the central, regional and local authorities went up by 8 % in 1978, after having increased by only 5 % in each of the two preceding years; however, this growth was almost 2 percentage points (or DM 6 to 7 billion) smaller than had been expected according to the budgets. Much of the faster rise in expenditure was attributable to developments in the field of capital investment. Spending on fixed assets (particularly buildings), for instance, increased by about 9 % in 1978, after having declined in 1976 and stagnated in 1977. Even so, it went up far less than provided for in the budgets. However, this was not because of any unforeseen restraint on the part of the central, regional and local authorities. In fact, the Federal and Länder Governments and the local authorities did everything they could to step up their investment activity, as shown in particular by the large volume of construction orders they placed. But in the construction industry the execution of orders was hampered by the shortage of qualified labour, while private demand for construction work rose sharply at the same time. Nevertheless, the rise in public capital investment was very steep, at 14 % in terms of nominal production value. The main reason why cash funds flowed out at a much slower pace was presumably that a large number of projects remained incomplete, so that final settlements still had to be effected. The tensions which arose in the construction market through the bunching of public and private demand, with all their undesirable consequences for construction costs and prices, have shown that in Germany there are narrow limits to a policy of boosting economic activity by expanding public capital investment.

The abandonment of the policy of deliberate restraint in expenditure also made itself felt in other sectors of the budget. This applies to investment grants and loans as well as to military purchases and transfers. The sharper growth of current transfers was mainly due to the fact that children's benefits and housing allowances were raised at the beginning of 1978, and that the higher payments for the promotion of vocational training which had come into force in the course of 1977 for the first time took effect over a full year.

Slackening growth of personnel expenditure

The rise in personnel expenditure, on the other hand, slowed down slightly; at 6 % it was distinctly smaller than the increase in total expenditure, in contrast to the trend of previous years. This was primarily because wages and salaries per employee were raised less than in 1977. Recruitment policy was eased, however: the number of employees of the central, regional and local authorities went up perceptibly last year, after having stagnated in 1977. Some observers have recommended that the number of staff in the public service should be increased even more sharply as a contribution to solving the general employment problems. This may be possible in some occupations, although such recruitment would make sense only if there were a corresponding demand. In other job categories there would be reason to fear that a significant proportion of the additional staff joining the public service would be drawn from areas in which the shortage of skilled labour is already acute.

Deficit increases again in 1978

As the central, regional and local authorities' expenditure rose rather more than their receipts, their deficit increased again in 1978 (by DM 6 billion to DM 38.5 billion), after it had been reduced sharply in the two preceding years. For the social security funds, on the other hand, 1978 was a year of financial consolidation. This was largely due to the postponement of the pension adjustment by six months (from mid-1978 to the beginning of 1979) and to the surprisingly vigorous inflow of contribution receipts. In all, the deficit of the social security funds halved, at only DM 2.5 billion (the pension insurance fund, taken by itself, admittedly incurred a somewhat larger deficit, but this was offset by certain surpluses, especially in the field of health insurance). Compared with 1977, the public sector deficit thus rose by over DM 4 billion to DM 41 billion; this was less than had been expected at the beginning of 1978. Considering the overall economic outcome in 1978, which was entirely consistent with the targets for real growth, the reduction of unemployment and price stability, it may be inferred that this expansion of the deficit,

1 Unlike capital investment by enterprises, public capital spending and much the greater part of expenditure on housing construction are still burdened with value-added tax because in these cases no tax is credited to the investor.

Economic growth, wages and prices: an international comparison

Percentage change on previous year

Countries	Real gross national product 1		Unit labour costs 2, 3		Consumer prices 3	
	1974/1978	1978 p	1974/1978	1978 p	1974/1978	1978
Belgium	2.3	2.2	8.5	2.3	9.2	4.5
Denmark	1.4	0.9	9.7	4.7	11.0	10.0
France	2.8	3.0	11.2	9.2	10.7	9.1
Ireland	3.7	6.8	15.5	11.8	15.3	7.7
Italy	2.1	2.6	19.8	14.5	16.4	12.1
Netherlands	2.2	2.0	7.2	4.3	7.8	4.1
United Kingdom	0.8	3.0	19.5	11.6	16.1	8.3
United States	2.3	4.0	8.0	8.5	8.0	7.7
Japan	3.7	5.6	12.0	−1.5	11.3	3.8
Total 4	2.2	2.7	11.6	7.7	11.0	7.5
Federal Republic of Germany	1.9	3.4	4.5	3.3	4.8	2.6

1 France, Italy, Ireland: gross domestic product. — **2** Gross wages and salaries (including social security contributions) per unit of gross value added in industry. — **3** In the respective national currency. — **4** Weighted with the share in German exports. — **p** Provisional.
Source: OECD and EEC.

though smaller than envisaged, was in fact quite large enough. A sharper rise in the deficit and the net borrowing requirement might even have worsened the financial conditions for a strong economic growth fuelled primarily by the private sector. Even though new indebtedness increased only moderately, some tensions arose during 1978 in the market for longer-term credits, where private demand went up steeply. The smaller rise in the deficit in 1978 also enhanced the prospects for the medium-term consolidation of the budgets, which will be necessary after 1979. In 1979 itself, however, a further growth of the deficit is to be expected as a result of the package of measures adopted last year, although it will probably be smaller than previously assumed. The stronger the economic upswing turns out to be, the more reason there will be to use additional tax revenue to reduce the deficit, which is essential, especially in the longer run.

3. Foreign trade and payments under the impact of new monetary unrest

External influences no longer as important as they were

Last year the foreign trade and payments of the Federal Republic of Germany on the whole contributed only a little to the strengthening of domestic economic activity; at all events, the stimulus imparted to the German economy by foreign countries was far less significant than in earlier upswings. The European partner countries were slow to overcome the economic weakness which many of them had displayed in 1977, so that the export prospects of German enterprises improved only gradually. A relatively subdued rise in exports contrasted with a rather strong real growth of imports, which was aided by low import prices. Both exports and imports were greatly influenced by the tendency of the Deutsche Mark to appreciate. The abrupt changes in the foreign exchange markets — periods of settled market conditions were followed by temporary upheavals of crisis proportions — were in themselves a source of uncertainty that noticeably handicapped foreign trade. The epicentre of these passing tremors in the monetary system was the U.S. dollar. The U.S. balance of payments continued to show a substantial and even growing deficit, and despite a number of "anti-inflation programmes" the inflationary tensions did not decrease but became stronger. In consequence foreign dollar investors increasingly switched out of the main reserve currency into other, more stable currencies — especially the Deutsche Mark, the Swiss franc and the Japanese yen — with the result that these currencies appreciated far more than can be explained simply by economic factors such as the differences between the respective inflation rates (see also Part A II).

Excessive appreciation makes competition keener

In spite of great endeavours by the monetary authorities to mitigate exchange rate fluctuations by intervening in the foreign exchange markets, the weighted external value of the Deutsche Mark increased substantially in 1978. Against the currencies of 23 of Germany's major trading partners it was on an average 6 1/2 % higher than in 1977.[1] At times the appreciation of the Deutsche Mark distinctly exceeded the inflation differential between other countries and Germany. Taking the average of 1978, the Deutsche Mark appreciated by a further 2 1/2 % "in real terms" (as measured by the mean weighted wholesale prices of 13 industrial countries), after the real external value of the Deutsche Mark had already increased by 2 1/2 % in 1977. The German business community consequently faced stiffer competition from foreign suppliers in all markets. In many cases market positions could be maintained only by making great concessions. Quite a number of German exporters felt obliged to reduce their Deutsche Mark sales prices abroad; on the whole, export prices, as measured by export unit values, were no higher than in 1977, whereas domestic selling prices again went up slightly. On the other hand, imports became much cheaper last year (−3 1/2 % as measured by unit values). This was mainly because of the steep nominal appreciation of the Deutsche Mark, which had a particularly strong impact in the case of products that are quoted in dollars in world markets. In addition, some world market prices declined even in dollar terms at times, e.g. petroleum prices up to the autumn of 1978. As a result of these favourable price trends for the domestic market, the German terms of trade improved by 3 1/2 %; this means that in order to pay for the same quantity of imports, 3 1/2 % fewer goods, in terms of volume, had to be exported. This was the only reason why the trade surplus in 1978, at DM 49 billion,[2] was roughly DM 3 billion larger than a year before (at current prices). The real impact of German foreign trade on domestic supply, production and employment in our partner countries is therefore revealed more clearly if the change in the surplus in 1978 is considered at 1977 prices; it then emerges that the trade surplus fell by DM 6 billion compared with the previous year. Since the price situation on the import side underwent a fundamental change at the beginning of this year — the prices of crude oil, petroleum products and other foreign raw materials rose steeply throughout the world and the tendency of the Deutsche Mark to appreciate came to an end — it is hardly to be expected that in 1979 the terms of trade will develop anything like as favourably as they did last year.

Exports not very vigorous

As the upward trend in world economic activity was not very strong and as competition in foreign markets grew keener at the same time, German exports were initially unable to develop any great momentum in 1978. Not until business activity picked up in major European partner countries did exports gather appreciable pace. At the turn of 1978/79, however, the crisis in Iran and the consequent cancellation of major export orders gave rise to renewed uncertainty about further export business. In value terms exports rose by only 4 % in 1978, compared with 6 1/2 % a year earlier; in terms of volume, too, the growth rate, at 4 %, fell distinctly short of the 1977 figure (5 1/2 %). In view of the rather low level of investment in many customer countries, Germany's traditional exports, namely capital goods (in particular mechanical engineering products), fared relatively badly last year. These exports hardly increased at all in terms of value. On the other hand, exporters of basic and producer goods, especially iron and steel and chemical products, scored notable successes abroad. Consumer goods, too, held their own relatively well in export business. In regional terms, Germany again managed to increase its sales (+ 6 %) to its most important markets — i. e. to the countries of the European Communities, which account for almost one half of total exports — in 1978. Germany thus profited last year from the accelerating growth of these markets; in much the same way, economic setbacks in neighbouring countries had affected German exports adversely in the past. A striking feature is that in 1978 almost 46 % of Germany's total exports went to EEC countries (43.5 % in 1975). The proportion of exports to the EEC thus approached the figure that obtained prior to the oil crisis (47 %). This must be rated all the higher as the share of OPEC countries in German exports has nearly trebled in the meantime (from 3.2 % in 1972 to 8.6 % in 1978), and this increase has naturally resulted in a corresponding decrease in the percentages of other regions. If this shift in the regional structure of exports due to the rise in oil prices is taken into account, a reversal in the integration process is not to be detected in German trade with EEC countries, even though the earlier special impetus has slackened. How far the adjustment process has

1 As the external value is now being calculated on the basis of geometric means, this figure differs from earlier data. See Monthly Report of the Deutsche Bundesbank, Vol. 31, No. 4, April 1979.

2 According to the official foreign trade statistics of the Federal Statistical Office, which records exports on an f.o.b. basis and imports on a c.i.f. basis, Germany's trade surplus amounted to DM 41 billion in 1978. In accordance with international practice, however, when drawing up the annual balance of payments the expenditure on the transport and insurance of imports is included not in merchandise transactions but in services. The overall balance on current account is not affected by this adjustment.

Regional breakdown of the foreign trade of the Federal Republic of Germany

Percentage of total exports or imports

Item		1972	1975	1978
EEC countries	Exports	47.0	43.5	45.8
	Imports	53.7	49.5	49.2
Other industrial countries	Exports	30.3	25.3	25.8
	Imports	23.0	22.0	23.9
OPEC countries	Exports	3.2	7.6	8.6
	Imports	6.5	11.0	8.0
Centrally planned economies	Exports	5.1	7.9	6.2
	Imports	4.2	4.7	5.2
Developing countries (excluding OPEC countries)	Exports	14.2	15.4	13.3
	Imports	12.5	12.7	13.7

progressed since the oil crisis and the extent to which Germany's foreign trade is being determined by the underlying structures is illustrated in particular by exports to OPEC countries, which, after years of well above-average growth, in 1978 bought slightly fewer German goods than a year before (— 2%), for the first time since the crisis. Some of these countries were compelled to revise their investment plans downwards, partly for balance of payments reasons, partly on domestic economic or political grounds; this hit German exports especially hard because of the large proportion of capital goods they contain. Exports to non-oil developing countries also failed to exceed the 1977 level.

Foreign products capture growing market shares

In contrast to German exports, which could only just keep pace with the expansion of the volume of world trade, foreign suppliers again captured new market shares in Germany. Because of the fall in prices mentioned above, the value of imports increased by barely 4% in 1978, but their volume went up by 7 1/2%, i.e. over twice as much as the real gross national product (3 1/2%). The strength of imports reflects the distinct upturn in domestic economic activity. Imports of raw materials and primary products, in particular, expanded sharply in the second half of the year as the growth of domestic production gathered pace. Moreover, the considerable demand for imports implies that the competitiveness of foreign suppliers has improved substantially in recent years. This is indicated above all by the abrupt rise in imports of finished goods. It has been obvious for years that Germany is increasingly being integrated into the international division of labour. Not least for this reason, imports have continued to expand quite strongly even when the domestic economic situation has changed relatively little. This means that for some time now German imports have contained a sizable growth component independent of income. This growth component is primarily attributable to the sustained appreciation of the Deutsche Mark and represents an effect that has assumed importance only gradually but is likely to persist even if the tendency towards appreciation ceases. With the strong growth of its imports, Germany has also greatly assisted the international balance of payments adjustment process in many partner countries. Western industrial countries have derived particular benefit: in 1978 purchases from these countries rose by roughly 7% in value, i.e. almost twice as fast as overall German imports.

Sizable deficits in the other sectors of the current account

The large net imports of services and German transfer payments also significantly boosted economic activity in other countries. It is true that the traditionally large German deficit in these two sectors taken together decreased for the first time in 1978, namely by almost DM 3 billion to DM 33 billion.[1] But this was entirely due to some temporary special factors. Thus, the profit distributions of German enterprises to foreign shareholders returned to normal in 1978 (at roughly DM 4 billion), after having soared to the record level of over DM 6 billion one year earlier in connection with the corporation tax reform. In addition, the refunds from the European Communities to Germany within the framework of the EEC agricultural market organisations, and especially in the context of the excessive production of milk and milk products, rose exceptionally fast. But as the

1 On an f.o.b. basis for merchandise imports and exports; expenditure on the transport and insurance of merchandise imports is included in services, as is always done in the annual balances of payments in accordance with international practice, whereas this is not possible in the monthly figures.

Main items of the balance of payments

DM billion

Item	1971	1972	1973	1974	1975	1976	1977	1978
A. Current account								
1. Foreign trade								
Exports (f.o.b.) **1**	136.0	149.0	178.4	230.6	221.6	256.6	273.6	284.9
Imports (f.o.b.) **1**	112.7	121.7	137.7	171.9	177.1	214.6	227.7	235.9
Balance	+23.3	+27.3	+40.7	+58.7	+44.5	+42.1	+45.9	+49.0
2. Supplementary trade items **2** and merchanting trade	+ 0.3	− 0.6	− 0.1	− 1.3	− 1.2	− 0.2	− 0.3	+ 1.5
Overall balance of trade	+23.5	+26.7	+40.6	+57.4	+43.3	+41.9	+45.7	+50.5
3. Services	− 9.2	−10.1	−12.7	−15.9	−16.9	−15.1	−18.0	−15.9
of which								
Foreign travel	− 7.3	− 8.6	−10.9	−12.4	−14.7	−14.6	−16.3	−19.2
Investment income	+ 0.8	+ 1.1	+ 1.6	− 0.2	+ 1.0	+ 2.3	+ 0.4	+ 4.5
4. Transfer payments	−11.5	−14.0	−15.6	−16.1	−17.9	−18.1	−17.8	−17.1
of which								
Remittances of foreign workers	− 6.5	− 7.5	− 8.2	− 7.7	− 7.4	− 6.7	− 6.0	− 5.7
Balance on current account	+ 2.9	+ 2.6	+12.3	+25.5	+ 8.5	+ 8.6	+ 9.8	+17.5
B. Capital account (capital exports: −)								
1. Non-banks								
Direct investments	+ 0.2	+ 0.9	+ 1.4	+ 1.6	− 1.9	− 2.3	− 2.9	− 3.7
German investments abroad	− 3.6	− 4.7	− 3.8	− 4.6	− 4.7	− 5.9	− 6.1	− 6.9
Foreign investments in Germany	+ 3.8	+ 5.6	+ 5.2	+ 6.2	+ 2.8	+ 3.6	+ 3.2	+ 3.1
Portfolio investments	+ 1.9	+13.4	+ 6.6	− 3.4	− 4.1	+ 4.1	− 1.5	+ 0.6
Foreign securities	− 0.1	+ 2.7	+ 0.1	− 0.9	− 2.5	− 0.6	− 3.9	− 3.0
Domestic securities **3**	+ 2.0	+10.7	+ 6.5	− 2.5	− 1.6	+ 4.8	+ 2.3	+ 3.7
Short-term financial credits	− 1.4	− 4.6	+ 0.6	+ 3.1	+ 2.5	− 0.0	+ 8.5	+ 1.0
Short-term trade credits	+ 3.4	+ 1.0	+ 4.6	−12.4	+ 4.1	− 5.7	− 3.9	− 3.9
All official transactions	− 1.0	− 1.0	− 2.0	− 0.9	+ 1.9	+ 1.9	− 2.2	− 1.8
of which								
Loans to developing countries	− 1.3	− 1.3	− 1.5	− 1.6	− 1.4	− 1.3	− 1.2	− 2.1
Other	+ 2.9	− 0.8	+ 3.1	− 1.7	− 0.4	+ 0.6	− 0.4	− 0.8
Total capital transactions of non-banks	+ 6.1	+ 8.9	+14.4	−13.6	+ 2.0	− 1.4	− 2.5	− 8.6
2. Banks								
Long-term lending	+ 2.7	+ 1.9	+ 4.3	− 1.3	−11.5	− 4.8	− 4.6	+ 6.2
Claims	+ 0.2	+ 2.1	+ 3.7	− 2.6	−13.5	− 9.7	− 9.6	− 8.5
Liabilities	+ 2.6	− 0.2	+ 0.6	+ 1.3	+ 2.0	+ 4.9	+ 5.0	+14.8
Security transactions	+ 0.6	+ 1.4	+ 0.2	− 0.2	− 0.1	− 0.3	− 1.6	− 1.2
Short-term capital movements	+ 1.2	− 0.4	− 5.1	− 9.7	− 2.3	+ 6.7	+ 8.1	+10.1
Claims	+ 0.1	− 1.6	− 7.9	−12.0	−13.0	− 2.7	+ 1.2	− 2.2
Liabilities	+ 1.1	+ 1.2	+ 2.8	+ 2.3	+10.8	+ 9.4	+ 6.9	+12.3
Other	+ 0.0	+ 0.2	− 0.5	+ 0.0	+ 0.0	− 0.0	− 0.2	− 0.3
Total capital transactions of banks	+ 4.5	+ 3.1	− 1.2	−11.2	−13.8	+ 1.6	+ 1.7	+14.9
Balance on capital account	+10.6	+12.0	+13.2	−24.8	−11.9	+ 0.2	− 0.8	+ 6.3
C. Balance of recorded transactions	+13.5	+14.6	+25.5	+ 0.6	− 3.4	+ 8.9	+ 9.0	+23.8
D. Balance of unclassifiable transactions (balancing item)	+ 2.9	+ 1.1	+ 0.9	− 2.6	+ 1.1	− 0.1	+ 1.4	− 4.0
E. Overall balance on current and capital accounts	+16.4	+15.7	+26.4	− 1.9	− 2.2	+ 8.8	+10.5	+19.8
F. Balancing item for the Bundesbank's external position **4**	− 5.4	− 0.5	−10.3	− 7.2	+ 5.5	− 7.5	− 7.9	− 7.6
G. Change in the Bundesbank's net external assets (increase: +)	+11.0	+15.2	+16.1	− 9.1	+ 3.3	+ 1.3	+ 2.6	+12.2

1 Special trade. — **2** Mainly warehouse transactions for account of residents and deduction of goods returned and of commission processing. — **3** Transactions in German securities are all ascribed to non-banks, since the statistics do not show precisely which residents are involved in such transactions. — **4** Counterpart of changes in the Bundesbank's external position which are not caused by external current and capital transactions: mainly the allocation of IMF special drawing rights and changes in the DM value of the external position of the Bundesbank owing to valuation adjustments.
Discrepancies in the totals are due to rounding.

gross German contributions to the EEC budget also increased considerably, Germany's net payments to the European Communities still amounted to over DM 2 billion. In the aggregate, Germany remained the world's largest net importer of invisibles. Judging from the underlying trend, Germany's deficits in this sector may be expected to rise further. This is suggested by the strong and undiminished growth of foreign travel, on which – even after deduction of the corresponding receipts – Germany spent over DM 19 billion in 1978 and thus about DM 3 billion (net) more than in 1977.

Larger current account surplus mainly due to special influences

As a result of the shifts in foreign trade prices caused by exchange rate movements, and of the above-mentioned special factors affecting invisibles, Germany's surplus on current account rose to DM 17.5 billion in 1978. The current account surplus was thus DM 7.5 billion larger than in 1977, but it is unlikely to remain long at the level reached in 1978. It is more probable that the surplus on current account will decline in 1979, as suggested by the latest figures, which indicate a marked increase in import prices as a reaction to the crisis in Iran (in January and February 1979 they rose by 2 1/2 % on average compared with one year earlier). Already in 1978 Germany's current transactions were more of a help than a hindrance to the international adjustment process, as is shown by the fact that the German surpluses increased only vis-à-vis the OPEC countries (from DM 4.1 billion to DM 8.1 billion) and the United States (from DM 3.9 billion to DM 8.4 billion). In the case of the United States this may have been because that country, as the key currency country, was slow to submit to the "categorical imperative" of the balance of payments. But in current transactions with the other industrial countries the existing deficit more than doubled (to DM 4.6 billion), and Germany's current account deficit vis-à-vis the non-oil developing countries also continued to rise slightly (to DM 6.8 billion).

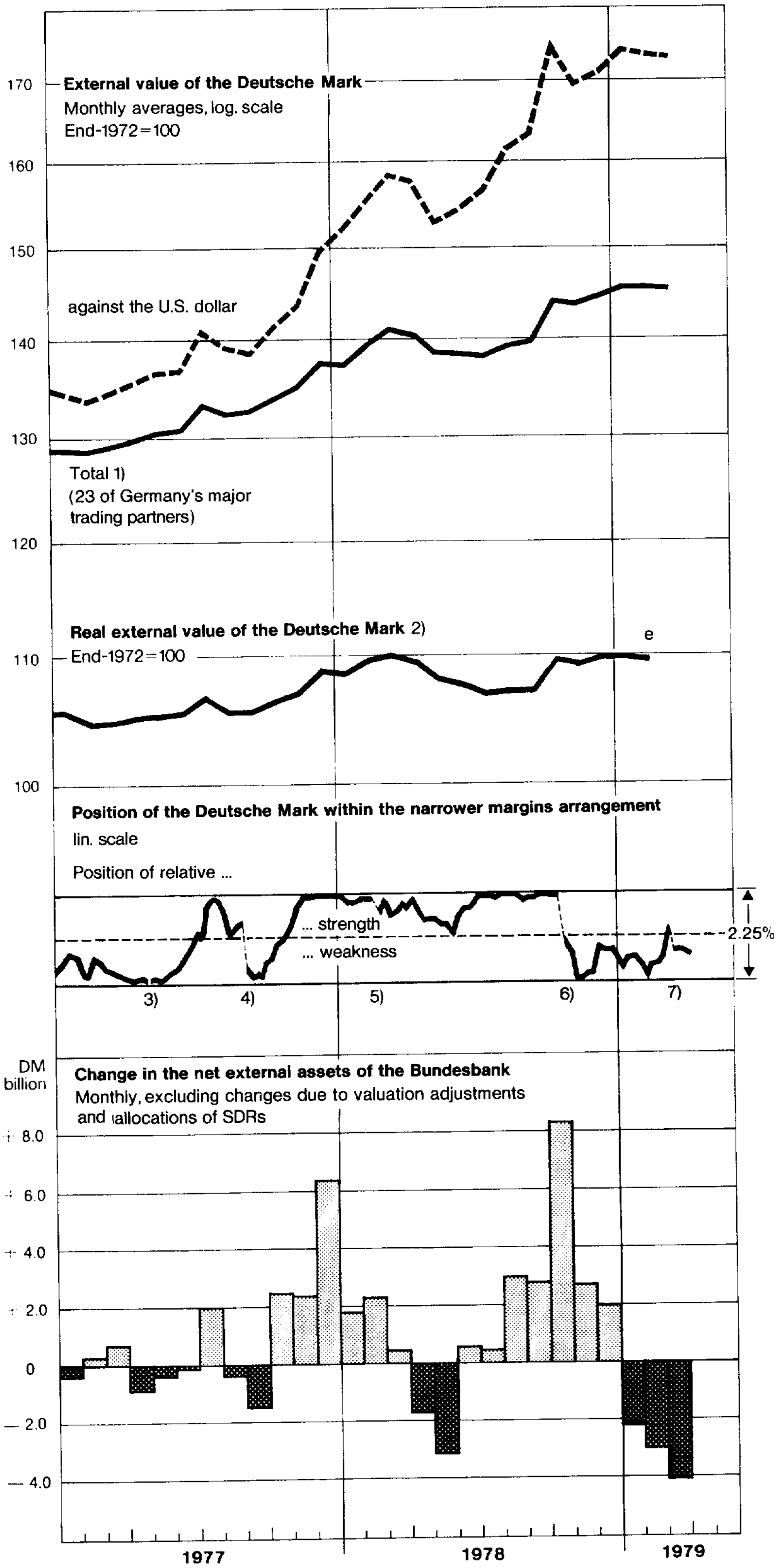
Large outflows in non-banks' capital transactions despite monetary upheavals

In 1978 capital transactions led to substantial inflows of funds to Germany in connection with the persistent monetary upheavals. However, taking the year as a whole, this applied only to banks, whereas non-banks recorded considerable capital outflows. Including the balancing item of the balance of payments, DM 12.5 billion flowed out from the non-bank sector (against only DM 1 billion in 1977); this provided a certain counterweight to the increase in domestic liquidity caused by the surpluses on current account. Specifically, the net capital outflows due to direct investments by enterprises went up by DM 0.75 billion to DM 3.75 billion. Stagnating investments in Germany by non-residents were accompanied – as for some years past – by strongly rising German direct investments in other countries. During the year under review domestic enterprises spent almost DM 7 billion – i.e. nearly DM 1 billion more than a year earlier – on direct investments in foreign subsidiaries or participations in foreign firms (including reinvested profits). In relation to the overall domestic investments of German enterprises (excluding housing), however, German investments abroad still came to less than 5%. A further substantial outflow of funds, namely almost DM 4 billion (net), was caused in 1978 by enterprises' trade credits, that is by the granting or use of credit terms in foreign trade, including advance payments. On the other hand, German firms raised over DM 1 billion of short-term financial credits in other countries, although this was far less than in 1977 (almost DM 9 billion), as the terms for short-term borrowing in the Euro-markets were not very attractive. Security transactions also led to a small net inflow of funds to enterprises and households (DM 0.5 billion); in this sector the declining interest of German buyers in foreign securities contrasted with growing purchases of domestic shares and bonds by non-residents. In 1978 official capital exports, at just under DM 2 billion, were slightly smaller than in 1977, although development aid loans went up sharply.

Monetary unrest strongly affects the banks' capital transactions

The capital transactions of banks, unlike those of non-banks, were strongly affected by the recurring unrest in the foreign exchange markets. As a result of the temporary "exodus from the key currency" the banks' long-term capital exports, which had been in progress for years, not only came to a halt but even gave way to net imports of long-term funds totalling DM 5 billion (including security transactions). In this sector alone there was thus a swing of over DM 11 billion compared with the preceding year. The net inflows to the banks would have been even larger had they not purchased DM 3 billion of so-called "Carter Notes" towards the end of the year. The fact that the United States, as the key currency country, for the first time took action to finance its balance of payments deficits through the foreign capital market has rightly attracted a great deal of public attention and been judged a favourable development for the dollar.

Exchange rate movements * and external position of the Bundesbank



* Based on official spot rates.- 1) Weighted external value in relation to the central rates of end-1972; geometric mean.- 2) Weighted external value against the currencies of 13 industrial countries after adjustment for the price discrepancies (as measured by the wholesale prices of industrial products) between Germany and other countries; geometric mean.- 3) Devaluation of the Scandinavian currencies in the European narrower margins arrangement with effect from April 4, 1977.- 4) Withdrawal of Sweden from the European narrower margins arrangement and devaluation of the Danish and Norwegian kroner with effect from August 29, 1977.- 5) Devaluation of the Norwegian krone in the European narrower margins arrangement with effect from February 13, 1978. - 6) Realignment of exchange rates in the European narrower margins arrangement with effect from October 16, 1978.- 7) Entry into force of the European Monetary System (EMS) on March 13, 1979.- e Figures for February 1979 estimated.

How greatly the movement into the Deutsche Mark was stimulated by the sustained monetary upheavals is also indicated by the fact that about half of the foreign funds newly placed at long term with banks (almost DM 15 billion) came from the Euro-market centres; another significant part came directly from OPEC countries. The inflow of funds was partly attributable to sales to non-residents of borrowers' notes issued by German banks, which for foreign lenders are more fungible than deposits, while the interest they bear — in contrast to the interest on bonds — is not subject to coupon tax. The above-mentioned steep rise in the long-term external liabilities of banks contrasted with a distinct fall against the previous year in German banks' lending to non-residents, despite the low level of interest rates in Germany. If the "Carter Notes", as a special operation of the U.S. and German monetary authorities to finance the U.S. balance of payments deficit, are left out of account, non-residents borrowed little more than DM 5 billion from German banks in 1978 (i.e. roughly DM 4 billion less than in 1977); the diminishing inclination of private foreign borrowers to raise additional Deutsche Mark credits was no doubt mainly due to the prolonged appreciation of the Deutsche Mark.

In the field of short-term capital transactions, too, banks continued to receive substantial amounts of foreign funds. The banks' short-term external liabilities increased by DM 12 billion in the course of the year. Almost half of this amount came from foreign non-banks, whose short-term balances with domestic banks — virtually all of which are held in Deutsche Mark — accordingly rose to DM 21 billion at the end of 1978 (and thus to three times the level of four years before). The German banks reinvested abroad only a very small part of the foreign funds that accrued to them, since their short-term external claims increased by little more than DM 2 billion in 1978. The banks therefore received a total of almost DM 15 billion (net) of foreign funds through long and short-term capital transactions, against DM 1.5 billion in each of the two preceding years.

Heavy inflows of foreign exchange to the Bundesbank

An inflow of this magnitude was possible only because the Bundesbank was repeatedly obliged to intervene massively in the foreign exchange markets. Thus, in the final analysis the German banks passed on to the Bundesbank a considerable part of the foreign funds they received directly or indirectly from domestic non-banks through net purchases of foreign exchange. Up to the end of October 1978, when the dollar reached its lowest level ever at DM 1.73, the Bundesbank took foreign exchange equivalent to DM 15 billion out of the market, the great bulk of it in the course of interventions; in fact, it took in well over half of this sum, namely about DM 9 billion, as a result of purchases under the European narrower margins arrangement (the "snake"). But after the realignment of mid-October the support purchases within the "snake" came to an end, and foreign exchange even flowed out again. These outflows were, however, more than offset by inflows due to interventions in the Deutsche Mark/dollar market arising from the participation of the Bundesbank in the programme to strengthen the dollar announced at the beginning of November 1978. Altogether, therefore, the Bundesbank recorded foreign exchange inflows totalling more than DM 4.5 billion in the last two months of 1978. Over the whole of last year the Bundesbank's reserves increased by almost DM 20 billion,[1] a figure that had not been reached since compulsory interventions against the dollar were discontinued in March 1973.

Foreign exchange outflows at the beginning of 1979

The Bundesbank was able to divest itself of almost DM 9 billion of this amount in the first three months of the present year. The main reason for this major turnaround was that, after the November measures to strengthen the dollar, exchange rate movements steadied and capital flows began to reverse, which in turn helped to stabilise conditions in the exchange market. Once the speculative capital movements had disappeared, the substantial interest rate differential between Germany and other industrial countries, especially the United States, increased in significance. The subdued trend of exchange rates in the first few months of 1979 — the rate of the dollar latterly standing at about DM 1.90 — at the same time partly rectified the appreciation of the Deutsche Mark, which had sometimes been very strong last year. When this Report went to press the weighted external value of the Deutsche Mark was noticeably lower than at the end of October 1978. In these last five months, moreover, the level of prices and costs in Germany has risen somewhat more slowly than in most other industrial countries; to this

1 Against this, a write-down of DM 7.5 billion was necessary at the end of the year owing to the valuation adjustment of the external position, so that the net external assets of the Bundesbank increased by just over DM 12 billion in 1978.

extent the earlier "real" appreciation of the Deutsche Mark has been followed by a tendency towards "real" depreciation that has no doubt slightly corrected the excessive exchange rate movements of the first ten months of 1978. This underlines the statement made before that price rises in Germany are no longer restrained as much by this factor as they were in 1978, when the real appreciation of the Deutsche Mark set distinct limits to price increases in domestic and especially in foreign business.

4. Monetary policy in a dilemma

(a) Temporary departure from the medium-term objective

Target for 1978 hard to set

Under the changing domestic and external economic conditions, monetary policy in 1978 developed for the Bundesbank into a dilemma between short and medium-term objectives. When setting an appropriate monetary growth target for 1978 it was not easy to find the right compromise between the short-term effects which the strong appreciation of the Deutsche Mark and the sharp expansion of the money stock had on domestic economic activity towards the end of 1977 and the longer-term objective of stabilisation. In mid-December 1977 the Bundesbank decided in spite of these difficulties to announce a monetary growth target for 1978. To provide adequate scope for vigorous economic growth accompanied by further progress towards stabilisation, the Bundesbank at the time considered it appropriate to aim at an average increase of 8 % in the central bank money stock in 1978. Assuming steady growth, this target for the average annual increase would have permitted a rise of only 5 to 7 % in the central bank money stock between the fourth quarter of 1977 and the fourth quarter of 1978.

Pronounced overshooting of the target in the first half of the year

In fact, the central bank money stock grew at a seasonally adjusted annual rate of over 11 1/2 % in the first six months of 1978. Since it had become evident as early as the spring that, given this sharp acceleration in the growth of the money stock, the quantitative monetary target for the year as a whole could no longer be attained, the Bundesbank decided in June to tolerate the prospective overshooting. The danger of prices rising could be considered small at that time in view of the steep "real" appreciation of the Deutsche Mark. Moreover, any curbing of the monetary expansion would have increased the risk of nipping the revival of domestic economic activity in the bud. There were also some indications that the rise in the money stock was overstated owing to some special factors. The Bundesbank made it clear, however, that the toleration of a departure from the annual target by no means implied the abandonment of the medium-term objective of a limited expansion of the money stock along the announced growth path.

"Easy" monetary policy appropriate in the second half of the year in the light of external developments

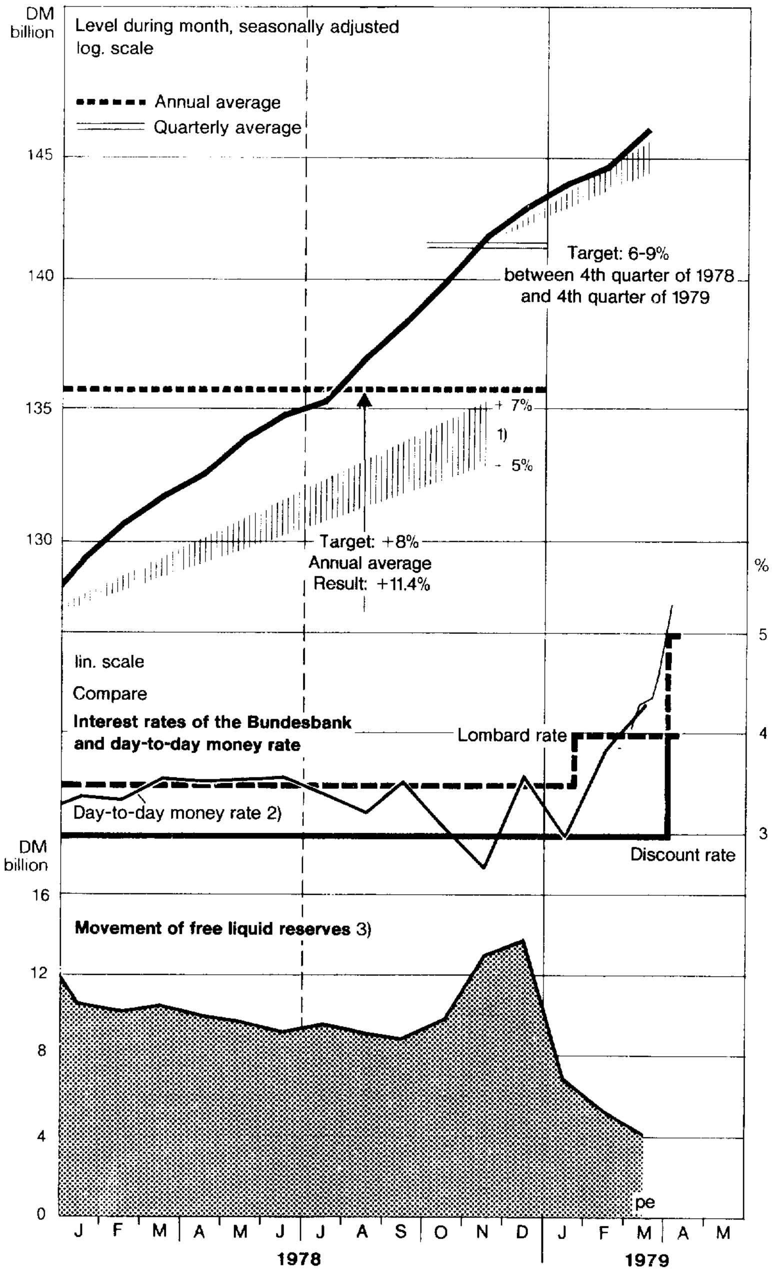
When economic prospects started to improve during the summer, the severe unrest in the exchange markets until the late autumn left little scope for pursuing a monetary policy that was more in line with the monetary growth target. Monetary expansion continued unabated in the second half of 1978, primarily because the net purchases of foreign exchange by the Bundesbank greatly stimulated the growth of the money stock. Between July and December 1978 the central bank money stock rose at an annual rate of 12 %, with only minor fluctuations in pace from month to month; this was in effect just as fast as in the first six months of last year. Comparing the average for 1978 with that for 1977, central bank money went up by just on 11 1/2 %. The monetary growth target envisaged for 1978 was thus greatly exceeded. In the last two decades, only 1972, a year which was strongly marked by international monetary unrest and substantial foreign exchange purchases by the Bundesbank, saw an even steeper increase in the central bank money stock, at an annual average of roughly 12 1/2 %.

Faster growth of all components of the money stock in 1978

In the first few months of 1978 the excessive growth of the central bank money stock at times seemed to be due to special influences affecting currency in circulation which made the rise in this component of the money stock appear less serious. In fact, in the first quarter of 1978 currency in circulation went up exceptionally fast (seasonally adjusted); as a result the central bank money stock (which includes currency in circulation in full but bank deposits only in proportion to their minimum reserve weights) was one-sidedly inflated. In the further course of the year currency in circulation continued to increase rapidly; however, its rise was soon outstripped by the growth of the minimum reserve component, which reflects domestic liabilities. Over the year as a whole both components of the central bank money stock accordingly went up at roughly the same rate, namely by about 12 %. The considerable overshooting of the monetary growth target in

Growth of the central bank money stock *

Target and movement to date



* Currency in circulation (excluding the banks' cash balances of domestic notes and coins, which are deductible from the required minimum reserves) plus the required reserves on domestic liabilities (calculated at constant reserve ratios, base: January 1974).- 1) At this growth rate (between the fourth quarter of 1977 and the fourth quarter of 1978) the average target would have been reached (given steady development).- 2) Monthly or bank week averages.- 3) Excess balances, domestic money market paper which the Bundesbank has undertaken to purchase and unused rediscount quotas.- pe Partly estimated.

1978 is not, therefore, ascribable to any exceptionally rapid expansion of currency in circulation. Nor can it be attributed to fortuitous or interest-rate-induced shifts among the various categories of deposits; at any rate, the other monetary aggregates (M1, M2, M3), which would indicate such shifts if their growth rates diverged strongly, all grew at roughly the same fast pace last year, as will be pointed out in detail below.

Gradual change of course and new monetary growth target for 1979

With money balances expanding faster than planned there was a growing danger of the "monetary cloak" of the economy becoming too large in the long run. The longer this trend continued, the harder it was to suppress doubts as to whether the appreciation of the Deutsche Mark and the associated pressure on domestic prices provided a sufficient guarantee that price movements would remain so subdued despite the sharp ex-

Monetary developments

Change during period 1

Item	1972	1973	1974	1975	1976	1977	1978
	DM billion						
A. Creation of central bank money and free liquid reserves of banks 2							
1. Net external position of the Bundesbank	+ 16.9	+ 27.2	− 2.8	− 2.1	+ 8.3	+ 8.4	+ 20.3
2. Net balances of central and regional authorities (increase: −)	+ 3.0	− 1.1	− 3.0	+ 1.7	+ 3.7	+ 5.0	− 2.1
3. Change in minimum reserves (increase: −)	− 8.1	− 6.4	+ 12.7	+ 7.2	− 4.6	+ 8.1	− 1.8
4. Change in rediscount quotas (reduction: −)	− 3.6	− 11.9	+ 4.5	+ 4.5	+ 0.7	+ 6.5	+ 4.4
5. Open market operations	− 2.1	− 6.3	− 1.5	+ 11.6	− 8.6	− 0.7	− 3.6
6. Lombard or special lombard loans	−	+ 1.1	+ 2.0	− 2.0	+ 6.5	− 6.5	+ 1.0
7. Unspecified determinants	− 3.2	− 0.1	− 4.6	− 1.1	− 5.6	− 3.5	− 3.8
Central bank money stock and free liquid reserves (1 to 7)	+ 3.0	+ 2.5	+ 7.4	+ 19.9	+ 0.3	+ 17.3	+ 14.3
Central bank money stock **3**	+ 10.4	+ 6.9	+ 5.8	+ 9.5	+ 7.9	+ 10.9	**11** + 14.1
Free liquid reserves of banks **4**	− 7.5	− 4.4	+ 1.6	+ 10.4	− 7.6	+ 6.3	+ 0.2
Memorandum items							
Level of free liquid reserves in the last month of the period	7.3	3.0	4.5	14.9	7.3	13.6	13.8
Lombard or special lombard loans outstanding in the last month of the period	1.3	0.8	2.8	0.8	7.3	0.8	1.8
	Seasonally adjusted, in %						
B. Key monetary indicators							
Central bank money stock **2, 5**	+ 13.3	+ 7.3	+ 6.3	+ 9.8	+ 8.4	+ 10.0	**11** + 11.8
Memorandum item							
As an annual average	+ 12.6	+ 10.6	+ 6.1	+ 7.8	+ 9.2	+ 9.0	**11** + 11.4
Lending by banks and the Bundesbank to domestic non-banks	+ 14.6	+ 9.9	+ 7.9	+ 10.5	+ 10.0	+ 9.5	+ 11.6
M1 (= currency in circulation and sight deposits)	+ 14.0	+ 1.8	+ 11.0	+ 14.0	+ 3.7	+ 11.3	+ 14.3
M2 (= M1 plus time deposits for less than 4 years)	+ 16.4	+ 13.4	+ 4.8	− 0.1	+ 6.4	+ 11.1	+ 13.1
M3 (= M2 plus savings deposits at statutory notice)	+ 13.8	+ 8.6	+ 8.3	+ 8.7	+ 8.2	+ 11.0	+ 10.9
	DM billion						
C. Money stock and its counterparts							
Money stock M3 (= C1 plus 2 less 3 less 4 less 5)	+ 47.1	+ 34.0	+ 35.2	+ 38.4	+ 41.0	+ 58.9	+ 64.8
Counterparts in the balance sheet:							
1. Volume of credit **6**	+ 86.4	+ 67.5	+ 59.8	+ 85.5	+ 91.2	+ 94.2	+ 125.4
of which							
Bank lending to domestic non-banks, total	+ 88.5	+ 65.2	+ 61.2	+ 78.9	+ 96.3	+ 95.8	+ 122.6
− to enterprises and individuals **7**	+ 53.7	+ 31.1	+ 26.0	+ 16.6	+ 46.5	+ 42.3	+ 49.0
− to the housing sector **8**	+ 24.5	+ 23.5	+ 15.2	+ 14.3	+ 19.3	+ 26.8	+ 38.9
− to public authorities	+ 10.3	+ 10.6	+ 20.1	+ 48.0	+ 30.5	+ 26.7	+ 34.7
2. Net external assets **9**	+ 8.7	+ 23.5	+ 13.2	+ 16.8	+ 8.3	+ 10.1	+ 7.1
3. Monetary capital	+ 47.0	+ 45.6	+ 34.5	+ 61.3	+ 59.1	+ 42.9	+ 54.9
of which							
Savings deposits at agreed notice	+ 17.1	+ 12.0	+ 8.5	+ 25.9	+ 12.2	+ 0.8	+ 7.7
Bank savings bonds	+ 3.5	+ 5.5	+ 4.8	+ 8.9	+ 10.4	+ 13.4	+ 10.3
Time deposits for 4 years and over	+ 8.7	+ 10.2	+ 8.0	+ 9.4	+ 11.4	+ 13.6	+ 17.0
Bank bonds outstanding **10**	+ 13.5	+ 14.3	+ 10.1	+ 12.9	+ 19.3	+ 9.7	+ 14.2
4. Central bank deposits of domestic public authorities	− 3.8	+ 4.2	+ 0.4	+ 1.4	− 10.2	− 0.8	+ 2.5
5. Other influences	+ 4.8	+ 7.2	+ 2.9	+ 1.2	+ 9.6	+ 3.3	+ 10.3

1 Unless otherwise indicated, based on end-of-month figures. — **2** Based on daily averages of the last month of the period and the last month of the previous period, respectively. — **3** Currency in circulation (as from March 1978 excluding the banks' cash balances of domestic notes and coins, which are deductible from the required minimum reserves) and required reserves on the banks' domestic liabilities at current reserve ratios. — **4** Excess balances, domestic money market paper which the Bundesbank has undertaken to purchase, unused rediscount quotas and — up to May 1973 — unused scope for raising lombard loans. — **5** Reserve component calculated at constant reserve ratios (base: January 1974). — **6** Banks and the Bundesbank; including credit based on the purchase of securities. — **7** Excluding housing. — **8** Excluding credit based on the purchase of securities. — **9** Banks and the Bundesbank. — **10** Excluding bank holdings. — **11** The statistical break caused by the redefinition of the central bank money stock (see footnote 3) has been eliminated. Discrepancies in the totals are due to rounding.

pansion of the money stock. When conditions in the exchange markets began to ease towards the end of the year it became clear that the dampening effect of the Deutsche Mark appreciation on prices could not necessarily be expected to continue — indeed, that a movement in the other direction was quite possible. For these reasons the Bundesbank started to change its monetary course around the turn of 1978/79. A first indication of this was given to the general public when in December 1978 the Bundesbank announced a monetary growth target for 1979. It envisages an expansion of the central bank money stock within a range of 6 to 9% between the fourth quarter of 1978 and the fourth quarter of 1979, i.e. a distinctly slower rate of growth than was achieved in 1978. The Bundesbank also stated that, depending on domestic economic developments on the one hand and the movement of exchange rates on the other, it would endeavour to aim more at the lower or more at the upper limit of the target range.[1] When announcing the monetary growth target, which the Central Bank Council adopted with the agreement of the Federal Government, the Bundesbank also intimated that another overshooting of the target is not acceptable under the conditions in prospect for 1979. An initial contractionary liquidity policy measure was approved at the same time, and was followed in January, February and March by further interest rate and liquidity policy measures designed to bring monetary expansion as gently as possible on to the growth path envisaged for the central bank money stock.

(b) Monetary measures and developments in the money market in 1978

"Wait-and-see" strategy in the money market

The "wait-and-see" attitude of the Bundesbank in 1978 was clearly reflected in developments in the domestic money market. Throughout the year the Bundesbank generally confined itself to preventing major fluctuations in money market rates and variations in bank liquidity. As a result of the Bundesbank's operations the banks almost always had an ample supply of liquid funds. In December 1978 the banks' free liquid reserves, which mainly consist of unused rediscount quotas, stood at roughly the same high level as at the end of 1977, at just under DM 14 billion; in the course of 1978 they fluctuated around DM 10 billion, with only minor variations. The Bundesbank also kept both the discount and lombard rates, which had been reduced by another 1/2 percentage point to 3% and 3 1/2% respectively in December 1977, at this historically very low level over the entire year. Virtually all the funds raised by the banks at the Bundesbank could be obtained at these rates. As indicated, the rediscount facilities were used only in part, not least because lombard credit was available without quantitative restrictions. In addition, the small difference between the lombard rate and the discount rate made it seem highly advisable to take up lombard loans (which can be repaid daily) when only very short-term funds were needed, rather than to rediscount trade bills, on which interest is payable for at least 5 days under the terms of submission. In such circumstances the "free liquid reserves" shown in the statistics give a very far from true picture of the banks' actual scope for obtaining central bank finance; in fact, their scope is much greater. In the money market the large supply of liquidity was mirrored in the fact that the money market rates in 1978 were on average 3/4 percentage point below the 1977 level. This applied to the call money rate as well as to the rates for one-month and three-month funds, the movement of which is determined among other things by the actual trend of interest rates in the day-to-day money market and by the trend anticipated by market participants.

Flexible use of liquidity policy instruments

This result could only be achieved by regular Bundesbank interventions in the money market; however, these were primarily technical "adjustments" rather than measures taken with a view to changing the course of monetary policy. At times the Bundesbank intensified its open market operations, in particular, last year in order to flexibly reduce or increase the liquidity of the banking system. Thus, during the period of large inflows of foreign exchange at the beginning of the year and again in the second half of 1978 the Bundesbank countered a possible inflation of bank liquidity primarily by selling mobilisation and liquidity paper (so-called "N" paper) to the banks on several occasions. As a result the banks' portfolios of such paper, which is not included in the money market regulating arrangements and consequently cannot be converted into central bank money at short notice on the banks' initiative, increased by some DM 7 billion to DM 8.5 billion. On

1 The reasons for setting a target range and a year-on-year growth target, which in 1979 has replaced the average annual growth target previously fixed, were set out in detail in the January 1979 Monthly Report (pp. 5—7).

the other hand, the Bundesbank at times bought trade bills from banks for resale after ten days (at a rate of interest of 3 1/4 %) outside the rediscount quotas to stabilise the money market. For the same purpose the Bundesbank temporarily agreed to Federal Government cash balances being shifted to the banks pursuant to section 17 of the Bundesbank Act. In the summer months, moreover, bank liquidity was increased by open market purchases of public bonds. However, these mostly short-term measures were insufficient to meet the needs of central bank money in the longer run without major tensions; in mid-1978 the Bundesbank therefore lowered the minimum reserve ratios and raised the rediscount quotas. After the massive inflows of foreign exchange to the Bundesbank in the autumn of 1978 it had to take counteractive liquidity policy measures: it increased the minimum reserve ratios as from November 1, 1978 and reduced the rediscount quotas with effect from January 1, 1979. Both these measures were on a slightly larger scale than the relief granted in the summer of 1978 (see Record of economic policy measures, pages 14—15).

Central bank money requirements met by inflows of foreign exchange

The fact that the level of free liquid reserves at the end of 1978 was as high as in 1977 indicates that the Bundesbank supplied the banks in the aggregate, combining the market factors determining liquidity on the one hand with the liquidity policy measures on the other, with roughly the amount they needed for net outpayments of cash and for complying with the reserve requirements (at current reserve ratios), namely some DM 14 billion. In effect this demand for central bank money was met by the Bundesbank's foreign exchange purchases alone; indeed, these purchases were even greater, at about DM 20 billion. The excess amount of net foreign exchange purchases was offset by contractionary factors such as the net balances which the public authorities built up at the Bundesbank or the Bundesbank's interest receipts. In 1978, for the first time since compulsory intervention against the U.S. dollar was discontinued in 1973, the Bundesbank on balance bought far more foreign exchange than was needed to finance the (rapidly growing) central bank money stock.

Measures of liquidity and interest rate policy in order to achieve the 1979 monetary growth target

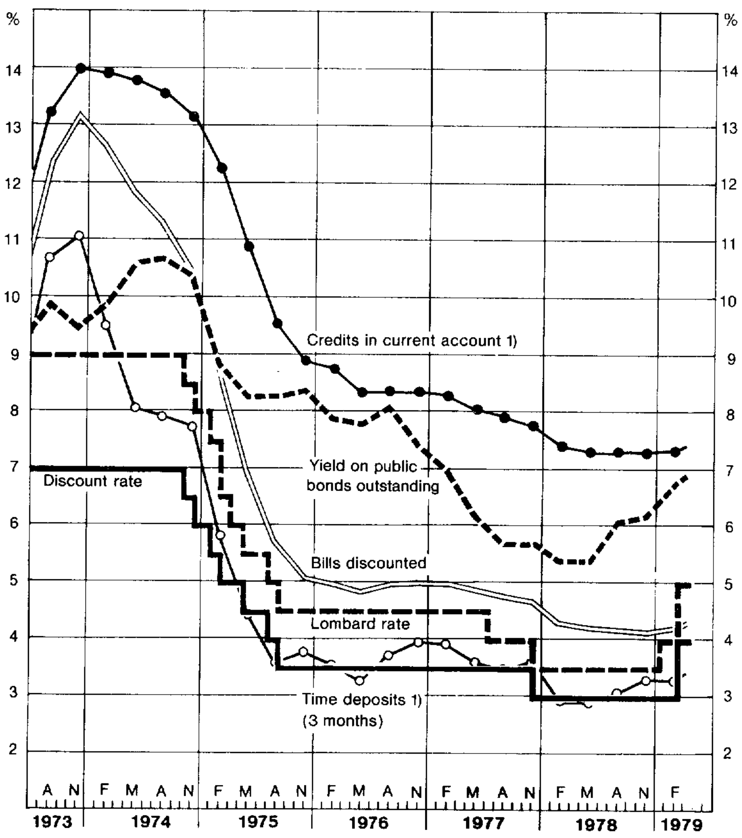
After the turn of 1978/79 the Bundesbank began gradually to reduce the banks' hitherto plentiful supply of liquidity. The cut in the rediscount quotas adopted in December became effective in January; a further DM 2.5 billion was siphoned off by a general increase in minimum reserves in February. On account of these two measures, which were assisted by withdrawals of funds caused by market factors, the banks' free liquid reserves dropped to roughly DM 4 billion during the first quarter of 1979 and thus to a level below which they can fall only slightly further on technical grounds. At the same time the banks' lombard debt went up exceptionally sharply to almost DM 11 billion. Their rediscount quotas were therefore raised by DM 5 billion to about DM 27 billion with effect from April 1, 1979. This enabled the banks to compensate for the liquidity drain associated with the sizable outflows of foreign exchange by rediscounting more bills and thus to fund at least some of the lombard loans which they had taken up at the Bundesbank, and which had grown vigorously in March. The banks' access to lombard loans remained free from quantitative restrictions, however. For the first time for over a year the lombard rate was changed — from 3 1/2 % to 4 % — in mid-January, which restored the normal difference of 1 percentage point between the discount and lombard rates. With this move the Bundesbank ended the prolonged period of very easy conditions in the money market. It continued this course by raising the discount and lombard rates by 1 percentage point each to 4 % and 5 %, respectively, with effect from March 30, 1979. This reduction in bank liquidity is intended to slightly narrow the scope for additional lending. At the same time the higher interest rates will probably help to focus more attention on the interest rate burden when new borrowing is being planned, so that the demand for credit will be curbed.

(c) Diverging interest rate trends

Distorted pattern of interest rates

The generally easy state of the money market on the one hand and the growing demand for long-term funds on the other led to marked differences in interest rate trends at the short and longer ends of the market. Interest rates for shorter-term bank lending, which as a rule are strongly influenced by the cost of funds to banks in the money market, fell until about the middle of 1978 and then remained at that historically very low level up to the end of January 1979. In contrast to this, interest rates in the capital market rose distinctly, though with interruptions, from the spring of 1978 onwards under the impact of a growing demand for longer-term credit and a stagnating supply of long-term funds. The

Movement of selected interest rates since mid-1973



1) Of under DM 1 million.

differences in interest rate trends in the short and longer-term fields corresponded to the varying credit needs in the individual sectors of the economy. The cost of loans rose most noticeably in the field of housing construction, which was experiencing a strong upswing and which is financed for the most part with long-term credit. The large public sector borrowing requirement likewise primarily enhanced the demand for long-term funds. By contrast, the longer-term credit needs of enterprises in the strict sense and consumers were smaller for quite some time; they took up more short and medium-term loans. Moreover, this demand for credit could be satisfied to a much greater extent than that for long-term loans on the basis of the plentiful supply of liquidity among the banks.

Exceptionally low lending rates

Around the turn of 1978/79 the interest rates charged for credits of under DM 1 million in current account averaged 7.3% and those for larger sums 6.2% — a low that has rarely been recorded since the interest rate statistics were first compiled in 1967. The banks' short-term lending rates were thus about 1/2 percentage point below the level registered a year before. Besides the easy state of the money market and the low level of central bank interest rates, this development owed something to the keen competition for good industrial customers and the interest rate differential between the domestic and the Euro-market, although competition would not have been conceivable in this form if stricter limits had been imposed on the banks' capacity to create credit. This applies to the domestic banking system. But indirectly there is also a link with the "even keener" competition in the Euro-markets, where no monetary policy limits are set to the banks' credit creation (outpayments of cash, minimum reserve requirements) but only banking limits such as a just acceptable interest margin. Not until February and March 1979 did short-term lending rates rise appreciably in response to the measures taken by the Bundesbank at the beginning of the year, whereas before that the banks had at the most cut down the special terms they granted their customers. By contrast, the interest rates charged for long-term bank credit, notably the terms quoted by the mortgage banks, began to increase as early as the summer of 1978 and have been moving distinctly upwards ever since. For example, the interest rates on mortgage loans secured by first mortgages on residential real estate, which in March 1979 — with relatively large differences among individual banking groups — averaged $6^3/_4$ %, have recently been almost $^3/_4$ percentage point higher than they were at their lowest point in May 1978. This upward movement of long-term bank interest rates mirrors — though not fully — the interest rate trend in the bond market.

Rise in interest rates in the capital market

The interest rate on bonds, which was still falling markedly at the beginning of last year, rose consistently from April 1978 onwards. The immediate cause was primarily the reversal in international capital flows following the strengthening of the dollar. (At all events, international bond transactions resulted in outflows of capital amounting to no less than DM 2.5 billion in the second quarter of 1978, after German bonds worth over DM 2 billion had been purchased by foreigners between October 1977 and March 1978.) In the further course of the year expectations of rising interest rates and thus a pronounced "wait-and-see" attitude on the part of investors soon became the predominant feature in the bond market. The average yield on all bonds outstanding rose between the low at the end of March 1978 and the beginning of August by over 1 percentage point to 6.6 %. Following efforts by the issuers to stabilise prices and a temporary increase in the open market purchases of the Bundesbank there was admittedly a brief slight fall in interest rates. But in the autumn interest rates in the market started to move up again. At the end of February 1979 the yield on bonds outstanding exceeded 7 % for the first time for two years. Since the spring of 1978 interest rates on bonds have thus risen by about $1^1/_2$ percentage points. The long-term interest rate is thus well ahead of short-term market rates and also of the central bank interest rates, which influence money market rates and short-term bank interest rates.

Late reaction of deposit rates

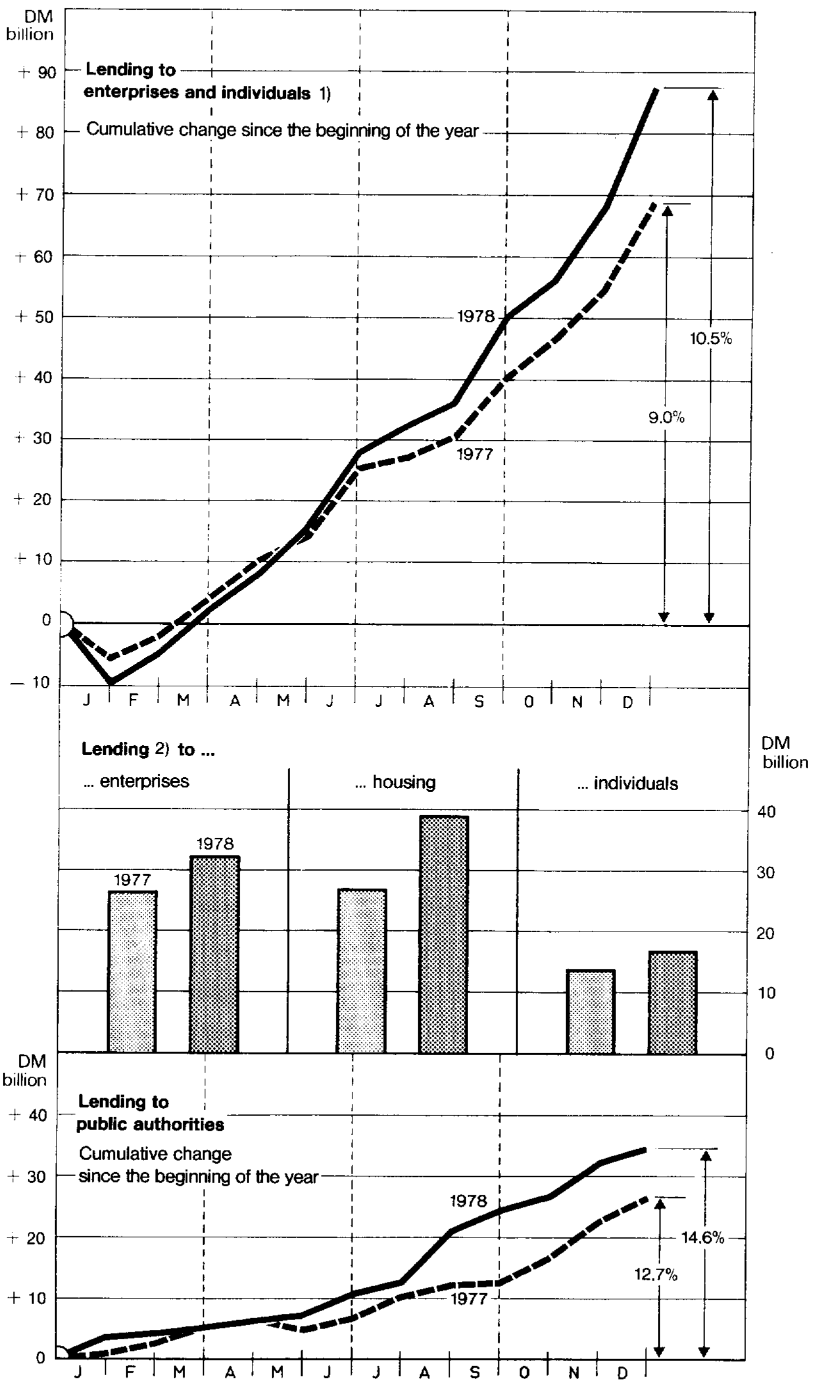
The costs incurred by the banks for short and longer-term funds in deposit business also showed divergent trends last year. Disregarding a slight upward adjustment of interest rates last summer and a purely seasonal firming of rates towards the end of the year, the rates paid on time deposits and borrowed funds remained in a trough until well into the new year, standing at the same very low level as at the beginning of 1969. Apart from occasional bonus payments the interest rates on savings deposits, which had been lowered by a further $^1/_2$ percentage point in February 1978, likewise remained nearly unchanged until early March 1979. By contrast, the interest rates on bank savings bonds, which were governed by developments in the bond market and the improvement in the terms of Federal savings bonds in September 1978 and at the end of January and the beginning of April 1979, have gone up slightly since the summer. In February/March 1979 all deposit rates — starting with those on time deposits — began to rise appreciably; the interest rates on savings deposits were in some cases raised by $^1/_2$ percentage point in March (since then the comparatively low rate of 3 % has been paid on savings deposits at statutory notice).

(d) The driving forces behind the monetary expansion

Cyclical rise in the demand for credit and low money market rates determine the rapid monetary expansion

The main driving force behind the money creation process and the resultant accelerated growth of the money stock last year was the faster domestic credit expansion accompanying the recovery of domestic economic activity — a recovery which initially varied considerably in strength. But the cyclical tendency towards rapid monetary expansion was able to develop fully only because money market rates and bank interest rates were exceptionally low. On the one hand, the depressed level of interest rates stimulated demand for credit; not only demand for loans for housebuilding purposes and — in the further course of the year — for other long-term capital projects but also households' demand for consumer credit responded favourably to the low interest rates. On the other hand, the low rates of interest offered little incentive to reduce the holding of money in very liquid form and to give greater preference to longer-term investments again. This is no doubt one of the reasons why enterprises and individuals showed little inclination to make more efficient use of their cash holdings (as they frequently had done during previous upswings), i. e. to enter into longer-term commitments in order to augment their interest receipts.

Bank lending to domestic non-banks *



* Including credit based on the purchase of securities.- 1) Including housing.- 2) Excluding credit based on the purchase of securities.

Growth of private demand for credit

Domestic non-banks increased their debt to banks and the Bundesbank by 11 1/2 % in 1978 and thus by more than in 1977 (9 1/2 %). The rise in new borrowing from the banking system, at DM 125 billion, was one third higher than in the preceding year, when the previous largest growth in absolute terms in a single year had been recorded, at DM 94 billion. A particularly striking feature was that bank lending to enterprises and individuals went up much faster than in any year since 1973, at 10 1/2 %, accelerating distinctly during the year. Private borrowers mostly raised longer-term loans at banks (DM 75 billion, an increase of 12 %). But short-term lending, which from the spring of 1978 onwards went up appreciably faster than a year before, also expanded comparatively sharply, at DM 13 billion (6 1/2 %), especially if it is borne in mind that industrial activity picked up only slowly at first and that enterprises' self-financing ratio and the money balances they had built up in the preceding years were very high. In view of the low level of interest rates, short-term credit was apparently funded at first in many cases. Later on, when the demand for capital goods strengthened, trade and industry as well as housing increasingly sought long-term resources. The strong growth of private credit demand, which continued unabated after the turn of the year, is primarily reflected in the faster rise in loan commitments. In 1978 enterprises and individuals arranged for their credit lines in current account and discount facilities to be increased by DM 30.5 billion and thus by over half as much again as a year previously; at the end of 1978 their unused credit lines were almost DM 19 billion higher than a year before. This suggests that enterprises expected their needs of borrowed working capital to be fairly large in the light of the anticipated expansion of business. Private customers also secured bank commitments for a considerable amount of longer-term loans. Some borrowers were apparently anxious to obtain the funds they required for future construction and other capital projects while the terms were still favourable. Outstanding assurances of longer-term credit therefore rose by almost DM 14 billion in 1978; in 1977 they had increased by less than half as much (DM 6.5 billion).

Borrowing requirements differ from industry to industry

There were definite focal points in private borrowing from banks. Housing loans rose by no less than DM 39 billion (13%) in 1978. In relative terms the increase in lending to employees was even steeper, at about DM 17 billion (20 1/2%), mainly no doubt in connection with the continued brisk demand for durable consumer goods, notably motor vehicles. As regards lending to enterprises, which, at DM 32 billion (7 1/2%), was slightly larger than a year before, a conspicuous feature is that the distributive trades (DM 10.5 billion) and the service enterprises and professions (DM 9.5 billion) topped the list. Manufacturing — i. e. industry and those craft enterprises which produce goods — raised only DM 3.5 billion of new credit. The low level of borrowing by this group of borrowers, which used to be the banks' chief private customers, was mainly due to their ample supply of liquidity. The marked differences in private demand for credit are borne out to some extent by the varying rates of business expansion among the individual banking groups. Thus the increase in lending to enterprises and individuals in 1978 was above the average in those banking groups which traditionally provide credit to small and medium-sized firms — notably firms in the distributive trades and the service sector — individuals and housing (i. e. savings banks, credit cooperatives, instalment sales financing institutions).

Expansionary effect of government deficits

In 1978 the banking system made some DM 36 billion available to the public authorities through direct advances and purchases of government securities, compared with DM 25.5 billion in 1977. Much as in the private sector, the bulk of the government's borrowing from banks took place in the second half of the year, in line with the usual seasonal pattern. Moreover, towards the end of the year the central and regional authorities spent most of the funds they had accumulated in their accounts at the Bundesbank in the first few months of 1978. The expansionary impact of the public authorities' transactions on the growth of the money stock was therefore considerably larger in the second half of the year than in the first.

External factors obscured

The direct stimulus imparted to domestic money creation by the external financial ties of enterprises and individuals in 1978 was if anything smaller, in purely statistical terms, than in the preceding years (see also page 23 ff.). The net external assets of the banks and the Bundesbank, the increase in which reflects the inflow of funds to domestic non-banks arising from external current and capital transactions, went up by only DM 7 billion in 1978 compared with DM 10 billion in 1977. However, this does not fully bring out the expansionary effects of inflows of funds from abroad on the domestic money stock. Many years of experience have shown that surges of funds entering the country from abroad result in a sharp expansion of the money stock, but that subsequent outflows of funds to other countries by no means end the acceleration; at best they are accompanied by a temporary slowdown in the growth rate of the money stock, but a fully corrective decrease in money balances does not normally occur.

Slow growth of monetary capital formation

Monetary capital formation (excluding time deposits and funds borrowed for less than four years and savings deposits at statutory notice), which in itself has a contractionary effect on the growth of the money stock, rose by DM 55 billion last year and thus distinctly more than in 1977 (DM 43 billion). As in 1977, but in contrast to other years, longer-term investments of funds at banks nevertheless increased less than the liquid assets which make up the money stock M3 (currency, sight deposits, time deposits and funds borrowed for less than four years and savings deposits at statutory notice). Savings deposits at agreed notice once more grew remarkably little (just over DM 7.5 billion), no doubt because of the release of another major amount of bonus-carrying savings deposits. But even if savers' other higher-yielding investments, notably those in bank savings bonds and bank bonds, are included, the propensity to acquire longer-term assets at banks was not particularly great; in view of the ruling interest rate level there was a predilection for short-term investments.

Cash holdings increase more rapidly than the other components of the money stock

Last year's strong liquidity preference was also reflected in the fact that, of all the components of the money stock, those with cash character grew fastest. Thus, in the course of 1978 sight deposits (15%) and currency in circulation (13%) rose most. Time deposits and funds borrowed for less than four years expanded by 11%. Significantly, savings deposits at statutory notice went up much more slowly (8%). The broadly defined money stock M3 therefore increased less, at 11%, than the money stock in the narrower definitions M2 (M3 excluding savings deposits) and M1 (currency and sight deposits), which rose by 13% and almost 14 1/2%, respectively.

Monetary growth inflated by special influences?

There is some evidence that last year's rapid monetary growth was influenced to a certain extent (which cannot be quantified precisely) by special factors. In the autumn of 1978 time deposits and funds borrowed for less than four years expanded exceptionally sharply for a while in the wake of the speculative inflows of funds from abroad, primarily to major enterprises. Some of these funds admittedly flowed out again around the turn of the year following the reversal in conditions in the exchange market. In addition to this effect on the money supply side, special movements of a short and longer-term nature which caused the demand of enterprises and individuals for money to rise more steeply, at least for a time, were probably also at work. Attention was drawn in the Report for 1977 (page 22) to a possible "structural change", particularly in currency in circulation. Some of the reasons mentioned there decreased in significance in the latter part of 1978 and at the beginning of 1979, e. g. the assumed trend towards an increase in holdings of Deutsche Mark notes abroad in so far as this trend was attributable to expectations of an appreciation of the Deutsche Mark, since exchange rate movements have given no grounds for such expectations since October 1978. Furthermore, it can no longer be maintained that pensioners' incomes, which are held in cash to a greater extent than other incomes, are rising disproportionately fast; in 1978, indeed, the opposite was true. In the second half of 1978 currency in circulation grew at a distinctly slower rate than sight deposits. Both types of cash assets went up very steeply, however, a fact which mirrors among other things the "wait-and-see" attitude towards longer-term investments engendered by the movement of interest rates. Another reason for the sharp growth of the money stock was, as mentioned, that the money available from both the banks and the Bundesbank was particularly cheap, so that even such a considerable increase in the liquidity in the hands of individuals and enterprises did not cost them much either in interest paid on bank credit or in interest income forgone on longer-term investments.

Cyclical "spreading effects"

In 1978 a certain cyclical, and thus temporary, influence on the expansion of the money stock may have been exercised by the fact that the pace of the economic recovery varied considerably from sector to sector. This possibly resulted in the demand for credit rising especially sharply in those industries in which favourable prospects for earnings, sales and income warranted a rapid increase in capital and consumption spending, whereas in other industries investment activity remained sluggish and a sizable stock of liquid assets was formed from current receipts and/or inflows of funds from abroad. The fact that the revival of economic activity was more concentrated than it used to be in sectors outside industry in which payments are perhaps slightly less streamlined may have accentuated these differences. At all events, both the above-mentioned variations in private borrowing from banks and the exceptionally strong increase in enterprises' liquid assets which will be discussed in more detail in the following section imply that "spreading effects" — as the simultaneous growth of lending and money balances under varying cyclical conditions among individual industries and enterprises is sometimes termed — were at work. However, such effects are unlikely to last very long under normal circumstances; in fact, they will probably disappear in the course of the economic upswing and the associated greater convergence of cyclical movements.

Change in the course of monetary policy indispensable

The expansionary impact of the presumed special factors on the money stock may have contributed last year to obscuring the connection between the growth of the money stock, the growth of the economy and the movement of prices (which is in any case not very close in the short run). Statistically, this development was reflected in the somewhat unusual change in the relationship between the gross national product and the money stock or, put differently, in the "velocity of circulation of money". This ratio declined further in 1978, contrary to past experience. 1978 was the third year since 1975 in which the money stock grew faster than the gross national product at current prices (whereas this used to happen only over shorter periods); moreover, it is rather unusual for this to occur during an (initially subdued) economic upswing. But such processes are of course not subject to strict laws; it would therefore not be impossible for the same thing to recur provided that the supply of money were kept very flexible. In the long term, however, such a development can almost be ruled out, judging from previous experience; hence it would be quite inappropriate to support a tendency of this kind by means of a consistently expansionary monetary policy. In the longer run a strong expansion of the "monetary cloak" increases the risk of the monetary side no longer curbing an excessive growth of demand and thus a future rise in prices. For this reason a change in the course of monetary policy had to be initiated at the beginning of 1979, with the intention of reducing the expansion of the money stock, in accordance with the target, to a level that continues to guarantee the greatest possible monetary stability.

5. Trends in the bond market

Bond market highly responsive

In 1978 the bond market, as the principal market for longer-term funds, did not quite regain the quantitative significance it had possessed in the preceding years. Compared with 1977, the amount raised in the bond market in 1978 declined by DM 14 billion to DM 36 billion. Nevertheless, the market for fixed interest securities was a focus of attention for both lenders and borrowers last year since the interest rate on bonds soon reflected the change in market sentiment. The experience that interest rates in the bond market tend to anticipate likely changes in general economic conditions and in developments in the credit markets was borne out once again. Following the surprisingly steep decline in interest rates during the first quarter of 1978 under the impact of speculative inflows of funds from abroad and the investment of some of these funds in fixed interest securities, the bond market firmed when the situation in the foreign exchange market reversed in the spring. But a definite turning point in the interest rate trend was not reached until the summer, when private domestic demand for credit continued to grow, seasonally adjusted, and it became clear that the government's credit requirements would rise further in 1979 as a result of the economic policy decisions taken at the "Bonn summit meeting". The great responsiveness of the bond market owes very much to the dominant role of "professional" market participants, including, besides banks and insurance enterprises, in particular yield-oriented investment funds.

Underlying market influences

However, the great "sensitivity" of participants can determine only short-term market developments and speed up changes in trend; longer-term interest rate movements continue to depend on underlying market factors. Last year these included the vigorously expanding demand for long-term housing loans, and especially — up to last autumn — for the relatively low-cost mortgage loans granted by the institutions issuing mortgage bonds; the growing demand prompted these institutions to increase their issues in the bond market accordingly. Moreover, the public sector was forced to make substantial direct or indirect calls on the bond market because of its growing financial requirements. This heavy demand contrasted with a shrinking supply of funds in the market for fixed interest securities. As the business community's credit needs grew from the autumn of 1978 onwards, the banks in particular reduced their bond purchases, since the acquisition of bonds is for them only a "substitute operation" as long as traditional lending does not absorb their full expansion potential. Households' saving also continued to rise, but the chief beneficiary from this was neither the banks (through more rapidly growing deposits) nor the bond market but rather the housing sector, which received an increasing flow of savings direct. Enterprises, finally, purchased about one third fewer bonds in 1978 than in 1977. This divergence between the supply of and the demand for capital in the bond market would have resulted in a rise in the interest rate on bonds even if the "fluctuations in sentiment" in the market had been less marked, as was the case, for instance, in October and December 1978, when pronounced upward move-

Acquisition of financial assets and incurrence of liabilities by the domestic non-financial sectors *

Item	1976 DM billion	1976 % of total	1977 DM billion	1977 % of total	1978 DM billion	1978 % of total	Memo item Change on previous year 1977 (DM billion)	Memo item Change on previous year 1978 (DM billion)
Acquisition of financial assets								
Longer-term	121.6	80.5	108.1	73.1	108.4	64.6	−13.5	0.3
of which								
with banks	54.1	35.8	49.6	33.5	47.9	28.5	− 4.5	− 1.7
with building and loan associations and insurance enterprises	24.6	16.3	26.2	17.7	28.7	17.1	1.6	2.5
securities	27.3	18.1	17.2	11.6	18.1	10.8	−10.1	0.9
abroad	4.7	3.1	4.4	3.0	4.8	2.9	− 0.3	0.4
Short-term	29.4	19.5	39.8	26.9	59.5	35.4	10.4	19.7
of which								
with banks	14.3	9.5	34.8	23.5	51.2	30.5	20.5	16.4
abroad	12.8	8.5	7.1	4.8	6.1	3.6	− 5.7	− 1.0
Total	151.0	100	147.9	100	167.9	100	− 3.1	20.0
Households	101.6	67.3	99.6	67.3	104.3	62.1	− 2.0	4.7
Enterprises	43.4	28.7	42.7	28.9	51.0	30.4	− 0.7	8.3
Government	6.1	4.0	5.6	3.8	12.6	7.5	− 0.5	7.0
Incurrence of liabilities								
Longer-term	132.5	88.5	125.0	83.7	148.2	89.9	− 7.5	23.2
of which								
at banks	79.9	53.4	74.8	50.1	108.3	65.7	− 5.1	33.5
at building and loan associations and insurance enterprises	13.6	9.1	13.6	9.1	14.4	8.7	—	0.8
in the security market	20.3	13.6	23.9	16.0	14.8	9.0	3.6	− 9.1
abroad	8.7	5.8	2.9	1.9	2.7	1.6	− 5.8	− 0.2
Short-term	17.2	11.5	24.3	16.3	16.6	10.1	7.1	− 7.7
of which								
at banks	14.3	9.6	12.8	8.6	12.8	7.8	− 1.5	—
abroad	4.8	3.2	13.0	8.7	1.6	1.0	8.2	−11.4
Total	149.7	100	149.3	100	164.8	100	− 0.4	15.5
Households	14.2	9.5	14.7	9.8	17.5	10.6	0.5	2.8
Enterprises	88.8	59.3	98.0	65.6	102.0	61.9	9.2	4.0
Government	46.8	31.3	36.6	24.5	45.3	27.5	−10.2	8.7
Financial surplus (+) or deficit (−) 1	1.3	×	− 1.4	×	3.1	×	− 2.7	4.5
Households	87.4	×	84.9	×	86.8	×	− 2.5	1.9
Enterprises	−45.4	×	−55.3	×	−51.0	×	− 9.9	4.3
Government	−40.7	×	−31.0	×	−32.7	×	9.7	− 1.7

* Households, enterprises (including housing), government (including social security funds); provisional. — 1 Acquisition of financial assets less incurrence of liabilities.
Discrepancies in the totals are due to rounding.

ments of the interest rate could only be prevented by reducing net sales to zero (nominal value).

Increased maturity transformation in the financing cycle

The underlying cause of the temporary tensions in the bond market was, as already implied, the failure of maturities to match on the supply and demand sides. This is clearly indicated by a comparison of the acquisition of financial assets of the domestic non-financial sectors (households, enterprises, government) with their incurrence of liabilities. The borrowing of the non-financial sectors in 1978 amounted to DM 165 billion against about DM 150 billion in each of the two preceding years; but the increase of DM 15 billion was entirely due to a rise in longer-term loans (+ DM 23 billion), while the growth of short-term debt was DM 8 billion smaller than in 1977. The breakdown by maturity of the domestic sectors' acquisition of financial assets showed just the opposite trend: the increase of DM 20 billion in 1978 against the previous year (to DM 168 billion) was wholly attributable to short-term investments. This divergence in the maturity pattern mirrors the differing financing behaviour of the individual non-financial sectors.

The most expansionary component of credit requirements in the enterprise sector was the credit demand of housing; its increase in 1978, at DM 48 billion, was one third larger than a year before, long-term loans naturally predominating. The credit needs of the rest of the business community, which are directed more towards short and medium-term loans, were smaller in 1978 than in 1977 (DM 54 billion against DM 62 billion). The second major source of demand for long-term credit was the government; its borrowing requirements in 1978, at DM 45 billion, were much larger than in 1977 (DM 37 billion), only longer-term loans being raised on balance. The government's scope for taking up funds on the desired terms in the bond market by issuing bonds of its own (including Federal savings bonds) was, however, narrower than in the preceding year; nevertheless, the additional requirements could in the main be met by means of longer-term bank loans.

In the field of financial asset acquisition the opposite trends prevailed. In the principal area of saving, i. e. among households, the very liquid types of assets (currency, sight and short-term time deposits) increased by DM 17 billion and thus by DM 3 billion more than a year previously. In 1978 households also built up their longer-term assets slightly faster than in 1977 (DM 87 billion against DM 85 billion). But the decisive change took place in the financial asset acquisition of the other sectors: on balance, enterprises and the government increased their liquid funds only. Enterprises enlarged their currency and sight deposits by almost DM 10 billion more than in 1977, namely by DM 19.5 billion, but they acquired longer-term financial assets totalling as little as DM 14 billion (against DM 15.5 billion in 1977). In the government sector, too, the acquisition of financial assets expanded only in the shorter-term field, while longer-term investments remained at the preceding year's level (the social security funds once again reducing their longer-term financial assets).

Amount raised in the bond market declines

The growing need for "maturity transformation" resulting from this divergent trend in the supply of and demand for funds could only be met by raising interest rates, namely the rates for long-term financial assets. The upward trend in interest rates, which was of course accompanied by price losses for older bonds, initially reduced the productiveness of the bond market. The market's absorptive capacity in 1978 was far smaller than in 1977. If all buyers — i. e. also banks — are included in order to obtain a full picture of the volume of sales in the bond market, gross sales of domestic bonds are found to have gone up by DM 15 billion to DM 95 billion (nominal value) last year. At the same time, however, redemptions rose by DM 21 billion to DM 51 billion. This was partly because the short-dated securities issued (mainly by public authorities) during the period of high interest rates in the first half of the seventies were increasingly falling due. Moreover, since a growing number of debtors repaid their high-interest-bearing loans, the issuing institutions for their part felt obliged to call more and more high-yielding bank bonds last year. Hence net sales of domestic bonds in 1978 were DM 6 billion smaller than in 1977. If, in order to gain an impression of the actual productiveness of the market, return flows resulting from price support purchases by issuers and open market operations in Federal bonds by the Bundesbank are included, the amount raised in the market by domestic issuers, calculated at market prices, came to only DM 36 billion in 1978 against DM 50 billion a year before.

Fewer calls by public authorities on the bond market

In view of the diminishing supply of funds the public authorities, in particular, made relatively few calls on the bond market through issues of their own last year (DM 11 billion net against DM 21 billion in 1977). Even after the inclusion of communal bonds (the proceeds of which are mostly used to finance loans to public authorities against borrowers' notes), government recourse to the bond market, at about DM 27 billion, was much smaller than in 1977 (DM 37 billion) despite the fact that the deficit of the central, regional and local authorities went up substantially. Enterprises also showed little interest in raising funds in the security markets. The amount of industrial bonds outstanding decreased further on account of redemptions (although slightly more shares were issued than in 1977, i. e. just over DM 5.5 billion — market value — against not quite DM 4.5 billion).

Banks the most important group of issuers

Banks were again the most important group of bond issuers last year. Their sales were in fact somewhat larger than in 1977, at just over DM 29 billion (net). In addition to sales of bonds issued by specialised banks, sales of mortgage bonds went up particularly fast, although the mortgage banks have lost some competitive ground since last autumn because of the rising interest rates on bonds. Nevertheless, new sales of mortgage

Purchases of bonds, by group of buyers and type of securities

DM billion market value

Item	Year	Domestic bonds Total 1	Bank bonds	Industrial bonds	Public bonds	Foreign bonds 2	All bonds
Residents	1976	44.7	31.7	– 0.5	13.6	1.4	46.1
	1977	49.1	29.2	– 0.4	20.3	4.6	53.6
	1978	39.2	30.1	– 0.8	9.9	3.6	42.8
Banks	1976	20.2	12.2	0.2	7.8	0.3	20.5
	1977	30.6	19.8	0.0	10.8	1.7	32.3
	1978	20.2	16.7	– 0.2	3.7	1.2	21.4
Non-banks	1976	31.1	19.4	– 0.7	12.3	1.0	32.1
	1977	19.3	9.5	– 0.4	10.2	2.8	22.1
	1978	15.5	13.4	– 0.6	2.7	2.3	17.8
Open market operations of the Bundesbank	1976	– 6.5	–	–	– 6.5	–	– 6.5
	1977	– 0.7	–	–	– 0.7	–	– 0.7
	1978	3.5	–	–	3.5	–	3.5
Non-residents 3	1976	3.1	e 0.1	e – 0.0	3.1	×	3.1
	1977	0.7	e – 0.3	e – 0.0	1.0	×	0.7
	1978	0.6	e – 0.7	e – 0.2	1.5	×	0.6
Purchases (= sales), total	1976	47.9	31.7	– 0.5	16.7	1.4	49.2
	1977	49.8	28.9	– 0.4	21.3	4.6	54.3
	1978	39.8	29.4	– 1.0	11.4	3.6	43.4

1 Net sales plus/less changes in issuers' holdings of their own bonds. — 2 Net purchases of foreign bonds by residents. — 3 Net purchases or net sales (–) of domestic bonds by foreigners. — e Estimated. Discrepancies in the totals are due to rounding.

bonds, at over DM 7.5 billion, were almost as large as in 1972, when the housing boom was approaching its peak.

Large gross sales of foreign Deutsche Mark bonds

Issuing activity in the market for foreign Deutsche Mark bonds also continued to be brisk. The high level of gross sales in 1977 (DM 13 billion) was exceeded by more than DM 2 billion. But as substantially more securities were redeemed at the same time, net sales, at just over DM 10 billion, were no larger than in 1977. Approximately four fifths of this amount was bought by non-residents. Including the bonds denominated in foreign currencies, little more than DM 3.5 billion of foreign bonds were sold in the domestic market against about DM 4.5 billion in the preceding year.

Decline in purchases by banks, and also by the general public in the course of the year

The decline in the productiveness of the bond market was mainly due to the fact that the banks reduced their bond purchases under the impact of the rising demand for direct credit and the growing uncertainty regarding interest rates, i. e. the increasing risk of price losses. It is true that they remained the most important group of buyers in the bond market in 1978, but their bond purchases, at DM 21 billion, were about one third smaller than in 1977. The banks' interest in bonds was particularly slight in the last quarter of 1978, when on balance they took no more than DM 3 billion of bonds into their portfolios. Domestic non-banks, which had cut down their bond purchases substantially in 1977, reduced their buying yet again in 1978 (DM 18 billion compared with DM 22 billion). Households — the most significant group among non-banks — invested some DM 10 billion in bonds according to preliminary estimates, and thus about the same amount as in 1977. But in contrast to that year, when private investors mainly purchased the units of bond-based investment funds and Federal savings bonds (which are not subject to price risks) and hardly bought any ordinary bonds at all, in 1978 they acquired far fewer Federal savings bonds (just under DM 3 billion against DM 7.5 billion in 1977), chiefly because the interest rates paid on them did not always conform to market trends, and, according to present information, also fewer units of bond-based funds. Purchases of "ordinary" bonds in 1978 were therefore larger than in 1977; however, this appears to have been the case only in the first quarter of the year, when interest rates were moving distinctly downwards and bonds were greatly in demand because of the rising prices. During the following two quarters the acquisition of bonds diminished rapidly under the influence of the reversal in the interest rate trend, and during the last quarter private buyers even reduced their bond holdings slightly.

Sustained tendency to "wait and see" at the beginning of the year

Investors' "wait-and-see" attitude persisted at the beginning of the new year. The volume of sales in the bond market, which is usually very large at that time of the year for a variety of reasons, remained well below the preceding year's figure, although, at an average of DM 5 billion (net) in January and February, it was by no means small. The issuers admittedly adjusted to the less favourable market conditions: public authorities turned to the "parallel markets" of the capital market, and regular issuers reduced their sales of bank bonds since their lending was slowing down because of the changed interest rate situation. However, this nursing of the market did not suffice to dissolve the (at least presumed) "investment log-jam" in the bond market. Owing to the size of the public sector deficits and the rapidly increasing scale of the maturing government debt that has to be refinanced, the central and regional authorities have assumed growing importance in the bond market through their decisions on the type of debt they incur and the terms they attach to their debt instruments.

The pattern of government debt . . .

In 1978 the change in the pattern of government borrowing was undoubtedly at variance with the proposals for a debt management directed towards an expansion of the direct relationship between private lenders and public borrowers and thus towards a reduction of the role of banks as intermediaries in the financing of government deficits. The (long-term) objectives behind these proposals are certainly to be endorsed. From the standpoint of monetary policy, the long-term financing of government deficits, in large part through the direct investment of private savings in claims on the government, is — except in special circumstances — without doubt to be preferred to the financing of a substantial proportion of the deficits through banks, particularly banks whose liabilities are partly included in the money stock. At all events, the longer-term investment of private savings in securities makes it more difficult to "remonetise" them prematurely in order to finance consumption, especially if this entails price losses for the saver.

. . . can be improved only in the long term

However, experience shows that in the short run there are strict limits to such structural improvements in the capital market. In particular, given the present importance of saving through accounts and contractual saving for the longer-term supply of funds in the financial markets, it is hardly to be expected that sales of government bonds to the general public can be expanded rapidly by employing new sales methods or changing the terms of the securities. As long as it is necessary to finance large government deficits the very announcement of which affects investors' expectations, this would increase the risk of major fluctuations in sentiment in the market, which may be particularly discouraging to small savers. Moreover, it is not impossible that, as the proportion of loans to the public sector increases, signs of "saturation" and market resistance will arise in the lending of banks and other institutional investors. Hence — in spite of the narrow scope for structural improvements in the short run — continuous efforts should be made to place an increasing amount of medium and long-term government securities with the general public direct. Needless to say, this presupposes that the terms of these securities are always in conformity with the market situation. Under these conditions there is certainly room for attempts to attract buyers direct by means of new types of government securities.

Resolute monetary policy supports the capital market in the long run

Interventions in the market by the central bank with its own resources to "smooth" prices, such as are not infrequently called for in order to counter some undoubtedly adverse effects of short-term market fluctuations, would in the last analysis not be able to prevent the present tensions in the bond market. Quite apart from the fact that the central bank's open market operations must in the end always be consistent with the intentions of monetary policy, it has become plain on earlier occasions that the Bundesbank can successfully resist rises in interest rates dictated by the market without conflicting with its primary duties only if the market disturbances are of extremely short duration. The sooner and more resolutely monetary policy measures that are recognised to be necessary by the market are taken, the smaller is the risk of the market being paralysed by the central bank when underlying market factors (in particular, rising cyclical and inflationary expectations) trigger a wait-and-see attitude among investors.

The Bundesbank's measures of March 29, 1979 must also be seen in this context. On the one hand, by raising the discount and lombard rates the Bank conformed to a certain degree to the changes in interest rates in the market and to the associated expectations of corresponding measures by the Bundesbank; hence this step removed one element of the wait-and-see attitude. On the other hand, these measures underline the

Bundesbank's intention of continuing its stability-oriented policy, even — and particularly — under the changed conditions caused by the increases in oil and raw material prices. The object is to remove the basis of the fears harboured here and there about the future development of the value of money. In the long run this will be the best protection against the much sharper rise in interest rates which would be inevitable if it proved impossible to prevent a domestic inflation.

II. International monetary developments and external monetary policy

1. The situation in the world economy in 1978

Global economic recovery continues

In 1978, the fourth year after the onset of the severe global recession in 1974/75, economic recovery continued on a world-wide scale. The expansionary forces in the western industrial countries were slightly stronger than in 1977. World trade also rose somewhat more rapidly in 1978, growing by 5% in real terms against 4.5% in the previous year. However, unemployment problems persisted and have probably even increased in global terms.

The differences in the pace of economic expansion were no longer as marked as in 1977. Of particular interest in this context is the fact that the gap in economic activity between the United States and most other western industrial countries narrowed in 1978. Whereas in 1977 this gap, measured in terms of the rates of growth of the real gross national product, amounted to almost 3 percentage points vis-à-vis the EEC, for example, last year it fell to about 1 percentage point. This development owed something not only to the slowing down of growth in the United States but also to an acceleration of growth in Western Europe, Canada and Japan. In most countries the recovery in economic activity was due in the main to private and public consumption. Except in Japan and Germany, investment activity again imparted only a weak stimulus.

Rates of inflation, which were generally still very high, continued to fall in Western Europe and Japan, albeit only slightly. In contrast, inflation in the United States increased so much during the year that monetary policy, in particular, had to be employed more energetically than in the past to combat it. The price differential between Germany and the other industrial countries changed only a little in 1978.

In the year under review most industrial countries were able to strengthen their external position further. This applies especially to a number of countries in Western Europe that traditionally have a weak balance of payments; as a result, an important condition for a durable recovery in these countries has improved.

Inflationary dangers increase again

The prospects of a consolidation of world economic activity admittedly continue to be clouded by a number of uncertainties. The chief danger consists in a renewed increase in the pace of inflation. The widely expected slowdown in economic growth in the United States, which indeed appears to be inevitable in view of the high rate of inflation there, would be bound to have a dampening effect on world economic activity. It remains to be seen to what degree this influence can be offset by stronger growth in Europe and Japan. The fact that the recovery of business activity in a number of countries, in particular Germany, is being fuelled more strongly than in earlier years by domestic economic forces must be rated a positive feature. Prospects are also impaired by uncertainty about future supplies of energy and oil price developments in view of the events in the Middle East. A stronger upsurge in world economic activity will probably be impeded by a return to rising oil-induced imbalances unless it proves possible to further the adjustment of current accounts in real terms and to reduce dependence on imported oil.

2. Exchange rate developments and exchange rate policy

(a) Foreign exchange markets dominated by the weakness of the dollar

Continuing weakness of the dollar . . .

In 1978, as in 1977, the foreign exchange markets were frequently subject to unrest and uncertainty fostered by the continuing weakness of the balance of payments and the acceleration of inflation in the United States. Under these circumstances, shifts in exchange rates in the foreign exchange markets were primarily at the expense of the U.S. dollar, which, with pronounced fluctuations, once again fell sharply in value vis-à-vis the "currencies of refuge", namely the Deutsche Mark, the Swiss franc, and the yen. During the periods of weakness, punctuated by quieter periods in which the dollar occasionally made a marked recovery, the movement of the dollar against the strong currencies was very uneven. Accordingly, there were large shifts between the Deutsche Mark, the Swiss franc, and the yen themselves. The degree to which the exchange rates of individual currencies fluctuated against each other is illustrated in the table on the following page.

. . . with marked shifts between "strong" currencies

Exchange rate fluctuations of selected currencies in 1978

Currency	Highest rate during year	Lowest rate during year	Maximum margin of fluctuation in %
	US$ 1 = ... CU 1		
Swiss franc	2.0525	1.4575	± 17
Yen	242.30	175.90	± 16
Deutsche Mark	2.1503	1.7285	± 11
	100 CU 1 = DM ...		
Swiss franc	132.70	104.80	± 12
Yen	1.0975	0.8420	± 13

1 Currency units.

Particularly in the spring and autumn of last year developments in the exchange markets were hectic. Thus, from mid-February to the beginning of March 1978 the Deutsche Mark strengthened against the U.S. dollar by almost 5%, while the Swiss franc rose by as much as 7%. Immediately afterwards, in the first half of March, the Swiss franc deteriorated again vis-à-vis the U.S. dollar by 10%. The exchange rate of the dollar changed just as abruptly in the course of October, when it declined against the Deutsche Mark by no less than 10% to an all-time low of DM 1.7285 (on October 30, 1978). The dollar fluctuated against the yen in a similar manner. However, the upward pressure on the yen in the middle of the year — independently of the general tendency of the dollar towards weakness — was probably accentuated by the large Japanese surplus on current account. By comparison with the end of 1977, and measured in terms of the dollar in each case, the Deutsche Mark rose last year by 15%, with the yen and the Swiss franc each strengthening by approximately 24%. With the exception of the Italian lira, which generally followed in the wake of the dollar's exchange rate, most other currencies of the European industrial countries improved against the dollar, with exchange rates fluctuating widely in some cases. Thus, at the end of 1978 the French franc was approximately 13% higher vis-à-vis the U.S. dollar than at the beginning of the year. Over the same period the pound sterling rose against the dollar by 6.5%.

Calm on the exchanges since the beginning of 1979

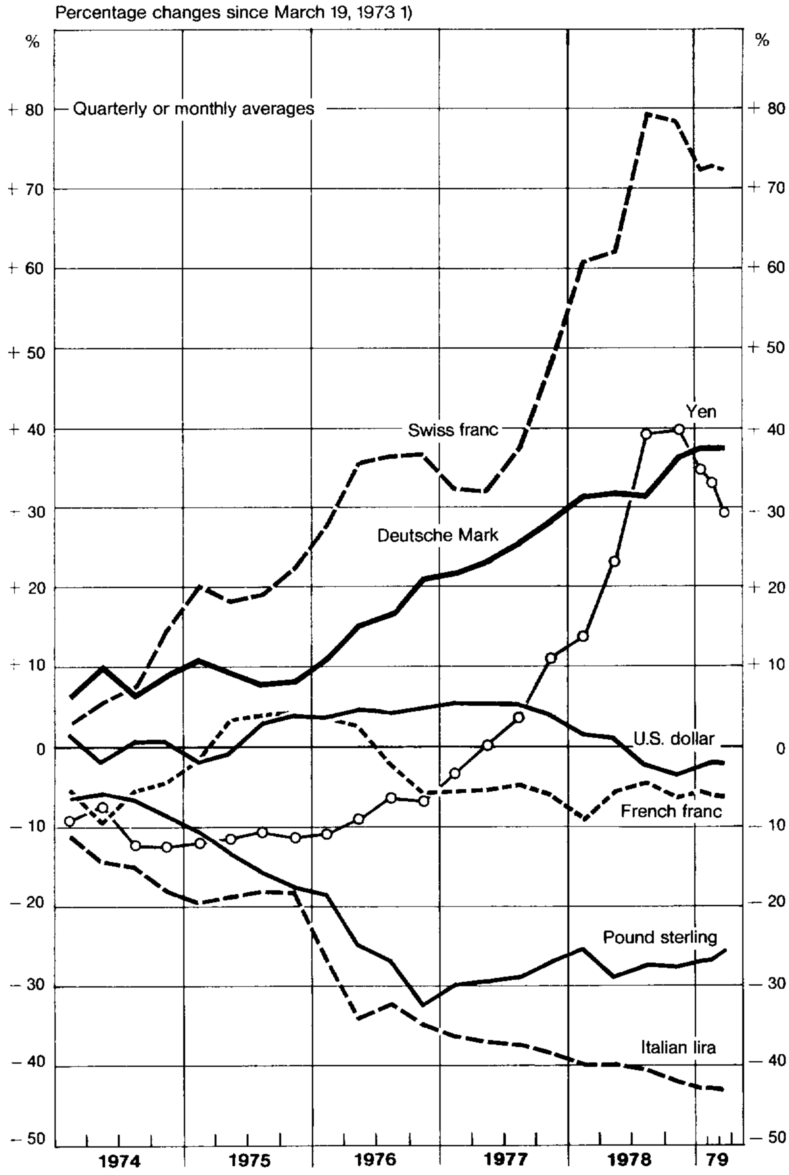
Since the beginning of 1979 conditions in the foreign exchange markets have settled down. Relatively large exchange rate changes occurred only with respect to the yen, which fell by roughly 6% against the dollar during the first three months of the year. Up to the end of March the rate of the dollar against the Deutsche Mark was about DM 1.85, with relatively slight fluctuations. The currencies of the EEC countries also remained remarkably stable during this period. Since the beginning of the year the changes in their mutual exchange rates have remained within the margins of fluctuation effective in the European Monetary System since March 13, 1979.

Considerable changes in the external value of individual currencies . . .

As the chart on page 44 illustrates, the marked changes in exchange rates once again led to considerable shifts in the weighted external value of the currencies of individual countries.[1] Thus, the weighted external value of the U.S. dollar weakened in 1978 on average by nearly 6% after remaining almost constant in 1977 by comparison with the previous year. Between the autumn of 1977, when the dollar began its decline, and the end of 1978 the decrease in its weighted external value amounted to approximately 9%. The rise in the weighted external value of the Deutsche Mark, at 6.5%, was slightly smaller than in the previous year (7.6%). By contrast, the effective upvaluation of the yen, at an average for the year of over 25%, and of the Swiss franc, at almost 24%, was far greater. However, there were also marked shifts in the weighted external value of a number of other currencies of industrial countries, which were reflected in losses in value of between 5% and 9% in the case of the Swedish and Norwegian kroner, the Canadian dollar and the lira.

1 The Bundesbank has recently begun calculating the external value of currencies by a new method. The comments in this section of the present Report can therefore be compared with what was said on the development of the nominal and real external value of currencies in earlier Annual Reports of the Bundesbank to only a limited degree. See Monthly Report of the Deutsche Bundesbank, Vol. 31, No. 4, April 1979.

Effective exchange rates of major currencies against the currencies of 23 countries *



* The calculation is based on the spot middle rates of the currencies officially quoted in Frankfurt and the spot rates of the currencies of other major trading partners of Germany.- 1) Central rates or market rates. Calculated on the basis of a geometric mean. The weights correspond to the regional structure of the average foreign trade turnover (exports plus imports) of the individual countries between 1975 and 1977.

. . . and their real exchange rates

Measured in terms of international price and cost differentials, the changes in exchange rates in 1978, as in the previous year, were mostly in the right direction, so that the shifts in real exchange rates were generally somewhat smaller than those in the weighted nominal external values of the relevant currencies. However, in accordance with the large rise in their weighted external values, measured in terms of the wholesale prices of manufactured goods, the "real upvaluation" of the yen and the Swiss franc, at approximately 14 % in each case compared with 1977, was also particularly marked. In 1978 there were likewise considerable changes by comparison with the previous year in the case of the pound sterling, which increased in value in real terms by 6 %, the Swedish krona, which fell in value in real terms by 8 %, and the Norwegian krone and the Canadian dollar, which depreciated by approximately 7 % each. On the other hand, the real external value of the U.S. dollar and the Deutsche Mark changed less in 1978 over the previous year — at least in comparison with the above-mentioned currencies — with a loss in the value of the dollar of approximately 4 % and an upvaluation of the Deutsche Mark of 2.5 %. The improvement in the international competitiveness of the United States vis-à-vis Western Europe and Japan was, however, probably greater in reality than the change in real exchange rates suggests. As a result of the fall in value of the Canadian dollar against the U.S. dollar of almost 8%, the United States suffered a loss in competitiveness last year vis-à-vis its most important trading partner, namely Canada.

(b) Exchange rate and intervention policy

Crisis of confidence surrounding the U.S. dollar . . .

The extreme shifts between the exchange rates of the dollar and the strong currencies, particularly at the beginning and in the second half of 1978, were obviously being nurtured by widespread doubts about the direction of economic policy in the United States. This impression is strengthened by the fact that for months the foreign exchange markets reacted extremely sensitively and hectically to news about the problem of inflation in the United States and its balance of payments. True, the U.S. Administration repeatedly emphasised its determination in 1978 to reduce the external imbalance and declared the fight against inflation to be its most urgent problem. In addition, as early as March 1978 it decided, within the framework of a three-point programme, to increase its own interventions in the foreign exchange markets to support the dollar. However, the continuing weakness of the dollar was not reversed until the U.S. President, under the impact of the critical situation that had been reached in the exchange markets, announced a comprehensive stabilisation programme on November 1, 1978. As part of this programme the resources made directly available to the United States for interventions in the foreign exchange markets were considerably enlarged. Specifically, it was decided

. . . stopped by the "November package" of the United States

- to increase the existing swap facilities with the central banks of Germany, Japan and Switzerland by \$ 7.6 billion to a total of \$ 15 billion;
- to issue foreign currency loans in the capital markets of the above-mentioned countries up to a total equivalent of \$ 10 billion ("Carter Notes");
- to utilise the unconditional drawing rights of the United States in the International Monetary Fund totalling approximately \$ 3 billion, and to sell special drawing rights equivalent to \$ 2 billion;
- to double the amount of gold offered at the monthly gold auctions of the U.S. Government to 1.5 million ounces.

Within the framework of this programme the Bundesbank provided the United States with approximately DM 1.5 billion in exchange for special drawing rights. Two thirds of the U.S. drawings in its reserve tranche with the IMF totalling \$ 3 billion was financed from the Deutsche Mark holdings of the IMF and via the provision of Deutsche Mark by the Bundesbank under the General Arrangements to Borrow. In addition, the Bundesbank agreed with the Federal Reserve System to increase the existing reciprocal swap arrangement to \$ 6 billion. Last year the United States took up loans totalling DM 3 billion in the German capital market by issuing DM-denominated Treasury Notes, and followed this up with a further DM 2.5 billion in February 1979. (In the Swiss capital market the United States has so far placed "Carter Notes" amounting to about 2 billion Swiss francs.)

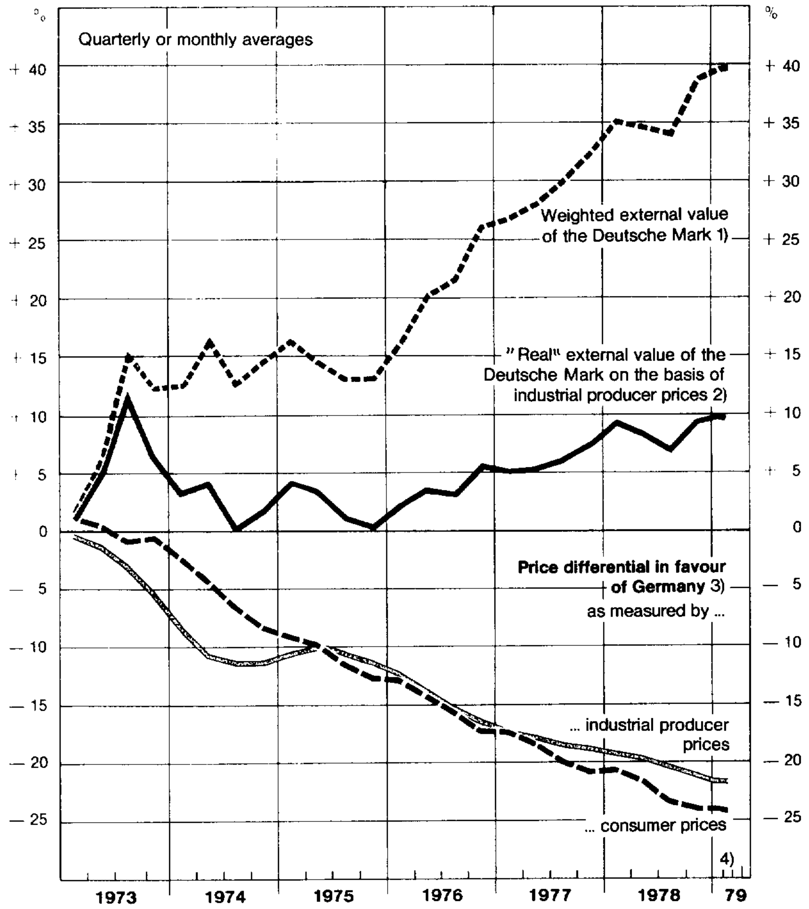
Change in the exchange rate policy of the United States

The package of measures taken on November 1, which was explicitly justified by reference to the aim of stabilising the foreign exchange markets, constitutes a welcome change of direction in U.S. policy. By raising foreign currency loans and using its own reserves, the United States has emphatically demonstrated its determination to take measures of its own to finance its balance of payments and to support the dollar, after having largely left this task to market forces and the central banks of other countries in the past.

The crucial factor for the further development of the dollar in the exchange markets was, however, that the United States combined these arrangements with restrictive monetary policy measures. The discount rate was raised by 1 percentage point to the record level of 9 1/2% and the minimum reserve requirements for certain time deposits were increased by 2 percentage points. The United States thus indicated more clearly than in the past its willingness to accept a slowdown in economic growth in order to combat inflation and the fall in the exchange rate of the dollar. This explicit recognition by the Unit-

Effective exchange rate of the Deutsche Mark and international price differential

Percentage changes since end-1972 *



* Calculated on the basis of a geometric mean.- 1) Against the currencies of 13 other industrial countries in relation to the central rates of end-1972.- 2) Weighted external value of the Deutsche Mark adjusted for the price differential in favour of Germany.- 3) Ratio of price movements in Germany to those in 13 other industrial countries (in national currencies, trade-weighted averages). A descending line indicates that price increases in Germany were lower than those abroad.- 4) Prices estimated.

ed States of its responsibility for the dollar has contributed to the renewed increase in confidence in the U.S. currency in the exchange markets in recent months.

For the future of the dollar it will be of decisive importance for the United States to pursue with determination the objective of slowing down the rate of domestic inflation and improving its balance of payments, employing fiscal and monetary policy as well as energy policy to this end. Admittedly, success in terms of domestic stability can only be achieved over time. This applies in particular to price developments, where a further worsening of the picture is rather to be expected.

Large-scale interventions to stabilise the foreign exchange markets

The at times turbulent developments in the foreign exchange markets repeatedly forced central banks to intervene in them. In accordance with internationally agreed rules, the intervention operations of the Bundesbank, as in previous years, were mainly directed towards smoothing erratic fluctuations in the exchange rate of the Deutsche Mark and avoiding the emergence of disorderly conditions in the foreign exchange markets as far as possible. As is proved by the rise in the exchange rate of the Deutsche Mark, and particularly by its increase in real terms during the period under review, this did not prevent the exchange rate from adjusting to differences in economic developments in Germany and abroad. All in all, the monetary authorities once again had to operate on a large scale in order to stabilise the exchange markets. The 14 central banks that participate in daily concertations (including the U.S. central bank) took a total of almost $ 50 billion out of the market as a result of interventions in the course of 1978. From time to time, whenever the situation in the foreign exchange markets was calm, it was possible

Changes in the net external position of the Deutsche Bundesbank due to interventions in the foreign exchange market and other foreign exchange movements*

DM billion

Period	Changes in net external position, total	Caused by interventions in DM/dollar market **1**	Caused by interventions within European narrower margins arrangement or EMS **2**	Caused by other foreign exchange movements **3**
1978				
January — March				
Continuation of dollar low of autumn 1977, narrower margins arrangement quiet	+ 4.1	+ 7.8	− 1.1	− 2.6
April — June				
Markets temporarily quieten down	− 4.1	− 1.5	− 0.1	− 2.5
July — mid-October				
Severe tensions in narrower margins arrangement, renewed decline in dollar	+12.8	+ 1.8	+10.1	+ 0.9
Mid-October — December				
Climax of dollar crisis with substantial support operations, narrower margins arrangement quiet	+ 7.3	+16.0	− 1.1	− 7.6
1978, total	+20.1	+24.1	+ 7.9	−11.8
1979				
January — March 12				
Markets stabilised, intervention balances run down	− 6.9	− 2.2	− 1.3	− 3.4
March 13 — end of March				
Markets quiet	− 3.0	− 1.3	− 0.5	− 1.2
1979 January — March, total	− 9.9	− 3.4	− 1.8	− 4.6

* Transactions basis. Excluding changes due to valuation adjustments. — **1** Interventions in U.S. dollars by the Bundesbank and in Deutsche Mark by the Federal Reserve Bank of New York. — **2** Including intramarginal interventions. — Norway withdrew from the narrower margins arrangement with effect from December 12, 1978. — On March 13, 1979 the narrower margins arrangement ("snake") was superseded by the European Monetary System (EMS). France, Italy and Ireland joined the group of participating countries. — **3** Including outflows of dollars due to conversions through the Bundesbank of foreign Deutsche Mark bonds and of notes and credits raised by foreigners.
Discrepancies in the totals are due to rounding.

to put back into the market some of the dollars that had been purchased via intervention operations. This means that the intervention figures in themselves are not indicative of the growth of aggregate monetary reserves, which among the group of central banks referred to here increased by $ 21.5 billion in 1978.

In 1978 the interventions of the Bundesbank in the dollar market totalled DM 12.3 billion. These interventions and other foreign exchange movements, such as the operations in the context of the European narrower margins arrangement (the "snake"), led to an increase of approximately DM 20 billion in the external assets of the Bundesbank in 1978.

Thus, developments in the foreign exchange markets once again confronted the Bundesbank with the dilemma between the demands of domestic and external economic stability that is familiar from earlier years. While Switzerland, which was at times in a much more intractable position, decided under the circumstances to give stabilising the exchange rate temporary precedence over quantitative monetary policy, the Bundesbank initially tolerated the overshooting of its growth target; however, it soon employed the instruments available to it in order to minimise the impact of foreign exchange inflows on bank liquidity and to counteract the undesirable acceleration in monetary growth. By announcing a target for monetary growth in 1979 the Bundesbank has made it clear that it intends to adhere to its stability-oriented quantitative monetary policy.

(c) Developments within the "snake"

Exchange rate corrections in the "snake"

The exchange rate relationships between the currencies participating in the European narrower margins arrangement were also affected by the general uncertainty in the foreign exchange markets. The Deutsche Mark was the strongest currency for the greatest part of 1978, but at least from time to time it was relieved of this role by other partner currencies, which was very welcome. This also applied to the period after October 16, 1978, when within the "snake" the Deutsche Mark was revalued by 4% and the Netherlands guilder and the Belgian franc were revalued by 2% each against the European Monetary Unit of Account (EMUA). In the preceding months – from July 1978 to October 13 – more than DM 10 billion had been used to support the other currencies in this arrangement. In the subsequent period of renewed uncertainty about the development of the dollar it proved to be an advantage that the Deutsche Mark was not the strongest currency in the "snake" but tended instead to follow the other partner currencies upwards against the dollar.

As early as the beginning of the year the Norwegian krone showed clear signs of weakness and with effect from February 13, 1978 it had to be devalued by 8% vis-à-vis the other currencies in the "snake". On December 12, 1978 the Norwegian Government decided to withdraw its currency from the European narrower margins arrangement.

3. The international adjustment of current accounts

Reduction in global imbalances

In global terms, there was a considerable reduction in imbalances in current accounts in 1978, and the situation now approximates more to that which existed before the oil crisis. This was mainly because of the decrease in the surpluses of the oil-exporting countries. However, there were wide discrepancies in developments within the individual groups of countries. The chief exceptions to the general rule were the further deterioration in the U.S. current account balance and the relatively strong increase in the current account surpluses of Japan, Germany, and Switzerland (see the table opposite). However, the change in the current account balances of these countries in dollar terms is overstated by the decline in the dollar's exchange rate and differences in the degree to which import and export prices have increased.

Another high U.S. current account deficit

The narrowing of the gap in growth between the United States and the other industrial countries did not produce the hoped-for reduction in the U.S. current account deficit, although an improvement did begin to set in towards the end of 1978. In regional terms, notably the foreign trade deficit of the United States with Japan has risen. At the same time, net U.S. imports of oil have fallen considerably, partly due to larger deliveries of Alaskan oil and to the exceptionally high level of oil imports for stockbuilding purposes in 1977.

Despite the higher rate of growth in some cases, the current account balances of most Western European industrial countries have not deteriorated. All in all, the deficit of $ 7 billion of these countries in 1977 gave way to a surplus of $ 17 billion in 1978. France and Italy, in particular, succeeded in strengthening their external positions. The external positions of the smaller OECD countries also developed far more favourably, their aggregate current account deficit falling by more than half.

Strong decrease in OPEC surpluses

Last year the change in the external position of the industrial countries was accompanied by opposite shifts in the balances of payments of the remaining countries. With a view to an improved international balance of payments adjustment process it is particularly welcome that the surplus of the OPEC countries fell from $ 31.5 billion in 1977 to only $ 11 billion last year. The oil-importing developing countries taken as a group, however, did not succeed in improving their balance of payments position; the available data indicate that their overall balance of payments on current account has even deteriorated considerably, viz. by about $ 10 billion. In this context the International Monetary Fund has pointed out that, if allowance is made for the increase in prices and the nominal growth of world trade last year, the current account deficit of this group of countries, at approximately $ 34 billion, is not out of keeping with the development of their external trade so far. In the aggregate, the burden on these countries was slightly reduced last year by the continuing favourable financing conditions in international credit markets. In addition, their situation was eased by the fact that a number of industrial countries, including Germany, cancelled some of the debts of least developed countries after agreements to this effect had been made at a meeting of the UNCTAD Trade and Development Board in March 1978. In the current year a further deterioration in the external po-

Balances on current account of major countries and groups of countries*

Country/group of countries	1975	1976	1977	1978 pe	1977	1978
	US$ billion				Percentage of gross national product	
EEC countries	− 0.1	− 7.0	+ 1.3	+ 16.1	0.1	0.8
of which						
Germany	+ 3.5	+ 3.4	+ 4.2	+ 8.7	0.8	1.4
(Memorandum item: DM billion)	(+ 8.5)	(+ 8.6)	(+ 9.8)	(+ 17.5)		
France	− 0.1	− 6.1	− 3.3	+ 4.1	0.9	0.9
United Kingdom	− 4.1	− 2.0	+ 0.5	+ 0.5	0.2	0.2
Italy	− 0.8	− 2.8	+ 2.3	+ 6.2	1.2	2.6
United States	+ 18.4	+ 4.3	− 15.3	− 16.0	0.8	0.8
Japan	− 0.7	+ 3.7	+ 10.9	+ 16.6	1.6	1.7
Switzerland	+ 2.6	+ 3.5	+ 3.4	+ 5.1	5.7	6.0
OPEC countries	+ 27.3	+ 37	+ 31.5	+ 11	.	.
Developing countries (excluding OPEC countries)	− 38.5	− 26	− 24	− 34	.	.

* Balances of trade, services, and private and official transfers (transactions basis). — **pe** Partly estimated.
Source: OECD and national statistics.

sition of the oil-importing developing countries is to be expected, not least because of the decisions of the oil-exporting countries as regards oil prices.

Changes in the terms of trade obscure progress in adjustment in real terms

The changes in exchange rates that took place last year caused the import and export prices of a number of industrial countries to diverge strongly. The resultant shifts in relative foreign trade prices — the "terms of trade" — affected the nominal foreign trade figures; they obscure the fact that marked progress was made in adjusting the quantitative development of foreign trade flows. Thus the volume of U.S. exports, which virtually stagnated in 1977, increased by 9% last year. At the same time the growth of the volume of U.S. imports slowed down from 13 % in 1977 to 10% in 1978. The shift in relative foreign trade prices was most marked with respect to Japan's current account balance, the improvement in which can be attributed in full to the improvement in the Japanese terms of trade. In the case of Switzerland and Germany, too, the terms of trade mask the fact that the volume of these countries' imports grew more strongly than the volume of their exports. The discrepancies between the nominal and real trends of the trade and current account balances reflect in large measure changes in competitiveness in terms of prices between the industrial countries, such as are also mirrored in the movement of the real rate of exchange; so far these changes have only partly resulted in corresponding shifts in international flows of goods and services. This picture confirms the experience that exports and imports frequently adjust to changes in prices in the foreign trade field only with a considerable time-lag. Thus the shifts that have occurred in competitive positions will probably lead to a further real adjustment in trade balances in 1979 and in the end also reduce nominal imbalances. The expectation that the gap in economic activity that exists between the United States and most other industrial countries will be closed or even reversed points in the same direction.

Obstacles to the continuing adjustment of current account balances

However, whether this will suffice to diminish further the existing imbalances in the global pattern of current accounts is an open question. Thus the increase in oil prices in 1979, which will be reflected in a corresponding burden on energy import balances, will directly counteract the cyclical and other forces which are working in the right direction. But even apart from this, there are other imponderables which might further delay the adjustment process between the industrial countries: it has already been pointed out that the increase in growth in Western Europe and Japan is subject to uncertainties in a number of respects. It is also unknown how quickly the efforts to achieve stability in the United States will be effective. The margin for possible differences in growth between the United States and the other economic regions mentioned above is correspondingly wide. The prospects of continuous growth and a reduction in balance of payments disequilibria would be additionally endangered by renewed currency upsets.

4. Financing the balance of payments deficits

Ample liquidity eases financing problems

It cannot be predicted with any certainty which particular financing problems will be raised by the expected changes in the pattern of current account deficits and surpluses in the world. The total amount of current account deficits that require financing is no doubt a better yardstick of the dimensions of the financing problem than the net deficits or surpluses of specific groups of countries. But at the same time the size of individual deficits on current account depends on the willingness of industrial countries, in particular, to provide financing in both the public and the private sphere. The sum total of deficits on current account again rose strongly world-wide in 1978, namely by about $ 10 billion to some $ 100 billion. (Owing to shortcomings in statistical recording the informative value of the available data is, however, seriously impaired by a large and growing discrepancy between aggregate surpluses and aggregate deficits.) Superabundant global liquidity has enabled the majority of countries not only to meet their current account deficits without difficulty but also to build up their foreign exchange reserves; about 60 % of the increase of some $ 44 billion in world monetary reserves was financed in the final analysis by borrowing.

(a) Financing by monetary authorities

Central banks again finance the U.S. deficit

In 1978 the external disequilibria in a number of countries were offset only in part by commercial credit transactions. This again applied particularly to the financing of the U.S. balance of payments. As long as uncertainty persisted in the foreign exchange markets, the widening interest rate differential in favour of dollar assets failed to stimulate offsetting capital flows to the United States. The steep rise of over $ 30 billion in foreign official dollar holdings in the United States shows that last year, as in 1977, foreign monetary authorities — primarily the central banks of Switzerland, Japan and Germany — financed not only the deficit on current account but also almost all U.S. net capital exports, which totalled some $ 16 billion.

Movement into "hard" currencies gains momentum of its own

It is obvious that the outflow of capital from the United States, which at times was considerable, was closely linked with the persistent unrest in the foreign exchange markets and the heavier demand for "hard" currencies. Initially this movement was simply a reaction to the weakness of the dollar, but it now seems to have developed a certain momentum of its own, prompted by the desire for a greater diversification of reserves and assets. Profit-oriented capital movements may be swamped by capital flows motivated by such considerations, and this impedes the international adjustment of balances of payments. The continuing tendency for more official reserves to be held in Deutsche Mark is a clear indication of the desire for such diversification.

(b) The role of the international financial markets

Much faster expansion of the international financial markets

Last year the greater part of global external financing requirements were again met through the international financial markets. After adjustment for double counting, the redemption of bonds and changes in value, new credit amounting to about $ 110 billion net was extended to final borrowers through these markets in 1978, i. e. about a quarter more than in the previous year. This substantial credit expansion was due — to an even greater extent than in the past — to the pronounced glut of funds in the world's financial markets. The fact that "blue chip" borrowers in the Euro-credit markets succeeded not only in reducing loan charges and lowering the premiums on the London Interbank Offered Rate (LIBOR) to 1/2 % p. a. (and in isolated cases to even less), but also in extending the average overall life of such credits by about two years to a total of nine years, was symptomatic of this situation.

This trend was mainly fostered by the extremely high U.S. balance of payments deficit, but it also owed something to expansionary monetary policies in countries in a strong balance of payments position. Moreover, the potential amount of credit available in the Euro-markets was increased further by the growing investment of official foreign exchange reserves in the Euro-currency markets. The above-mentioned efforts to promote diversification probably also had a major impact on the gross expansion of the Euro-markets, especially since the accumulation of non-dollar balances was partly financed by borrowing in the dollar markets. At the same time banks operating internationally once again tended to transfer a growing proportion of their domestic lending and deposit

International credit and bond markets

US$ billion

Item	1973	1974	1975	1976	1977	1978 p
A. Medium-term Euro-currency loans **1**	20.9	28.5	20.6	27.9	33.8	66.3
1. By type of borrower						
Public agencies **2**	14.6	19.5	13.9	20.2	27.2	50.8
Private agencies	6.3	9.0	6.7	7.6	6.5	15.5
2. By group of countries						
Industrial countries	12.7	19.0	6.8	10.6	13.0	30.4
of which						
Seven major OECD countries **3**	(9.2)	(13.2)	(1.8)	(4.4)	(6.2)	(18.3)
Other OECD countries	(3.2)	(5.1)	(4.4)	(5.5)	(6.8)	(12.2)
Developing countries	7.4	8.2	11.2	14.4	17.8	31.9
Oil-exporting countries	2.8	0.8	3.2	3.4	6.3	9.9
Other developing countries	4.5	7.4	8.0	11.0	11.6	22.0
Centrally planned economies **4**	0.7	1.1	2.7	2.5	2.5	3.6
Other **5**	0.2	0.4	0.1	0.3	0.3	0.4
B. International bond markets	10.1	12.2	22.8	34.3	33.8	33.3
Euro-bonds **6**	4.2	3.5	9.1	14.6	18.5	14.6
of which						
In U.S. dollars	(2.4)	(2.1)	(3.6)	(9.2)	(11.5)	(6.3)
In Deutsche Mark **7**	(1.1)	(0.6)	(3.1)	(2.8)	(5.1)	(6.7)
By type of issuer						
Public agencies **2**	2.0	2.6	5.4	8.1	9.7	9.1
Private agencies	2.1	0.8	3.7	6.4	8.9	5.5
Traditional foreign bonds	4.5	5.2	11.6	18.3	14.1	17.5
of which Issued in Germany	(0.5)	(–)	(0.4)	(1.1)	(0.9)	(1.2)
Special issues **8**	1.4	3.6	2.1	1.4	1.2	1.3
Total (A plus B)	31.0	40.7	43.4	62.2	67.6	99.6

1 Publicised internationally syndicated loans running for more than 12 months and almost entirely financed on a roll-over basis which have not necessarily been taken up yet. — **2** Including public enterprises and financial institutions and including international organisations. — **3** Canada, France, Germany, Italy, Japan, United Kingdom, United States. — **4** Including Comecon institutions. — **5** Including international organisations. — **6** Internationally syndicated bond issues. — **7** Including some Deutsche Mark issues floated by purely German syndicates. — **8** Including special issues in Deutsche Mark. — **p** Provisional.
Discrepancies in the totals are due to rounding. — Source: OECD and World Bank.

business to the international financial markets because of their greater freedom from monetary and bank supervision regulations and the associated cost advantages. The investments of oil-exporting developing countries, by contrast, were only of secondary importance.

Divergent trend of international bond issues and medium-term Euro-credits

The gross volume of medium-term syndicated Euro-currency loans granted by international banks, most of which are financed at short term on a roll-over basis, doubled in 1978 to $ 66 billion. On the other hand, the volume of international bond issues, at the equivalent of $ 33 billion (gross), barely regained the level of the preceding year. The net amount raised in the bond markets, at $ 26 billion, was, however, distinctly below the previous year's figure, whereas the increase in the volume of predominantly medium-term Euro-credits was substantially higher, even in net terms, at $ 40 billion.

The slight decline in the gross volume of bond issues was largely due to the weakness of the dollar and the rising money market rates in the dollar markets. As a result of the low demand for Euro-dollar and traditional dollar issues, the share of the dollar fell to 41 % compared with 57 % in each of the two preceding years. Hence the dollar was overtaken for the first time in the field of international bond issues by the Deutsche Mark, the Swiss franc and the yen combined, in which currencies bonds equivalent to $ 17 billion were issued (excluding the foreign currency resources taken up by the United States — "Carter Notes"); this compares with issues worth $ 13 billion denominated in dollars. The share of the Deutsche Mark alone amounted to 24 %; thus it has doubled within only two years.

At $ 22 billion, about two thirds of the new international bonds consisted of issues by industrial countries. Developing countries again increased their direct access to these markets from $ 4 billion to $ 5 billion. By contrast, issues by international development institutions, which had built up large liquid reserves in the previous year and were reluctant to borrow because of the higher dollar interest rates, decreased from $ 3.6 billion to $ 2.1 billion. Taken as a whole, the share of developing countries in the total amount raised in international bond markets, at just over 20 %, therefore went down slightly. On the other hand, they increased their borrowing in the medium-term Euro-markets by nearly 80 % compared with 1977 to $ 32 billion. This figure includes the newly contracted debt of the oil-exporting developing countries, which amounted to $ 10 billion.

(c) The situation in the Euro-markets

Greater transparency of the Euro-markets desirable

The consistently strong expansion and inner momentum of the Euro-markets, as the corner-stone of the international financial markets, again focused attention last year on the risks posed by these developments. One of the factors which aroused concern was the lengthening of the life of the Euro-currency loans that are largely financed on a roll-over basis. The resultant increase in maturity transformation undoubtedly made the international banking system more vulnerable to sudden withdrawals of deposits. Competitive pressure in the financial markets sharply reduced the premiums on LIBOR; these premiums now appear to reflect the differing country risks inadequately. In view of the internationalisation of banking business and of the volume of financing handled in these markets, a further improvement in the facilities available to the supervisory authorities for detecting and assessing the prevailing risks seems to be urgently necessary. The provision of consolidated balance sheets of banks operating in the Euro-markets — as is already the rule in a number of countries — could make a contribution to solving this problem.

"Unobtrusive" financing defers the adjustment problems

During the first few years after the outbreak of the oil crisis in autumn 1973 the Euro-markets performed a very useful transformation function by recycling about one third of the OPEC countries' financial surpluses to the oil-importing countries to finance their deficits on current account; in this way they helped materially to preserve the freedom of world trade. But following the distinct decline in the current account surpluses of the OPEC countries in 1977 and 1978, it can be said that there has been a large-scale "over-recycling" in the last two years. "Unobtrusive" financing with no strings attached, particularly through the Euro-markets, has enabled many countries to run higher deficits for longer periods than are compatible with the increased cost of imported oil and the need to prevent its implicit deflationary consequences. The dangers this entails for the international community are obvious: by the excessively generous financing of their external disequilibria countries in a weak balance of payments position defer their adjustment problems, but these problems will nevertheless arise in the end with all the greater severity and their solution will require all the more radical measures. Thus there is an increasing risk not only that financial crises will occur but also that the countries in question will resort to protectionism when the deferred adjustment problems finally become acute.

Monetary autonomy may be undermined

Particularly in countries where payments are almost free from controls, such as Germany, the freedom of action of the national monetary authorities may be undermined by the close links between the Euro-markets and the domestic money and credit markets. The huge volume of the Euro-markets, in conjunction with their great flexibility, constitutes a source of financing for private borrowers that is hard to control by purely national measures. Moreover, if conditions in the foreign exchange markets are unsettled, the Euro-markets can greatly amplify speculative capital movements.

In view of these problems it is to be welcomed that the central banks of the Group of Ten countries and Switzerland have recently reaffirmed their 1971 standstill agreement on the investment of monetary reserves in the Euro-currency markets. However, the share of the Group of Ten countries in statistically recorded central bank investments in the Euro-markets, at about $ 10 billion out of a total of some $ 90 billion, is relatively small.

The expansion of the international financial markets could more easily be kept within limits that are acceptable in terms of external monetary policy if the major countries were to agree jointly on a framework of conditions for these markets. This would of course be no substitute for stability-oriented fiscal and above all monetary policies in these countries. Given the continuing predominant role of the U.S. dollar as a financing and reserve currency and the sizable deficits on the U.S. current and capital accounts, the United States bears a particular responsibility in this connection.

(d) Official balance of payments assistance

Small share of official balance of payments assistance

In inverse proportion to the sustained strong credit expansion in the international financial markets, balance of payments assistance by official institutions again declined appreciably during the period under review. The volume of new drawings in the International Monetary Fund increased slightly (by about $ 400 million) compared with 1977 to some $ 4.7 billion, but to a much greater extent than in earlier years this increase was due to drawings in the so-called reserve tranche, which are to be regarded not as credits but as recourse to monetary reserves and which are not subject to economic policy conditions. Almost two thirds of the IMF's new lending in 1978, at about $ 3 billion, consisted of drawings in the reserve tranche by the United States in the context of the measures it took last November to strengthen the dollar. As a result of substantial repayments in the credit tranches, particularly by the United Kingdom and Italy, and under the oil facilities, the overall volume of IMF balance of payments assistance outstanding decreased by about $ 4.5 billion in 1978.

No new loans were granted during the period under review under the support mechanisms of the European Communities, owing to the progress made by member states towards external stability. Instead, Italy repaid not only the balance of the Bundesbank's gold-pledged loan to the Banca d'Italia but also the balance of the loan it had been granted under the EEC medium-term financial assistance mechanism.

5. Development of international liquidity

U.S. deficit again the main source of the increase in reserves

In 1978 there was a further steep increase in international liquidity. After adjustment for changes in the value of gold and SDR holdings and of reserve positions in the IMF, which are denominated in SDRs, about 75% of the growth of the monetary reserves derived from the financing of the U.S. balance of payments deficit by foreign monetary authorities. In the aggregate, adjusted monetary reserves went up by almost $ 40 billion last year; this was, however, far less than in the record year of 1977, when international liquidity rose by some $ 57 billion. But when making this comparison it should be borne in mind that about $ 7 billion was removed from the IMF reserve statistics on Saudi Arabia in 1978 on the ground that this sum served as cover for banknotes in circulation.

The actual — and very desirable — slowdown in the global increase in reserves is mainly attributable to the deterioration of about $ 16 billion (or, after adjustment for the above-mentioned statistical change, of $ 9 billion) in the reserve position of the oil-exporting countries. The monetary reserves of the industrial countries rose at about the same pace as in 1977 and those of the "other developing countries" slightly faster. In 1978 the "other developed countries" built up their reserves significantly more than in the preceding year, for the first time since 1975.

New allocation of SDRs . . .

After a pause of several years the IMF decided in December 1978 to allocate new special drawing rights amounting to SDR 12 billion over a period of three years. (At the beginning of 1979 Germany received the first instalment equivalent to DM 534 million of its share of these newly allocated special drawing rights.) This decision represents a compromise since the IMF itself and a number of its members had originally advocated far larger allocations of SDRs to strengthen their role as a reserve asset and to replace some of the credit created in international financial markets by official liquidity. But other countries, including Germany, argued in favour of more modest allocations which would take sufficient account of consolidating the position of the SDR as a reserve asset. They expressed their concern that an excessive additional boost to international monetary reserves would stimulate inflationary tendencies and inhibit the efforts to achieve adjustment.

. . . and increase in quotas in the IMF

In addition to this decision, which had a direct impact on liquidity, the IMF's scope for supplying extra liquidity was greatly enhanced by the entry into force on April 1, 1978 of the increase in quotas agreed under the sixth general review of quotas, as mentioned in this section of the Report for 1977. Moreover, last December, in the context of the seventh review of quotas, the Board of Governors decided in principle to raise the quotas

World monetary reserves

(Special drawing rights, reserve positions in the IMF, foreign exchange, gold)

US$ billion

Item	Change 1: Average annual change 1970–74	Change 1: 1975	Change 1: 1976	Change 1: 1977	Change 1: 1978	Level at end-1978
I. Development by type of reserves						
1. Foreign exchange holdings						
Claims of monetary authorities on the United States	+12.0	+ 3.9	+11.3	+34.1	+30.4	156.4
Sterling claims of monetary authorities on the United Kingdom	+ 1.1	− 2.6	− 3.8	+ 0.3	− 0.5	3.5
Identified foreign exchange holdings of monetary authorities in the Euro-market	+ 8.2	+ 7.0	+11.4	+ 9.6	**pe** + 7.0	**pe** 82.0
Other foreign exchange holdings of monetary authorities	+ 3.0	− 2.7	+ 6.5	+13.3	+ 6.7	44.7
Total	+24.3	+ 5.6	+25.4	+57.3	+43.6	286.6
2. Special drawing rights, reserve positions in the IMF, gold **2**	+ 1.7	+ 4.4	+ 5.6	− 0.1	− 3.8	76.3
Total monetary reserves	+26.0	+10.0	+31.1	+57.2	+39.8	362.9
Memorandum item						
Total monetary reserves including changes due to valuation adjustments	+28.2	+ 7.1	+30.6	+60.4	+45.1	362.9
II. Regional development						
1. Industrial countries	+11.2	+ 4.3	+10.4	+34.9	+35.5	209.0
of which						
Germany	+ 4.8	− 1.0	+ 3.8	+ 4.5	+13.4	53.9
Japan	+ 1.9	− 0.6	+ 3.8	+ 6.5	+10.0	33.5
United States	− 0.8	+ 0.5	+ 2.6	+ 0.2	− 1.0	19.6
Switzerland	+ 0.8	+ 1.6	+ 2.6	+ 0.7	+ 7.4	21.6
United Kingdom	+ 0.8	− 1.4	− 1.2	+16.8	− 4.1	17.1
Italy	+ 0.2	− 2.0	+ 1.9	+ 4.8	+ 2.9	14.8
France	+ 0.8	+ 4.0	− 2.8	+ 0.2	+ 2.3	13.9
2. Other developed countries **3**	+ 2.5	− 3.1	+ 0.4	+ 0.8	+ 6.4	26.0
All developed countries (1 plus 2)	+13.7	+ 1.2	+10.8	+35.8	+41.9	235.0
of which: EEC countries	+ 8.1	+ 0.7	+ 1.8	+28.5	+16.6	119.1
3. Oil-exporting countries **4**	+ 8.5	+ 9.8	+ 8.8	+ 9.9	−15.9	60.2
of which						
Saudi Arabia	+ 2.7	+ 9.1	+ 3.7	+ 2.9	**5** −10.8	19.4
Iran	+ 1.6	+ 0.6	− 0.1	+ 3.4	− 0.1	12.2
Venezuela	+ 1.1	+ 2.4	− 0.3	− 0.4	− 1.8	6.5
4. Other developing countries	+ 3.8	− 1.0	+11.5	+11.5	+13.8	67.8
All countries	+26.0	+10.0	+31.1	+57.2	+39.8	362.9

1 Excluding valuation gains on SDRs, reserve positions in the IMF and holdings of gold due to the devaluation of the dollar in 1971 and 1973, and excluding changes arising from fluctuations in the value of the SDR since mid-1974. — **2** Gold valued at the dollar equivalent of SDR 35 per ounce. — **3** Finland, Greece, Iceland, Ireland, Malta, Portugal, Spain, Turkey, Yugoslavia; Australia, New Zealand, South Africa. — **4** Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, United Arab Emirates, Venezuela. — **5** US$ 7 billion of which owing to change in statistical recording. — **pe** Partly estimated.
Discrepancies in the totals are due to rounding. — Source: IMF, BIS and national statistics.

by a further 50%. Provided that all members of the IMF accept the increase in quotas envisaged for them, the total amount of the quotas will rise to almost SDR 60 billion, albeit hardly before the end of 1980. Considering the existing level of monetary reserves, the declining trend in lending by the IMF and the danger of a weakening of the Fund's conditionality principle, some countries, including Germany, would have preferred a smaller overall increase in quotas.

The Supplementary Financing Facility ("Witteveen Facility") of the IMF, which was approved in principle in the summer of 1977, was put into effect in February 1979. This special facility is available for a limited period only and is designed to provide IMF members whose normal drawing rights are not sufficient to finance their balance of payments deficits with additional funds that are subject to economic policy conditions. Regarding Germany's financing commitment amounting to SDR 1,050 million, the Bundesbank concluded a loan agreement with the IMF in January 1979.

6. The European Monetary System

New approach to the creation of a zone of greater exchange rate stability

With the European Monetary System (EMS), which entered into force on March 13, 1979, the member states of the European Communities have embarked on a new approach to economic and monetary policy integration.[1] The immediate objective of the EMS is to link the participating currencies more closely to each other under newly agreed rules and thus to create a zone of stable exchange rates. At the same time these closer ties are intended to improve the conditions for stronger economic growth and higher employment and hence to make a European contribution to economic recovery throughout the world. It is planned to establish the EMS in its final form after a transitional period of two years and to set up a European Monetary Fund, the functions and structure of which are to be worked out in detail in the months ahead.

External monetary policy as an integrating factor . . .

Great hopes are being pinned on the EMS. External monetary policy is being regarded as a major starting point for efforts to promote the integration of the European economies. In its field of responsibility, and without prejudice to the duties assigned to it, the Bundesbank has long been working towards the achievement of the joint objectives which the countries of the European Communities set themselves in the Treaties of Rome. This applies not least to the obligation incumbent on member states to treat their exchange rate policies as a matter of common interest and to grant each other support if any of them finds itself in balance of payments difficulties.

. . . requires the backing of stabilisation policy

During the preparation of and negotiations on the European Monetary System the Bundesbank and the Federal Government repeatedly pointed out that the EMS will have a prospect of lasting success only if it is based on the principle of monetary stability. As economic interests are converging sharply and interdependence has increased, a regional monetary arrangement — especially among the economies in the EEC, which are already closely interlinked in many fields — appears more promising than, say, a return to a system of fixed but adjustable parities on a world-wide basis. But even in this case a number of conditions must be fulfilled if disappointments and setbacks that would be detrimental to the future of the EEC are to be avoided. In particular, it must be ensured that the participants in the EMS pursue a resolute policy of domestic stabilisation. This is also assumed by the Commission of the European Communities in its recommendations to bring about a greater harmonisation of economic policies and economic developments in Community countries, in which it considers it crucially important to the success of the EMS that inflation rates and inflation differentials in the European Communities be reduced.

The EMS incorporates several major features of the "snake" arrangement which it has superseded, and builds on the foundations which that arrangement laid. It also includes a number of new features that still have to be tried out in practice. One of these innovations is the "indicator of divergence", which is designed to show when the movement of a currency is deviating from that of the other Community currencies. If a currency crosses the "threshold of divergence" against the European Currency Unit (ECU) as the common denominator of the exchange rates of participating currencies, there is a presumption that appropriate measures will be taken to reduce the tensions in the pattern of exchange rates. Special importance is attached to the question of whether the Community countries will regard the triggering of the indicator as a reason to take action irrespective of the differential between their currencies in terms of stability or whether, during the envisaged consultations when the need actually arises, they will seek to distribute the burden of adjustment in such a way that the common objective of stability is taken into account. The Bundesbank has resisted all efforts to link the indicator of divergence to an obligation to take action regardless of the cause of the disequilibrium underlying the divergence and regardless of the requirements of stabilisation policy. On the other hand, it considers the obligation to start consultations once the threshold of divergence has been reached to be a useful innovation.

Changes in central rates will remain necessary

Changes in central rates are expressly provided for in the EMS and are, moreover, by no means inconsistent with the objective of more stable exchange rates. Indeed, timely adjustments of exchange rates are an essential part of a system of more stable exchange

1 The structure and operation of the EMS were described in the Monthly Report of the Deutsche Bundesbank, Vol. 31, No. 3, March 1979.

rates as long as there is a pronounced inflation differential between the participating countries. Without such adjustments of central rates, monetary crises with their typical speculative excesses would be bound to occur sooner or later. The credit potentially available in the EMS together with existing monetary reserves will allow even major balance of payments disequilibria to be bridged in cases where the underlying conditions for adjustment have already been created. However, the financing of balance of payments disequilibria is no substitute for necessary action, including the adjustment of central rates. Any attempt to defend unrealistic exchange rates by means of persistent intervention and with the aid of credit mechanisms would soon be condemned to failure.

If these basic requirements are complied with, the EMS may mark the starting point of a development that opens up favourable prospects for the European Communities and for the international monetary system as well. It goes without saying that in the further evolution of the EMS due regard must be paid to international commitments, particularly those applying in the IMF.

7. Recent developments in the International Monetary Fund

Initial experience of exchange rate surveillance by the IMF

As stated in the Report for 1977, the Second Amendment to the Articles of Agreement of the International Monetary Fund entered into force on April 1, 1978. Its main innovations are the provisions on the exchange rate system and exchange rate policy, on the role of gold and the special drawing right, and on questions affecting the organisation of the IMF.[1] During the period under review initial experience was gained of the rules governing the exchange rate policies of IMF members and of the surveillance of these policies by the IMF (both of which were approved on April 1, 1978 by the Executive Board). The inclusion of the surveillance procedure in the regular consultations between the IMF and its members has in principle been a success. On the other hand, practical experience has shown that — contrary to the original intentions — special consultations may be desirable not only when definite exchange rate measures are adopted by member countries but also when necessary action is not taken or an appropriate exchange rate movement does not occur. As a result, the Managing Director of the IMF will in case of need enter into confidential discussions with a member in future in order to take account of this requirement.

Use of SDRs liberalised

During the period under review the IMF made use of a further new provision of the amended Articles of Agreement permitting the liberalisation of the use of special drawing rights. In accordance with this provision the Executive Board decided that members may in future use their SDRs to repay liabilities, to grant loans and as collateral. The use of SDRs in swap and forward transactions and for donations is at present under discussion in the IMF. The "reconstitution" requirement, i.e. the obligation incumbent on participants in the SDR Department to hold a certain minimum average percentage of their cumulative net allocations of SDRs over time, was lowered from 30% to 15%.

In line with a decision of the Interim Committee of the IMF the Executive Board raised, with effect from January 1, 1979, the interest rates on SDR credit and debit balances from 60% to 80%, and on the interest-bearing part of the reserve tranche in the IMF from 60% to 72%, of the weighted market rates for specific money market securities in the United States, the United Kingdom, Japan, France and Germany.

The monthly gold auctions of the IMF, which have been carried out regularly since 1976 as part of a four-year programme, were continued on a routine basis during the period under review. The aggregate bids were generally several times higher than the amounts on offer, which totalled about half a million ounces. So far the Trust Fund in favour of developing countries has received over $ 2 billion from these gold sales, representing the net profit that has been made.

1 The principal amendments and their significance were discussed in the Monthly Report of the Deutsche Bundesbank, Vol. 29, No. 8, August 1977.

Part B: Notes on the Deutsche Bundesbank's annual accounts for 1978

1. Legal basis, classification and valuation

Legal basis, accounting system and annual accounts

The legal basis for the annual accounts of the Bank is provided by section 26 of the Deutsche Bundesbank Act (Gesetz über die Deutsche Bundesbank) of July 26, 1957 (Federal Law Gazette I, page 745); the provisions it contains regarding the accounting system and the annual accounts remained unchanged during the year under review.

Classification of the annual accounts

The classification of the balance sheet has remained unchanged against the previous year. In sub-item 2.1 on the assets side the term "gold tranche" has been replaced by the term "reserve tranche" in connection with the entry into force of the Second Amendment to the Articles of Agreement of the International Monetary Fund.

The item

Gains from the write-up of gold

has been added to the profit and loss account.

Valuation

The provisions of the Companies Act (Aktiengesetz) were taken into account mutatis mutandis in the valuation (section 26 of the Bundesbank Act).

2. Conversion account

The combined conversion account of the institutions amalgamated to form the Deutsche Bundesbank is attached to the German original of this Report as Appendix 1.

Through the adjustment of the partial conversion accounts for the Bank deutscher Länder and the Land Central Banks to the position shown by the books at December 31, 1978, the Bank's title to the allocation of equalisation claims rose by DM 7,842.79 to DM 8,103,771,347.68; the claim on the Federal Government arising from the non-interest-bearing debt certificate issued in connection with the currency conversion in Berlin remained unchanged at DM 547,168,481.20 during the year under review.

The closing of the combined conversion account of the institutions amalgamated to form the Deutsche Bundesbank, which was envisaged for December 31, 1978, has been postponed until December 31, 1979 in view of the adjustments expected for 1979.

3. Annual accounts

The annual accounts for 1978 are attached to this Report as an Appendix; as usual, the notes on them are in the same order as the items in the balance sheet and profit and loss account. At the same time a report is rendered on the Bank's activities during 1978.

Balance sheet

Comparison of balance sheet figures

At December 31, 1978 the balance sheet total had increased by DM 31,086.2 million, compared with end-1977, to DM 166,106.0 million.

Comparison of balance sheet figures

DM million

Assets	December 31 1977	December 31 1978
Gold	14,065.4	17,082.5
Reserve position in the International Monetary Fund and special drawing rights		
Drawing rights within the reserve tranche	2,950.9	4,820.6
Loans under special borrowing arrangements	2,635.7	3,043.0
Special drawing rights	3,008.3	3,283.8
Balances with foreign banks and money market investments abroad	56,579.5	72,316.3
Claims on the European Monetary Cooperation Fund	1,708.3	2,251.1
Foreign notes and coins	22.7	16.9
External loans and other external assets		
Loans in connection with EEC medium-term monetary assistance	1,021.6	–
Claims arising from foreign exchange offset agreements with the United States	1,884.0	1,636.4
Other loans to foreign monetary authorities	3,832.5	276.9
Loans to the World Bank	2,517.7	2,483.3
Foreign bills of exchange	1,628.9	1,684.6
Domestic bills of exchange	12,399.7	16,401.9
Lombard loans	5,558.9	6,164.9
Cash advances (book credits)	904.7	155.7
Treasury bills and discountable Treasury bonds	–	–
Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin		
Equalisation claims	8,136.4	8,136.4
Non-interest-bearing debt certificate	547.2	547.2
Securities	692.5	4,217.6
German coins	810.0	698.3
Balances on postal giro accounts	998.8	1,214.3
Other claims	1,191.6	1,170.7
Land and buildings	782.4	843.3
Furniture and equipment	35.6	50.1
Items in course of settlement	3,349.2	6,718.7
Other assets	1,131.6	1,309.4
Prepaid expenses and deferred income	27.8	29.0
Balancing item in respect of the valuation adjustment of the monetary reserves and other foreign currency positions – accumulated loss –	6,597.9	9,553.1
Total	135,019.8	166,106.0
Contingent claims	1.0	0.7

Liabilities	December 31 1977	December 31 1978
Bank notes in circulation	65,567.4	74,799.1
Deposits of banks	52,491.3	59,366.1
Deposits of public authorities		
Federal Government	296.3	2,384.3
Equalisation of Burdens Fund and ERP Special Fund	150.1	162.7
Länder Governments	1,629.4	2,027.6
Other public depositors	44.3	56.7
Deposits of other domestic depositors		
Federal Railways	6.8	6.5
Federal Post Office	3,418.7	3,515.4
Other depositors	479.2	564.7
Liabilities arising from mobilisation and liquidity paper sold	5,366.1	13,204.6
Liabilities arising from foreign business	489.0	4,544.4
Counterpart of special drawing rights allocated	1,386.9	1,291.7
Provisions	1,945.0	1,985.0
Other liabilities	104.5	116.5
Deferred expenses and accrued income	255.3	691.2
Capital	290.0	290.0
Reserves	1,099.5	1,099.5
Total	135,019.8	166,106.0
Contingent liabilities	1.0	0.7

Assets

Gold

At December 31, 1978 the gold holding amounted to DM 17,082.5 million against DM 14,065.4 million at end-1977. Except for a small increase stemming from the restitution of gold by the International Monetary Fund to its members, this rise is entirely attributable to a write-up of DM 2,988.5 million which reversed the write-downs of earlier years – particularly those caused by the revaluations of the Deutsche Mark – on the historical cost of the gold (section 155 (4) of the Companies Act).

Reserve position in the International Monetary Fund and special drawing rights

Drawing rights within the reserve tranche

At December 31, 1978 the drawing rights within the reserve tranche amounted to DM 4,820.6 million against DM 2,950.9 million at end-1977. The change is due to other members' Deutsche Mark drawings and transactions of similar effect equivalent to SDR 1,385.6 million and to the payment of 25% of the subscription in special drawing rights (SDR 139 million) in connection with the increase of SDR 556 million in the German quota. These increases were accompanied by decreases deriving from Deutsche Mark repayments and transactions of similar effect equivalent to SDR 654.5 million and by the valuation adjustment at the end of the year. The level of drawing rights within the reserve tranche represents the difference between the German quota of SDR 2,156 million and the Deutsche Mark balances at the disposal of the IMF equivalent to SDR 131.8 million.

Loans under special borrowing arrangements

Loans under special borrowing arrangements amounted to DM 3,043.0 million at December 31, 1978 against DM 2,635.7 million at end-1977. During the year under review a loan of SDR 582.9 million was granted to the International Monetary Fund to finance a Deutsche Mark drawing by the United States under the General Arrangements to Borrow (GAB) of the IMF. Of the GAB loans granted to the IMF in 1977 to finance Deutsche Mark drawings by the United Kingdom (SDR 458.0 million), SDR 210.6 million was repaid in advance, while the GAB loan in respect of Deutsche Mark drawings by Italy (SDR 20.2 million) was repaid in full. The loans under the 1975 IMF oil facility came to SDR 447.5 million after SDR 105.2 million had been repaid in advance in the year under review.

Special drawing rights

The amount of special drawing rights (SDRs) held at December 31, 1978 is shown at DM 3,283.8 million compared with DM 3,008.3 million at end-1977. Increases resulting from the acquisition of SDRs from the United States (SDR 600.0 million), under the EEC settlement arrangements (SDR 100.0 million), on account of designation and other transactions (SDR 42.1 million), and from the payment of interest on SDRs purchased by the Bank (SDR 26.2 million) were accompanied by decreases deriving from the raising of the German quota (SDR 139.0 million), freely agreed transactions (SDR 426.9 million) and the valuation adjustment at the end of the year. The valuation adjustment affected both the total holding (SDR 1,378.9 million) and the counterpart of SDRs allocated shown on the liabilities side (SDR 542.4 million).

Balances with foreign banks and money market investments abroad

Balances with foreign banks and money market investments abroad amounted to DM 72,316.3 million at December 31, 1978 against DM 56,579.5 million at December 31, 1977. Current transactions resulted in an increase of about DM 25.1 billion in the year under review, but this was reduced to DM 15.7 billion by the valuation adjustment of foreign currency assets as at December 31, 1978.

Claims on the European Monetary Cooperation Fund

This item comprises claims arising from operations in the foreign exchange market in support of the currencies of the EEC member states that participate in the European narrower margins arrangement.

Foreign exchange deals

The Bank's turnover in foreign exchange spot deals (foreign currency against Deutsche Mark) amounted to DM 56,881.0 million in the year under review against DM 32,676.6 million in 1977. The number of deals, at 6,837 compared with 6,860 in the previous year, remained practically unchanged on the year. These deals consisted of

	1977		1978	
	Number	DM million	Number	DM million
Purchases	3,696	17,822.9	4,002	29,263.5
Sales	3,164	14,853.7	2,835	27,617.5
	6,860	32,676.6	6,837	56,881.0.

The substantial increase in turnover compared with the preceding year was caused partly by the further rise in U.S. dollar purchases in the market in the course of intervention operations and partly by growing U.S. dollar outflows from the Bundesbank in connection with the conversion of foreign Deutsche Mark bonds and major loans raised by foreigners in Germany.

Cross deals (foreign currency against foreign currency) decreased during the year under review, at 544 deals equivalent to DM 4,041.5 million against 622 deals equivalent to

DM 5,645.2 million in 1977. In addition, 175 U.S. dollar inter-centre switch transactions amounting to US$ 25.8 million were concluded, against 328 transactions amounting to US$ 53.6 million in the previous year.

External payments

The Bank executed the following payment orders in the context of external payments:

External payments

Number of orders

Year	Outgoing external payment orders: in foreign currency	in Deutsche Mark	Total	of which settled under automated standing order procedure	Incoming external payment orders: in foreign currency	in Deutsche Mark	Total
1977	552,529	1,342,325	1,894,854	1,646,159	16,428	198,566	214,994
1978	550,546	1,444,987	1,995,533	1,746,988	15,355	197,652	213,007

Sales of foreign cheques

During 1978 8,501 (1977: 7,875) foreign cheques payable to order worth DM 516.9 million (1977: DM 477.8 million) were sold. In addition, the Bank sold 27,755 traveller's cheques worth DM 2.9 million against 26,045 traveller's cheques worth DM 2.5 million in the preceding year.

Simplified collection procedure for foreign cheques

The number and amount of items received under the simplified collection procedure for foreign cheques continued to rise during the year under review. Further details are given in Appendix 4 of the German original of this Report.

Foreign commission business

The Bank took in the following for realisation on a commission basis:

	1977 Number	1978 Number
Bills, cheques, etc.	26,584	30,018
Foreign notes and coins	4,591	5,191
	31,175	35,209.

Foreign notes and coins
Purchases and sales

The amount of foreign notes and coins held at December 31, 1978 came to DM 16.9 million compared with DM 22.7 million at end-1977. During the year under review the Bank effected 40,232 purchases (1977: 61,495) and 38,881 sales (1977: 42,018) of foreign notes and coins.

External loans and other external assets
Loans in connection with EEC medium-term monetary assistance

The German share in a credit which the member states of the European Communities — with the exception of the United Kingdom — had granted to Italy under the arrangements for medium-term monetary assistance was shown in this item at end-1977; this share was repaid, as agreed, in the year under review. No new credits were granted under these arrangements.

Claims arising from foreign exchange offset agreements with the United States

The U.S. dollar claims arising from foreign exchange offset agreements concluded with the United States for the years from 1973 to 1975 are shown here.

Other loans to foreign monetary authorities

This item comprises the U.S. dollar loan granted to the Banco de Portugal against the security of gold. The loan granted to the Banca d'Italia was repaid during the year under review.

Loans to the World Bank

As in preceding years, loans to the World Bank were mainly granted against borrowers' notes denominated in Deutsche Mark.

Foreign bills of exchange

At the end of 1978 the portfolio of foreign bills accumulated through purchases in Germany amounted to DM 1,684.6 million compared with DM 1,628.9 million at December 31, 1977. The share of Deutsche Mark bills in the total value of the foreign bills purchased averaged about 75% in 1978 (1977: about 70%).

Purchases of foreign bills of exchange in the Land Central Bank areas

Land Central Bank	1977 Number	1977 DM million	1978 Number	1978 DM million
Baden-Württemberg	23,351	861.5	26,649	1,039.7
Bavaria	7,775	1,309.1	10,698	1,355.6
Berlin	554	244.0	674	515.4
Bremen	1,449	217.2	1,849	194.7
Hamburg	6,629	733.5	6,962	849.8
Hesse	9,969	1,700.0	11,309	1,870.8
Lower Saxony	1,916	207.5	2,794	186.8
North Rhine-Westphalia	19,680	1,710.0	22,312	1,684.3
Rhineland-Palatinate	3,701	364.5	4,287	362.7
Saarland	1,883	322.7	2,104	317.7
Schleswig-Holstein	429	27.6	610	37.5
Total	77,336	7,697.6	90,248	8,415.0

Domestic bills of exchange

Taking the average of all return days, the Bank's portfolio of domestic bills in the year under review, at DM 17,224 million, was again larger than in the previous year (DM 14,728 million). At the end of 1978 the Bank held domestic bills worth DM 16,401.9 million against DM 12,399.7 million at end-1977. Purchases of domestic bills increased particularly from mid-year onwards, after the Bundesbank had raised the total amount of rediscount quotas at the beginning of July and brought the individual quotas more into line with the various banks' portfolios of bills eligible for rediscounting at the Bundesbank.

The domestic bill portfolio comprised	Dec.31,1977 DM million	Dec.31,1978 DM million
Domestic bills discounted	10,902.6	14,646.6
Prime bankers' acceptances acquired in the course of open market operations	1,497.1	1,755.3
	12,399.7	16,401.8.

Purchases of domestic bills of exchange in the Land Central Bank areas

Land Central Bank	1977 1 Thousands	1977 1 DM million	1978 1 Thousands	1978 1 DM million
Baden-Württemberg	497	18,767.9	494	18,255.0
Bavaria	373	21,159.8	328	18,221.4
Berlin	28	4,444.0	22	2,930.1
Bremen	33	4,091.3	42	3,314.2
Hamburg	204	18,035.0	149	12,314.2
Hesse	366	41,398.3	329	29,823.5
Lower Saxony	121	5,870.9	128	6,460.0
North Rhine-Westphalia	527	40,019.2	526	38,436.9
Rhineland-Palatinate	58	2,437.5	65	2,342.8
Saarland	22	1,818.9	27	1,482.7
Schleswig-Holstein	36	1,652.0	35	1,597.0
Total	2,265	159,694.8	2,145	135,177.8

1 Including domestic bills bought in open market operations under repurchase agreements

The average value of the bills purchased in the year under review was DM 63,017 compared with DM 70,503 in the preceding year.

Of the bills purchased, the following were returned and charged, in the absence of payment, to the parties presenting them for rediscounting:

	1977		1978	
	Number	DM million	Number	DM million
	4,800	47.0	4,114	55.1
as % of the total purchased	0.21	0.03	0.19	0.04.

Discount rate

During the whole of 1978 the discount rate for domestic and foreign bills stood unchanged at 3 %.

Prime bankers' acceptances

The amount of prime bankers' acceptances which the Bank is prepared to purchase in the course of its open market operations was increased from DM 1.8 billion to DM 2.0 billion with effect from July 1, 1978. Owing to this raising of the ceiling and the continued relatively favourable buying rates of the Bank (which were not changed during 1978) compared with the money market rates, the Bank's purchases of prime bankers' acceptances — as usual, only from the Privatdiskontgesellschaft-Aktiengesellschaft — again distinctly exceeded the previous year's figure (DM 6,922.5 million against DM 5,641.9 million in 1977).

Resales from the Bank's portfolio via the broker to the market (DM 669.9 million) were larger than a year before (DM 418.8 million); together with direct sales to a public authority amounting to DM 550.0 million the Bank resold a total of DM 1,219.9 million from its portfolio.

As a result, slightly more prime bankers' acceptances than in 1977 remained in the Bank's portfolio until payment on maturity, namely DM 5,444.4 million against DM 5,046.5 million in the previous year. At December 31, 1978 the Bank held prime bankers' acceptances stemming from open market operations amounting to DM 1,755.3 million (end-1977: DM 1,497.1 million).

Open market operations in bills under repurchase agreements

In order to ease particular tensions in the money market the Bank conducted open market operations in bills under repurchase agreements between March 13 and June 16, 1978. In the course of these operations the Bank purchased trade bills at market rates outside the rediscount quotas on condition that the banks submitting the bills simultaneously repurchased them forward. The largest amount of bills held by the Bank as a result of such operations was DM 4,927.5 million (on May 12, 1978). The market rate for open market operations under repurchase agreements was $3^1/_4$ %.

Lombard loans

Taking the average of all the return dates of the year under review, the Bank granted DM 2,251 million of lombard loans to banks (1977: DM 1,974 million). As in preceding years, such loans were subject to marked fluctuations, the largest amounts being granted in March and between May and July.

Lombard loans in the Land Central Bank areas

DM million

	Lombard loans granted		Outstanding at	
Land Central Bank	1977	1978	Dec. 31, 1977	Dec. 31, 1978
Baden-Württemberg	17,065.9	22,820.6	1,600.9	1,491.4
Bavaria	10,616.2	9,882.7	189.5	285.1
Berlin	968.6	1,441.3	—	5.0
Bremen	1,148.4	1,626.4	1.5	—
Hamburg	7,991.0	7,276.4	145.6	271.2
Hesse	91,824.6	100,761.4	2,308.5	2,775.5
Lower Saxony	6,997.1	8,481.3	245.7	352.1
North Rhine-Westphalia	17,964.6	21,368.1	941.2	775.3
Rhineland-Palatinate	4,269.9	6,320.9	65.7	155.4
Saarland	843.8	764.5	30.4	34.2
Schleswig-Holstein	4,312.1	4,290.4	29.9	19.6
Total	164,002.2	185,034.0	5,558.9	6,164.8

Lombard rate

During the year under review the lombard rate stood unchanged at $3^1/_2$ %.

Cash advances (book credits)

Section 20 (1) 1 of the Bundesbank Act lays down the following credit ceilings:

	DM million
for the Federal Government	6,000
for the Federal Railways	600
for the Federal Post Office	400
for the Equalisation of Burdens Fund	200
for the ERP Special Fund	50

for the Länder Governments DM 40 per inhabitant; for Berlin, Bremen and Hamburg DM 80 per inhabitant.

Treasury bills which the Bank holds in its portfolio or which it has undertaken to purchase are to be counted towards the credit ceilings in addition to the book credits.

Federal Government Equalisation of Burdens Fund Länder Governments

Cash advances (book credits) outstanding

DM million

Borrower	December 31, 1977	December 31, 1978
Federal Government	822.4	–
Länder Governments		
Berlin	30.2	–
Bremen	–	30.4
Hamburg	–	125.3
Schleswig-Holstein	52.1	–
Total	904.7	155.7

At December 31, 1978, just as in the preceding year, no cash advances (book credits) to the Equalisation of Burdens Fund were outstanding.

Federal Railways Federal Post Office

No book credits to the Federal Railways or Federal Post Office were outstanding at December 31, 1978; such credits are to be shown together with claims arising from the purchase of Treasury bills and discountable Treasury bonds in the item "Loans to the Federal Railways and Federal Post Office" on the assets side.

Interest rate

Throughout the year the rate of interest on book credits was identical with the Bank's discount rate.

Treasury bills and discountable Treasury bonds

The Bank was again very active as the selling agent for the discountable Treasury bonds of the Federal Government and its special funds. These securities, which serve financing purposes, are distinct from the mobilisation and liquidity paper issued pursuant to sections 42 and 42 (a) of the Bundesbank Act, which will be reported on below. No Treasury bills serving financing purposes were issued during the year under review.

No public authority money market paper was held by the Bank during the year under review.

Federal Government

To meet the borrowing requirements of the Federal Government, discountable Treasury bonds amounting to DM 4,299.8 million (1977: DM 5,270.5 million) were issued. As usual, the bulk of these securities were purchased by banks and — albeit on a much smaller scale — other institutional investors. When selling these bonds the Bank again in part used the tender procedure. For the 2-year discountable Treasury bonds issued by tender between April 27 and May 2, 1978 this procedure was modified in so far as no "maximum discount" up to which bids could be made was specified. The requirement that the bidders should thus fix the discount without any guidance from the issuer evidently did not lessen the desire to participate. The tender yielded DM 1,517.2 million, and thus a similar amount to preceding tenders.

Just over one fifth (DM 937.1 million) of the total sales of Federal Government discountable Treasury bonds consisted of a special type, Federal "financing bonds", which since February 1975 have been sold in a standardised manner to non-banks, mostly through banks (but also by the Bank direct), as securities that are not returnable prior to maturity.

After the redemption of DM 4,244.4 million (1977: DM 4,662.1 million) of discountable Treasury bonds (including financing bonds), the amount of Federal Government discountable Treasury bonds types "B" and "BN" (the latter not being returnable prior to maturity) outstanding at December 31, 1978 came to DM 8,575.4 million (end-1977: DM 8,520.0 million). Of this total, DM 1,408.2 million was repurchasable by the Bank (type "B").

Federal Railways

The (returnable) discountable Treasury bonds of the German Federal Railways (type "Ba") which fell due in 1978 were reissued (DM 100.0 million). The securities of the German Federal Railways which are not returnable before maturity (type "BaN") outstanding at end-1977 were redeemed (DM 10.1 million). The amount of Federal Railways discountable Treasury bonds (Type "Ba") outstanding at end-1978 came to only DM 400.0 million.

Federal Post Office

In the year under review the German Federal Post Office again refrained from issuing any discountable Treasury bonds; at end-1978 no such bonds of the Federal Post Office were outstanding.

At December 31, 1978 the outstanding amount of money market paper issued for the account of the Federal Government and its special funds came to DM 8,975.4 million (end-1977: DM 8,930.1 million). Further details are given in the following table.

Money market paper issued for the account of the Federal Government and its special funds

DM million

Type of paper	Outstanding at Dec. 31, 1977	1978 Issued	1978 Redeemed	Outstanding at Dec. 31, 1978
Discountable Treasury bonds of the Federal Republic of Germany "B" **1** and "BN" **2**	8,520.0	4,299.8	4,244.4	8,575.4
of which "Financing bonds"	(1,248.2)	(937.1)	(542.9)	(1,642.4)
Discountable Treasury bonds of the German Federal Railways "Ba" and "BaN" **2**	410.1	100.0	110.1	400.0
Total	8,930.1	4,399.8	4,354.5	8,975.4

1 The letter "B" serves to distinguish these bonds from mobilisation and liquidity paper. — **2** The letters "BN" and "BaN" denote securities which may not be returned prior to maturity.

Länder Governments

With respect to Länder Government money market paper, the discountable Treasury bonds of one Land Government still outstanding at the beginning of 1978 (DM 50.0 million) were redeemed; no new securities were issued.

Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin

Equalisation claims

The Bank's equalisation claims on the Federal Government, as inscribed in the government stock register at December 31, 1977, increased by DM 8,997.48 The change of DM 7,842.79 in the equalisation claims arising from the Bank's own conversion account is explained in the combined conversion account of the institutions amalgamated to form the Deutsche Bundesbank as shown by the books at December 31, 1978, which account is attached to the German original of this Report as Appendix 1.

Non-interest-bearing debt certificate

In 1978 the Bank's claim on the Federal Government in respect of the currency conversion in Berlin remained unchanged at DM 547.2 million.

Equalisation claims and non-interest-bearing debt certificate in respect of Berlin in 1978

DM thousand

Type of paper	Outstanding at December 31, 1977	Increase/ Decrease in 1978	Outstanding at December 31, 1978
Equalisation claims arising from			
Own conversion account			
Bank deutscher Länder	5,504,423.9	− 2.4	5,504,421.5
Land Central Banks	2,599,344.7	− 5.5	2,599,339.2
	8,103,768.6	− 7.9	8,103,760.7
Conversion of Berlin pre-capitulation balances	31,172.2	+ 16.4	31,188.6
Conversion of RM balances at banks in the Eastern Sector of Berlin	1,464.2	+ 0.5	1,464.7
	8,136,405.0	+ 9.0	8,136,414.0
Non-interest-bearing debt certificate	547,168.5	—	547,168.5
Total	8,683,573.5	+ 9.0	8,683,582.5

Loans to the Federal Railways and Federal Post Office

As in the preceding year, no loans to the Federal Railways or Federal Post Office were outstanding at December 31, 1978. See also the notes on the items "Cash advances (book credits)" and "Treasury bills and discountable Treasury bonds".

Securities

The Bank's portfolio of securities — chiefly bonds of the Federal Republic of Germany, the German Federal Railways and the German Federal Post Office — increased by DM 3,525.1 million on balance in the year under review to DM 4,217.6 million as a result of open market operations (end-1977: DM 692.5 million).

Issue of bonds

In 1978 fifteen bond issues totalling DM 9,250 million (1977: nine issues amounting to DM 7,450 million) were launched through the Federal Bond Consortium, which is under the direction of the Bank. Of this total, DM 1,750 million (1977: DM 1,600 million) was reserved for the issuers' own institutions and for price support operations.

At end-1978 the outstanding amount of bonds of the Federal Republic of Germany came to DM 31,053.8 million (end-1977: DM 27,439.4 million), that of the German Federal Railways to DM 13,833.1 million (end-1977: DM 12,369.6 million) and that of the German Federal Post Office to DM 8,490.8 million (end-1977: DM 8,886.2 million).

Bond issues of the Federal Republic of Germany and the German Federal Railways in 1978

Issuer	Amount issued in DM million: Total	of which sold through Federal Bond Consortium	Terms: Nominal interest rate (%)	Period to maturity in years	Issue price (%)	Yield (%)	Start of sales
German Federal Railways	850	650	6	12	100	6.00	Jan. 16
Federal Republic of Germany	800	600	5½	8	99.75	5.54	Feb. 14
Federal Republic of Germany	500	400	6	15	99.75	6.03	Feb. 14
Federal Republic of Germany	500	400	5	6	100	5.00	Apr. 13
Federal Republic of Germany	500	400	5¼	8	99.50	5.33	Apr. 13
Federal Republic of Germany	500	400	5¾	12	100	5.75	Apr. 13
German Federal Railways	750	600	6	10	99	6.14	June 14
Federal Republic of Germany	900	800	6	6	99	6.20	Sep. 4
Federal Republic of Germany	500	400	6½	10	99	6.64	Sep. 4
German Federal Railways	550	450	6	6	99.50	6.10	Oct. 26
Federal Republic of Germany	700	600	6	6	99.50	6.10	Nov. 27
Federal Republic of Germany	500	400	6½	10	99	6.64	Nov. 27
Federal Republic of Germany	1,000	800	6¼	6	100	6.25	Dec. 28
Federal Republic of Germany	350	300	6½	8	99.50	6.58	Dec. 28
Federal Republic of Germany	350	300	6¾	10	100	6.75	Dec. 28

Issue of Federal savings bonds

With the assistance of the Bank DM 3,161.0 million (gross) of Federal savings bonds were sold to private investors through banks and to a certain extent by the Bank itself in 1978 (1977: DM 7,617.4 million). In the course of the year under review the rate of interest paid on Federal savings bonds was reduced twice to bring it into line with market rates, and later on raised in accordance with market trends.

In the year under review DM 22.6 million of Federal savings bonds from former tranches were resold to the issuer prior to maturity (1977: DM 23.2 million), and a further DM 335.0 million were redeemed on maturity. The amount of Federal savings bonds outstanding rose from DM 21,988.4 million (end-1977) to DM 24,791.8 million at December 31, 1978.

Gross sales, interest rates and yields of Federal savings bonds in 1978

Issues	Sales period 1978	Gross sales in DM million: Total	Federal savings bonds A 1	Federal savings bonds B 2	Interest rate in (%), and yield (%) after, ... year after issue: 1st year	2nd	3rd	4th	5th	6th	7th
1978/1+2	Jan. 11 – March 10	1,468.3	840.8		3.50	4.75	5.25	5.75	6.00	6.50	
					3.50	4.11	4.47	4.77	4.99	5.21	
				627.5	3.50	4.75	5.25	5.75	6.00	6.50	6.50
					3.50	4.12	4.50	4.81	5.05	5.29	5.46
1978/3+4	March 20 – Sep. 11	1,063.6	584.1		3.25	4.50	5.00	5.50	5.75	6.25	
					3.25	3.86	4.23	4.52	4.74	4.96	
				479.5	3.25	4.50	5.00	5.50	5.75	6.25	6.25
					3.25	3.87	4.25	4.56	4.80	5.04	5.21
1978/5+6	Sep. 12 – Dec. 29	629.1	319.7		3.25	5.00	5.50	6.25	6.50	6.75	
					3.25	4.11	4.55	4.94	5.22	5.44	
				309.4	3.25	5.00	5.50	6.25	6.50	6.75	6.75
					3.25	4.12	4.58	4.99	5.29	5.53	5.71
Total	Jan. 2 – Dec. 29	3,161.0	1,744.6	1,416.4							

1 With annual payment of interest. – **2** With accrual of interest.

Issue of medium-term notes

Through the agency of the Bank, DM 8,207.4 million of Treasury bonds (medium-term notes) of the Federal Republic of Germany were sold by tender in five tranches in 1978 (1977: DM 8,451.4 million in four tranches). There were nine issues running for three and four years and bearing nominal interest rates of between 4% and 6%, as shown in more detail in the following table.

Treasury bonds (medium-term notes) of the Federal Republic of Germany issued by tender in 1978

Amount DM million	Nominal interest rate %	Running for ... years	Selling price %	Yield on issue %	Month of sale
1,015.3	4	3	99.10	4.33	March
686.4	4¼	4	98.80	4.59	
1,393.2	5	3	99.90	5.04	June
1,309.2	5¼	4	99.90	5.28	
626.6	5¾	3	98.90	6.16	August
388.3	6	4	98.50	6.44	
2,057.5	5½	4	99.70	5.59	September
500.1	5¼	3	98.60	5.77	November
230.8	5¾	4	99	6.04	

In addition, with the agreement of the Bank DM 500 million of Treasury bonds (medium-term notes) of the Federal Republic of Germany were sold without using the tender procedure (1977: DM 1,295 million of medium-term notes of the Federal Republic of Germany and the German Federal Railways).

At the end of 1978 the outstanding amount of medium-term notes of the Federal Republic of Germany came to DM 24,358.3 million (end-1977: DM 18,897.4 million) and that of the German Federal Railways to DM 995.0 million (end-1977: DM 1,395.0 million); no medium-term notes of the German Federal Post Office were outstanding at the end of 1978 (end-1977: DM 50.0 million).

Admission to stock exchange dealing

The Bank introduced the above-mentioned bond issues of the Federal Republic of Germany and the German Federal Railways together with an issue of the Equalisation of Burdens Bank to official dealing on all German stock exchanges. The Bank also introduced five tranches of medium-term notes of the Federal Republic of Germany issued in the previous year and fourteen tranches issued in the year under review to regulated unofficial dealing on the Frankfurt stock exchange.

Price support operations

In the year under review, as in preceding years, the Bank conducted price support operations for the account of the issuers on the eight German stock exchanges in respect of the bonds issued by the Federal Government and its special funds, one Land Government, the Reconstruction Loan Corporation and the Equalisation of Burdens Bank, in order to smooth out price fluctuations.

The Bank as paying and collecting agent for bonds

As the paying and collecting agent for, in particular, bonds of the Federal Government (including external bonds) and its special funds, the Bank paid 5,749,151 interest coupons and matured bonds during the year under review (1977: 7,135,542). Of these, 399,974 interest coupons and matured bonds were presented to foreign agents for payment (1977: 445,888).

German coins

The amount of German coins held by the Bank came to DM 698.3 million at end-1978 (end-1977: DM 810.0 million). In 1978 the Federal Government was credited with DM 387.4 million for coins taken over from the Mints and debited with DM 19.2 million for coins no longer fit for circulation (including about DM 15.0 million for silver DM 5 coins, which have been withdrawn from circulation). Altogether, between 1948 and 1978 the Bank — acting for the account of the Federal Government — took over coins amounting to DM 8,897.6 million and redeemed DM 1,621.8 million of coins which were no longer fit to circulate or had been called in.

The total amount of coins in circulation at the end of 1978 (DM 6,577.5 million) divided by the number of inhabitants of the Federal Republic of Germany including the Land of Berlin on September 30, 1978 (61.3 million) yields a coin circulation of DM 107.30 per head of population (1977: DM 99.31).

In the year under review the DM 5 commemorative coins "Gustav Stresemann" and "Balthasar Neumann" were put into circulation.

Balances on postal giro accounts

The postal giro account balances, including the branches' transfers in transit to the postal giro account of the Bank (Central Office) at Frankfurt am Main, amounted to DM 1,214.3 million at December 31, 1978 (1977: DM 998.8 million). The Bank's credit balances on that account and on the postal giro account of the Land Central Bank in Berlin, other than those required for current payments, are offset daily, in rounded amounts, against the giro balances of the Central Cash Office of the Federal Post Office and the Berlin (West) Postal Giro Office.

Postal giro transactions with third parties

	1977				1978			
	Transfers received from third parties		Transfers made to third parties		Transfers received from third parties		Transfers made to third parties	
Area	Number	DM million	Number	DM million	Number	DM million	Number	DM million
Land Central Bank								
Baden-Württemberg	90,163	19,491.4	19,840	1,928.8	72,900	17,496.4	10,116	1,625.1
Bavaria	64,439	10,067.0	13,198	6,306.5	58,147	10,933.6	11,948	6,072.6
Berlin	26,722	2,648.6	3,405	889.5	20,952	2,705.1	3,286	910.5
Bremen	10,380	536.3	1,811	0.2	8,024	455.6	1,893	0.2
Hamburg	61,741	16,153.9	2,398	123.4	58,958	17,323.7	1,824	122.9
Hesse	58,855	7,193.1	9,143	4,669.2	49,075	7,832.9	7,762	5,109.1
Lower Saxony	61,769	6,755.4	5,725	1,363.8	61,094	6,446.6	5,566	1,580.7
North Rhine-Westphalia	117,683	19,163.4	21,624	5,196.7	112,985	19,206.1	26,675	5,207.9
Rhineland-Palatinate	28,266	1,964.3	7,042	775.5	27,960	1,985.5	8,687	914.3
Saarland	5,909	1,700.1	948	0.4	6,546	1,712.7	600	0.2
Schleswig-Holstein	5,109	57.7	2,593	0.4	5,289	51.2	3,477	0.6
Total	531,036	85,731.2	87,727	21,254.4	481,930	86,149.4	81,834	21,544.1
Bundesbank — Central Office —	22,472	1,479.3	1,966	6.8	31,088	1,766.6	1,648	5.0
Grand total	553,508	87,210.5	89,693	21,261.2	513,018	87,916.0	83,482	21,549.1

Other claims

Other claims are shown at DM 1,170.7 million (end-1977: DM 1,191.6 million). They include the balance arising from intra-German settlements (commercial payments under the "Berlin Agreement"), which amounted to DM 795.0 million (1977: DM 659.8 million). The turnover on the relevant sub-accounts is shown in Part A IV of the German original of this Report.

Land and buildings

After additions totalling DM 111.3 million and depreciation totalling DM 50.4 million, land and buildings are shown at DM 843.3 million.

Furniture and equipment

The balance sheet value of furniture and equipment amounts to DM 50.1 million after additions totalling DM 35.3 million and depreciation totalling DM 20.8 million.

Items in course of settlement

The "Items in course of settlement" mainly comprise the intercity credit and debit transfers proceeding inside the Bank at the end of the year and the cheques and direct debit orders being cleared. At December 31, 1978 the balance of items in course of settlement stood at DM 6,718.7 million (end-1977: DM 3,349.2 million).

Other assets

The "Other assets" are shown at DM 1,309.4 million (end-1977: DM 1,131.6 million). As in the previous year, much the greater part of this amount consisted of interest due in 1979 but assignable to the profit and loss account for the year under review on funds invested abroad and on securities (DM 1,211.2 million against DM 1,041.6 million at end-1977).

This item also includes the Bank's 30% share, amounting to DM 75 million, in the capital of the Liquidity Consortium Bank of Frankfurt am Main (set up as a private limited company). The provision included in the articles of association of that bank that, if necessary, further capital is to be paid up in proportion to the existing share entails for the Bank a maximum commitment of DM 225 million.

Prepaid expenses and deferred income

The prepaid expenses and deferred income comprise salary and pension payments made in the year under review but relating to 1979.

Balancing item in respect of the valuation adjustment of the monetary reserves and other foreign currency positions — accumulated loss —

See the notes on page 76 of this Report.

Liabilities

Bank notes in circulation

The amount of bank notes in circulation rose from DM 65,567.4 million at end-1977 to DM 74,799.1 million at December 31, 1978.

Currency in circulation

DM million

End of	Bank notes	Federal coins	Currency in circulation, total
1973	46,246.9	4,727.6	50,974.5
1974	50,272.5	5,128.8	55,401.3
1975	55,143.2	5,406.3	60,549.5
1976	59,038.3	5,699.8	64,738.1
1977	65,567.4	6,097.6	71,665.0
1978	74,799.1	6,577.5	81,376.6

The denominations of the bank notes and Federal coins in circulation are shown in Appendix 4 to the German original of this Report.

In the year under review the Bank again took over Bundesbank notes of various denominations from the printing offices and put them into circulation or made them ready for that purpose.

The bank notes (including small money tokens) destroyed as being no longer fit for circulation or after having been called in amounted to:

	1973	1974	1975	1976	1977	1978
Number (millions)	460.1	424.0	399.4	486.4	459.1	560.9
Value (DM million)	16,528.0	15,638.0	15,110.5	18,556.5	18,086.2	22,682.1.

The number and value of the counterfeit bank notes detained in payments in the Federal Republic of Germany and Berlin (West) decreased by more than a third against the preceding year owing to a decline in the number of counterfeit DM 100 notes detained. The rise in the amount of counterfeit Federal coins detected was caused by an increase in the use of such counterfeits in vending machines.

Counterfeits detected

	Bank notes		Federal coins	
Year	Number	DM thousand	Number	DM thousand
1973	1,090	65.4	10,077	34.0
1974	881	59.4	8,181	28.6
1975	927	92.3	14,151	65.0
1976	2,709	275.0	8,249	31.0
1977	9,754	946.0	6,754	25.7
1978	6,341	586.4	9,835	35.5

Deposits of banks

The banks' deposits on giro accounts mainly comprise the minimum reserves to be maintained with the Bank. The sub-item "Other" contains deposits of domestic banks on U.S. dollar accounts; the number of transfers between these accounts amounted to 92,838 in the year under review against 87,368 in the previous year. Compared with end-1977 the deposits are shown as follows:

	Dec. 31, 1977 DM million	Dec. 31, 1978 DM million
Deposits on giro accounts	52,464.2	59,338.0
Other	27.1	28.1
	52,491.3	59,366.1.

Deposits of public authorities

The item "Deposits of public authorities" is composed of public authorities' current balances.

Compared with end-1977 the deposits are shown as follows:

	Dec. 31, 1977 DM million	Dec. 31, 1978 DM million
Federal Government	296.3	2,384.3
Equalisation of Burdens Fund and ERP Special Fund	150.1	162.7
Länder Governments	1,629.4	2,027.6
Other public depositors	44.3	56.7
	2,120.1	4,631.3.

Deposits of other domestic depositors

The deposits of other domestic depositors are made up as follows:

	Dec. 31, 1977 DM million	Dec. 31, 1978 DM million
Federal Railways	6.8	6.5
Federal Post Office (including postal giro and postal savings bank offices)	3,418.7	3,515.4
Other depositors	479.2	564.7
	3,904.7	4,086.6.

Giro transactions, simplified cheque and direct debit collections

In the turnover on giro accounts, the percentage of cashless settlements was:

	Number	Amount
1977	99.84	98.13
1978	99.86	98.27.

Annual turnover on the giro accounts of the Bank

Turnover	1977 Number of transactions	1977 Total amount	1977 Average amount	1978 Number of transactions	1978 Total amount	1978 Average amount
	Thousands	DM million	DM thousand	Thousands	DM million	DM thousand
(a) Credits						
Cash payments	1,131	180,390	159.5	1,095	182,594	166.8
Clearings with account-holders	11,197	2,838,823	253.5	1 5,119	3,094,342	604.4
Local transfers	35,902	2,808,280	78.2	33,394	3,127,542	93.7
Intercity transfers	166,163	2,814,467	16.9	177,138	3,088,775	17.4
Cheque and direct debit collections (total presented)	587,740	1,234,617	2.1	694,377	1,371,696	2.0
Total	802,133	9,876,577	—	911,123	10,864,949	—
(b) Debits						
Cash payments	1,496	190,131	127.1	1,472	194,141	131.9
Clearings with account-holders	3,859	2,790,272	723.2	3,063	3,027,429	988.4
Local transfers	35,902	2,808,280	78.2	33,394	3,127,542	93.7
Intercity transfers	169,221	2,862,092	16.9	182,883	3,138,060	17.2
Cheque and direct debit collections (total paid)	581,319	1,233,885	2.1	672,821	1,367,250	2.0
Total	791,797	9,884,660	—	893,633	10,854,422	—
(c) Percentage of total turnover (credits and debits)		%			%	
Cash payments		1.87			1.73	
Clearings with account-holders		28.49			28.19	
Local transfers		28.42			28.80	
Intercity transfers		28.73			28.67	
Cheque and direct debit collections (total presented and paid)		12.49			12.61	
		100.00			100.00	

1 Since 1978 individual vouchers included in summary vouchers have not been counted as separate transactions.

The annual turnover on the giro accounts of the Bank again went up steeply compared with the previous year. This is mainly because of the increase of about 18% during the year under review (1977: about 17%) in the number of items presented by the banks under the simplified collection procedure for cheques and direct debit orders and the rise of some 8 % in the number of intercity transfers. The sharp increase (of about 19 %) in 1977 in the number of local transfers outside the clearing system did not continue in the year under review; in fact, the number of such transfers fell by some 7 %. By contrast, the number of local transfers inside the clearing system grew, implying a reorganisation.

The percentage of automatically processed intercity transfers continued to rise. In the year under review 93 % (1977: 88 %) of the 443 million items presented for collection and 77 % (1977: 71 %) of the 115 million credit transfers, as well as 251 million direct debits (1977: 181 million) and 68 million credit transfers (1977: 46 million) recorded on magnetic tape, were handled by the Bank's computer centres. The volume of payments executed through the paperless exchange of data media was approximately 40 % larger than in the preceding year. Such payments thus accounted for 39 % (1977: 34 %) of the payment items presented under the automated procedure. In the aggregate, 93 % of intercity transfers — paper-based as well as paperless — were processed automatically in the year under review. The development of the automation of intercity transfers since 1973 is shown in the following table.

Automation of intercity transfers

	Collection orders presented							Intercity credit transfers despatched						
		processed							processed					
		in paper-based operations							in paper-based operations					
	Total	conventional		automated		through the paperless exchange of data media		Total	conventional		automated		through the paperless exchange of data media	
Year	millions	millions	%	millions	%	millions	%	millions	millions	%	millions	%	millions	%
1973	317	175	55	142	45	—	—	113	113	100	—	—	—	—
1974	374	142	38	232	62	0.2	0	123	75	61	48	39	0.1	0
1975	423	143	34	272	64	8	2	163	85	52	73	45	5	3
1976	501	83	17	313	62	105	21	174	62	36	83	48	29	16
1977	587	47	8	359	61	181	31	169	36	21	87	51	46	28
1978	694	31	5	412	59	251	36	183	26	14	89	49	68	37

If local payments and clearing transactions, which are not yet processed automatically, are also included, about 63 % of the cashless payments at the Bank are automated.

As a result of the further automation, the concentration of the incoming items continued in 1978. The number of items debited in collections declined further from 21 million to 19 million and the number of items credited in credit transfers decreased from 19 million to 18 million. Since 1973 the number of items debited in collections has thus fallen from 99 million to 19 million, in spite of the simultaneous increase from 317 million to 694 million in the number of items presented.

Domestic commission business

Domestic bills, cheques, etc. were acquired on a commission basis as follows:

	Number	DM million
1977	67,416	744.6
1978	65,532	706.2.

Liabilities arising from mobilisation and liquidity paper sold

In the year under review sales of mobilisation and liquidity paper pursuant to sections 42 and 42 (a) of the Bundesbank Act were in the aggregate — i. e. taking Treasury bills and discountable Treasury bonds together — substantially larger than in the preceding year, at DM 30,129.0 million against DM 18,862.6 million. This increase in sales was chiefly due to mobilisation and liquidity Treasury bonds, DM 9,240.8 million of which were sold (1977: DM 537.1 million). The amount of mobilisation and liquidity Treasury bonds outstanding rose to DM 8,980.8 million at December 31, 1978 (end-1977: DM 2,478.0 million), DM 2.738.0 million of such securities having matured.

The turnover of mobilisation and liquidity Treasury bonds did not change radically in the year under review. The amount outstanding went up by nearly half to DM 4.2 billion (end-1977: DM 2.9 billion) owing to sales totalling DM 20.9 billion (1977: DM 18.3 billion) and redemptions totalling DM 19.6 billion (1977: DM 18.3 billion). As usual, the revolving investment of funds of foreign institutions was a prominent feature of these transactions.

The liabilities arising from mobilisation and liquidity paper outstanding amounted to DM 13,204.6 million at December 31, 1978 against DM 5,366.1 million at end-1977.

Mobilisation and liquidity paper sold and redeemed

DM million

Type of paper	1977 Outstanding at December 31	1978 Sold	Redeemed	Outstanding at December 31
Treasury bills (running for up to 90 days)	2,888.1	20,888.2	19,552.5	4,223.8
Discountable Treasury bonds (running for 6 to 24 months)	2,478.0	9,240.8	2,738.0	8,980.8
Total	5,366.1	30,129.0	22,290.5	13,204.6

Liabilities arising from foreign business

At December 31, 1978 the liabilities arising from foreign business, at DM 4,544.4 million compared with DM 489.0 million at end-1977, were almost ten times as large as a year before. This increase owed much to the fact that, as part of the programme of November 1, 1978 to stabilise the balance of payments, the U.S. monetary authorities acquired substantial Deutsche Mark balances through drawings in the IMF, by selling special drawing rights to the Bank and by issuing Treasury Notes denominated in Deutsche Mark in Germany, and deposited the bulk of these balances at the Bank. Specifically, the liabilities arising from foreign business are made up as follows:

	Dec. 31, 1977 DM million	DM million	Dec. 31, 1978 DM million	DM million
Deposits of foreign depositors				
Banks	408.2		4,092.1	
Other depositors	67.0	475.2	439.3	4,531.4
Liabilities to the European Monetary Cooperation Fund		—		—
Other				
Provision of cover for credits of				
non-residents	2.1		2.9	
residents	11.6		9.6	
	13.7		12.5	
Miscellaneous liabilities	0.1	13.8	0.5	13.0
		489.0		4,544.4.

No liabilities to the European Monetary Cooperation Fund were outstanding at the end of 1978, as at end-1977. Regarding the claims outstanding at December 31, 1978, see the notes on item 4 on the assets side on page 60 of this Report.

Counterpart of special drawing rights allocated

The counterpart of the special drawing rights allocated by the International Monetary Fund and shown on the assets side in sub-item 2.3 corresponds to the allocations of SDRs to the Federal Republic of Germany between 1970 and 1972 totalling SDR 542.4 million.

Provisions

Provision for pensions

DM 111.1 million was withdrawn from the provision for pensions in order to pay pensions and widows' and orphans' allowances. After an increase of DM 151.1 million this provision amounted to DM 1,685.0 million at December 31, 1978 against DM 1,645.0 million at end-1977.

Other provisions

The provision for hazards inherent in domestic and foreign business remained unchanged at DM 300 million.

Other liabilities

The other liabilities are shown at DM 116.5 million against DM 104.5 million at end-1977.

Deferred expenses and accrued income

Deferred expenses and accrued income amounted to DM 691.2 million at December 31, 1978 (end-1977: DM 255.3 million). As before, this item mainly comprises interest received in the year under review, but relating to the following year, on domestic and foreign bills and U.S. Treasury Notes.

Capital

The capital of the Bank amounts to DM 290 million; it is held by the Federal Government (section 2 of the Bundesbank Act).

Reserves

The legal reserves and other reserves remained unchanged at DM 969.0 million and DM 130.5 million, respectively.

Contingent liabilities and claims

The contingent liabilities and claims amounted to DM 0.7 million against DM 1.0 million at end-1977.

Profit and loss account

Comparison of expenditure and receipts

DM million

Expenditure	1977	1978	Receipts	1977	1978
			Interest received		
Interest paid on mobilisation and liquidity paper	119.4	683.4	Funds invested abroad	4,332.8	5,270.5
Other interest paid	5.3	18.4	Loans to domestic banks	709.0	670.4
	124.7	701.8	Equalisation claims	244.1	244.1
Administrative expenditure			Securities	71.3	194.5
Staff costs	525.6	546.3	Cash advances (book credits)	28.5	8.0
Other	103.4	108.7			
Note printing	102.0	121.8	Other interest received	2.6	2.6
Depreciation	62.8	71.2		5,388.3	6.390.1
Increase in the provision for pensions	164.4	151.1	Fees received	9.3	12.1
Pension payments in respect of the Reichsbank	35.5	34.6	Gains from the write-up of gold	–	2,988.5
Other expenditure	17.1	122.3	Other receipts	64.9	86.8
Write-downs of monetary reserves and other foreign currency positions	7,880.2	10,574.9	Loss for the year	3,553.2	2,955.2
Total	9,015.7	12,432.7	Total	9,015.7	12,432.7

Before allowing for the valuation adjustment of the external positions at the end of the year (write-downs of monetary reserves and other foreign currency positions and the write-up of gold), receipts exceeded expenditure by DM 4,631.2 million in 1978 (1977: DM 4,327.0 million).

Interest

	1977 DM million	1978 DM million
Interest received amounted to	5,388.3	6,390.1;
after deduction of interest paid, namely	124.7	701.8,
interest is shown in the profit and loss account at	5,263.6	5,688.3.

In the year under review total interest income, at DM 6,390.1 million, was DM 1,001.8 million larger than a year before. The interest received from funds invested abroad went up by DM 937.7 million to DM 5,270.5 million owing to rising interest rates and growing investments. Interest income from lending to domestic banks — domestic bills, lombard loans and foreign bills bought in Germany — fell by DM 38.6 million to DM 670.4 million. The interest received from securities increased by DM 123.2 million to DM 194.5 million because of the larger average security portfolio during the year under review. The interest accruing from equalisation claims remained unchanged at DM 244.1 million. Other interest income decreased by DM 20.5 million to DM 10.6 million as a result of the smaller recourse to cash advances.

The interest paid, at DM 701.8 million, rose by DM 577.1 million compared with the preceding year. DM 683.4 million (1977: DM 119.4 million) was paid on Treasury bills and discountable Treasury bonds of the Federal Government (mobilisation and liquidity paper pursuant to sections 42 und 42(a) of the Bundesbank Act), sales of which in 1978 were substantially larger than in 1977.

Fees

Fees totalling DM 12.1 million were received in the year under review (1977: DM 9.3 million).

Gains from the write-up of gold

The write-up of gold, which reversed write-downs made in former years, amounted to DM 2,988.5 million; see also the notes on page 59 of this Report.

Other receipts

At DM 86.8 million, the other receipts are shown DM 21.9 million larger than at end-1977.

Expenditure

Administrative expenditure
Staff costs

Administrative expenditure on personnel rose by DM 20.7 million compared with the previous year to DM 546.3 million. This was mainly because of statutory or negotiated pay rate increases for established employees ("officials") and unestablished salary and wage earners and the rise in the Bank's staff during the year under review.

On January 1, 1979 the Bank employed 13,658 persons. The decrease in staff recorded in recent years came to an end on the conclusion of the first phase of automation, particularly the automation of cashless payments. For the first time since 1973 the number of staff went up, namely by 451 compared with January 1, 1978. This rise was mainly due to the increased recruitment of junior staff in line with the growth of the volume of work, but it also owed something to the greater security requirements of the Bank.

Payments to serving members of the Directorate of the Bank and the Central Bank Council amounted to DM 6,566,819.71 in the year under review. Former members of these bodies and of the Board of Directors and Board of Managers of the Bank deutscher Länder and the Managing Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 6,147,499.70.

Changes in staff regulations

In 1978 the Bank again concluded a number of new pay agreements for its wage and salary earners, thereby bringing their legal situation into line with that of the wage and salary earners of the Federal Government.

Staff of the Bank

	Beginning of 1978					Beginning of 1979				
				of whom					of whom	
	Central Office	Land Central Banks	Total 1	male	female	Central Office	Land Central Banks	Total 1	male	female
Officials	744	4,587	5,331	5,104	227	778	4,802	5,580	5,301	279
Salary earners	1,555	5,299	6,854	3,131	3,723	1,557	5,493	7,050	3,255	3,795
Wage earners	191	831	1,022	180	842	195	833	1,028	182	846
Total	2,490	10,717	13,207	8,415	4,792	2,530	11,128	13,658	8,738	4,920

1 of whom, working part time

	Beginning of 1978	Beginning of 1979
Officials, female	8	8
Salary earners	306	336
Wage earners	739	738

Other

Other (non-staff) administrative expenditure increased by DM 5.3 million to DM 108.7 million in the year under review.

Note printing

Expenditure on note printing amounted to DM 121.8 million against DM 102.0 million in the previous year.

Depreciation and increases in provisions

Depreciation of land and buildings and of furniture and equipment, and also increases in provisions, were discussed in connection with the respective balance sheet items.

Pension payments in respect of the Reichsbank

Payments to members of the former Deutsche Reichsbank and other persons to whom the Act Concerning Section 131 of the Basic Law applies, for whom the Bank is required to provide in accordance with section 41 of the Bundesbank Act, amounted to DM 34.6 million in the year under review (1977: DM 35.5 million).

Other expenditure

Other expenditure rose from DM 17.1 million in 1977 to DM 122.3 million in 1978. The increase is chiefly accounted for by the write-downs of the portfolio of securities required at the end of the year.

Write-downs of monetary reserves and other foreign currency positions

The valuation of the monetary reserves and other foreign currency positions necessitated write-downs totalling DM 10,574.9 million in the 1978 annual accounts (1977: DM 7,880.2 million).

Loss for the year

	DM million
After entering these write-downs of DM 10,574.9 million and the write-up of gold totalling DM 2,988.5 million in the profit and loss account, there remains a loss for the year of	2,955.2;
together with the balancing item brought forward from 1977 in respect of the valuation adjustment of the monetary reserves and other foreign currency positions — loss brought forward — of	6,597.9
there arises an accumulated loss to be carried forward to 1979 of	9,553.1.

This amount is shown on the assets side of the balance sheet in item 23 as the balancing item in respect of the valuation adjustment of the monetary reserves and other foreign currency positions — accumulated loss —.

Frankfurt am Main, April 1979

Deutsche Bundesbank
The Directorate
Dr. Emminger Pöhl
Dr. Emde Dr. Gleske Dr. Irmler Prof. Dr. Köhler Dr. Schlesinger Werthmöller

Part D: Report of the Central Bank Council

The annual accounts of the Deutsche Bundesbank for 1978, the combined conversion account of the institutions amalgamated to form the Deutsche Bundesbank as shown by the books at December 31, 1978, and the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1978, were audited by Treuarbeit Aktiengesellschaft Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft of Frankfurt am Main and Dr. Wollert — Dr. Elmendorff KG Wirtschaftsprüfungsgesellschaft of Düsseldorf, whom the Central Bank Council had appointed to be auditors in accordance with section 26 of the Bundesbank Act.

In their certificates of audit the auditors confirmed without qualifications that the annual accounts for 1978, the bookkeeping and the conversion account as shown by the books at December 31, 1978, complied with German law and that the Fund for the Purchase of Equalisation Claims had been properly administered.

The Central Bank Council approved the annual accounts for 1978 on April 12, 1979. At the same time it confirmed the conversion accounts for the Bank deutscher Länder and the Land Central Banks as well as the combined conversion account of the institutions amalgamated to form the Deutsche Bundesbank as shown by the books at December 31, 1978, and approved the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1978.

Since the publication of the Report for the Year 1977 the following changes have taken place in the Central Bank Council and the Directorate of the Deutsche Bundesbank:

Died

on January 18, 1979
the President of the Land Central Bank in Bavaria
Kurt Stadler.

Retired

as at the close of April 30, 1978
the Vice-President of the Land Central Bank in Bavaria
Erich Küspert,

as at the close of September 30, 1978
the Vice-President of the Land Central Bank in Saarland
Georg Lippert.

Appointed

with effect from May 1, 1978
Herbert Zimmer
to be Vice-President of the Land Central Bank in Bavaria,

with effect from October 1, 1978
Dr. Herwald Schmidt
to be Vice-President of the Land Central Bank in Saarland.

The Central Bank Council, acting also on behalf of the Directorate and of the Managing Boards of the Land Central Banks, expresses to the entire staff of the Deutsche Bundesbank its thanks for their loyal and understanding cooperation during 1978. The Council likewise wishes to record its appreciation of the excellent collaboration with the staff representative committees.

Frankfurt am Main, April 1979

Dr. Otmar Emminger
President of the Deutsche Bundesbank

Appendix to Part B

Balance sheet of the Deutsche Bundesbank as at December 31, 1978

Assets

	DM	DM	DM
1 Gold			17,082,502,613.86
2 Reserve position in the International Monetary Fund and special drawing rights			
2.1 Drawing rights within the reserve tranche		4,820,610,649.—	
2.2 Loans under special borrowing arrangements		3,043,002,763.03	
2.3 Special drawing rights		3,283,756,247.41	11,147,369,659.44
3 Balances with foreign banks and money market investments abroad			72,316,285,839.84
4 Claims on the European Monetary Cooperation Fund			2,251,095,832.73
5 Foreign notes and coins			16,946,956.84
6 External loans and other external assets			
6.1 Loans in connection with EEC medium-term monetary assistance		—	
6.2 Claims arising from foreign exchange offset agreements with the United States		1,636,387,031.16	
6.3 Other loans to foreign monetary authorities		276,883,200.—	
6.4 Loans to the World Bank		2,483,290,620.—	4,396,560,851.16
7 Foreign bills of exchange			1,684,632,473.74
8 Domestic bills of exchange			16,401,885,958.84
9 Lombard loans			6,164,844,400.—
10 Cash advances (book credits)			
10.1 Federal Government		—	
10.2 Equalisation of Burdens Fund		—	
10.3 Länder Governments		155,729,500.—	155,729,500.—
11 Treasury bills and discountable Treasury bonds			
11.1 Federal Government		—	
11.2 Länder Governments		—	—
12 Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			
12.1 Equalisation claims		8,136,414,008.50	
12.2 Non-interest-bearing debt certificate		547,168,481.20	8,683,582,489.70
13 Loans to the Federal Railways and Federal Post Office			
13.1 Cash advances (book credits)		—	
13.2 Treasury bills and discountable Treasury bonds		—	—
14 Securities			4,217,629,163.48
15 German coins			698,287,445.93
16 Balances on postal giro accounts			1,214,286,858.80
17 Other claims			1,170,640,601.57
18 Land and buildings			843,339,431.45
19 Furniture and equipment			50,132,177.—
20 Items in course of settlement			6,718,698,073.64
21 Other assets			1,309,409,184.28
22 Prepaid expenses and deferred income			29,016,456.12
23 Balancing item in respect of the valuation adjustment of the monetary reserves and other foreign currency positions — accumulated loss —			9,553,100,875.21
Rights of recourse in respect of contingent liabilities	707,224.88		
			166,105,976,843.63

	DM	DM	DM
1 Bank notes in circulation			74,799,147,565.—
2 Deposits of banks			
2.1 Deposits on giro accounts		59,337,960,390.85	
2.2 Other		28,104,578.77	59,366,064,969.62
3 Deposits of public authorities			
3.1 Federal Government		2,384,320,779.74	
3.2 Equalisation of Burdens Fund and ERP Special Fund		162,688,749.96	
3.3 Länder Governments		2,027,571,220.72	
3.4 Other public depositors		56,733,283.76	4,631,314,034.18
4 Deposits of other domestic depositors			
4.1 Federal Railways		6,487,900.80	
4.2 Federal Post Office (including postal giro and postal savings bank offices)		3,515,374,717.15	
4.3 Other depositors		564,745,647.57	4,086,608,265.52
5 Liabilities arising from mobilisation and liquidity paper sold			13,204,550,000.—
6 Liabilities arising from foreign business			
6.1 Deposits of foreign depositors		4,531,371,258.27	
6.2 Liabilities to the European Monetary Cooperation Fund		—	
6.3 Other		12,986,819.03	4,544,358,077.30
7 Counterpart of special drawing rights allocated			1,291,725,600.—
8 Provisions			
8.1 Provision for pensions		1,685,000,000.—	
8.2 Other provisions		300,000,000.—	1,985,000,000.—
9 Other liabilities			116,540,214.86
10 Deferred expenses and accrued income			691,168,117.15
11 Capital			290,000,000.—
12 Reserves			
12.1 Legal reserves		969,000,000.—	
12.2 Other reserves		130,500,000.—	1,099,500,000.—
Contingent liabilities	707,224.88		
			166,105,976,843.63

Profit and loss account of the Deutsche Bundesbank for the year 1978

Expenditure

	DM	DM
1 Administrative expenditure		
1.1 Staff costs	546,353,974.33	
1.2 Other	108,666,687.35	655,020,661.68
2 Note printing		121,748,323.77
3 Depreciation		
3.1 of land and buildings	50,443,907.54	
3.2 of furniture and equipment	20,796,694.16	71,240,601.70
4 Increase in the provision for pensions		151,097,691.14
5 Pension payments in respect of the Reichsbank		34,560,501.74
6 Other expenditure		122,344,599.79
7 Write-downs of monetary reserves and other foreign currency positions		10,574,922,489.56
		11,730,934,869.38

Receipts

	DM
1 Interest	5,688,254,882.85
2 Fees	12,127,199.44
3 Gains from the write-up of gold	2,988,500,830.11
4 Other receipts	86,842,931.04
5 Loss for the year	2,955,209,025.94
	11,730,934,869.38

Appendix to the profit and loss account

	DM
1 Loss for the year	2,955,209,025.94
2 Balancing item brought forward from 1977 in respect of the valuation adjustment of the monetary reserves and other foreign currency positions — loss brought forward —	6,597,891,849.27
3 Accumulated loss	9,553,100,875.21

Frankfurt am Main, February 6, 1979

Deutsche Bundesbank
The Directorate

Dr. Emminger Pöhl

Dr. Emde Dr. Gleske Dr. Irmler Prof. Dr. Köhler Dr. Schlesinger Werthmöller

According to the audit which we have duly carried out, the bookkeeping and annual accounts comply with German law and the Bank's by-laws.

Frankfurt am Main, March 2, 1979

Treuarbeit Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

Dr. Scholz, Certified Auditor — Dr. Haufschild, Certified Auditor

Dr. Wollert — Dr. Elmendorff KG
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