Report of the Deutsche Bundesbank

for the Year 1989

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Members on April 1, 1990

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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 1989

I. International trends

1. The global economic setting

Sustained expansion of business activity

In 1989 the economic performance of the Federal Republic of Germany was again determined by a sustained expansion of global business activity, to which it made a major contribution itself. In the seventh year of upswing in a row, industrial countries recorded a growth in real GNP of 3.5% in 1989. Output expanded at an above-average pace in Japan and continental Europe – including, in particular, the Federal Republic of Germany. In countries with internal and external stabilisation problems, such as the United States and the United Kingdom, the momentum of business activity admittedly slackened somewhat in the course of 1989. While signs of a slowdown were perceptible in other industrial countries, too, this was primarily because the expansion of output came up against the limits set by the growth of production potential. Among other things, this is suggested by the steep increase in world trade, the volume of which went up by 7½% in 1989. This rise, which was over twice as strong as that in GNP, probably also reflects capacity bottlenecks in some national economies – bottlenecks which increasingly forced these economies to meet their demand for goods and services (including their demand for capital goods to expand their production potential) abroad.

Improved conditions for growth and buoyant investment activity

Hence the sustained strength of business activity is also indicated by the fact that global investment activity continued to accelerate. Taking the average of 1988-9, the gross fixed capital formation of enterprises (outside the housing sector) in industrial countries expanded by just under 10%. It thus increased almost twice as fast as during the first five years of the upswing which started in 1983. In many countries the growing exhaustion of productive reserves sparked off investment in capacity extensions, which in turn enhanced growth potential. It appears that an increasing part is being played in this by technological innovations permitting a more flexible employment of the factors of production. For the rest, the improvements which have been initiated in recent years in the underlying macro-economic conditions are now apparently starting to pay dividends. These include the relaxation of government controls, measures of tax reform, the favourable trends in corporate profits made possible by moderate wage settlements and, last but not least, the preparation of a Single European Market by the end of 1992.

Tensions in the growth process

However, the improvement of the supply-side conditions and the extension of industrial production potential could not prevent increasing tensions from making themselves felt in the growth process in 1989. For instance, the price situation deteriorated noticeably. On average, the growth rate of consumer prices in industrial countries accelerated by over 1 percentage point in 1989, to 4½%. At the beginning of 1990 the current year-on-year rate was as high as almost 5%. In certain countries, it is true, this owed something to special factors, such as rising indirect taxes and administrative price increases. In addition, during 1989 a number of currencies depreciated not inconsiderably against the US dollar, which is the most important invoicing currency on global commodity markets. At the same time it appears, however, that more and more advantage was taken of the scope for raising prices presented by the growing utilisation of capacity and an ample money supply. Moreover, in individual countries, such as the United Kingdom, the United States and Spain, there were signs of an increase in labour cost pressure and thus of a danger of an automatic acceleration of domestically generated inflation.

Global tightening of monetary policy

In order to counter as early as possible the risks this posed to stability, many central banks tightened their monetary policy further during 1989. They thus continued their strategy of an initially prophylactic, but subsequently necessary fight against inflation. In some cases exchange-rate-policy goals also played a role. In the course of 1989 all major central banks initially sought to tighten up

Key macro-economic variables in selected industrial countries

Country	Real national product 1		Real domestic demand		Consumer prices 2		Balance on current account	
	1988	1989 p	1988	1989 p	1988	1989 p	1988	1989 p
	Change from previous year in %						US$ billion	
Industrial countries 3	+ 4.4	+ 3.5	+ 4.6	+ 3.6	+ 3.3	+ 4.4	4 − 52.1	4 − 76.1
of which								
European industrial countries	+ 3.7	+ 3.5	+ 4.4	+ 3.5	+ 3.4	+ 4.9	+ 14.4	+ 2.3
of which								
Germany	+ 3.6	+ 4.0	+ 3.7	+ 2.8	+ 1.3	+ 2.8	+ 50.4 ° (+ 88.3)	+ 55.5 ° (+104.2)
France	+ 3.5	+ 3.5	+ 3.9	+ 3.2	+ 2.8	+ 3.5	− 3.6	− 3.4
United Kingdom	+ 4.3	+ 2.5	+ 7.4	+ 3.9	+ 4.9	+ 7.9	− 26.0	− 33.2
Italy	+ 3.9	+ 3.4	+ 4.3	+ 3.7	+ 5.0	+ 6.3	− 5.2	− 9.5
United States	+ 4.4	+ 2.9	+ 3.3	+ 2.4	+ 4.1	+ 4.9	−126.5	−105.9
Japan	+ 5.7	+ 4.9	+ 7.6	+ 5.7	+ 0.7	+ 2.3	+ 79.6	+ 57.0
Canada	+ 5.0	+ 2.6	+ 5.8	+ 5.2	+ 4.0	+ 5.1	− 8.4	− 15.8

1 Real GNP/GDP. — 2 Cost of living index. — 3 OECD countries excluding Turkey. — 4 The statistically recorded current account deficit of the industrial countries is not accompanied by corresponding surpluses on the part of other groups of countries; in fact, owing to statistical errors and omissions (= missing surpluses or overly large deficits) the aggregated "global balance on current account" shows a distinct deficit, which, according to IMF calculations, came to roughly US$ 90 billion in 1989. — p Provisional. — ° Calculated in DM billion.
Sources: IMF and national statistics. BBk

money market conditions. Interacting with market forces, the entire short-term interest rate level consequently shifted upwards. This did not, however, reflect an "interest rate race" between the central banks, but rather an effort (stimulated by common problems) on the part of the monetary policy makers to combat the causes of inflation at their domestic roots. This generally resulted in short-term interest rates rising more steeply than the yields on long-term assets. Hence the yield curve is now flat in major countries, or — as in Canada and the United Kingdom — it has become "inverse", i.e. the interest rates on long-term financial assets are lower than those on short-term investments. Quite apart from the fact that this is almost inevitably the case at first in the event of a steep rise in central bank interest rates, which affect the short end of the market, it can also be interpreted as a sign that the markets are counting on central bank stabilisation policies being successful in the long run. Over the longer term, of course, it will be important not to disappoint these expectations.

Relaxation of US monetary policy should not set wrong signals

In the second half of 1989 a cautious relaxation of monetary policy gained ground in the United States; primarily, no doubt, this represented a response by the US monetary authorities to the slackening of economic activity in their country. This must not result in a softening of the anti-inflationary stance adopted in the rest of the world, since that could impart misleading signals to the general public world-wide. In this context, monetary policy makers must bear in mind as well that in many countries the time-lags associated with restrictive monetary policy measures are currently to be rated longer than usual, since the business community is now able to draw on large reserves of funds, in the domestic market and the Euro-markets alike. Moreover, they must also take due account of the fact that many and varied financial innovations are facilitating "evasive action" on the part of both private and public debtors.

Monetary policy afforded relief by the consolidation of public finance

In 1989 the central banks' policy, which was geared primarily to containing inflation expectations, was buttressed by the progressive consolidation of public finance. Relative to GNP, the overall public sector deficit in the seven most important industrial countries declined from an average of 1½% in 1988 to just over 1% in 1989. Admittedly, not all countries took full advantage of the greater scope for budgetary consolidation afforded by the boom, while some of them (such as the United States) have meanwhile moved into a period of slower economic growth. In 1989, just as in the previous year, the public sector deficit in the United States was equivalent to 2% of GNP. Against the background of the existing high level of public debt, the structural increase in the internal and external interest burden, the sluggish private propensity to save and growing uncertainties in the financial "superstructure" of the US economy, further progress towards the reduction of the US public sector deficit appears to be imperative. In the remainder of the western world, too, the concrete formulation of public financial policy continues to exhibit major differences, which cannot be explained solely in terms of the national features of macro-economic saving and investment patterns. While some countries, such as Japan and the United Kingdom, are meanwhile running substantial surpluses in their national budgets, a number of European Mediterranean countries continue to tolerate public sector deficits of the order of over 10% of GNP. It would be asking too much of monetary policy if, in such circumstances, it was expected to ensure monetary stability all on its own. Instead, it needs the support of a frugal medium-term financial policy, formulated "correctly" in terms of supply-side requirements, so as to enable accruals of savings (which are too small world-wide relative to the demand for capital) to be increased and at the same time put to productive uses.

International co-operation facing old and new challenges

International economic policy cooperation was continued and intensified in 1989. Particular importance was attached to coordinated economic policies, geared to stability and growth alike, in the seven major industrial countries, inter alia with a view to a further reduction in the external disequilibria of these countries, which after all are highly significant for the world economy. The fact that this coordination was oriented more towards macro-economic objectives and a more realistic assessment of the effectiveness of intervention in the foreign exchange markets no doubt helped greatly to reduce the discrepancies in economic trends among the countries of the Group of Seven. The high degree of utilisation of macro-economic resources admittedly contributed to inflationary tendencies gaining ground again in the course of 1989. The uncertainties and pressures associated with the political and economic opening-up of central and eastern Europe further accentuated these problems. The underlying economic situation (which, viewed as a whole, has remained favourable all the same) should be exploited to effect additional structural adjustments in individual national economies. Domestically speaking, the envisaged merging of the EC markets to form a Single European Market and the cooperation in prospect with central and eastern European countries call for a progressive liberalisation of the markets for goods, services, capital and labour. Both within the EC and world-wide it is essential to avoid protectionist tendencies and large-scale "bloc formation". The progress made within the Uruguay round of GATT warrants hope; at the same time, however, the debates on import protection in the context of the Single EC Market (e.g. in the area of car imports) suggest that the freedom of world trade can never simply be taken for granted.

Limited successes in the external adjustment process

Notwithstanding the joint endeavours to achieve a balanced development of the world economy, the reduction in global disequilibria made insufficient headway in 1989. Although the US current account deficit decreased by just over US$ 20 billion to US$ 106 billion last year and the Japanese surplus fell by US$ 23 billion to US$ 57 billion, the current account deficits of other countries (especially the United Kingdom, Canada and Spain) increased distinctly and Germany's surplus rose. The US external position relative to western Europe as a whole eased; vis-à-vis the EC member states alone, the United States actually ran a small foreign trade surplus in 1989. On the other hand, the disequilibria within Europe, particularly those between Germany and its partner countries, increased considerably. These shifts in regional imbalances must be seen, inter alia, against the background of exchange rate movements. For instance, the persistent depreciation of the US dollar against the Deutsche Mark and other European currencies until the end of 1987 has operated right up to the present in the direction of a welcome adjustment process, while exchange rates within the European Monetary System – despite some substantial differences in inflation rates – have remained immobilised at the level of early 1987. In the final analysis, constant nominal exchange rates result in a steady improvement in the competitive positions of countries with relatively low inflation rates, and give rise to trade disequilibria which are unsustainable in the long run, unless the differences in price levels decrease owing to inflationary adjustments in the country with more stable prices. Distortions of this kind can only be avoided and corrected if not just monetary policy but also financial, wage and foreign trade policies respond sufficiently flexibly to the requirements of the adjustment process, and if the exchange rate, too, is not ruled out as an instrument of adjustment.

2. Monetary policy in the dilemma posed by efforts to achieve monetary integration within the European Community

Increased efforts to achieve integration within the European Community

The need emphasised in the foregoing section to reduce external disequilibria and economic disparities as quickly as possible is particularly pressing in the European context. In recent months the endeavours to bring about progressive monetary integration within the European Community have gathered pace. Some EC member states are still showing considerable differences in their economic and stabilisation policy performance. The monetary policy makers will have to pay heed to progress in monetary policy coordination going hand in hand with increasing convergence in budgetary and general economic policy. Without such parallelism, the EC central banks might find themselves compelled to counteract tensions arising within the Community unilaterally by means of monetary policy action. In the process, they would at the same time run the risk of failing to meet their primary target of safeguarding price stability in the individual member states, as well as in the Community as a whole.

First stage on the road to the economic and monetary union due to begin on July 1, 1990

According to the resolution passed by the European Council in Madrid in June 1989, what is known as the first stage on the road to a European economic and monetary union is due to begin on July 1, 1990. In view of this, cooperation between the EC economic and finance ministers and between the governors of the EC central banks was put on a new footing. At the centre of cooperation in the Council of Ministers is a new multilateral surveillance procedure. It is intended to help achieve the degree of economic convergence needed for the first stage of the economic and monetary union. For the Committee of EC Central Bank Governors, which is already in existence, a more intensive consultation procedure was agreed. The function of that Committee (which has the prime objective of maintaining monetary stability) is to discuss the broad principles of monetary policy in member states; moreover, it should be consulted – normally in advance – on decisions such as the annual setting of monetary and lending targets. At the same time, the Committee is expected to express its views on general monetary policy issues in the Community and its member states (both to individual countries and to the EC Council of Ministers as well as, where appropriate, to the general public).

Convergence indicators of the EMS countries participating in the exchange rate mechanism*

in %

Period	Federal Republic of Germany	Belgium	Denmark	France	Ireland	Italy	Nether-lands
	Consumer price movements (Change from previous year)						
1974-78	4.7	9.2	11.0	10.7	15.3	16.7	7.9
1979-83	4.9	7.0	10.1	11.8	15.9	17.3	5.2
1984-88	1.2	3.0	4.6	4.4	4.6	7.1	1.1
1988	1.3	1.2	4.5	2.8	2.1	5.0	0.7
1989	2.8	3.1	4.8	3.5	4.1	6.3	1.1
	Balances on current account 1 (Share in GNP/GDP)						
1974-78	1.4	0.1	− 3.3	− 0.1	− 5.6	− 0.5	2.1
1979-83	− 0.3	− 2.9	− 3.6	− 0.7	−11.0	− 0.8	1.8
1984-88	3.3	1.5	− 3.6	− 0.1	− 1.8	− 0.4	2.9
1988	4.0	2.3	− 1.6	− 0.4	2.0	− 0.6	2.3
1989	4.4	2.3	− 1.5	− 0.4	1.7	− 1.4	2.3
	Public sector financial balances 2 (Share in GNP/GDP)						
1974-78	− 3.0	− 4.8	+ 0.1	− 1.1	− 8.2	− 9.6	− 2.3
1979-83	− 3.0	−10.5	− 5.6	− 1.7	−12.4	−10.5	− 5.3
1984-88	− 1.6	− 8.3	− 0.1	− 2.3	− 9.5	−11.2	− 5.7
1988	− 2.1	− 6.8	+ 0.3	− 1.3	− 2.6	−10.6	− 5.0
1989	+ 0.2	− 6.6	− 0.4	− 1.4	− 2.8	−12.2	− 5.0
	Growth in the broad money stock 3 (Change from previous year)						
1974-78	9.0	11.9	12.3	—	—	22.4	12.8
1979-83	6.8	5.5	11.7	11.6	15.5	18.4	6.7
1984-88	5.6	8.8	12.0	7.7	6.2	11.9	7.1
1988	6.4	7.8	3.9	7.5	7.9	12.4	9.0
1989	5.7	8.1	4.2	7.4	5.4	**4** 13.2	**4** 12.8

* Excluding Spain, which did not join the EMS exchange rate mechanism until June 19, 1989. — **1** Belgium including Luxembourg. — **2** On the basis of the national accounts. — **3** M2 for Belgium, Denmark and the Netherlands; M3 for France, Germany, Ireland and Italy. In the case of Belgium, the first figures relate to the period 1976-78. — **4** Average of the period Jan.-Nov. 1989 against the previous year.
Sources: OECD, BIS and national statistics. BBk

Cooperation must prove its worth

During the first stage, the task facing the EC Council of Ministers and the Committee of EC Central Bank Governors will be that of paving the way — without any changes in institutional conditions or national responsibilities — for the transition to an economic and monetary union. To this extent, the first stage is to be regarded as a preliminary phase in which the individual EC member states must prove their willingness and ability to be incorporated in a community of stability. Moreover, in the field of monetary policy the stablest currencies will assume a bench-mark function. With price stability as the definite final goal of monetary policy, after all, the pursuit of Community objectives cannot be based on a Community average. Instead, the countries which are more prone to inflation must work towards a "hardening" of their currencies. The fixing of exchange rate relationships envisaged in the further course of the monetary integration process, and the replacement of national currencies by a Community currency as the final step, can only be accomplished on the basis of assured domestic price stability in the individual EC member states.

Convening of an inter-governmental conference

At their meeting in Strasbourg in December 1989, the heads of state and government of the EC member states decided that an inter-governmental conference should be convened before the end of 1990 to negotiate the contractual basis for the further stages of an economic and monetary union. In line with this decision, once the first stage has been successfully completed, economic and monetary decision-making powers are to be transferred gradually, as far as is necessary, to existing or newly established Community institutions. Foremost among the institutions to be newly established is a European central banking system; detailed proposals for the concrete design of such a system have already been put forward. The "Report on economic and monetary union in the European Community" (Delors Committee Report), which was drawn up at the request of the EC heads of state and government by a committee of experts comprising the governors of the EC central banks and a number of other monetary specialists, and which was published in April 1989, declared that a European central banking system of this kind is necessary in the final stage of an economic and monetary union in order to ensure consistent monetary policy on the responsibility of a single Community decision-making body in charge of central bank policy. Other approaches – especially the "evolutionary" strategy of the UK Treasury – are based on the assumption that the monetary policies of member states can be harmonised with one another in the course of monetary competition and, after a period of common "hardening", can be embodied in a system of fixed exchange rates.

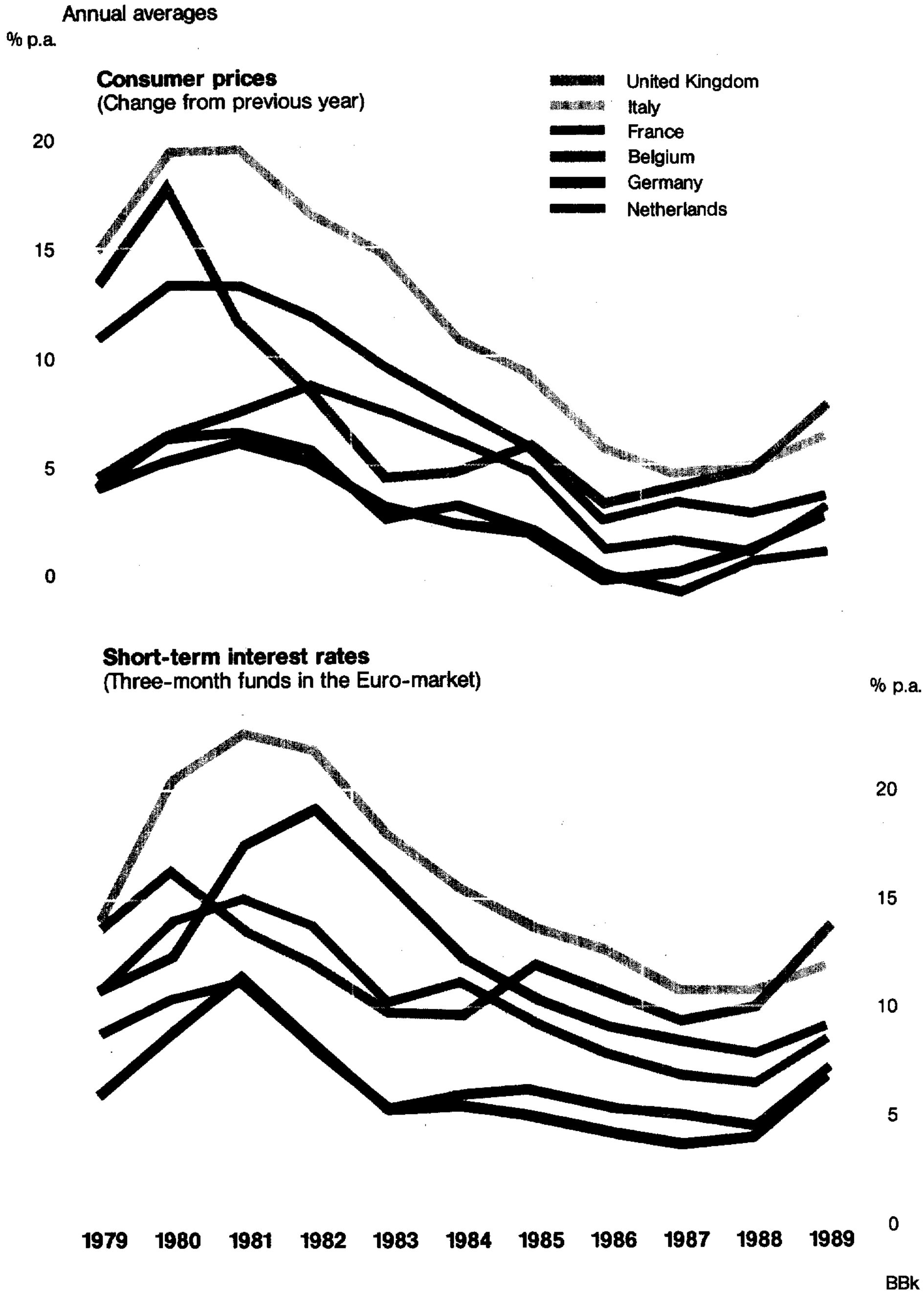
Requirements to be met by a European central banking system

In the Bundesbank's view, stringent demands in terms of stabilisation policy must be met by any European central banking system. It is only on this condition that it would be acceptable for EC member states with stable currencies to relinquish their national monetary policy sovereignty. One major requirement would be that the guide-lines on monetary policy are unequivocally geared, at Community level, with binding effect for the entire currency area, to the priority of the target of price stability. In the final stage, responsibility for Community monetary policy should rest exclusively with the European central bank which is to be established. Hence this bank, in its monetary policy decisions, must be independent of all other economic policy makers, including the governing bodies of the Community. Neither the Council of Ministers nor the Commission nor national governments may have the right to issue instructions to the European central bank. The statutory and institutional independence of the EC monetary authority would not imply that this authority was beyond the reach of any form of democratic control. The European central banking system would be brought into being by a treaty requiring ratification, would have a clear statutory mandate and would be provided with governing bodies whose members were appointed by Community institutions with a democratic right to do so. In order to safeguard their personal independence, the members of the governing bodies of the bank should be appointed to office for sufficiently long periods. Lending by the European central bank to public authorities in member states or in the Community (over and above the ceilings for pure cash advances) should be prohibited. Similarly, the central bank and the banking system should not be required to purchase government securities, either in the context of conventional issuing operations or in the secondary market.

Federative structure

Moreover, the consistency of monetary policy decision-making must not be put at risk even if the European monetary authority is to be given a federative structure in order to take due account of the diversity of states within the Community. On the analogy of the structure of the Deutsche Bundesbank, the system could consist of an executive board plus the central banks of the member states. The authority to take major decisions affecting the overall stance of monetary policy would be vested in a body composed of the members of the executive board and the governors of the national central banks. As long as national currencies continued to exist – as would be likely in the initial stages of a monetary union – Community monetary policy would largely be conducted by national central banks in their domestic money markets. The range of policy instruments required for this purpose would have to be harmonised to such an extent that the monetary targets set at a European level could be attained in the context of a potential-oriented monetary policy without causing undue disruption of the financial markets. In this connection, a coordinated minimum reserve system in all member states, as a quasi-automatic "constraint on money creation", would be very useful, as would traditional discount policy and flexible open market operations for the

Movements in consumer prices and interest rates in selected EC member states



ongoing management of the money market. Direct intervention in market mechanisms – e.g. through quantitative credit controls, measures to regulate lending or interest rate provisions – should then become dispensable.

Fiscal policy support imperative

For safeguarding the value of money in the Federal Republic of Germany, and also in the Community at large, it is of vital importance that a broad consensus on stabilisation policy should be achieved at the forthcoming inter-governmental conference on the requirements for a monetary union, and that this consensus should be clearly reflected in the EEC Treaty, which is due to be amended, as well as in the other legal instruments. In this connection attention will also have to be paid to devising rules which ensure that Community monetary policy is underpinned by consistent, stability-oriented behaviour on the part of the EC governments. In particular, binding rules and procedures for safeguarding adequate budgetary discipline among member states will have to be envisaged. There is no evidence that good behaviour on the part of public authorities can be enforced solely by disciplinary mechanisms emanating from the capital market, especially as the public sector is not normally very responsive to changes in interest rates. Since exchange rate changes will no longer be possible as a sanctionary measure for the markets in the final stage of the monetary union, a minimum of binding budgetary commitments to Community goals appears to be imperative in order to guarantee, throughout the Community, that degree of discipline in public sector budget management which is necessary for the continued existence of the economic and monetary union. Dispensing with the monetary financing of budget deficits and with the assumption of joint and several liability for the public debt of individual member states is not, on its own, enough for the purpose. In addition, the Council of Ministers should be given powers to set ceilings for the budget deficits of EC countries and to demand prior consultations before member states borrow abroad in third currencies.

Crucial role of the first stage

To date it has not been possible to elaborate a concrete, generally accepted "model" for the transfer of national monetary and economic policy powers to Community institutions. The favourable macro-economic circumstances and good stability and monetary policy conditions required for this purpose will depend not least on the outcome of the further convergence of national economic and monetary policies that can be achieved during the first stage. In the view of the German monetary policy makers, the economic foundations that justify a transfer of central bank powers to a Community monetary authority should be laid, as far as possible, already at this stage. The first stage on the road to the economic and monetary union has the character of an adjustment and learning process whereby the member states are expected to arrive at a substantial and lasting consensus on their economic and monetary policies. At present there are still considerable differences between individual EC member states as regards economic structures, economic adaptability and standards of living. In this context it should be recognised that the nucleus of the "hard currency countries" (which at present includes France, for instance) has become larger over time. However, the number and importance of the countries whose stability is at risk are not small. Some sizeable discrepancies in national inflation rates, unemployment, budget balances and current account positions are an unmistakable reflection of this. Some major economic policy efforts will be necessary in future to overcome disparities of this kind. Given this situation, it is not surprising that – despite some notable advances in the field of practical cooperation, particularly in the EMS – consistent monetary policy throughout the Community is still at a rudimentary stage in many respects. This is suggested, inter alia, by some substantial differences in interest rates from country to country and by divergent national rates of monetary and credit expansion.

3. Monetary union with the German Democratic Republic as a new challenge

The Federal Republic's particular responsibility towards the GDR

While the European integration process is being given new impetus by the start of the first stage on the way to the implementation of the economic and monetary union, the upheavals in central and eastern Europe are creating completely new conditions for political and economic relations between western industrial countries and the states of the Council for Mutual Economic Assistance (CMEA). In this connection the Federal Republic of Germany is in an exposed position in both directions: on the one hand, it is actively involved in the western European integration process, in which it remains closely incorporated; on the other hand, in view of the envisaged unification of the two Germanys, it bears a particular economic, social and political responsibility towards the GDR – a responsibility which is shared by no other EC member state. The Federal Republic's offer to the GDR to create an economic and monetary union at an early date is to be regarded as a preliminary stage to the achievement of political unification. The serious deterioration in economic conditions in the GDR and the growing exodus of emigrants to the Federal Republic, which threatens to pose severe economic and social problems for both German states, have reinforced the need to find swift economic and monetary policy solutions. The Federal Cabinet's monetary policy offer, which is linked to the condition that at the same time the way should be paved for a viable social market economy in the GDR, opens up to the population there future prospects that may well counteract the manpower exodus. This exceptional situation justifies the rapid implementation of monetary unification, even though, given the differing economic systems in the two Germanys hitherto, solutions without any precedent are required.

Monetary union between the two Germanys not comparable to European monetary union

The objectives which must be achieved at short notice in this field are not at variance with the views expressed by German representatives on the step-by-step implementation of the integration process in the EC. Here, in view of the necessity of further progress in the twelve member states towards convergence in the monetary and general economic policy field, the principles of a step-by-step approach and "parallelism" reaffirmed in the Delors Committee Report must continue to apply. In the final stage of a European economic and monetary union the Federal Republic of Germany, just like the other member states, must irrevocably surrender its monetary policy sovereignty to a European central banking system. After an introduction of the Deutsche Mark in the GDR, by contrast, the Bundesbank's responsibility for monetary policy will be retained in full. Outside the narrower area of monetary policy, the introduction of the Deutsche Mark in the GDR will entail an adjustment of economic and financial policy conditions in that country to those in the Federal Republic – indeed, such an adjustment will no doubt partly precede the monetary union, the object being, as indicated above, to bring about political unification. In the European integration process, by contrast, it is left to future developments to show how far the sovereignty of EC member states in areas outside those fields which are associated with the goal of a Single European Market and economic and monetary union remains unaffected or likewise gives way to a broader political union. In view of the existing productivity and real income gaps, the serious weaknesses in the infrastructure of the GDR economy and the transitional difficulties connected with the transformation of conditions in a planned economy into those in a free-market economy, the extension of the currency area of the Deutsche Mark to include the GDR involves particular risks, although, thanks to the economic potential of the Federal Republic, these risks will be manageable. After all, it must not be forgotten that – also from the standpoint of the Federal Republic, as the member with the strongest economy – the creation of a European economic and monetary union is an operation of quite a different economic order from the merging of the two Germanys, whose macro-economic performances are in a mutual ratio of approximately 8 to 10 : 1.

Risks and opportunities presented by the introduction of the Deutsche Mark in the GDR

Needless to say, at first the introduction of the Deutsche Mark in the GDR will make no difference to the real income gap between the two Germanys (the main cause of the population exodus), though it will significantly improve the propensity to work of east German wage and salary earners and self-employed persons, the number of whom will doubtless increase swiftly. If the ground is prepared speedily, especially in legislative terms, an inflow of private capital to the GDR is to be expected, and will help to narrow the present productivity gap in a way typical of a present-day industrial economy: by mobilising the two factors of production, labour and capital. No less important, however, is the fact that the monetary unification of the two Germanys and the abolition of all intra-German trade barriers will give rise to an internal market on which the

Economic structural variables for the German Democratic Republic and the Federal Republic of Germany in 1988

Item	Unit of measurement	GDR	Federal Republic
Population and employed persons 1			
Population	Thousands	16,666	61,450
Employed persons			
Total	Thousands	8,980	27,354
As % of the population	%	53.9	44.5
Output			
Produced national income at 1985 prices 2	M billion	268.4	.
Gross national product at 1985 prices 3	DM billion	.	1,988.9
Gross capital formation at 1985 prices 3			
Total	M billion/DM billion	77.0	419.0
of which			
Machinery and equipment	M billion/DM billion	44.1	181.8
Construction	M billion/DM billion	28.5	222.0
Households' income, currency in circulation and financial assets			
Average monthly gross remuneration of employees in industry 4	M/DM	1,290	3,876
Currency in circulation 5	M billion/DM billion	15.6	6 142.6
Savings balances with banks 5	M billion/DM billion	151.6	7 714.6
Foreign trade			
Exports	"Valuta M" billion 8/DM billion	90.2	567.7
of which			
to socialist countries and centrally planned economies	"Valuta M" billion 8/DM billion	62.7	24.7
Imports	"Valuta M" billion 8/DM billion	87.2	439.6
of which			
from socialist countries and centrally planned economies	"Valuta M" billion 8/DM billion	59.9	20.5

1 Annual average. — 2 In the GDR excluding large parts of the services sector. — 3 Rebased from the original base 1980. — 4 GDR excluding part-time employees; Federal Republic: mining and manufacturing sector. — 5 End-of-year levels. — 6 Excluding the cash holdings of domestic banks. — 7 Excluding bank savings bonds. — 8 According to UN statistics, one "Valuta Mark" was approximately equivalent to DM 0.63 in 1988. BBk

economy of the GDR will have to hold its own under conditions of free competition. At the same time, the economy of the GDR will be exposed to competition from the entire free world, just as, conversely, it will be able to exploit the advantages deriving from its incorporation in the global division of labour: it will be able to buy raw materials and primary products wherever they are cheapest (and, moreover, with reliable delivery dates) — always provided, of course, that the enterprises then taking decisions on their own responsibility are and remain solvent. This will depend, among other things, on the debt burdens which enterprises, craft firms, farmers and the housing sector have to shoulder from the outset. In the monetary union these will constitute liabilities in Deutsche Mark, i.e. in a hard and convertible currency, to which the Deutsche Mark interest rate level will apply. Interest rate subsidies, which were the normal practice in the planned economy, and which would merely continue the faulty economic accounting with non-market-related prices, have to be avoided from the start. This new situation will, on the one hand, virtually enforce the adjustment of economic structures in the GDR — an adjustment which is unavoidable anyway — and thus contribute to a faster growth of productivity. On the other hand, drastic treatment of this type involves a substantial risk to employment. Whether significant or sustained unemployment does in fact arise will depend primarily on how quickly it proves possible to provide jobs under completely changed basic conditions by setting up small and medium-sized firms in industry, in craft trades and in the services sector, thus absorbing the labour released elsewhere. The reason why this is so important is that losses in employment are to be expected, if only on locational grounds, in some key areas of the old economic structure, which was maintained by the methods of a planned economy. A great deal will hinge on the stance of employees, trade unions and managements: under the conditions of a monetary union, the attempt to bring real wages in the GDR, despite the lower level of productivity there, into line with those in the Federal Republic at an early date might result in heavy unemployment. Hence it is essential that, from "D-day" onwards, management and labour in both parts of the unified monetary and economic area act with a sense of responsibility.

Financial advantages of the monetary union

The difficult adjustment problems will, however, be accompanied by substantial advantages of the monetary union for the GDR. The introduction of the Deutsche Mark will eliminate transfer and exchange rate risks in the Federal Republic's transactions with the GDR, and such risks vis-à-vis other western European countries will be lessened by the GDR's participation in the Federal Republic's membership of the EMS. Moreover, this will foster the necessary private capital imports into the GDR, and thus the transfer of real resources for additional investment and of western industrial know-how from the Federal Republic and the rest of the EC. In a monetary union with the Federal Republic, the GDR's scope for borrowing from the rest of the world will no longer be restricted by a shortage of foreign exchange, but will only be limited by the individual creditworthiness of every would-be borrower. Additional borrowing potential in international capital markets will be available to the GDR, provided that the lenders can be sure of dealing with solvent borrowers.

Transfer of resources in favour of the GDR through a reduction in the current account surplus

In view of the GDR's immense pent-up demand, a substantial part of the funds which will accrue to the GDR through direct investment and financial credits from the Federal Republic or abroad will exert an impact on demand in west Germany. Fiscal transfer payments by the Federal Republic, too, will stimulate east German demand for west German products. Since capacity in the Federal Republic is already being very heavily utilised, the transfer of real resources to the GDR will also involve foreign capital and consumer goods, and will reinforce the tendency towards a reduction in the Federal Republic's current account surplus with the rest of the world (other than the GDR). A restructuring of this kind will benefit the international adjustment process, too. In a market economy, however, restructuring operations of this nature do not take place without corresponding price signals, which must not be distorted by government subsidies or other measures. Hence, in the wake of the transfer of resources to the GDR, tensions that might jeopardise stability can be kept under control all the more easily if the authorities succeed in achieving a reduction in the current account surpluses and buttressing it by means of a strong external value for the Deutsche Mark. In other words, a depreciation of the Deutsche Mark would strengthen the inflationary tendencies that might arise from the demand pressure.

Challenges facing monetary, budgetary and wage policy

The maintenance of the internal and external stability of the Deutsche Mark will be an acid test for the Bundesbank's monetary policy, as well as for budgetary and general economic policy in the Federal Republic in the period following the introduction of the Deutsche Mark in the GDR. For monetary policy it will then be essential to limit the imponderables associated with the currency conversion in the GDR, and especially the risks posed by a possible "monetary overhang" in that country. The unresolved issues, in addition to the details of the conversion procedure (which had still not been settled at the time of writing), include the behaviour of the residents of the GDR, and particularly the question of whether they will be inclined to hold converted balances — on the assumption of sufficiently attractive terms — as financial and capital assets, or whether they will speedily transform them into demand for goods and services. A definitive answer to this question cannot be given here. This makes it all the more important for the Bundesbank to be able to exercise effective monetary control throughout the currency area of the Deutsche Mark. In the longer run, credit and capital market rates in the two Germanys will have to be kept at an appropriate level in order to encourage saving in the common economic area and prevent consumption expenditure and capital spending from getting out of hand. In the special case of the GDR, limiting borrowing by public authorities there might be contemplated. Quite generally, this will necessitate the support of budgetary policy (by the public sector) and incomes policy (by management and labour), so as to achieve an appropriate distribution of burdens among all those concerned who bear or have newly assumed responsibility for stabilisation and economic policy in the envisaged common economic and monetary area.

II. Economic trends in the Federal Republic of Germany and central bank policy

1. Strong economic growth with moderately rising domestic prices

Growth in the critical area of capacity utilisation

As a result of the continued strong growth, above all in European partner countries, the domestic economy was again confronted with a significant demand pull from abroad in 1989. This at the same time had a marked impact on the domestic propensity to invest. The buoyancy of exports and investment activity contributed much to the fact that the increase in real GNP in the Federal Republic of Germany, at 4%, was unexpectedly high. Since the beginning of the upswing in autumn 1982 overall output has risen at an annual rate of 3% and thus substantially faster than production potential. At the beginning of this period the utilisation of potential had been below average. By the end of 1989 fixed capacity utilisation had reached a level not recorded since the early seventies. The labour supply, too, has been utilised to an ever-increasing extent in the course of the upswing. In 1989 employment rose more steeply than in any of the six preceding years. Simultaneously, there was for the first time a noticeable drop in the number of persons registered as unemployed, whereas the number of vacancies rose considerably. In addition, more and more industries and regions are facing a lack of suitable labour. In spite of the growing exhaustion of capacity reserves, the upward movement of prices in the course of 1989 remained limited on the whole, thanks to the virtual stability of unit labour costs and the comparatively moderate pricing policies pursued by enterprises. This not unfavourable result probably also owed something to monetary policy, which – in view of the growing cyclical pressures – was tightened further in several stages in 1989.

Unabated demand pull from abroad

The rapid expansion of foreign demand was to a considerable extent due to the fact that the propensity to invest has increased in recent years, particularly in many continental European economies. For the Federal Republic of Germany, a country that specialises strongly in the production of capital goods within the framework of the international division of labour, this resulted in a further rise in demand pressure from abroad. The export orders, for instance, which were received by the domestic capital goods industry (excluding road vehicle manufacture) in 1989 rose by 14% in nominal terms. In the purchasing countries the corresponding imports occasionally caused the respective trade and current account deficits to rise. At the same time, however, these imports enabled additional production facilities to be created there, facilities which will strengthen their competitiveness – at least in the medium term – and which could thus serve to reduce the external imbalances again. This is, however, hardly true of imports of consumer goods and consumer durables. The fact that foreign demand for goods of these types, too, from Germany has in part surged upwards is rather to be seen as an indication of the growing overheating of the economies of major partner countries. In 1989 the foreign orders placed with the consumer goods sector were 13% and those lodged with the motor industry (whose products are for the most part used privately) were 12% higher than in 1988. Especially in these subsectors of German export business – subsectors in which reactions to changes in prices are normally fairly marked – demand from abroad was probably also boosted by the fact that the Deutsche Mark was rather weak vis-à-vis the currencies of a number of other industrial countries over fairly long periods in the course of 1989, thereby lowering the prices of their imports from Germany. Towards the end of 1989, however, the Deutsche Mark appreciated once more against the freely floating currencies. At the same time the export pull slackened slightly, too, because business activity in North America and the United Kingdom was losing momentum. In 1989 as a whole export orders surpassed the level recorded in the corresponding period of the preceding year by as much as 11½% in nominal terms and by 8% in real terms.

Key economic variables in the Federal Republic of Germany

Item	Unit	1986	1987	1988	1989	1986	1987	1988	1989
						Change from previous year in %			
Aggregate demand									
Private consumption	DM billion	1,068.6	1,112.7	1,156.8	1,213.4	+ 2.9	+ 4.1	+ 4.0	+ 4.9
Public consumption	DM billion	382.7	397.0	411.5	418.3	+ 4.7	+ 3.7	+ 3.7	+ 1.7
Fixed capital formation	DM billion	377.4	390.0	419.1	462.9	+ 4.6	+ 3.3	+ 7.5	+ 10.5
Machinery and equipment	DM billion	161.4	170.5	184.9	207.6	+ 4.9	+ 5.6	+ 8.4	+ 12.3
Construction	DM billion	216.0	219.5	234.3	255.3	+ 4.4	+ 1.6	+ 6.7	+ 9.0
Increase in stocks	DM billion	+ 1.5	+ 5.5	+ 13.7	+ 25.1	.	.	.	.
Domestic expenditure	DM billion	1,830.2	1,905.1	2,001.1	2,119.7	+ 3.7	+ 4.1	+ 5.0	+ 5.9
Foreign balance 1	DM billion	+ 115.0	+ 112.6	+ 120.6	+ 140.7	.	.	.	.
Exports	DM billion	638.2	638.7	687.8	778.2	− 1.4	+ 0.1	+ 7.7	+ 13.2
Imports	DM billion	523.3	526.1	567.2	637.6	− 7.8	+ 0.5	+ 7.8	+ 12.4
GNP at current prices	DM billion	1,945.2	2,017.7	2,121.7	2,260.4	+ 5.5	+ 3.7	+ 5.2	+ 6.5
Memorandum items									
Orders received by the manufacturing sector	1985 = 100	100.2	100.4	110.2	122.4	+ 0.2	+ 0.3	+ 9.8	+ 11.0
Domestic orders	1985 = 100	102.4	102.1	110.5	122.4	+ 2.4	− 0.3	+ 8.2	+ 10.8
Foreign orders	1985 = 100	96.5	97.6	109.8	122.4	− 3.5	+ 1.1	+ 12.5	+ 11.5
Orders received by the construction sector	1985 = 100	109.1	106.2	116.0	132.2	+ 9.1	− 2.7	+ 9.3	+ 13.9
Distribution of income									
Wage and salary income	DM billion	1,041.4	1,084.1	1,126.4	1,176.1	+ 5.1	+ 4.1	+ 3.9	+ 4.4
do. as a percentage of national income	%	69.0	69.2	68.2	67.2	.	.	.	.
Entrepreneurial and property income	DM billion	468.1	483.1	525.3	575,0	+ 9.1	+ 3.2	+ 8.7	+ 9.5
Memorandum items									
Gross income of producing enterprises	DM billion	376.0	391.7	431.3	464.8	+ 14.5	+ 4.2	+ 10.1	+ 7.8
do. as a percentage of national income	%	24.9	25.0	26.1	26.5	.	.	.	.
National income	DM billion	1,509.5	1,567.3	1,651.7	1,751.1	+ 6.3	+ 3.8	+ 5.4	+ 6.0
Output									
GNP at 1980 prices	DM billion	1,614.7	1,641.9	1,701.8	1,769.2	+ 2.3	+ 1.7	+ 3.6	+ 4.0
Productivity 2, 3	1980 = 100	112.9	115.3	119.5	123.5	+ 1.8	+ 2.1	+ 3.7	+ 3.4
Output in the producing sector (excluding construction) 4	1985 = 100	101.8	102.4	106.4	111,3	+ 1.8	+ 0.6	+ 3.9	+ 4.6
Construction output 4	1985 = 100	106.4	106.1	110.7	118,0	+ 6.4	− 0.3	+ 4.3	+ 6.6
Employment									
Employed 3	Millions	27.0	27.2	27.4	27.7	+ 1.4	+ 0.7	+ 0.7	+ 1.4
Wage and salary earners 3	Millions	23.9	24.1	24.3	24.7	+ 1.5	+ 1.0	+ 0.9	+ 1.5
Memorandum item									
Total number of man-hours worked 3, 5	1980 = 100	96.3	95.9	95.9	96.4	+ 0.5	− 0.4	− 0.0	− 0.6
Unemployed	Thousands	2,228.0	2,228.8	2,241.6	2,037.8	− 3.3	+ 0.0	+ 0.6	− 9.1
do. as a percentage of the total labour force	%	7.9	7.9	7.7	7.1	.	.	.	.
Prices and wages									
Cost of living index for all households	1985 = 100	99.9	100.1	101.4	104.2	− 0.1	+ 0.2	+ 1.3	+ 2.8
Producer price index of industrial products 6	1985 = 100	97.5	95.1	96.3	99,3	− 2.5	− 2.5	+ 1.3	+ 3.1
Overall construction price level	1980 = 100	115.5	117.7	120.1	124.0	+ 1.8	+ 1.9	+ 2.0	+ 3.2
Index of import prices	1985 = 100	84.3	79.8	80.8	84.4	− 15.7	− 5.4	+ 1.2	+ 4.5
GNP deflator	1980 = 100	120.5	122.9	124.7	127.8	+ 3.1	+ 2.0	+ 1.5	+ 2.5
Memorandum item									
Unit labour costs in the economy as a whole 7	1980 = 100	113.0	115.4	115.5	115.9	+ 2.6	+ 2.1	+ 0.1	+ 0.3
Overall negotiated wage and salary level									
on a monthly basis	1980 = 100	123.7	128.0	131.5	135.0	+ 3.5	+ 3.4	+ 2.7	+ 2.7
on an hourly basis	1980 = 100	125.8	130.5	134.9	139.9	+ 4.1	+ 3.8	+ 3.3	+ 3.7

1 Balance of transactions in goods and services with the rest of the world (including the GDR). — 2 GNP at 1980 prices per man-hour worked; calculated by the Bundesbank. — 3 The results of the 1987 population census and census of places of employment have already been taken into account. — 4 Results for kinds of activity units. — 5 Calculated by the Bundesbank. — 6 Domestic sales. — 7 Index of gross wages and salaries per employee divided by index of real GNP per employed person.
The figures from the national accounts from 1987 onwards are provisional.

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On the domestic market, too, the sharp increase in foreign demand strengthened investment in manufacturing, the sector which accounts for the vast bulk of exports. Last summer industrial enterprises were expecting their investment budgets for 1989 to expand by 14% in all, and their plans for 1990 envisage similarly high rates of growth. Outside the industrial sector – more precisely, in the services sector – investment activity had already increased strongly in preceding years.

Considerably higher propensity to invest in the manufacturing sector

In general, the underlying conditions for corporate investment have improved in the course of the upswing: sales opportunities have been rated even more favourable in the light of the prospect of the completion of the Single European Market as from 1993; enterprises' profitability has been increasing perceptibly and lastingly. Hence they had considerable own funds at their disposal – quite apart from the fact that borrowed funds were available on favourable terms up to mid-1989. In view of the growing utilisation of their fixed capacity, it has recently become more and more urgent for enterprises to expand their production facilities – as can be seen, inter alia, from the upturn in demand for industrial construction work. Modernisation and rationalisation investment did not become any less important, however, because working hours were reduced further and the supply of skilled labour on the market was dwindling. Overall, fixed investment by producing enterprises in 1989 rose by 12½% in value and 9½% in volume. The share of this investment in real GNP thus amounted to 13% – up 2 percentage points on the low of 1982, but still not quite as high as at the beginning of the seventies.

Favourable underlying conditions for investment

In 1989 demand in part surged upwards not only in industrial construction but also in other construction subsectors. On average the total orders placed with the construction industry were a nominal 14% and a real 10½% up on the previous year. This increase in demand considerably exceeded the extent to which construction output could be expanded in the same period. In the winter months of 1989-90 this imbalance tended to become even greater as a result of a steep rise in ordering. This owed much to the burgeoning growth of demand for housing, due largely to the heavy inflow of immigrants and resettlers from eastern Europe as well as to supply bottlenecks on the housing market, which were thereby exacerbated. In order to mitigate these problems, the Federal Government adopted a number of measures to promote housing construction in 1989. Moreover, the public sector itself stepped up its orders considerably in that year.

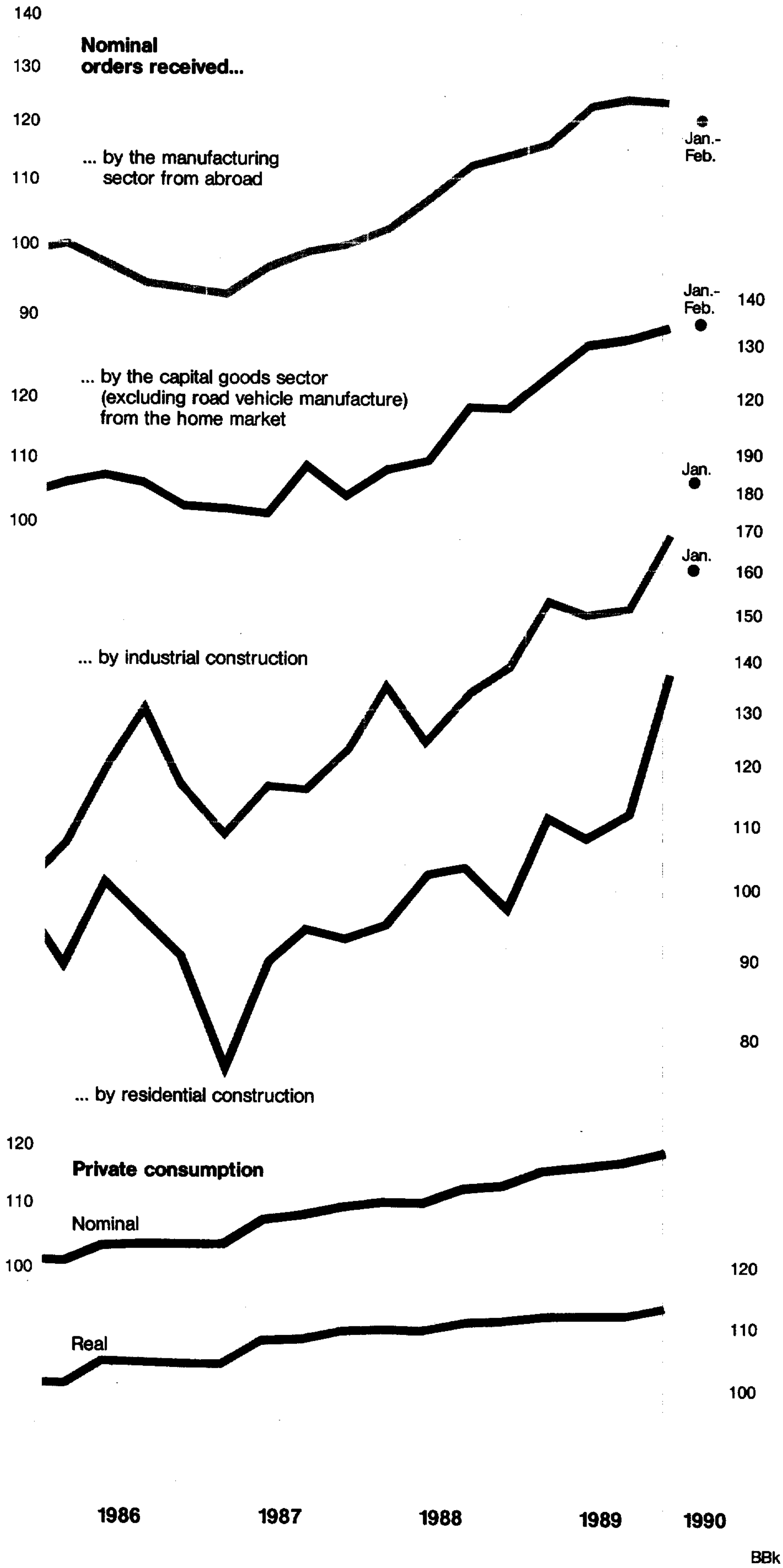
Marked expansion of demand for construction work

Compared with foreign demand and demand for capital goods, consumption by households in Germany rose only moderately in 1989. It expanded by 1½% at constant but by 5% at current prices. In terms of volume, this increase was smaller than that recorded in the three preceding years, so that the investment boom was not fuelled additionally from this angle. The trend in private consumption is all the more remarkable because households' income rose quite strongly. In 1989 average gross wages and salaries went up by 3%, while the number of employees increased by 1½%. In contrast to 1988, however, there was no tax relief. Households' disposable income (including government current transfers and other receipts) grew in 1989 by 4½%, i.e. to virtually the same extent as before. The fact that the real expansion of private consumption in 1989 was nevertheless significantly lower than in 1988 was due largely to its growth being curbed purposely by the raising of public levies at the beginning of the year and, partly, also by external price increases, principally in the energy sector. Taking the average of 1989, the cost of living index for all households was just under 3% higher than in 1988. But for the higher public levies and the market-induced increases in energy prices, the cost of living would have risen by only 2%, i.e. barely more than in 1988. Households adjusted to this pressure on their real disposable income by reducing their saving slightly in

Moderate increase in real private consumption

Trends in demand

1985=100, seasonally adjusted, quarterly, log. scale



some cases. At any rate, the share of private saving in disposable income dropped somewhat in 1989, namely by ½ percentage point to 13½%.

Strong growth of production and heavy capacity utilisation, above all in the manufacturing sector

The pressure emanating from both foreign and domestic demand caused aggregate output to rise very strongly again in 1989. Total production in the Federal Republic – i.e. the real gross domestic product – was 3½% higher than in 1988, and the real gross national product (which also includes, inter alia, net investment income generated abroad) increased by 4%. The expansion of production potential, which probably amounted to between 2% and 2½% in 1989, failed to keep pace with the growth of domestic output. In the seventh consecutive year of upswing, the utilisation of the available resources thus reached a pitch at which production bottlenecks emerged in quite a number of sectors. This applied, above all, to extensive areas of manufacturing, on which the spate of foreign orders and the pressing domestic demand for capital goods focused. According to the Ifo Business Survey, at all events, average capacity utilisation in industry in 1989 was some 3% higher than in 1988, reaching a level at the end of the year which was equal to that registered during the boom at the beginning of the seventies. The growing shortage of qualified labour, in particular, was mitigated in part by increased overtime. In spite of such bottlenecks, the manufacturing sector was nevertheless able to raise its output by 5% in 1989, with capital goods producers taking the lead by increasing their output by 7%. The expansion of production was thus far stronger than had been expected at the beginning of 1989. On the one hand, this probably owed something to the fact that brisk investment activity caused fixed capacity in industry to increase more markedly than had been anticipated. On the other hand, the introduction of new production processes which are associated to an ever-increasing extent with the use of micro-electronics probably facilitated the adjustment of industrial production to higher requirements. Even so, the increase in output in 1989, taken as a whole, was unable to keep pace with the growth of demand. This is indicated, not least, by the fact that order backlogs in industry rose perceptibly, according to an Ifo Institute survey.

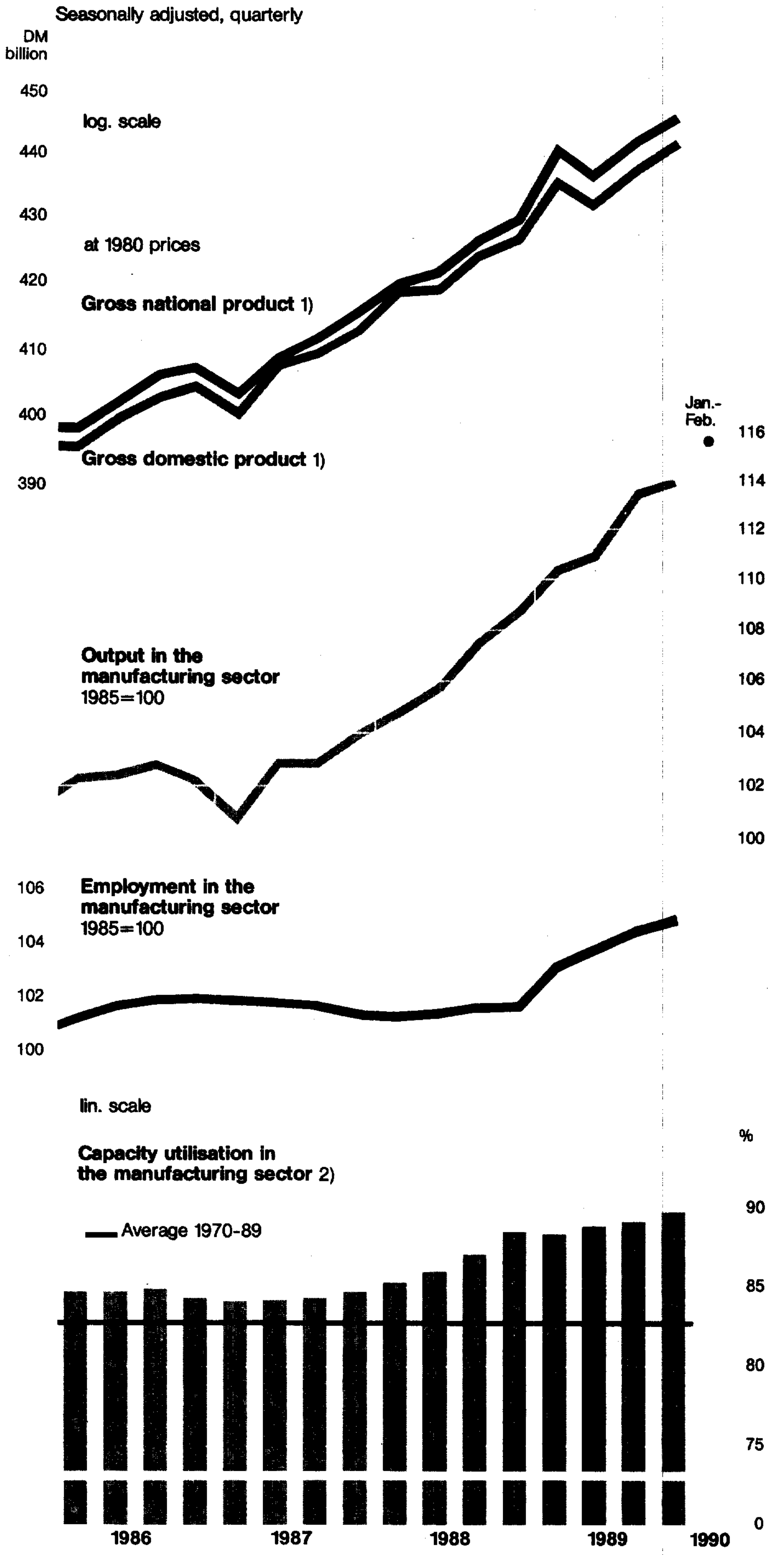
Threat of overheating in the construction sector

In the course of 1989 the construction sector (which – owing to its labour intensity and the inadequate supply of skilled workers – is particularly affected by the growing shortage of manpower) was likewise confronted with a situation similar to that faced by the manufacturing sector. The construction sector, however, benefited from the fact that the unusually mild weather after the turn of 1988-9 impeded its production even less than had been the case in winter 1987-8. In 1989 total construction output – measured in terms of real construction investment – surpassed the level recorded in the preceding year by 5½%. The growth of both industrial construction investment and housing investment (the latter also including the measures undertaken to renovate and modernise the existing stock of dwellings) was of about the same order of magnitude, while the number of housing units completed in 1989 rose considerably more markedly than the total housing construction volume, namely by one-seventh to around 240,000.

Rising demand for labour against the backdrop of a more limited supply

The substantial expansion of output simultaneously caused the supply of suitable labour to contract. Towards the end of 1989, however, this bottleneck situation was somewhat mitigated by the heavy inflow of immigrants from the GDR. More than one-half of these immigrants are persons seeking employment, often with vocational qualifications roughly similar to those required on the labour market here. In 1989 some 345,000 such immigrants as well as 375,000 ethnic German resettlers from eastern Europe moved to the Federal Republic of Germany. 525,000 of this total figure of 720,000 immigrated in the second half of the year; in the first three months of 1990 the overall inflow amounted to some 290,000 persons. In the summer of 1989, i.e. prior to the

Output



1) Also adjusted for working-day variations.- 2) Results of the Ifo Business Survey.

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onset of this wave of immigration, the seasonally adjusted labour force totalled 27.76 million persons, and was thus 380,000 persons or 1.4% larger than twelve months earlier, while in February 1990 the corresponding year-on-year increase amounted to 505,000 persons or 1.8%. The marked growth in employment was due mainly to the fact that – in contrast to the situation prevailing as recently as 1988 – the manufacturing sector, too, recruited considerable additional staff over and above the already long-standing expansion of the number of persons employed in the tertiary sector. It was quite impossible, however, to satisfy the rising demand for labour in full. With respect to the regional distribution and qualifications, the domestic labour supply still diverges considerably from the growing personnel demand in the economy. The large number of vacancies reported to the labour exchanges must presumably be regarded as a sign that neither the volume nor the structure of demand and supply on the labour market match properly. However, the number of vacancies registered with the labour exchanges does not reflect the unsatisfied demand in full because past experience shows that these exchanges are not always involved in the recruitment of labour. At any rate, the "free" job market, as reflected in the jobs advertised in daily newspapers, indicated that the demand for labour continued to rise right up to the end of the period under review.

Marked drop in unemployment

The strong demand for labour caused unemployment to decline perceptibly in 1989 in spite of the massive inflow of manpower from abroad; on average over the year, a total of 2.04 million persons were registered as unemployed, i.e. 205,000 fewer than in 1988; the unemployment rate thus amounted to 7.1% of the total labour force. Estimates suggest that the number of unemployed domestic members of the work-force declined by 250,000 to 1.90 million. At the end of March 1990 the labour exchanges registered a seasonally adjusted total of 1.89 million unemployed, 1.63 million of whom were nationals of the Federal Republic, their number having thus decreased by 330,000 against the preceding year. At the same time, 265,000 immigrants and ethnic German resettlers were unemployed, 165,000 more than twelve months earlier.

Easy price situation

In spite of the unmistakable cyclical tensions, domestic inflationary pressures remained comparatively moderate in 1989. Although the average annual increases in prices at both the consumer and the industrial producer levels, at roughly 3% in each case, were perceptibly higher than a year before, this was due in part to non-cyclical factors. This holds true, for instance, of fiscal measures, above all of the measures affecting the tax on mineral oil products and natural gas. The entry into force of these measures at the beginning of 1989 caused the cost of living index and the producer price index for industrial products to rise by around ½% each. An external factor that pushed up prices until well into the spring of 1989 was the circumstance that there was a marked increase in the dollar quotations for energy sources on international markets, while the prices for other commodities remained comparatively stable. In view of the simultaneous tendency for the Deutsche Mark to weaken vis-à-vis the US dollar, this led to a sudden upsurge in all Deutsche Mark import prices. In subsequent months price movements on world markets were more subdued, and the Deutsche Mark strengthened once more against the US dollar. Even so, according to the HWWA index, average Deutsche Mark prices for raw materials and energy in 1989 were together still 18% higher than in 1988, whereas those for all imported goods rose by 4½%. Another factor pushing consumer prices (in particular) upwards – a factor which is less dependent on cyclical trends – was the steep increase in agricultural producer prices, which averaged no less than 8½% in 1989.

Conditions on the labour market

In thousands

Item	1986	1987	1988	1989	1988	1989
	Annual average				Change from December to December	
Employment						
Employed **p**	26,960	27,157	27,354	27,729	+ 247	+ 477
of whom						
Wage and salary earners **p**	23,910	24,141	24,348	24,713	**2** + 218	**2** + 404
Short-time workers	197	278	208	108	– 110	– 58
Vacancies	154	171	189	251	+ 30	+ 99
Unemployed	2,228	2,229	2,242	2,038	– 118	– 139
Memorandum item						
Unemployment rate in % **1**	7.9	7.9	7.7	7.1	.	.
Movements on the labour market	Annual total				Change from previous year	
Increase in unemployed	3,637	3,726	3,669	3,806	– 58	+ 138
Decrease in unemployed	3,766	3,636	3,786	3,945	+ 150	+ 159
Increase in vacancies	1,841	1,823	1,934	2,229	+ 111	+ 295
Job placements	1,965	1,998	2,116	2,282	+ 118	+ 166
Pattern of unemployment	End-September					
Unemployed, total	2,046	2,107	2,100	1,881	– 7	– 219
by sex						
male	1,040	1,082	1,074	951	– 9	– 123
female	1,006	1,025	1,026	930	+ 1	– 96
by nationality						
Germans	1,803	1,843	1,837	1,663	– 5	– 174
of whom						
from eastern Europe and the GDR	37	43	83	151	+ 41	+ 68
foreigners	243	264	262	218	– 2	– 45
by vocational qualification						
unqualified	1,040	1,065	1,024	887	– 40	– 137
qualified	1,006	1,042	1,075	993	+ 33	– 82
by age						
up to 24 years	503	479	415	324	– 64	– 90
25 to 44 years	919	953	970	865	+ 17	– 105
45 to 64 years	624	676	715	692	+ 40	– 24

1 Unemployed as a percentage of the total labour force. – **2** Change from fourth quarter to fourth quarter. – **p** As from 1987 provisional.

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Stable unit labour costs

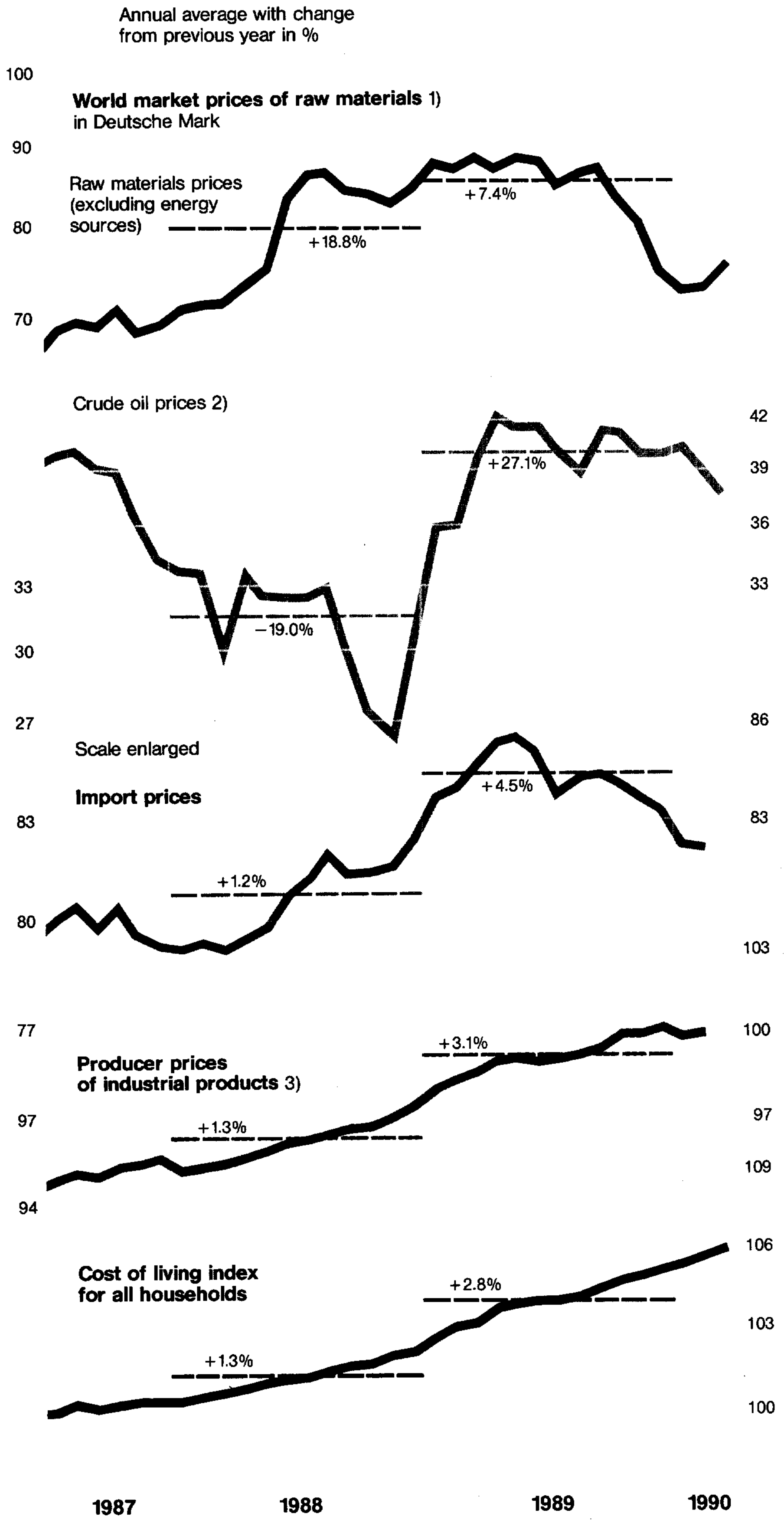
Moderate wage increases, which owed something to the collective wage agreements concluded in preceding years for fairly long periods, and a sharp rise in productivity ensured that overall unit labour costs remained practically stable in 1989. The accelerated upward movement of prices in the construction sector, however, was a warning sign of the transmission of cyclical pressures to price movements. In 1989 the average annual level of overall construction prices, which had risen by around 2% p.a. between 1986 and 1988, surpassed its previous year's level by a good 3%; in the first quarter of 1990 it was as much as 5% higher. Moreover, it must be mentioned in this context that real estate prices, which had been developing along moderate lines for years, and had actually declined in the northern parts of the Federal Republic, started to rise more markedly again.

Increased risks to stabilisation policy in 1990

Prices at the industrial producer and consumer levels alike continued to move quietly around the turn of 1989-90. An important role was played in this context by the exchange-rate-induced drop in import prices and the declining price pressure in the field of agricultural products. However, this unexpectedly favourable trend does not provide any justification whatsoever for any slackening in the efforts undertaken to maintain stability. There is still a danger in the Federal Republic of production potential being overextended. In 1990 the growth of domestic demand must be expected to be far stronger than it was in 1989. A major reason for this assumption is the significant income tax relief

Prices

1985=100, seasonally adjusted, log. scale



1) HWWA index of raw materials prices.- 2) Not seasonally adjusted.- 3) Domestic sales.

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effective from the beginning of 1990, which allows a more rapid increase in private consumption to be foreseen. At the same time, the growing supply bottlenecks on the housing market indicate that demand for residential construction work will continue to be high. As has already been outlined in the preceding section of this Report, the transfer of resources to the GDR and other countries of central and eastern Europe which are in the midst of fundamental changes must also be expected to accelerate in the slightly longer term. These risks to stabilisation policy emanating from the demand side must be taken particularly seriously, not least because it must be feared — in contrast to the situation in 1989 — that the pressure of wage costs will increase in future. The outcome of the recently finalised wage negotiations for the construction sector, at all events, is very much higher than that of the wage agreements concluded in recent years. Judging from the state of the negotiations when this Report went to press, much the same is to be expected for the metal-working industry, too. Moreover, it appears doubtful whether the increase in productivity in 1990 will equal that achieved in 1989, since the available capacity reserves are now probably well-nigh exhausted.

2. Financial policy with varying effects on business activity

Strong expansion in tax revenue in 1989

In 1989 public finance tended to have a dampening impact on economic activity, and this supported the Bundesbank's stabilisation efforts. Looked at in isolation, the strong growth in tax receipts reduced the demand potential of households and business; it exceeded by far the simultaneous rise in government expenditure. Both "built-in stabilisers" and tax policy measures interacted here. Compared with the previous year, tax revenue went up by just over DM 47 billion or 9½% in 1989; mainly owing to the unexpectedly strong rise in taxable income and turnover, it was DM 14 billion higher than had been envisaged in the budgets at the end of 1988. In the case of wage tax and assessed income tax, the progressive nature of the tax scale was felt in full in 1989, the year between the two tax cuts of 1988 and 1990. The excise tax increases in 1989 and the withholding tax temporarily levied on domestic interest income in that year likewise contributed to the considerable growth in tax receipts. Among the other types of income, the high Bundesbank profit was of particular significance. In 1989 DM 10 billion was transferred to the Federal Government (which had received only DM 0.2 billion one year earlier).[1] Including social security contributions, which mainly shadowed the rise in wages and salaries and in the number of employees while contribution rates remained unchanged, total public sector receipts grew by 8% in 1989.

Moderate increase in total public sector expenditure

By contrast, total public sector expenditure went up at a rather moderate pace (about + 3%) in 1989. Thus, another step was taken towards reducing the government spending ratio (the ratio of government expenditure to GNP), a strategy which has been pursued for some time now. In 1989 this ratio amounted to only 46½%, compared with a peak of nearly 52% in 1982.[2] In the course of 1989, additional outlays compared with the budget became necessary, mainly owing to new government tasks which emerged as a result of the inflow of ethnic Germans from eastern Europe and immigrants from the GDR and on account of the opening of the GDR border; however, they were accompanied by economies deriving from the reduction in unemployment in the wake of the vigorous economic growth.

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1 This did not involve any substantial squeeze on income in the private sector. The main reason for the more favourable result was that in 1988, unlike the situation in 1987, the Bundesbank's net profit was not absorbed in balance sheet terms by valuation losses on the monetary reserves.

2 The government spending ratio has been calculated here on the basis of expenditure as defined in the financial statistics. If the definition of the national accounts is used, the ratio is slightly lower, though the decline is roughly the same.

Only slight growth in social security spending

At the individual levels of government, trends in spending varied considerably in 1989. The favourable overall result owed a great deal to the social security funds. As a consequence of the Health Reform Act, the expenditure of the statutory health insurance institutions actually declined (from DM 134.5 billion in 1988 to DM 130 billion). The economies at the Federal Labour Office resulting from the buoyant state of economic activity and cutbacks in several promotional measures more than offset the additional burdens associated with the influx of ethnic Germans from eastern Europe and immigrants from the GDR. Although the expenditure of the pension insurance funds continued to rise rather strongly, total spending by the social security sector went up by only 1½%.

But somewhat faster rise in spending by the central, regional and local authorities

By contrast, the growth in the expenditure of the central, regional and local authorities in 1989 was somewhat up on the year. At approximately 4%, it was above the medium-term rate of about 3% deemed to be acceptable by the Financial Planning Council (in which the Federal and Länder Governments and local authorities coordinate the basic stance of their financial policy). The rise in public sector capital spending accelerated sharply (to 7%). The local authorities (the most important public capital investors) once again started substantially more projects, as they usually do when their financial trend is comparatively favourable. Moreover, public sector capital formation was given a further boost by the subsidised loans granted within the framework of the Reconstruction Loan Corporation's multi-year credit programme for local authorities and the Federal Government's financial assistance programme for structurally weaker Länder, which came into effect early in 1989. The expenditure of the central, regional and local authorities on current transfers to households (mainly social expenditure) went up vigorously, too (+ 5%). There was a particular rise in spending on baby allowances (owing to longer periods of entitlement), on refunds to the pension insurance funds in respect of child-rearing benefits, on social assistance and on payments to ethnic Germans from eastern Europe and to immigrants and visitors from the GDR. Spending on unemployment assistance, on the other hand, declined somewhat owing to the favourable economic trend. Other operating expenditure, too, increased quite strongly (+ 5%). By contrast, personnel spending (+ 2½%) had a moderating impact on the trend in expenditure, thanks to the multi-year pay settlement for the public sector.

Substantial reduction in the budget deficit

Overall, the budget deficit of the central, regional and local authorities, which had amounted to more than DM 50 billion in 1988, declined to only DM 21 billion (or barely 1% of nominal GNP) in 1989.[1] Hence the underlying financial situation prior to the 1990 tax reform was much more favourable than had originally been expected. Since, moreover, a substantial surplus was recorded in the social security sector (by health insurance institutions, in particular), the overall public sector budget deficit declined to just over DM 7 billion in 1989; this corresponded to 0.3% of GNP. A similarly low deficit ratio (0.1%) was last recorded in 1973.

Business activity in 1990 stimulated by the tax reform

The overall economic situation in 1990 – unlike that in 1989 – will be given an expansionary impetus by the tax reform, at the least. In the private sector the income tax cuts will spark off additional demand for consumer and capital goods. However, despite the significant losses of revenue which the tax reform, if considered in isolation, entails for the budgets of the central, regional and local authorities, total tax receipts in 1990 will probably be somewhat up on the year owing to the strong increase in taxable income and turnover. The reductions in contribution rates to the statutory health insurance institutions,

1 The Bundesbank profit transfer is included in full in this figure as revenue.

Finances of the public authorities*

Item	1986	1987	1988 pe	1989 pe	1986	1987	1988 pe	1989 pe
	DM billion				Change from previous year in %			
A. Budgetary trend								
Central, regional and local authorities								
Expenditure								
Personnel expenditure	202.5	211.1	216.6	222	+ 4.6	+ 4.3	+ 2.6	+ 2.5
Other operating expenditure	100.6	103.4	105.6	111	+ 3.4	+ 2.7	+ 2.1	+ 5
Transfers **1**	172.6	182.4	192.1	201.5	+ 4.3	+ 5.7	+ 5.3	+ 5
Interest	57.8	58.6	60.5	61	+ 3.3	+ 1.3	+ 3.4	+ 1
Fixed capital expenditure	55.6	57.2	57.6	61.5	+ 7.0	+ 2.9	+ 0.7	+ 7
Financial aid **2**	40.2	39.9	40.4	41	+ 1.9	− 0.8	+ 1.4	+ 2
Total expenditure **3**	629.9	653.0	673.7	699.5	+ 4.2	+ 3.7	+ 3.2	+ 4
of which								
Federal Government	263.9	271.5	278.2	293	+ 1.7	+ 2.9	+ 2.5	+ 5
Länder Governments	254.1	263.9	270.3	282.5	+ 4.4	+ 3.8	+ 2.4	+ 4.5
Local authorities	172.5	179.2	185.2	194.5	+ 5.9	+ 3.9	+ 3.3	+ 5
EC **4**	19.6	20.2	25.3	24.5	+ 6.2	+ 3.0	+ 25.5	− 3.5
Receipts								
Tax revenue	452.4	468.7	488.1	535,5	+ 3.5	+ 3.6	+ 4.1	+ 9.5
Other receipts	136.0	134.8	132.8	146	+ 4.6	− 0.9	− 1.5	+ 10
Total receipts **3**	587.8	602.0	620.2	678.5	+ 4.0	+ 2.4	+ 3.0	+ 9.5
of which								
Federal Government	240.6	243.6	242.2	**5** 278	+ 1.6	+ 1.2	− 0.6	+ 14.5
Länder Governments	236.4	244.4	253.9	275	+ 4.5	+ 3.4	+ 3.9	+ 8.5
Local authorities	170.8	176.7	185.4	196.5	+ 4.4	+ 3.5	+ 5.0	+ 6
EC	19.6	20.2	25.3	24.5	+ 6.2	+ 3.0	+ 25.5	− 3.5
Surplus (+) or deficit (−)	− 42.1	− 51.0	− 53.5	− 21	.	.	.	.
of which								
Federal Government	− 23.3	− 27.9	− 36.0	**5** − 15	.	.	.	.
Länder Governments	− 17.7	− 19.5	− 16.4	− 7.5	.	.	.	.
Local authorities	− 1.7	− 2.6	+ 0.3	+ 2	.	.	.	.
Social security funds								
Expenditure	353.9	370.7	394.9	400	+ 3.6	+ 4.7	+ 6.5	+ 1.5
Receipts	360.0	374.2	393.6	413.5	+ 4.8	+ 3.9	+ 5.2	+ 5
Surplus (+) or deficit (−)	+ 6.1	+ 3.5	− 1.3	+ 13.5	.	.	.	
Public authorities, total								
Expenditure	943.0	981.3	1,021.9	1,050	+ 4.1	+ 4.1	+ 4.1	+ 3
Receipts	907.0	933.7	967.0	1,042.5	+ 4.4	+ 2.9	+ 3.6	+ 8
Deficit (−)	− 36.0	− 47.6	− 54.9	− 7.5	.	.	.	
	Level at end of year in DM billion				Change from previous year in DM billion			
B. Indebtedness of the central, regional and local authorities								
Borrowers' note loans	486.2	489.8	502.7	496,5	− 11.5	+ 3.6	+ 12.9	− 6
Securities	293.1	339.9	382.0	415	+ 49.7	+ 46.8	+ 42.1	+ 33
Other debt	21.7	19.2	18.3	18	+ 2.6	− 2.5	− 0.9	− 0.5
Total indebtedness	801.0	848.8	903.0	929.5	+ 40.8	+ 47.8	+ 54.2	+ 26.5
of which								
Federal Government	415.4	440.5	475.2	490.5	+ 23.0	+ 25.1	+ 34.7	+ 15.5
Länder Governments	264.4	284.6	302.6	310.5	+ 16.9	+ 20.3	+ 18.0	+ 8
Local authorities	107.3	110.0	111.3	113	+ 1.7	+ 2.7	+ 1.4	+ 1.5

* Including hospitals keeping commercial accounts and other special accounts. Receipts and expenditure are shown here under the period for which they are intended, in accordance with budgetary practice. — **1** Mainly social expenditure and current grants to the enterprise sector. — **2** Expenditure on investment grants and loans to third parties, plus the acquisition of participations. — **3** This aggregate — unlike the figures below for the Federal and Länder Governments and local authorities — does not include transfers between the various levels of government (apart from differences in clearing operations). — **4** EC expenditure financed out of EC revenue in Germany. — **5** The Bundesbank profit transfer is included in full in the figure as Federal Government revenue. — **pe** Partly estimated.

Discrepancies in the totals are due to rounding.

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which were made possible by the Health Reform Act, likewise serve (as intended) to reduce the burden of taxes and social security contributions to be paid to the government.

Steeper expansion of expenditure

Contrary to what was planned in the budgets, the rise in public sector spending will gather pace in 1990. New requirements are arising, first and foremost in the context of political developments in the GDR and in central and eastern Europe. In the Federal Republic of Germany, too, additional expenditure is to be expected. In January 1990 a rise in special allowances for public sector employees was agreed upon. At the end of March the Bundestag approved a supplementary budget according to which the envisaged growth rate of Federal spending compared with 1989 is to increase to about 6 %. At Länder and municipal level, too, expenditure could go up at a similar pace, in accordance with the budgets and the new regulations on special allowances for public sector employees, which were not included in the budgets. Hence the deficit of the central, regional and local authorities will expand substantially in 1990. Admittedly, judging only by the measures which have actually been approved so far, it will probably not exceed the 1988 level (just over DM 50 billion). However, the budgetary trend understates the cyclical impact to a certain extent, since the increase in measures to promote housing construction, which was approved in 1989, is reflected relatively little at first in shortfalls in receipts or additional expenditure.

Financial policy facing additional tasks in support of economic changes in the GDR

However, there are still considerable uncertainties on both sides of the budget. On the one hand, there would be a chance of tax revenue developing more favourably if the buoyant trend in business activity continued. On the other hand, there are signs that the extension of the currency area of the Deutsche Mark to include the GDR and the restructuring of the economy of the GDR in line with the principles of a market economy will impose additional financial burdens upon the Federal Republic of Germany, at least initially, although the scale of these burdens is not yet predictable. The most obvious means of financing these burdens would be cuts in public sector spending and in tax concessions in the Federal Republic, particularly in those concessions which were introduced because individual regions had been cut off from their traditional economic connections when the border was set up and the Berlin wall was built. Indeed, a significant cut in subsidies seems to be all the more appropriate since very heavy additional demands from disadvantaged sectors of the GDR economy might otherwise ensue, with reference to the need for equal treatment. From a macro-economic point of view, too, a restructuring of the public sector budgets would be the best way of achieving the required real transfer of resources. Yet it probably has to be expected that economies can be realised only gradually and can satisfy only part of the additional demand. The Federal Cabinet has already stated that the Federal Government intends to contribute to the cost of the measures needed in the area of social security in the GDR, particularly in the context of establishing an unemployment insurance scheme and reorganising the retirement pension system. Public finance in the GDR will initially be hard hit by the disappearance of the hitherto crucial revenue in the form of transfers from publicly-owned enterprises, because other taxes and levies will start to flow only with a time-lag, and some sources of revenue will become more productive only as the country's economic potential increases. Moreover, the government will be called upon to help enterprises survive in a competitive economy – an environment which has been utterly unknown hitherto. However, even in the face of these challenges the Federal Republic must not abandon its principle of sound budgetary policy – a principle which has been a distinctive feature of the past few years.

Favourable basic situation of public finance in the Federal Republic

Happily, the basic situation of public finance in the Federal Republic is favourable. The relief for tax-payers resulting from the 1990 tax reform will not generate major pressures in the budget situation of the central, regional and local authorities. The preceding stabilisation measures, especially those on the expenditure side, will enable the overall tax ratio in 1990 to decline to about the same low level as in the late fifties. In the social security sector, too, the pension insurance reform which was approved by Parliament in 1989 paves the way over the longer term for macro-economically acceptable financial trends, while the financial situation of the statutory health insurance institutions has improved for the time being thanks to the Health Reform Act. The momentum of the private sector is being enhanced by the stimuli imparted by public finance. To this extent, the conditions are good for coping with temporary extra burdens by means of government assistance to step up the economic potential and overcome transitional problems in the social security sector in the GDR. However, such government assistance can only be of a subsidiary nature and must not lead to the emergence of a "subsidy psychology", which, once created, is difficult for the policy makers to eliminate, as experience in the Federal Republic has shown. Government assistance must remain "helping the GDR to help itself"; it should not relate to any tasks which can best be performed with the aid of private initiative and private capital, once an appropriate free-market framework has been created.

3. Faster growth in the external surpluses

Sharp rise in the current account surplus

Fostered by the rapid expansion in the world economy and the temporary weakness of the Deutsche Mark, the Federal Republic of Germany's external surplus increased once again in 1989. The current account surplus rose to DM 104 billion, or 4½% of GNP, compared with DM 88 billion, or 4% of GNP, in 1988. As import prices went up more rapidly than export prices, which meant that the terms of trade changed to Germany's disadvantage, the increase in the surplus was even higher "in real terms". Around the turn of 1989-90, the export boom seems to have abated somewhat. Given the strong rise in domestic demand, the prospect that the surpluses will decline is improving, especially – as explained in more detail in the introductory part of this Report – since the political changes in central and eastern Europe (particularly in the GDR) and the creation of a unified economic area comprising the Federal Republic of Germany and the GDR will probably encourage this tendency.

Rapid growth in exports as a result of expansionary world trade and Germany's high degree of competitiveness

Germany's exports rose by 13% in value and 8½% in real terms in 1989. This increase was primarily due to the strong growth in the industrial countries and the high degree of competitiveness of German export products. In addition to the price advantage enjoyed by their goods, which was enhanced by the depreciating tendency of the Deutsche Mark until the summer of 1989, German suppliers benefited from the fact that foreign demand concentrated mainly on capital goods, which account for a comparatively high proportion of German exporters' range of products. All of these factors combined enabled German exporters to participate fully again in the expansion of world trade (by around 7½%) in 1989; indeed, they actually achieved a slight increase in their share.

Surge in imports owing to heavy domestic demand and low-priced supply

Germany's imports also grew unusually fast in 1989, viz. by a nominal 15% and a real 7½%. The import pull was therefore greater than in any of the previous ten years. This was largely due to the sharp rise in domestic demand, which increasingly had to be satisfied through imports because of the growing capacity and delivery bottlenecks. Moreover, in the second half of the year, when the Deutsche Mark was recovering and being quoted at higher and higher rates, import prices stabilised and, later on, actually declined. This led to a further improvement in the competitiveness of imports – notably of capital

Major items of the balance of payments

DM billion

Item	1982	1983	1984	1985	1986	1987	1988	1989
A. Current account								
1. Foreign trade								
Exports (f.o.b.) **1**	427.7	432.3	488.2	537.2	526.4	527.4	567.7	641.3
Imports (f.o.b.) **1**	365.2	378.5	421.4	451.1	403.0	399.5	428.4	493.4
Balance	+ 62.6	+ 53.8	+ 66.8	+ 86.0	+ 123.4	+ 127.9	+ 139.2	+ 148.0
2. Supplementary trade items and merchanting trade **2**	+ 0.8	+ 3.3	− 1.1	− 1.3	− 1.5	− 1.8	+ 0.6	− 3.0
Balance of trade	+ 63.3	+ 57.0	+ 65.8	+ 84.7	+ 121.9	+ 126.1	+ 139.8	+ 145.0
3. Services								
Receipts	116.6	118.8	133.5	142.5	141.3	144.4	150.9	182.5
Expenditure	141.6	137.1	141.6	149.7	150.4	159.5	170.5	188.6
Balance	− 25.0	− 18.3	− 8.1	− 7.3	− 9.1	− 15.1	− 19.6	− 6.2
4. Transfer payments	− 25.9	− 25.2	− 29.7	− 29.1	− 27.1	− 28.9	− 31.9	− 34.6
of which								
Remittances of foreign workers	− 8.3	− 8.3	− 9.0	− 8.0	− 7.5	− 7.3	− 7.4	− 7.5
Transfers to the European Communities	− 7.5	− 6.1	− 7.5	− 8.2	− 7.9	− 9.9	− 12.2	− 12.9
Balance on current account	+ 12.4	+ 13.5	+ 27.9	+ 48.3	+ 85.8	+ 82.1	+ 88.3	+ 104.2
B. Capital account								
1. Long-term capital transactions								
(a) German investment abroad (increase: −)	− 28.3	− 36.5	− 45.0	− 61.7	− 55.4	− 62.5	− 97.9	− 92.2
Direct investment	− 6.0	− 8.1	− 12.5	− 14.1	− 20.9	− 16.4	− 19.8	− 25.3
Foreign securities	− 11.4	− 10.4	− 15.7	− 31.5	− 21.3	− 24.9	− 72.9	− 49.8
Lending to non-residents	− 8.7	− 14.7	− 14.2	− 13.1	− 10.3	− 18.6	− 2.4	− 13.9
Other investment abroad	− 2.3	− 3.3	− 2.6	− 3.0	− 3.0	− 2.7	− 2.8	− 3.3
(b) Foreign investment in Germany (increase: +)	+ 14.2	+ 29.5	+ 25.2	+ 48.8	+ 88.9	+ 39.5	+ 11.0	+ 69.4
Direct investment	+ 2.0	+ 4.5	+ 1.6	+ 1.7	+ 2.6	+ 3.4	+ 2.4	+ 11.2
Domestic securities and official domestic borrowers' notes	+ 12.2	+ 25.5	+ 21.7	+ 36.3	+ 69.1	+ 21.2	− 3.2	+ 40.6
Securities	+ 2.8	+ 13.6	+ 17.4	+ 38.3	+ 74.1	+ 33.2	+ 7.7	+ 45.8
Borrowers' notes	+ 9.4	+ 11.9	+ 4.3	− 2.0	− 5.0	− 12.0	− 10.9	− 5.2
Lending to residents **3**	+ 0.1	− 0.3	+ 1.9	+ 10.9	+ 17.3	+ 14.9	+ 12.0	+ 17.8
Other investment in Germany	− 0.1	− 0.2	− 0.0	− 0.1	− 0.1	− 0.1	− 0.2	− 0.1
Balance of long-term capital transactions	− 14.2	− 7.0	− 19.8	− 12.9	+ 33.4	− 23.1	− 86.9	− 22.7
2. Short-term capital transactions (net capital exports: −)								
(a) Banks	+ 8.1	+ 1.8	+ 0.1	− 27.7	− 59.0	− 6.1	− 20.0	− 56.7
Assets	+ 4.3	+ 5.3	− 17.8	− 33.4	− 65.8	− 15.4	− 30.1	− 81.0
Liabilities	+ 3.8	− 3.6	+ 17.8	+ 5.7	+ 6.8	+ 9.3	+ 10.1	+ 24,3
(b) Enterprises and individuals	+ 3.2	− 8.9	− 16.1	− 14.1	− 56.7	− 11.0	− 22.0	− 44.5
Financial relations with foreign banks	+ 7.1	− 2.5	− 3.3	− 13.5	− 49.3	− 11.1	− 11.5	− 33.3
Financial relations with foreign non-banks	− 2.0	− 0.6	− 4.0	+ 2.8	− 2.2	− 1.8	− 2.1	− 4.7
Trade credits	− 1.9	− 5.9	− 8.7	− 3.5	− 5.2	+ 1.9	− 8.4	− 6.6
(c) Official	− 0.3	− 4.3	− 1.6	+ 0.1	− 0.3	+ 1.4	+ 1.7	− 4.3
Balance of short-term capital transactions	+ 11.0	− 11.5	− 17.7	− 41.7	− 116.0	− 15.8	− 40.3	− 105.5
Balance on capital account	− 3.2	− 18.4	− 37.5	− 54.6	− 82.6	− 38.9	− 127.1	− 128.2
C. Balance of unclassifiable transactions (balancing item)	− 6.2	+ 0.8	+ 6.5	+ 8.1	+ 2.7	− 2.0	+ 4.1	+ 5.0
D. Balancing item in respect of the Bundesbank's external position 4	− 0.4	+ 2.4	+ 2.1	− 3.1	− 3.2	− 9.3	+ 2.2	− 2.6
E. Change in the Bundesbank's net external assets 5 [A plus B plus C plus D] (increase: +)	+ 2.7	− 1.6	− 1.0	− 1.3	+ 2.8	+ 31.9	− 32.5	− 21.6

1 Special trade. — **2** Mainly warehouse transactions for account of residents and deduction of goods returned and of cross-border commission processing. — **3** Excluding official domestic borrowers' notes. — **4** Counterpart of changes in the Bundesbank's external position which are not caused by external current and capital transactions: changes in the Deutsche Mark value of the Bundesbank's assets and liabilities denominated in foreign currencies owing to the revaluation at the end of the year and differences between the transaction values of the Bundesbank's foreign exchange transactions and the changes in the external position shown at balance sheet rates. — **5** Valued at balance sheet rates. Discrepancies in the totals are due to rounding. BBk goods and chemical products. In 1989 the share of foreign goods in the satisfaction of aggregate domestic demand rose to about 30% in all.

Trade surpluses concentrate on Europe

Calculated on an f.o.b.-f.o.b. basis,[1] Germany's foreign trade surplus went up in 1989 from just under DM 140 billion to DM 145 billion. The surpluses were focused even more markedly than before on trade with other European countries. No doubt the inflexibility of nominal exchange rates within the exchange rate system of the EMS and the "real" depreciation of the Deutsche Mark associated with the inflation differentials played an important part in this. On the other hand, the trade surplus with the United States was halved in 1989; it was thus about DM 20 billion lower than in 1986. To some extent, this adjustment in US-German trade is probably a reflection of the after-effects of the Deutsche Mark's strong appreciation against the US dollar up to the end of 1987. Thus, calculated as an annual average of 1989, the Deutsche Mark was still worth 40% more against the US dollar than it had been four years before. In addition, it was probably the divergent economic trends on both sides of the Atlantic that resulted in Germany's trade balances with its European neighbours and with the United States developing in such diametrically opposite ways.

Growing net investment income reduces the deficits on services account

The external surpluses again led to a sharp rise in Germany's external assets in 1989, and the investment income generated abroad therefore increased. Germany's net investment income thus amounted to DM 22 billion, a development which was encouraged by rising interest rates abroad as well. It is naturally unlikely that this trend could be sustained if interest had to be paid at higher rates in future on Germany's growing gross external liabilities. Owing to the rise in investment income – while net expenditure on foreign travel was virtually static – the overall deficit on services account (including the freight and insurance costs payable on imports) dropped from nearly DM 20 billion in 1988 to about DM 6 billion in 1989. At all events, the services account is no longer the counterbalance to the trade surpluses which it once was; if the net external assets continue to grow, the deficit on it may diminish even further.

Improved conditions for Deutsche Mark investments

For a number of reasons, Germany's capital transactions in 1989 were characterised by the renewed interest of non-residents in Deutsche Mark assets in Germany and by a similarly motivated decline in residents' interest in investment abroad. The announcement in April 1989 that withholding tax was to be abolished attracted non-resident investors back to the German capital market. In addition, the Federal Reserve System switched to a more expansionary monetary policy in the spring, while short-term interest rates in Germany were raised on a number of occasions. As a result of these contrasting developments, dollar investments lost much of their interest rate advantage over similar Deutsche Mark assets in the course of the year. The upward trend in the Deutsche Mark against non-EMS currencies during the second half of the year, and the "eastern euphoria" sparked off by the upheavals in central and eastern Europe, further stimulated demand for German securities, although this tendency was not continuously sustained.

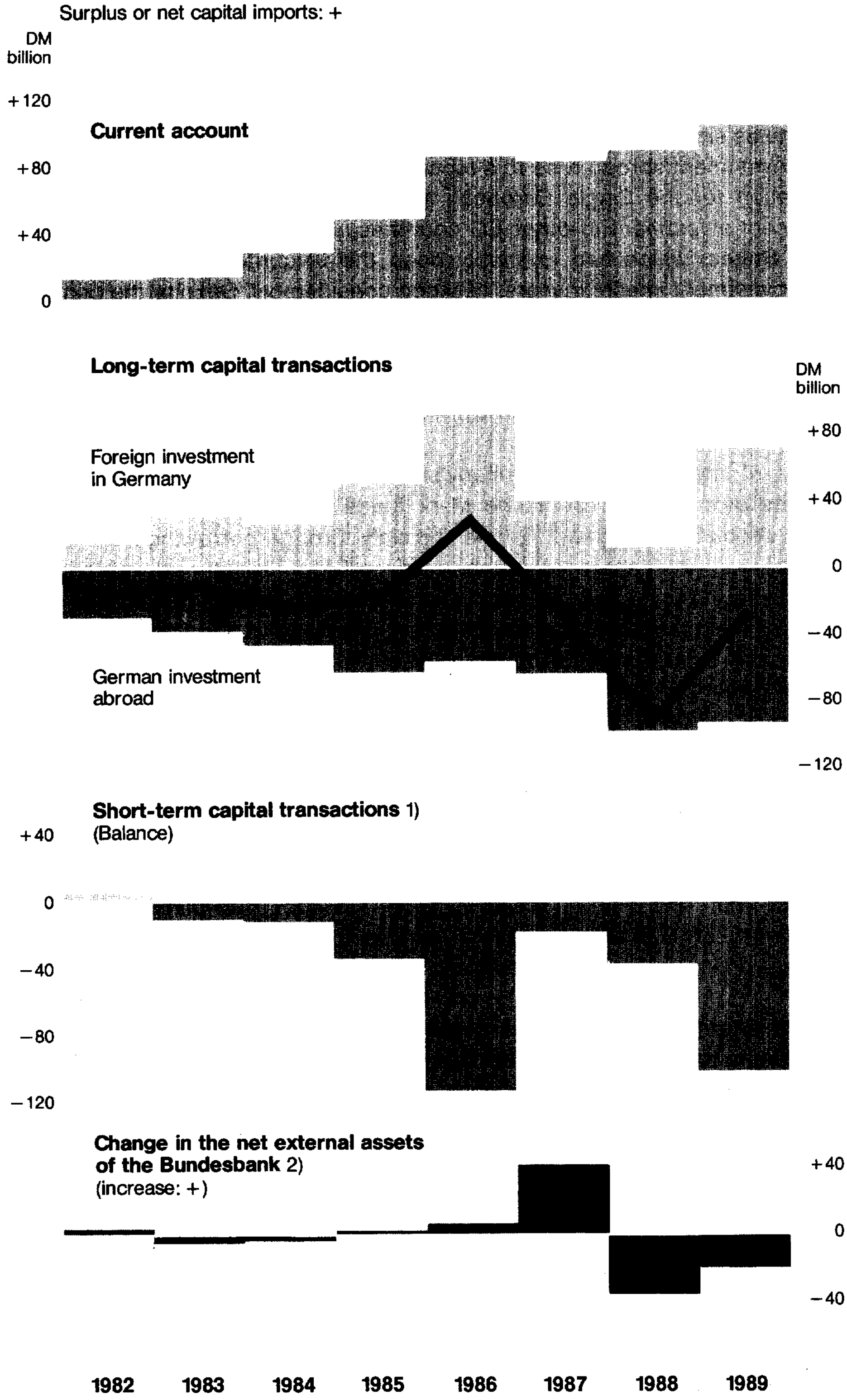
Non-residents buy more German securities

As a result of the reversal in trends in favour of Deutsche Mark assets in the course of the year, net long-term capital outflows from Germany declined to DM 23 billion in 1989, compared with a total of DM 87 billion, or the equivalent of the current account surplus, in 1988. This was primarily due to the changed attitude of foreign investors, who placed DM 69 billion in Germany in 1989

1 In line with international balance of payments practice and in contrast to the official German foreign trade statistics and the customary practice for the figures published in the Monthly Reports, both exports and imports are recorded here on an f.o.b. basis. The freight and insurance costs payable on imports are included in the services account.

Balance of payments pattern

Surplus or net capital imports: +



1) Including the balancing item of the balance of payments.- 2) Resulting from transactions.

BBk

against only DM 11 billion in 1988. As described in more detail below (on pp. 48-50), non-residents were mainly interested in German shares. Encouraged by the favourable economic data and the "eastern euphoria", non-residents invested a record DM 23 billion in the German share market (not counting participations). US and Japanese investors bought German equities on a comparatively large scale for the first time (as far as this can be judged from the statistics). Non-residents also stepped up their purchases of domes-

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Das Schriftstück erscheint unmittelbar
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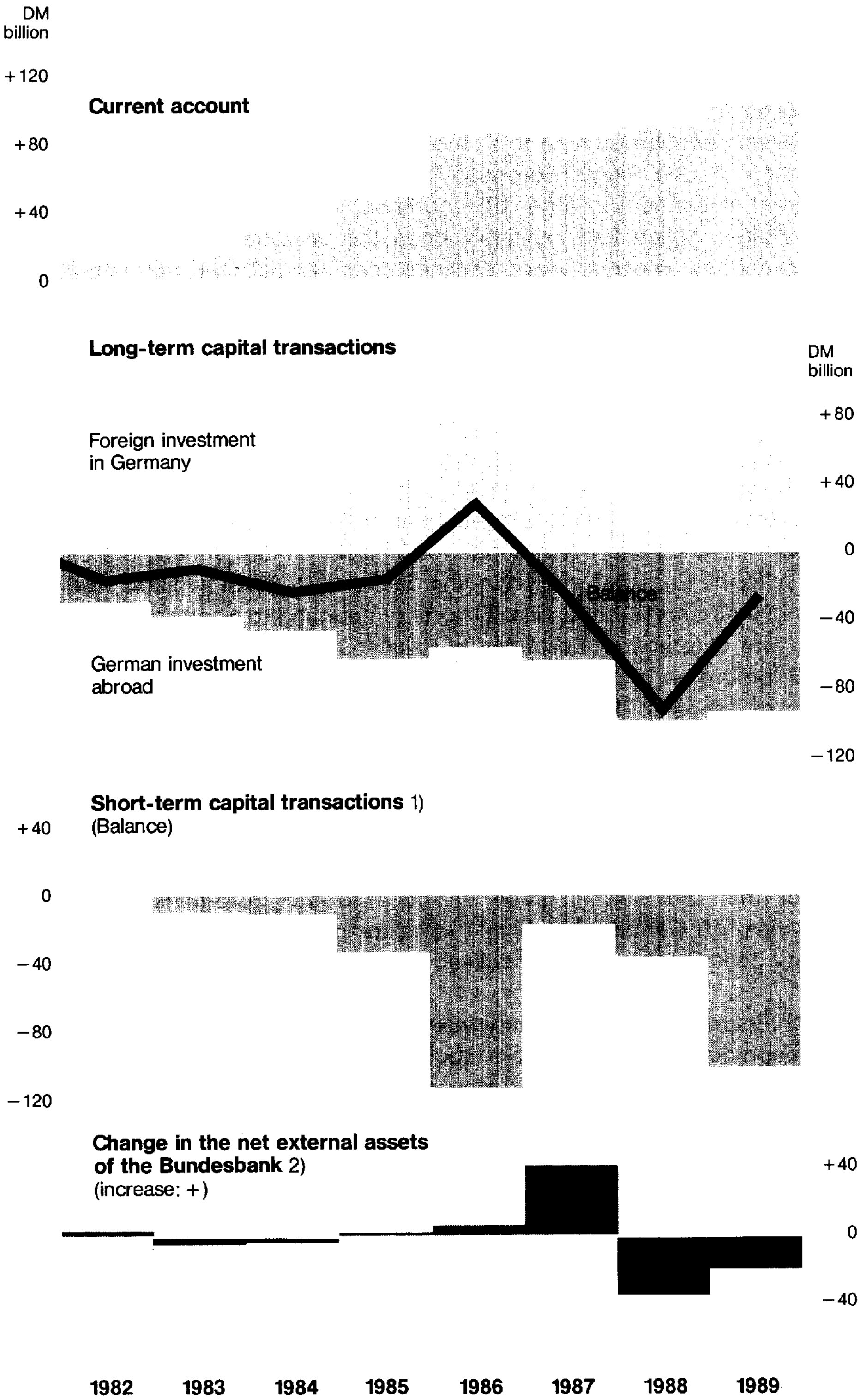
Balance of payments pattern

Surplus or net capital imports: +



1) Including the balancing item of the balance of payments.- 2) Resulting from transactions.

BBk

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Sustained large capital exports

At a total of DM 92 billion, Germany's long-term capital exports in 1989 were not quite as sizeable as they had been in the previous year. As a result, German direct investment abroad rose to a record DM 25.5 billion. In the course of their preparation for the Single European Market, German enterprises increased their direct investment in other EC countries, while the share invested in the United States, which had invariably been the favourite country for German direct investment in earlier years, declined considerably. Despite the continued rise in saving in Germany, residents invested about one-third less in foreign securities in 1989, at a total of DM 50 billion, than they had done a year before, when tax considerations, interest rates and exchange rates led to massive outflows of portfolio capital from Germany.

Balance of payments adjustment through outflows of short-term funds

In view of the decline in Germany's net long-term capital exports, non-residents procured the Deutsche Mark funds they required to finance their current account deficits with Germany mainly through borrowing from domestic banks, via which short-term funds totalling DM 57 billion net were exported (primarily to the Euro-DM market) in the course of 1989. In addition, non-banks increased their short-term capital exports (amounting to a total of about DM 45 billion), with enterprises' Euro-market balances increasing particularly sharply (DM 36 billion). A number of different motives probably account for this build-up of deposits. Just like the large short-term capital exports of banks, enterprises' financial assets may have been attracted by the comparatively favourable interest rates for Euro-DM funds, although some division in the market no doubt also played a role here. Large enterprises – it is predominantly these which are increasingly building up their cash balances in the Euro-market – obtain better terms there than they normally would at home. The fact that this shift in cash balances to the Euro-banks (notably to subsidiaries of German "parents") is also posing a growing number of monetary policy problems is discussed below (see p. 39).

Doubling of the Bundesbank's external liabilities

The slight increase in the monetary reserves recorded in 1989 is accounted for by "autonomous" inflows of dollars, such as interest income and dollar receipts from US troops stationed in Germany. On the other hand, with an increase of DM 24.5 billion, the Bundesbank's external liabilities almost doubled in the course of the year. This was mainly because the US monetary authorities invested with the Bundesbank Deutsche Mark which they had bought in support of that currency while it was weak. As a result of these additions to the liabilities side, the Bundesbank's net external assets (calculated at transaction rates) declined by DM 19 billion on balance in 1989.

Change in sentiment in favour of the Deutsche Mark

The Deutsche Mark's lengthy period of weakness, which had started as early as the beginning of 1988, did not come to an end until the second half of 1989. During this period a change in sentiment in favour of the Deutsche Mark emerged in the foreign exchange market and became even stronger towards the end of the year. Confidence in the Deutsche Mark was no doubt strengthened not only by the positive expectations which the financial markets initially associated with developments in the GDR and eastern Europe, but also by the increasingly "tightening" monetary policy of the Bundesbank. As a result of several rises in short-term interest rates in Germany, the interest rate advantage of the US dollar over the Deutsche Mark had been completely eliminated by the autumn of 1989. Despite fluctuations, the dollar exchange rate remained at around DM 1.70 to the dollar from the beginning of 1990 to the

Changes in the net external position of the Bundesbank*

DM billion; increase in foreign exchange: +

Period		Net external position, total	Operations in the foreign exchange market 1				Other foreign exchange movements
			Deutsche Mark-dollar market	EMS			
				Total	Inter-vention	Debt settle-ment 2	
1988	January	+ 4.0	+ 2.2	–	–	–	+ 1.8
	February	– 5.3	–	– 6.1	–	– 6.1	+ 0.8
	March	– 1.6	–	–	–	–	– 1.6
	April	+ 2.0	+ 0.6	–	–	–	+ 1.4
	May	– 3.1	–	–	–	–	– 3.1
	June	– 8.8	– 2.5	–	–	–	– 6.3
	July	– 11.2	– 11.3	–	–	–	+ 0.1
	August	– 8.6	– 9.0	–	–	–	+ 0.5
	September	– 2.6	– 1.1	–	–	–	– 1.6
	October	+ 0.9	– 0.1	–	–	–	+ 1.0
	November	+ 3.1	+ 1.1	–	–	–	+ 2.0
	December	– 3.4	– 0.2	–	–	–	– 3.2
	Total	– 34.7	– 20.3	– 6.1	–	– 6.1	– 8.2
1989	January	– 4.2	– 4.4	–	–	–	+ 0.1
	February	– 0.7	– 1.9	–	–	–	+ 1.2
	March	– 4.1	– 2.6	–	–	–	– 1.5
	April	– 0.1	– 0.9	–	–	–	+ 0.9
	May	– 5.9	– 8.4	–	–	–	+ 2.6
	June	– 2.0	– 3.0	–	–	–	– 1.0
	July	– 0.8	– 0.4	–	–	–	– 0.3
	August	+ 0.9	– 1.0	–	–	–	+ 2.0
	September	– 2.7	– 3.6	–	–	–	+ 0.9
	October	+ 1.9	– 2.4	+ 3.0	+ 3.0	–	+ 1.3
	November	– 0.6	–	– 3.0	–	– 3.0	+ 2.4
	December	– 0.8	– 0.0	–	–	–	– 0.8
	Total	– 19.0	– 28.7	–	+ 3.0	– 3.0	+ 9.7
1990	January	+ 1.0	– 0.1	–	–	–	+ 1.1
	February	+ 1.8	–	–	–	–	+ 1.8
	March	– 1.3	– 1.5	–	–	–	+ 0.2
	1st quarter	+ 1.5	– 1.6	–	–	–	+ 3.1

* Excluding liquidity swaps. Transactions recorded according to the date of entry. — 1 Including operations by other central banks, where they affect the external position of the Bundesbank. — 2 Deutsche Mark repayments to the Bundesbank by EMS partners.
Discrepancies in the totals are due to rounding. BBk

middle of April. At that point, the weighted external value of the Deutsche Mark against the currencies of all major industrial countries was 6% higher than at the beginning of 1989. The fact that it did not show any greater improvement was primarily due to the largely "fixed" exchange rates in the EMS. Although the aforementioned appreciation of the Deutsche Mark offset the earlier losses in nominal exchange rates, the lower rate of inflation in Germany was still left out of account.

4. Monetary policy in the service of prophylactic inflation control

(a) "Tightening" the monetary policy stance

Continuation of the forward-looking basic stance

The domestic and external developments described in the previous sections of this Report made heavy demands on monetary policy during 1989. Against the background of a number of years with an ample supply of liquidity, growing cyclical pressures and a sustained weakness of the Deutsche Mark in the exchange markets, the threats to price stability increased. In 1989 the Bundesbank therefore continued the "tightening" of its monetary policy stance which it had initiated in mid-1988. This was reflected in the achievement of the monetary target and various increases in its key interest rates, aimed at countering foreseeable inflation risks at an early stage. A monetary policy stance of this kind was fully in line with the external and domestic monetary

Record of economic policy measures

I. Domestic and external monetary policy

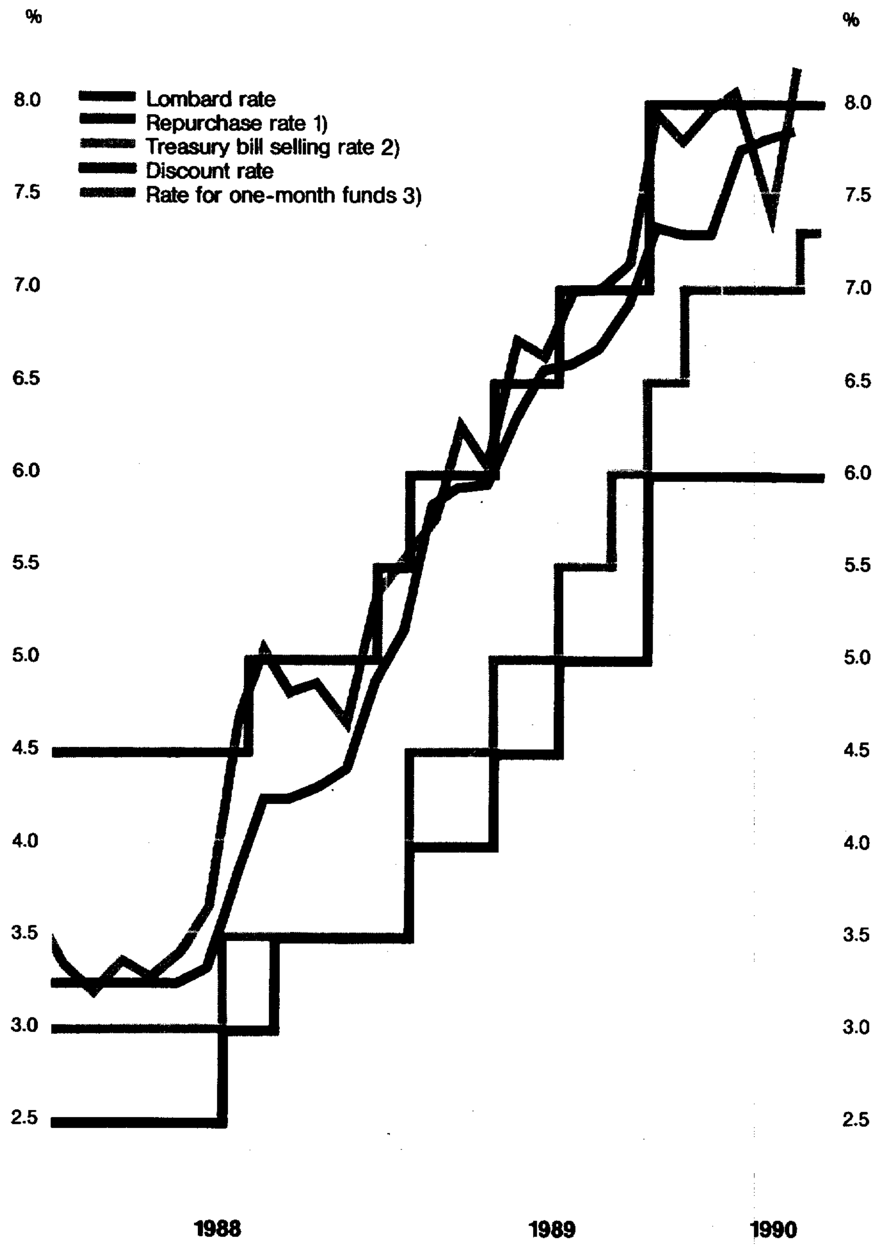
1989	
January 19	The Bundesbank raises the discount rate from 3.5% to 4% and the lombard rate from 5.5% to 6% with effect from January 20 in order to restrain monetary growth and counteract upward trends in prices and any further weakening of the exchange rate of the Deutsche Mark.
April 6	The Bundesbank approves its annual accounts for the financial year 1988; DM 10.0 billion of its net profit is transferred to the Federal Government.
April 20	With effect from April 21, the discount rate is raised from 4% to 4.5% and the lombard rate from 6% to 6.5%, primarily because monetary expansion in the Federal Republic of Germany continues to be stronger than is consistent with stabilisation policy requirements.
June 19	Spain joins the exchange rate mechanism of the EMS. The margin of fluctuation for the Spanish peseta in the EMS is set at ±6% for a transitional period. At the same time, the Council of EC Economic and Finance Ministers decides to amend the composition of the ECU basket with effect from September 21, 1989 and to include the Spanish peseta and the Portuguese escudo in the basket.
June 26-7	The European Council of the heads of state and government of the EC member states declares that the report of the Committee for the Study of Economic and Monetary Union ("Delors Committee Report") provides a sound basis for the work remaining to be done. At the same time, it is decided that the first stage of the process towards economic and monetary union is to begin on July 1, 1990 and that the appropriate institutions should make preparations for convening an inter-governmental conference to determine the subsequent stages.
June 29	The Bundesbank reviews and reaffirms its monetary target for 1989. In view of the risk of domestic and external price and cost rises, the Bundesbank considers it advisable to work towards as moderate a growth of the money stock as possible for the remainder of the year, contributing in this way to the enhancement of the internal and external purchasing power of the Deutsche Mark. With the same ends in view, the Bundesbank raises the discount rate from 4.5% to 5% and the lombard rate from 6.5% to 7% with effect from June 30.
September 7	As part of the structural adjustment of its refinancing facilities, the Bundesbank decides to phase out (by the end of 1991) some special facilities which serve to finance foreign trade. This reduces the overall refinancing facilities available to the banking system by a total of roughly DM 6 billion. To compensate for this reduction, the banks' ordinary rediscount quotas at the Bundesbank are increased by DM 5 billion with effect from November 2.
October 5	The Bundesbank raises the discount and lombard rates from 5% to 6% and from 7% to 8%, respectively, with effect from October 6. By taking this decision the Bundesbank continues its policy of counteracting any tendency for business activity to get out of hand, averting any threat of price and cost rises, strengthening the external purchasing power of the Deutsche Mark and aiming for the rest of the year at as moderate a growth of the money stock as possible, while taking due account of the corporate funds in the Euro-market.
December 8-9	The European Council of the heads of state and government of the EC member states decides to call an inter-governmental conference "charged with preparing an amendment of the Treaty with a view to the final stages of EMU" before the end of 1990.
December 14	The Bundesbank announces its monetary target for 1990. In that year, as before, the Bundesbank will gear its monetary policy to maintaining the domestic purchasing power of the Deutsche Mark and at the same time contributing to the steady continuance of economic growth. In order to achieve these objectives, the Bundesbank considers it appropriate, in view of the existing uncertainties, to fix the monetary target for the period from the fourth quarter of 1989 to the fourth quarter of 1990 at 4% to 6%.
1990	
January 8	In the twelfth exchange rate realignment within the EMS the Italian lira is devalued by about 3.7% and at the same time the margin of fluctuation for the lira within the EMS is narrowed to ±2.25%.
March 12	The Council of EC Economic and Finance Ministers adopts a "decision on the attainment of progressive convergence of economic policies and performance during stage one of economic and monetary union" (superseding the Council decision on convergence and the Council directive on stability and growth of 1974) and a decision putting cooperation between the central banks of EC member states on a new footing.

II. General economic and financial policy

1989	
January 1	Excise tax increases and some elements of the 1990 Tax Reform Act (including, in particular, the 10% withholding tax on domestic interest income) become effective.

	Key provisions of the Health Reform Act come into force; the aim of this Act is to dampen the rise in costs in the statutory health insurance scheme. About one-half of the amount saved is to be used for new benefits (primarily for nursing care at home), and the rest is to provide scope for lowering contributions.
	The Structural Assistance Act enters into effect, providing for financial assistance from the Federal Government totalling DM 2.45 billion annually for the Länder Governments (other than Baden-Württemberg and Hesse) with respect to Länder and municipal capital formation.
January 25	In its 1989 Annual Economic Report the Federal Cabinet notes that the economic situation in the Federal Republic of Germany at the beginning of the year is marked by a strong upswing. In 1989 real GNP is expected to grow by about 2½%; this expansion will probably be accompanied by a rise of just over ½% in the number of employed and a slight decline in the unemployment rate. The Federal Cabinet anticipates that it will be possible to limit the average annual increase in consumer prices to between 2% and 2½% in 1989.
March 16	The government coalition adopts a family, social and housing construction policy programme. Among other things, the periods of entitlement to baby allowances (which depend upon income) and baby leave are to be gradually increased to eighteen months as from mid-1989 and mid-1990, children's benefits for the second children of parents in lower-income groups are to be raised from DM 100 to DM 130 a month as from July 1, 1990 and the education promotion scheme is to be reorganised. Moreover, the depreciation allowances for rented housing are to be improved.
May 10	The Federal Cabinet approves a number of amendments to the 1990 Tax Reform Act, including, in particular, the abolition of withholding tax on domestic interest income as from July 1, 1989 and the retroactive doubling of savers' tax allowance as from the beginning of 1989 to DM 600/DM 1,200 (single persons/married couples) annually.
June 2	The Bundestag passes the 1989 supplementary budget, which provides for additional expenditure and receipts totalling just over DM 1 billion each.
July 5	The Federal Cabinet approves the draft Federal budget for 1990 and the financial plan for the period from 1989 to 1993. The budget volume in 1990 amounts to DM 301.5 billion (3.4% more than the estimate for 1989, including the supplementary budget) and the financial deficit to DM 34.5 billion. Over the medium term, expenditure is to rise by 3% a year. The deficit is to decrease gradually to DM 26.5 billion by 1993.
November 9	The Bundestag passes the 1992 Pension Reform Act, the aim of which is to keep the statutory pension insurance funds financially in balance over the medium and longer term.
November 23	In its Annual Report the German Council of Economic Experts points out that, in order to safeguard monetary stability and achieve further success with respect to employment, it is essential to keep cost rises low and to further improve supply-side conditions. Moreover, the Council warns against over-hasty steps towards a European monetary union. For 1990 it estimates the growth rate of real GNP at 3%.
November 24	The Financial Planning Council affirms that the containment of public sector indebtedness continues to be a major objective. Hence, it says, the target must remain that of limiting the growth in the expenditure of the public sector as a whole to an average of about 3% over the next few years. In addition, the central, regional and local authorities should postpone building starts wherever possible in order to avoid tensions in the construction sector.
December 1	The Bundestag passes the 1990 Federal budget, with an expenditure volume of DM 300 billion (+3%) and a financial deficit of just under DM 28 billion.
December 5	The establishment of a fund to finance visitors' payment media for travellers from the GDR is announced for a transitional period of two years as from January 1, 1990. In the first year the fund will have a volume of about DM 3 billion. About three-quarters of the Deutsche Mark amounts required for the conversion of sums in GDR Mark into Deutsche Mark will be raised by the Federal Republic and about one-quarter by the GDR.
1990	
January 1	The most important provisions of the 1990 tax reform enter into force. The net volume of tax relief (including some further minor tax amendments) is put at about DM 25 billion.
January 22	In its 1990 Annual Economic Report, the Federal Cabinet notes that the German economy is in superb shape. For 1990 it expects real GNP to rise at an average annual rate of 3% or more. Domestic demand, it believes, will probably go up somewhat more strongly still, not least owing to the third stage of the tax cuts.
January 24	The German Council of Economic Experts submits a special report on the preconditions for and opportunities presented by an economic reform in the GDR. As a model for the reform, it recommends an open social market economy. Public financial assistance should be granted to the GDR by the Federal Republic only to supplement private capital flows.
February 13	The Federal Cabinet submits to the Prime Minister of the GDR an offer to open negotiations immediately on the creation of an economic and monetary union between the two Germanys.
March 29	In a resolution passed by the Central Bank Council, the Bundesbank recommends to the Federal Cabinet that it should take due account of a number of "key variables" when converting the monetary system of the GDR to Deutsche Mark as part of a treaty between the two Germanys.
March 30	The Bundestag approves a supplementary Federal budget for 1990 involving additional expenditure totalling just under DM 7 billion net (mostly assistance payments to the GDR). This will increase the Federal deficit shown in the budget to DM 34.5 billion.

Interest rates of the Bundesbank and rate for one-month funds



1) Average monthly interest rate for one-month securities repurchase agreements; uniform allotment rate (volume tenders, "Dutch" interest rate tenders) or weighted allotment rate ("US-style" interest rate tenders).- 2) Normally for 3 days.- 3) Monthly averages including changes due to working-day variations (e.g. in "short" Februaries).

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policy requirements of Germany's western European neighbours, as well as those of other industrial countries.

Tightening of interest rate policy in the wake of growing threats to stability

In the course of 1989 the Bundesbank raised the discount and lombard rates four times altogether; the allotment rates for securities repurchase agreements went up accordingly. As early as the beginning of the year the discount and lombard rates were raised from 3.5% and 5.5% to 4% and 6%, respectively, with effect from January 20. Further increases, by ½ percentage point each, followed as from April 21 and – in connection with the usual review of the monetary target at mid-year – from June 30. The increase of 1 percentage point each in the discount and lombard rates (to 6% and 8%, respectively, effective as from October 6) took central bank interest rates to their highest level since 1982. As these measures were dictated by inflationary pressures rather than by current cost and price trends, they sometimes took market participants somewhat by surprise, although sometimes they had already been discounted in market rates to such an extent that they tended to restore calm to the markets. In order to make it easier for the banks to adjust to the new interest rate level after interest rate policy action of this kind, or in order to take the edge off exaggerated interest rate fears in the financial markets, the Bundesbank, following changes in its key interest rates, offered one-month securities repurchase agreements in the shape of volume tenders (with a fixed rate) on various occasions, switching back to (US-style) interest rate tenders, which are more market-related, after some time only.

Uncertainties in the financial markets around the turn of 1989-90

Around the turn of 1989-90 new expectations of interest rate increases emerged in the financial markets. In the money market this was sometimes due mainly to tensions in the Euro-currency market as well as to short-term domestic liquidity shortages, which the Bundesbank relieved in the context of its ongoing provision of funds. At the longer end of the financial markets, too, an abrupt surge of interest rate increases began; uncertainties about the envisaged economic and monetary union with the GDR coincided with interest rate increases in international capital markets. This also affected the longer end of the German money market. During this period, the Bundesbank maintained its basic monetary policy stance with a steady hand, with the result that the day-to-day money rate and the allotment rates for securities repurchase agreements, all of which have been offered in the form of interest rate tenders since the beginning of January 1990, had changed only a little by the end of March.

Adjustments to the more durable forms of the provision of funds

The significance of securities repurchase agreements as a flexible tool for money market management increased further in 1989. A major factor in this connection was that foreign monetary authorities built up their Deutsche Mark deposits with the Bundesbank strongly (see p. 30). To offset the associated drain on bank liquidity, the Bundesbank saw a need to provide much more liquidity than was necessary to accommodate the current demand for central bank money (currency in circulation and minimum reserve balances). Against this background, the usual monthly pattern of weekly securities repurchase agreements with maturities of about one month was extended in July 1989 by an additional two-month tender. Since then, four one-month agreements and two two-month agreements have been offered by tender each month (usually at the beginning and in the middle of each month). With a view to a structural adjustment of the refinancing facilities available to the banks, in September 1989 the Bundesbank decided to phase out some special facilities for the financing of foreign trade. To offset the consequent reduction in liquidity, the Bundesbank at the same time increased the "ordinary" rediscount quotas by DM 5 billion; this increase became effective on November 2, 1989.

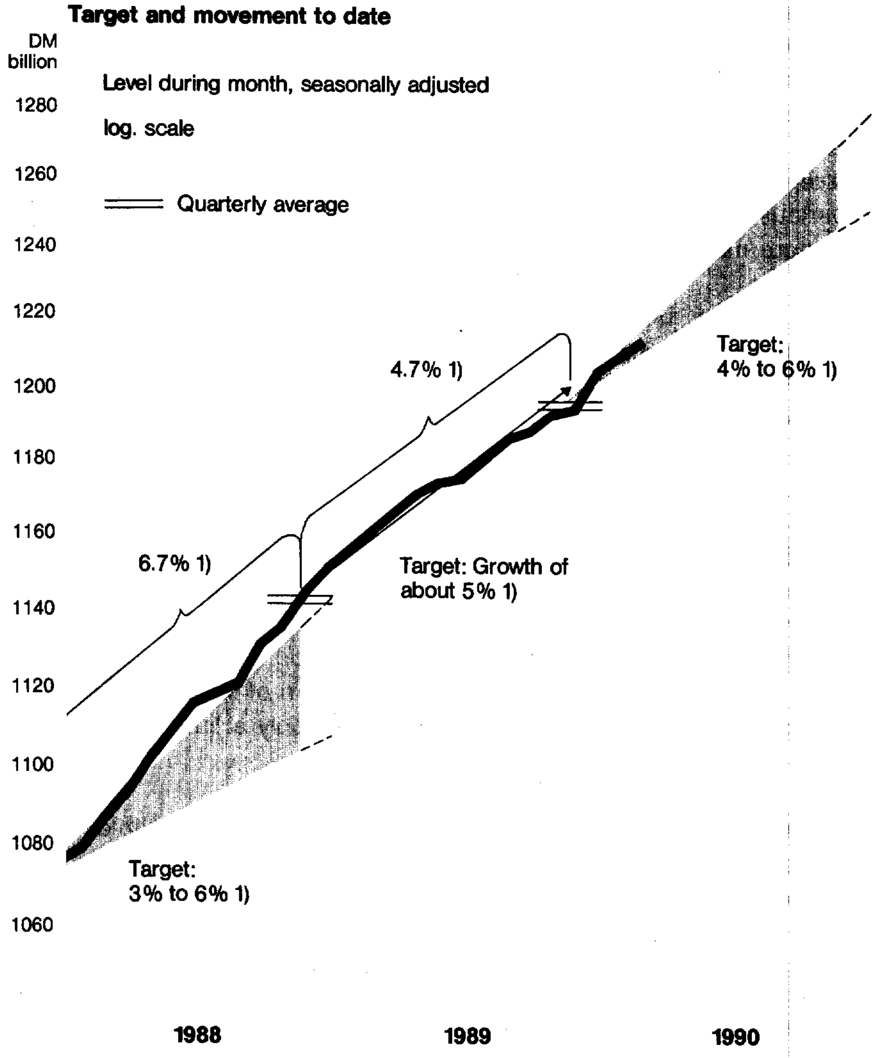
(b) Domestic money stock expansion on target

1989 monetary target

The Bundesbank underlined its stabilisation policy stance, as usual, by setting an "intermediate target" for its monetary policy in 1989, envisaging an increase of about 5% in the money stock M3 from the fourth quarter of 1988 to the fourth quarter of 1989 as being appropriate. In view of the excessive monetary expansion observed towards the end of 1988, which also reflected tax motives for holding liquid funds (the "withholding tax effect"), this target seemed quite ambitious. In fact, the growth of the money stock remained appreciably above the envisaged target path until well into the spring of 1989. In the case of currency in circulation, in particular, this owed a great deal to "evasive reactions" to the withholding tax on domestic interest income, which was introduced at the beginning of the year. Large releases of savings deposits at the beginning of 1989 under individual capital formation schemes also contrib-

Growth of the money stock M3 *

Target and movement to date



* Average of five bank-week return days; end-of-month levels included with a weight of 50%.–
1) Between the fourth quarter of the preceding year and the fourth quarter of the current year. BBk

uted to the strength of monetary growth. After the Federal Cabinet had announced its intention of abolishing withholding tax, investors abandoned their extremely strong preference for liquid funds. This primarily affected currency in circulation, which stopped growing for a while. This adjustment of cash-holding propensity now seems to have been largely completed. Given the general interest rate rise, non-interest-bearing sight deposits also increased only a little further from the spring of 1989, while double-digit growth rates were recorded until quite recently for time deposits yielding increasingly attractive rates of interest. As the "basic savings rate" was falling further and further behind market yields, savings deposits at statutory notice, which had previously benefited from their exemption from withholding tax, declined sharply during 1989. Even inclusive of interest credited, at the end of the year they were DM 14.5 billion down on their level at the end of 1988. The low basic savings rate paid by almost all banks is naturally causing this form of deposits gradually to diminish in significance, for, when the price does not respond, quantity does, even in oligopolistic markets. A "strategy" of this kind, designed to resolve profitability problems in some parts of the banking industry, will presumably fail to pay off in the longer run.

Target implementation

In the event, the growth of the overall domestic money stock M3 was on target by and large as from early summer 1989. From the fourth quarter of 1988 to the fourth quarter of 1989 the rise in the Bundesbank's monetary policy indicator came to 4.7%. The monetary target, set at "about 5%", was thus met fairly well. The slowdown in domestic monetary growth must be qualified, however, inasmuch as it was accompanied by a strong build-up of Euro-deposits and non-banks' holdings of short-dated bank bonds. Viewed over 1989 as a whole, these components expanded by a total of more than DM 40 billion, which was equivalent to almost two-thirds of the increase (of DM 66 billion) in the domestic money supply. Contributory factors were the more attractive interest rates in the Euro-market, the introduction of withholding tax at the beginning of 1989 and the external situation (see pp. 28-30).

Target corridor for 1990

In setting the monetary target for 1990, which was adopted in December 1989, the Bundesbank signalled a continuation of its basic stance, which is to lend monetary support to safeguarding the stability of the value of money and to foster non-inflationary economic growth. In deriving the monetary target for 1990 it once again made allowance for a slightly stronger expansion of real macro-economic production potential than in the preceding years, at 2½%. This assumption is based primarily on the rise in the labour force caused by the heavy immigration into the Federal Republic of Germany, and also on the increase in investment activity. The price level was assumed to rise at an average annual rate of 2%. Including an unchanged ½ percentage point increment to take account of the slowdown in trend of the velocity of circulation of money, this yielded for the average and for the course of 1990 a growth rate of about 5% for the money stock M3, which seemed to be compatible with stabilisation policy requirements. In consideration of the existing uncertainties about the economic bench-mark figures included in the calculation, the target for monetary growth between the fourth quarter of 1989 and the fourth quarter of 1990 was formulated in terms of a corridor of 4% to 6%. It remains to be seen whether the growth of the money balances held in the Euro-market, which are not included in the money stock definition, may perhaps warrant a slower or slightly faster expansion of the domestic money stock within the target corridor mentioned. The decision on the course to be adopted will depend on whether money balances in the Euro-market are growing at an accelerated rate or are declining.

(c) Policy issues of monetary targeting

Expansionary "prior charges" dating back to the second half of the eighties

With monetary growth moving on to the envisaged target path in the course of 1989, the underlying conditions for stabilisation policy have improved on the monetary side. The unforeseen, rather too rapid expansion of the "monetary cloak" in the preceding years (which saw considerable overshooting) was not reversed, however. Nevertheless, there is some evidence that the associated stabilisation policy risks are ultimately to be rated less pronounced than might be assumed at first sight. Given virtual price stability between 1986 and 1988, for instance, the inflationary risk of holding cash seemed fairly low, and the opportunity cost of holding liquid assets was small owing to the low level of interest rates. Enterprises and individuals therefore presumably maintained fairly large cash balances. Another factor contributing to the faster expansion of currency in circulation may have been the increase in the demand for Deutsche Mark banknotes, especially in the GDR and other central and eastern European countries. It remains to be seen, however, whether changes of this kind in cash holding patterns will be permanent. At any rate, one cannot rule out the danger that, with the growing stability risks and the associated market-induced rise in the level of interest rates, the former relationships between money balances and the demand for goods will be restored, i.e. that the available "liquidity cushions" will be used to expand spending. To this

Monetary developments

Change during year 1

Item	1983	1984	1985	1986	1987	1988	1989
	DM billion						
A. Central bank money requirements of banks and liquidity policy measures by the Bundesbank 2							
1. Provision (+) or absorption (−) of central bank balances by:							
Rise in central bank money 3 (increase: −)	− 10.1	− 7.1	− 6.6	− 13.1	− 15.5	− 18.6	− 9.4
Foreign exchange movements (excluding foreign exchange swaps and repurchase agreements)	− 2.0	− 3.9	− 0.7	+ 8.7	+ 38.7	− 30.6	− 20.0
Cash transactions of the central and regional authorities (including shifts of Federal balances under section 17 of the Bundesbank Act)	+ 1.7	+ 1.3	− 4.2	− 0.2	+ 1.8	+ 2.3	− 2.2
Transfer of the Bundesbank's profit to the Federal Government	+ 11.0	+ 11.4	+ 12.9	+ 12.7	+ 7.3	+ 0.2	+ 10.0
Other factors	− 9.7	− 12.1	− 14.0	− 8.0	− 8.9	− 8.3	− 11.4
Total 1	− 9.0	− 10.6	− 12.5	+ 0.0	+ 23.3	− 54.9	− 32.9
2. Liquidity policy measures							
Change in minimum reserves 4	− 0.2	− 0.4	+ 0.1	+ 7.4	− 6.1	+ 0.2	− 0.1
Change in refinancing facilities	− 0.7	+ 7.8	+ 3.3	− 5.6	− 7.6	+ 0.4	+ 7.5
Open market operations (with non-banks, in "N paper" − excluding short-term sales of Treasury bills − and in long-term securities)	+ 2.4	− 3.9	+ 0.1	+ 1.4	− 1.0	+ 0.4	− 0.4
Securities repurchase agreements	+ 6.6	+ 7.7	+ 16.5	− 9.5	− 5.5	+ 50.4	+ 26.7
Other assistance measures in the money market 5	− 3.4	± 0.0	+ 0.6	+ 1.5	− 2.3	+ 0.4	+ 0.2
Total 2	+ 4.7	+ 11.3	+ 20.6	− 4.8	− 22.5	+ 51.8	+ 33.9
3. Remaining deficit (−) or surplus (+) [1 plus 2]	− 4.3	+ 0.7	+ 8.1	− 4.8	+ 0.8	− 3.1	+ 1.0
covered or absorbed by:							
Recourse to unused refinancing facilities (reduction: +)	+ 3.3	− 1.0	− 3.1	+ 4.2	+ 0.1	+ 0.9	− 0.5
Raising (+) or repayment (−) of lombard or special lombard loans	+ 1.0	+ 0.3	− 5.0	+ 0.6	− 0.9	+ 2.2	− 0.6
	%						
B. Key monetary indicators							
Money stock M3 6	+ 5.7	+ 4.5	+ 5.2	+ 7.3	+ 6.4	+ 7.0	+ 4.6
Money stock M3 extended 7	+ 6.2	+ 4.0	+ 4.8	+ 7.3	+ 6.2	+ 7.4	+ 8.4
Money stock M2 (= M3 excluding savings deposits)	+ 2.5	+ 4.8	+ 4.6	+ 6.1	+ 5.8	+ 7.4	+ 11.5
Money stock M1 (= currency in circulation and sight deposits)	+ 8.0	+ 5.3	+ 5.3	+ 7.7	+ 7.6	+ 10.3	+ 5.3
Lending by banks and the Bundesbank to non-banks in the Federal Republic of Germany	+ 6.7	+ 6.0	+ 5.1	+ 4.3	+ 4.1	+ 6.3	+ 5.8
	DM billion						
C. The money stock and its counterparts							
Money stock M3 [= 1 plus 2 less 3 less 4 less 5]	+ 45.3	+ 41.3	+ 45.4	+ 65.7	+ 62.6	+ 76.1	+ 66.4
Counterparts in the balance sheet							
1. Volume of credit 8	+ 113.2	+ 108.1	+ 98.1	+ 81.7	+ 87.0	+ 138.2	+ 135.8
of which							
Bank lending to non-banks in the Federal Republic of Germany	+ 111.3	+ 110.0	+ 100.6	+ 77.8	+ 89.8	+ 137.6	+ 136.3
− to enterprises and individuals 9	+ 44.0	+ 47.4	+ 48.5	+ 39.9	+ 38.6	+ 69.5	+ 92.2
− to the housing sector 10	+ 48.1	+ 43.5	+ 33.2	+ 33.7	+ 22.6	+ 26.6	+ 37.2
− to public authorities	+ 19.3	+ 19.1	+ 18.9	+ 4.2	+ 28.6	+ 41.5	+ 7.0
2. Net claims on parties outside the Federal Republic of Germany 11	+ 1.2	+ 0.8	+ 30.0	+ 55.9	+ 53.2	− 5.2	+ 36.2
3. Monetary capital	+ 67.1	+ 69.7	+ 75.0	+ 69.8	+ 70.7	+ 42.8	+ 110.2
of which							
Savings deposits at agreed notice	− 2.0	+ 6.0	+ 11.2	+ 15.3	+ 9.7	− 5.7	− 7.9
Bank savings bonds	+ 13.0	+ 16.3	+ 10.4	+ 9.9	+ 9.8	− 0.2	+ 14.3
Time deposits and funds borrowed for 4 years and over	+ 27.2	+ 26.3	+ 34.5	+ 37.6	+ 43.1	+ 46.4	+ 38.7
Bank bonds outstanding 12	+ 22.6	+ 13.2	+ 9.3	− 4.7	− 2.0	− 5.8	+ 48.6
4. Central bank deposits of domestic public authorities	+ 0.9	− 1.2	+ 1.3	− 1.1	+ 3.5	− 1.1	+ 3.3
5. Other factors	+ 1.0	− 1.0	+ 6.5	+ 3.2	+ 3.4	+ 15.3	− 8.0

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 (excluding the banks' holdings 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; changes in the required reserves resulting from changes in the reserve ratios are shown in item A.2. — **4** Including changes in minimum reserves due to growth in reserve-carrying foreign liabilities. — **5** Bill-based repurchase agreements, short-term sales of Treasury bills, foreign exchange swaps and repurchase agreements, quick tenders and shifts of Federal balances under section 17 of the Bundesbank Act. — **6** Currency in circulation and sight deposits, time deposits for less than 4 years and savings deposits at statutory notice held at banks in the Federal Republic, as from 1986 as a monthly average (of five bank-week return days, end-of-month levels included with a weight of 50%). — **7** Money stock M3 extended to include Euro-deposits and short-term bank bonds held by non-banks in the Federal Republic of Germany. — **8** Banks and the Bundesbank; including lending against securities. — **9** Excluding housing. — **10** Excluding lending against securities. — **11** Banks and the Bundesbank. — **12** Excluding banks' portfolios.

Discrepancies in the totals are due to rounding. BBk extent, monetary policy makers must be prepared to face the need to make allowance for the statistical "monetary overhang" at very short notice.

Longer-term relationships obscured by temporary distortions

The longer-term underlying relationships between monetary expansion and macro-economic spending have been obscured in recent years by, inter alia, other (partly temporary) disruptive factors. The most significant one was the general public's response to the announcement of withholding tax in autumn 1987. It caused the liquidity preference of many households to shoot upwards. Demand for currency, in particular, rose rapidly. After the announcement of the abolition of withholding tax in spring 1989, these dislocations of monetary trends were reversed. Monetary growth was therefore somewhat slower for a while last year than would appear warranted if one considers the rise in interest rates in isolation.

New risks owing to the rapid growth in Euro-deposits

In 1989 new expansionary risks emerged as a result of the rapid growth in domestic non-banks' Euro-deposits. The "extended money stock M3", which also includes Euro-deposits and the short-dated bank bonds held by residents, grew by 8½% between the fourth quarter of 1988 and the fourth quarter of 1989, compared with 4¾% for the corresponding domestic aggregate. Corporate liquidity, in particular, thus increased more steeply in 1989 than is suggested by the domestic monetary aggregates, even though only part of these liquid funds can be regarded unequivocally as a mere shifting of domestic cash balances to the reserve-exempt "offshore centres" of the Euro-market. A rise in external deposits, which presumably represents some kind of "supplement" to the domestic money stock, is apparent in other neighbouring European countries with free capital movements, too, and there as well it is reducing the efficiency of the monetary policy instruments, which are tailored to the domestic money stock. In order to capture the "bias" in the domestic monetary aggregates resulting from the growth in Euro-deposits, the Bundesbank has recently been paying greater attention to extended monetary aggregates which include liquidity held in the Euro-market.[1] This is in line with the Bundesbank's pragmatic approach of not gearing its policy just to a single intermediate monetary target variable if actual trends suggest that part of monetary expansion has been shifted to some other areas not yet covered. In the past, too, there has occasionally been a need to account to the general public for some temporary "misdirections" of the chosen target variable. In addition to the ongoing monitoring of its key monetary policy target and control aggregate (M3), the Bundesbank therefore constantly evaluates a broad range of other monetary and general economic data and, if required, develops control variables, which may show that the indicator chosen – like M3 in the case of cash holdings in the Euro-market – sometimes has weaknesses.

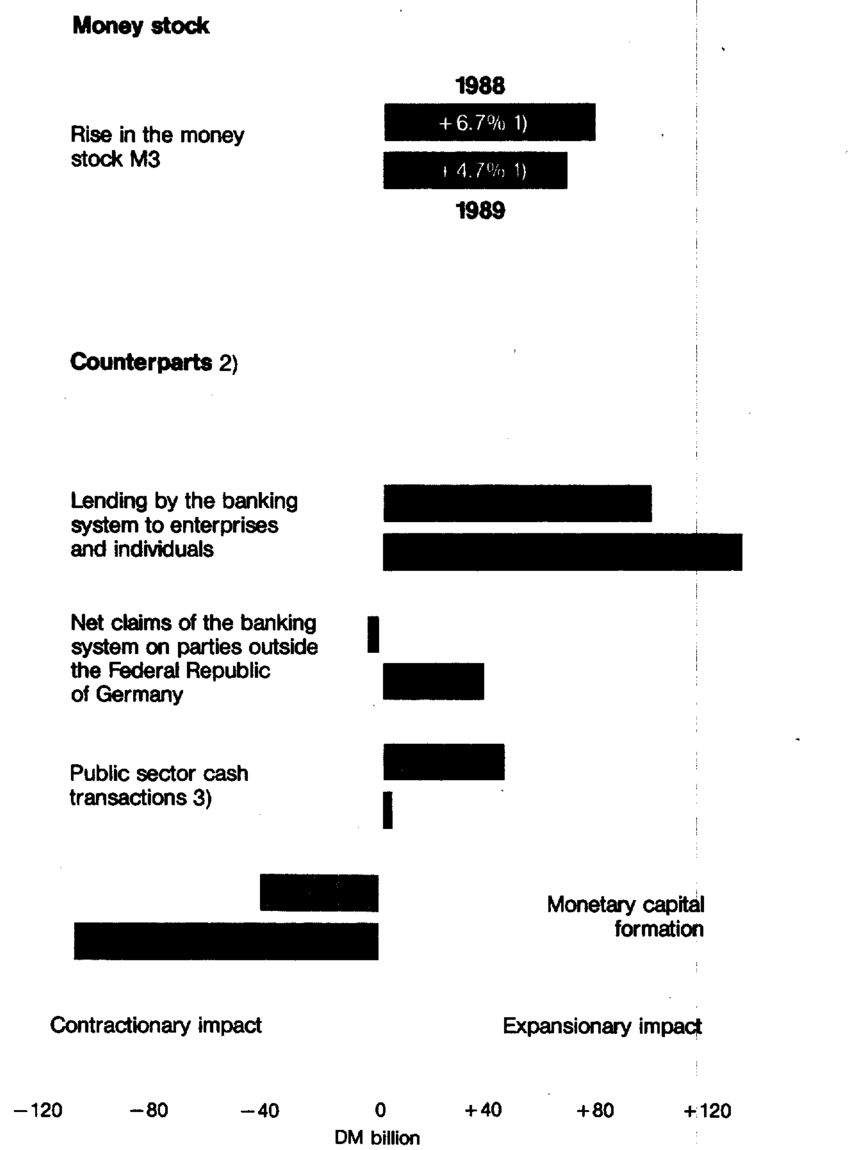
Monetary targeting faced with new challenges

Despite some disruptive factors, the Bundesbank's monetary targeting strategy has proved to be flexible and adaptable. New challenges are already in prospect, however, given the rapidly proceeding reforms in eastern Europe and the proposed extension of the Deutsche Mark currency area to include the GDR. Key monetary indicators and structural relationships, such as the ratio of monetary growth to macro-economic expenditure (on the stability of which the Bundesbank has hitherto been able to rely), will have to be monitored and interpreted particularly carefully under the current changing conditions. On top of these more technical difficulties, however, it is essential – especially in times like these – not to lose sight of the actual objective of monetary

1 Nevertheless, the Bundesbank has so far refrained from substituting the "extended money stock M3" for the traditional (domestic) money stock M3 as its key monetary policy indicator. It is in particular the poorer indicator qualities of the extended aggregate that argue against any such substitution. These poorer qualities are due, among other things, to the relatively short observation periods available at present for the necessary analysis of the relations with domestic demand, the domestic supply of goods, the trend in the "velocity of circulation", etc.

The money stock and its principal counterparts

Change in DM billion or %



1) Change as an average of the fourth quarter from the fourth quarter of the previous year.– 2) The change in the counterparts as shown reflects their expansionary (+) or contractionary (–) impact on the money stock.– 3) Lending by the banking system to public authorities less public sector deposits at the Bundesbank.

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targeting (which can be rated successful so far), i.e. safeguarding monetary stability.

(d) The driving forces behind the monetary expansion process

Buoyant private demand for credit . . .

In 1989 the buoyancy of the domestic demand for credit remained the driving force behind the money creation process in the Federal Republic of Germany. The focus of domestic credit expansion clearly shifted to the private sector, a trend which can almost be regarded as typical of the now well-advanced stage of the economic upswing, with a disproportionately strong increase in industrial and residential construction investment. The strength of revenue improved the public authorities' financial situation. New public sector borrowing from the German banking system accordingly dropped to DM 7 billion in 1989, compared with DM 42 billion in 1988. This decrease also owed something to the fact that in 1989 the central, regional and local authorities (notably the Federal Government) stepped up their borrowing abroad, where government bonds were much in demand. In contrast to this, households' and enterprises' propensity to borrow increased strongly in all maturity categories. Thus private demand for longer-term loans, which started to pick up some time ago, and increased by over 6½% in 1989, remained the mainstay of bank lending. Given the cyclical rise in enterprises' working fund needs, the growth of short-term lending, at 9%, was even faster in relative terms. Overall, bank lending to enterprises and individuals expanded by some DM 130 billion, or just over 7%, last year, compared with about 5½% a year before. Against the background of the high level of investment activity and the strong demand for cars, both direct lending to enterprises and self-employed persons and consumer credit rose much more rapidly (by some 9%); although housing loans increased more slowly (by 5%), they, too, went up at a faster rate than in 1988.

... and increased inflows of funds from abroad

In addition to domestic credit expansion, non-banks' external payments likewise stimulated the domestic money creation process in 1989. After net outflows of over DM 5 billion had been recorded in 1988, net inflows of funds were registered again as from mid-1989, reflecting the strengthening of the Deutsche Mark in the exchange markets. The net claims of the banking system on parties outside the Federal Republic of Germany, a rise in which mirrors inflows to the non-bank sector, went up in 1989 by DM 36 billion. The "supply of funds" from the aggregate domestic and foreign lending activities of the banking system, at DM 172 billion, was thus almost one-third up on the 1988 figure.

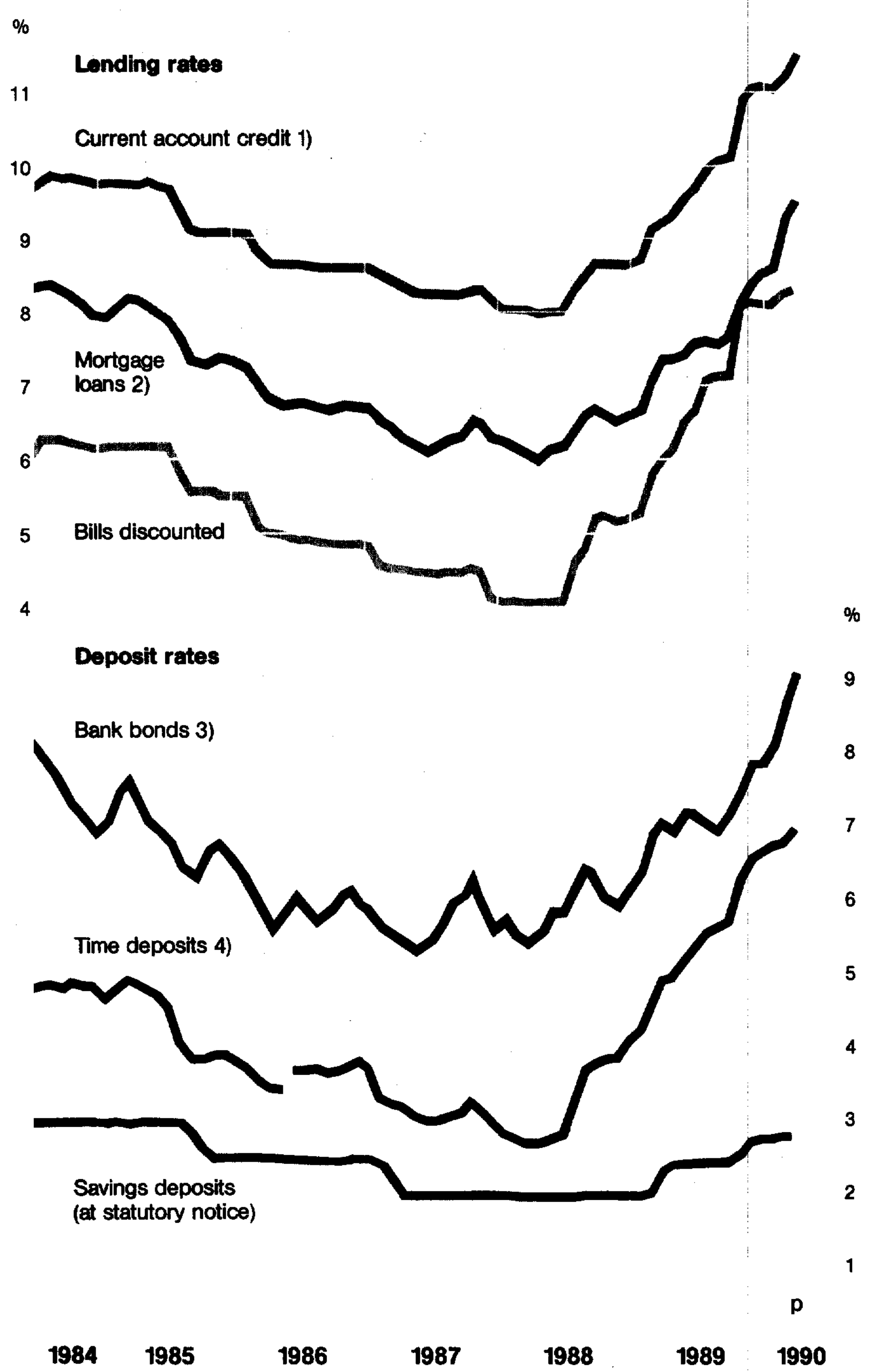
Steep interest rate increases in short-term business

Owing to the growing demand for funds, the progressive reduction in the supply and rise in the cost of central bank money, as well as the link with interest rates abroad, the banks' lending rates came under strong upward pressure in 1989, starting at the short end of the market. Thus, an average of 9½% – and hence some 3 percentage points more than in the "interest rate trough" of spring 1988 – was charged for major credit in current account towards the end of 1989. The average cost of bills discounted, at 8%, was up by 4 percentage points. Interest rates in long-term business rose less rapidly until the end of the year, in line with trends in the capital market. At the end of 1989 the banks were charging an average of 8¾%, i.e. about 1½ percentage points more than in the spring of 1988, for loans with interest locked in for ten years. As described above, however, these interest rate increases were not sharp enough to restrain credit expansion appreciably.

Strong propensity of non-banks to invest at long term

The fact that monetary growth did not overshoot the Bundesbank's target in 1989 despite the rapid expansion of the banks' lending business was solely due to the buoyancy of monetary capital formation. Following the removal of the uncertainties about the taxation of interest income, domestic non-banks' propensity to invest at long term soared. The rising interest rate level in the capital market imparted further stimuli to this consolidation process, particularly during the second half of the year. Altogether, long-term funds to the record amount of over DM 110 billion accrued to the banks last year. This was two and a half times as much as in 1988 (DM 43 billion), when domestic monetary capital formation plummeted. Sales of bank bonds in particular, which carry interest at market-related rates and whose circulation in the hands of domestic non-banks had decreased in each of the last three years, shot up in 1989 (DM 49 billion). Sizeable inflows of funds to banks were likewise recorded in long-term time deposit accounts (DM 39 billion), in the shape of additions to capital and reserves (DM 17 billion) and from sales of bank savings bonds (DM 14 billion). By contrast, there were again considerable outflows of funds (– DM 8 billion) in the field of traditional long-term deposit account saving. In

Movements in selected bank interest rates



1) Under DM 1 million.- 2) Effective average rate for variable-rate mortgage loans secured by residential real estate.- 3) Yield on bonds outstanding.- 4) With agreed maturities of 1 month to 3 months inclusive and sums of DM 100,000 and over but less than DM 1 million; up to and including May 1986 under DM 1 million and maturities of 3 months.- p Provisional.

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addition to large releases of savings contracts under schemes for individual capital formation, a major factor here was probably that the interest rates paid on "ordinary savings deposits" with longer periods of notice – as distinct from special savings facilities (for instance, growth saving, fixed-rate saving, savings certificates, insurance saving, instalment-based saving schemes) and bank savings bonds – lagged considerably behind the rising market rates.

Commercial banks remain on the advance

The rapid expansion of private demand for credit in 1989 primarily benefited the commercial banks (i.e. substantially the private banks), which traditionally play a major role in short-term lending to trade and industry and which expanded their total lending to enterprises and individuals by 12.2 % last year. Within this category, lending by big banks rose by 13.6 % and that by regional banks (including other commercial banks) by 10.2 %. Among the other categories of banks, the lending volume of credit cooperatives, in particular, went up at an above-average rate (+ 7.5 %). Savings banks (+ 5.4 %) and their regional institutions (+ 0.7 %) could not quite keep up with the general trend. Owing to the consolidation of public finance and to public lending programmes launched by the Reconstruction Loan Corporation in favour of local authorities, the communal loan business of the savings bank sector was sluggish; on balance, private customers' demand for credit was also comparatively moderate. The regional institutions of credit cooperatives (+ 4.5 %) and mortgage banks (+ 2 %) also lagged somewhat behind their competitors.

Divergent trends in profitability in the banking industry

In 1989 the banks' average interest income probably increased further, though not as much as their volume of business. The disproportionately fast growth of their – more profitable – shorter-term lending counteracted a fall in their interest margins, but their borrowing transactions – in particular those of savings banks and credit cooperatives – became distinctly more costly on account of interest-rate-induced switching from traditional savings deposits to time deposits and borrowed funds and to securitised borrowing. Net commissions received increased once again in the year under review, especially among commercial banks. The staff costs and other operating expenditure of all categories of banks grew more slowly than their volume of business. The rise in the aggregate operating results of all categories of banks is likely to have roughly matched that of 1988. In the case of big banks the growth of the operating results outpaced that of the volume of business. To what extent overall bank profits are reduced by "other" expenses cannot yet be said definitely. Many banks have no doubt had to write down their bond portfolios, but there have not infrequently also been trading profits from equities.

Danger of competitive distortion resulting from EC standards

Overall, banks probably applied their profits to increasing their reserves from "internally generated resources" in 1989. This would be desirable in view of the forthcoming stricter capital adequacy requirements in the EC area. It would not be consistent with the principles of a single European financial market, however, if in this context different solvency rules for banks and investment firms were to be introduced. This would imply – against the background of basically identical risks – a regulatory bias in favour of pure investment firms, a line of business virtually non-existent in the Federal Republic of Germany because of the predominance of the universal banking system. In this connection, official institutions and the banking associations are called upon to join forces in seeking to ensure that the banks operating as universal banks in the Federal Republic of Germany neither suffer competitive disadvantages in the European integration process nor are forced solely by virtue of the EC regulations to switch over to a system of functional separation in the financial services sector, such as predominates in the Anglo-Saxon countries.

5. Capital market under the impact of buoyant business activity and prophylactic inflation control

(a) Shifts of emphasis in the overall financing cycle

Indications of a return to normal in the domestic capital market

After the setback in 1988, the tone of the capital market in the Federal Republic of Germany improved in 1989. Last year domestic and foreign investors returned to the market, and the customary investment pattern of the major groups of buyers, which was seriously disrupted by the announcement of withholding tax in the autumn of 1987, gradually emerged again. The more attractive interest rates and the burgeoning expectations of an appreciation of the Deutsche Mark in the second half of the year – expectations which were ascribable at least in part to the progressive tightening of monetary policy – likewise made investment opportunities in the German capital market appear in a far more favourable light.

Strengthening of domestic long-term financial asset acquisition

The above-mentioned signs of a return to normal were conspicuously reflected in the domestic non-financial sectors' portfolio behaviour. Their longer-term investments in the domestic securities markets and in subsectors of the "non-organised" capital market, which had declined by DM 47.5 billion in 1988, rose by DM 26.5 billion to almost DM 80 billion in 1989. In the process, domestic bonds in particular regained a strong position. Investment in bonds, at DM 18 billion, made up nearly one-quarter of longer-term financial asset acquisition in Germany in 1989; in 1988, by contrast, the domestic non-financial sectors had reduced their holdings of such paper by DM 13 billion. At the same time, their longer-term financial asset acquisition abroad in 1989 (at DM 72.5 billion) was distinctly smaller than a year before. Their new investment in foreign bonds, in particular, declined by DM 23 billion to DM 41.5 billion, as a mirror image of their increased purchases in the domestic bond market. This primarily affected high-yielding foreign currency bonds, which had previously been much in demand.

Share purchases neglected

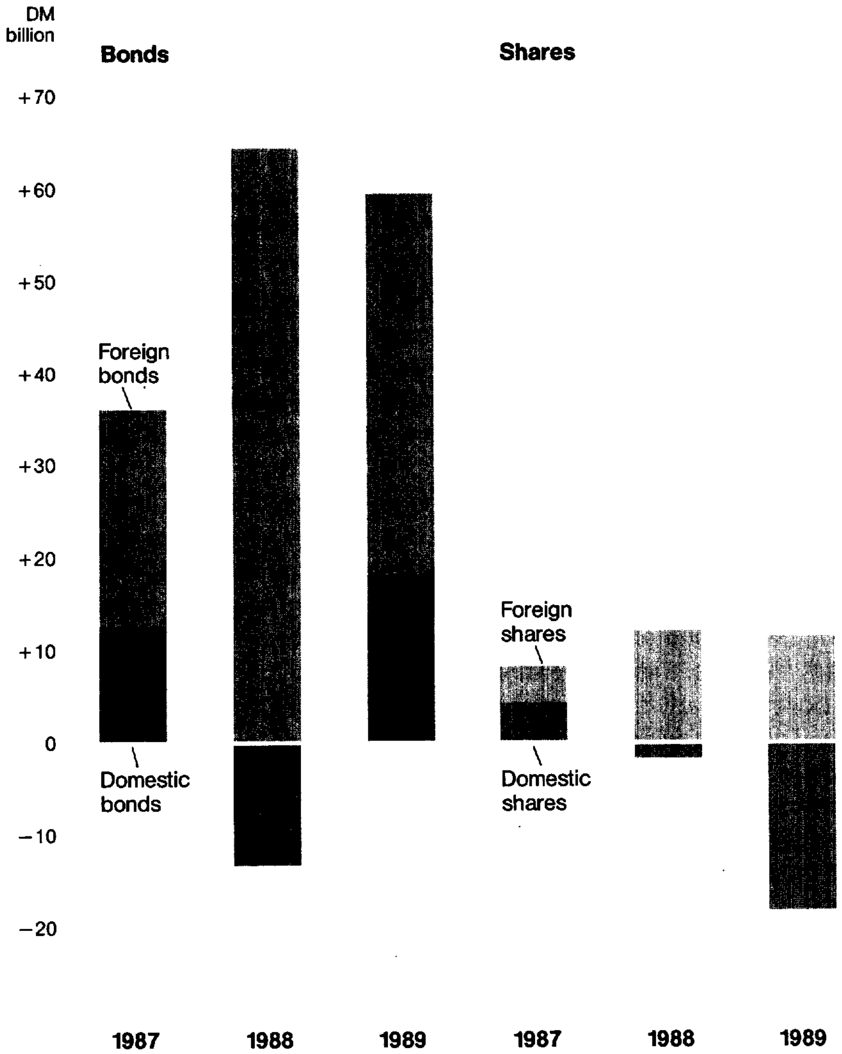
In contrast to the growing domestic propensity to buy longer-term fixed-interest-bearing securities, in 1989 it did not prove possible to interest the general public in longer-term purchases of shares. Last year the domestic non-financial sectors actually sold DM 18 billion (net) of German equities from their portfolios, notably including some record sales by households after the "mini-crash" in October. This represented a severe setback to the efforts to grant savers greater participation in productive assets by means of the broad dispersion and durable placement of share capital.

Acquisition of liquid financial assets remains very strong

The acquisition of liquid financial assets continued to run at a high level in 1989. The prime reason for this was the accumulation, on interest rate grounds, of short-term time deposits in Germany and in the Euro-markets. Domestic banks gradually improved their terms for these deposits by some 2½ percentage points in the course of 1989. In view of the uncertainties surrounding interest rate movements at times, short-term time deposits were also of interest for the "interim investment" of funds available at long term. Altogether, deposits of this kind by the domestic non-financial sectors with domestic banks expanded by no less than DM 60 billion in 1989 against a mere DM 5.5 billion a year before. This seems to have owed something to pure switching operations by households to the debit of their holdings of currency and sight deposits and of their low-yielding savings deposits at statutory notice. At the same time, large sums were added – particularly by major corporations – to short-term financial assets in the Euro-market (see p. 30).

Securities purchases by the domestic non-financial sectors *

Net purchases (+) or net sales (–)



* Households, enterprises (including the housing sector), public authorities (including the social security funds).

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Foreign investors return to the German market

A mainstay of the German capital market in 1989 – in addition to domestic non-banks – was foreign buyers of securities. In view of the dwindling yield advantage of other major investment currencies and of the strengthening of the Deutsche Mark in the course of the year, they returned to the German bond market in increasing numbers. Their sizeable purchases, at DM 22.5 billion (against DM 2 billion in 1988), consisted almost entirely of Federal bonds. Even more significant were foreign investors' purchases in the German share market. On balance, non-residents bought German equities to the record amount of more than DM 26 billion. About two-thirds of these purchases were made in the fourth quarter of 1989, when price prospects in the German share market were rated particularly favourable against the background of the "opening-up" of eastern Europe and the GDR.

Structural shifts in borrowing

As far as borrowing is concerned, in 1989 the domestic non-financial sectors continued to prefer longer-term loans from banks and other financial intermediaries in Germany (DM 105.5 billion). In addition, they received considerable longer-term funds (DM 40 billion) through sales of securities. At the same time, however, their short-term debt to domestic banks more than doubled. The "maturity gap" between the inflow of short-term funds and longer-term lending by banks was therefore in the end less marked than in 1988. In view of the strengthening of longer-term financial asset acquisition, banks were able to raise more maturity-matched funds through issues of bank bonds, and to this extent to contain the interest rate risks associated with the flatter yield curve.

(b) Marked shifts in the interest rate pattern in the bond market

Rising capital market rates world-wide

In 1989 interest rate movements in the German capital market were strongly affected by the pronounced buoyancy of economic activity at home and abroad and the progressive tightening of monetary policy. In the first few months of the year demand pressures in the major industrial countries and rising energy prices world-wide led to fears of inflation and increases in capital market rates. In Germany this trend was accentuated by the weakness of the Deutsche Mark in the foreign exchange markets until the summer. At the end of May the yield on domestic bonds outstanding reached an "interim peak" of 7¼ %.

"Inverse" yield curve marks the success of stability-oriented monetary policy

The upsurge in interest rates was particularly pronounced in the short money-market-related maturity categories. Hence the yield curve in the German capital market flattened out perceptibly from the short end of the market, and finally actually became slightly "inverse". In contrast to the situation in earlier periods of monetary restriction, such as the beginning of the seventies and the early eighties, this yield pattern, which is typical of a restrictive phase of monetary policy, already emerged at the comparatively low interest rate level of about 7 %. This was widely regarded as a sign of the confidence of market participants in the Bundesbank's efforts to combat dangers to the stability of prices right from the start by means of a forward-looking monetary policy, thus making exaggerated expectations of inflation and interest rate rises appear quite unfounded.

Temporary brightening of the interest rate situation in the summer

The period of relaxation in the capital market which ensued from June onwards was attributable to a brisk foreign demand for bonds and a sustained propensity to buy on the part of domestic investors. The capital market yield fell to distinctly less than 7 % at the beginning of August. Given the sustained boom and the increasing capacity bottlenecks in Germany, interest rates started to rise again as time went by. Since interest rates on bonds in the United States were beginning to fall and the yield differential vis-à-vis dollar assets was narrowing, the Deutsche Mark strengthened in the foreign exchange markets. The slump in share prices in mid-October, precipitated by the New York stock market crash, interrupted this upward trend in interest rates only for a short time. The capital market yield reached its highest level of the year in the second half of November, at just under 8 %.

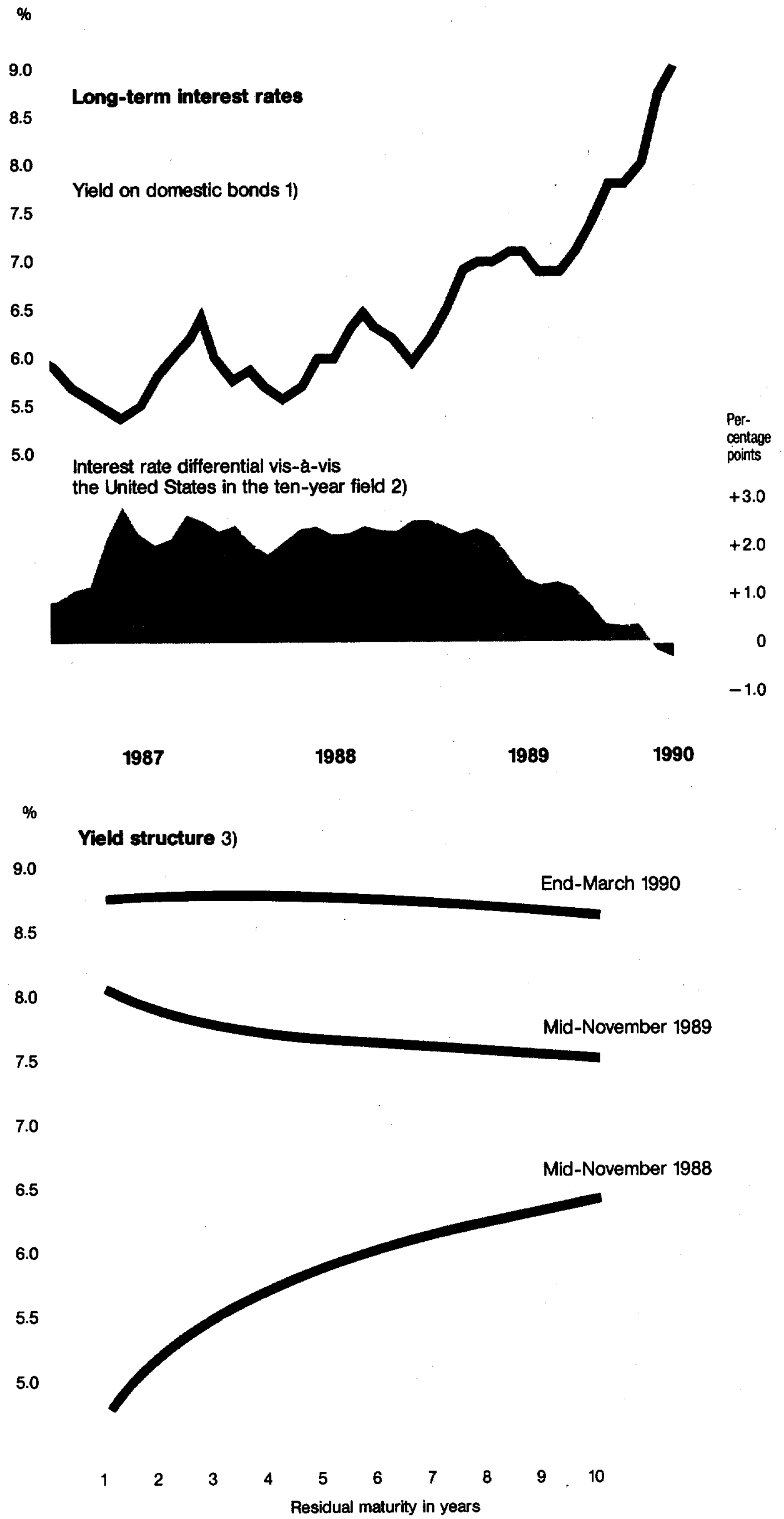
Sharp surges in yields at the beginning of 1990

After a short period of relaxation in December 1989, bond rates started to surge upwards under the impact of the turbulent developments in eastern Europe and the GDR. In February and March 1990 the yield on bonds outstanding overshot the 9 % mark at times. The rise in interest rates was particularly pronounced in the longer-term maturity categories. Since then, the slightly "inverse" interest rate pattern has flattened out again from the long end of the market. Quite recently – for the first time for thirteen years – German bonds have been yielding slightly more than US fixed interest securities, although the interest rate fluctuations have been relatively large in both countries. In mid-April 1990 the capital market yield in Germany came to almost 9 %.

Buoyant bond market

In view of investors' growing confidence, the German bond market proved to be very buoyant in 1989. At DM 40.5 billion, foreign borrowers again accounted

Interest rate movements in the bond market



1) Yields on all bonds outstanding; monthly averages.- 2) Yields on ten-year Treasury bonds in the United States less yields on ten-year Federal bonds (estimated figures) in Germany; monthly averages.- 3) Regression curves for Federal bonds, adjusted for coupon effects.

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for a relatively large proportion of the total amount raised in the German bond market (DM 125 billion). The bulk of the sales, however, consisted of domestic bonds (DM 78.5 billion net, compared with only DM 35 billion in 1988). The hopes of a recovery of the German capital market associated with the abolition of withholding tax on domestic interest income were thus fulfilled.

Bank bonds a focus of interest

After the severe setback in 1988 (redemptions totalling DM 11 billion net), bank bonds in particular made a remarkable come-back. At DM 52.5 billion in 1989, they accounted for the lion's share of the funds raised in the bond market. The banks primarily issued "other" bank bonds (DM 39 billion net). This flexible instrument for funding lending to enterprises and individuals is increasingly being used, inter alia by smaller banks, especially since there is no need for special cover funds from lending and investment business for such issues.

Less borrowing in the bond market by the public sector

The public sector, which was able to reduce its deficits quite strongly (see p. 23), had far less recourse to the bond market in 1989, at DM 25.5 billion, than in the preceding years. Traditional Federal bond issues with maturities of ten years were its principal source of funds; these are particularly popular among foreign institutional investors. The Federal Government received DM 4 billion from ongoing sales of its five-year special Federal bonds. In the case of Federal savings bonds, by contrast, redemptions and premature repurchases predominated (− DM 1.5 billion). For the rest, sales of Treasury financing paper (which, however, are not included in public sector bond market debt on account of their comparatively short maturity) were strikingly high.

The Deutsche Mark as a major international currency of issue

Issuing activity in the market for foreign Deutsche Mark bonds was quite brisk, especially in the first few months of 1989. Mainly because of its exemption from withholding tax, this paper was of particular interest to domestic and foreign buyers at that time, and they therefore accepted a yield discount of between ¼ and ½ percentage point on comparable domestic Deutsche Mark issues. Upon the abolition of withholding tax on domestic interest income as from July 1, 1989, these relative advantages of the foreign bond market ceased to apply. Even in the second half of the year, however, the Deutsche Mark remained an attractive international bond currency. Altogether, foreign Deutsche Mark bonds to the amount of DM 23 billion net were sold in 1989, compared with DM 28.5 billion a year before. In future, this market segment will probably benefit from the fact that the minimum maturity of foreign issuers' Deutsche Mark bonds was reduced to two years as from July 1, 1989, and that the obligation to report envisaged issues to the Bundesbank ceased to apply at the same time. These measures also open up the possibility of issuing what are known as "medium-term notes" denominated in Deutsche Mark, and facilitate the use of swaps.

Declining inflow of capital to investment funds

The declining inflow of capital to bond-based investment funds (those open to the general public), which, by virtue of the composition of their fund assets, enable private investors to purchase indirectly in foreign markets, must be rated an additional indication of investors' return to the domestic capital market. In particular, foreign funds, which had met with great interest among investors in 1988 (mainly for tax reasons), had to accept a halving of the inflow from Germany to them, to DM 6.5 billion, in 1989. Domestic bond-based funds, roughly two-thirds of whose fund assets, on an average, were invested in foreign bonds at the end of 1989, fared better on the whole, with sales of units amounting to DM 16 billion, but in their case, too, the inflow of resources slackened sharply as from spring 1989.

Sales and purchases of bonds in the Federal Republic of Germany*

DM billion

Year	Sales, total	Sales of domestic bonds 1			Sales of foreign bonds 2	Sales of foreign investment fund units 2	**Memo item** Balance of transactions with non-residents 3
		Total	of which				
			Bank bonds	Public bonds			
1985	103.4	76.1	33.0	42.7	27.5	– 0.1	+ 4.1
1986	103.8	87.5	29.5	57.8	16.4	– 0.1	+ 42.8
1987	113.3	88.2	28.4	59.8	24.8	0.4	+ 9.8
1988	102.8	35.1	–11.0	46.2	54.7	13.1	– 65.6
1989	125.2	78.4	52.4	25.6	40.5	6.3	– 24.3
		Purchases by					
			domestic non-banks 5				
	Purchases, total	banks (incl. the Bundesbank) 4	Total	Domestic bonds	Foreign bonds	Foreign investment fund units	non-residents 2
1985	103.4	32.5	39.4	15.9	23.7	– 0.1	31.5
1986	103.8	32.4	12.3	– 0.3	12.7	– 0.1	59.1
1987	113.3	43.6	34.7	11.3	23.0	0.4	35.0
1988	102.8	34.6	66.2	2.8	51.0	12.4	2.1
1989	125.2	14.7	88.0	46.9	35.1	6.0	22.5

* Including foreign investment fund units. — **1** Net sales at market values plus/less changes in issuers' holdings of their own bonds. — **2** Transaction values. — **3** Purchases of domestic bonds by non-residents less sales of foreign bonds and investment fund units to residents; — = capital exports, + = capital imports. — **4** Book values. — **5** Residual.
Discrepancies in the totals are due to rounding. BBk

(c) Buoyant share market

Light and shade in the German share market

1989 was a year of light and shade in the German share market. Record amounts raised, rising share prices and growing turnovers bore witness to the German share market's impressive performance as a source and transmission centre of liable capital. Despite the favourable tone of the stock exchange, however, it did not prove possible — as already mentioned — to induce domestic investors to buy more, and more durably, in the domestic share market, thereby basing this market more firmly in Germany.

Steady upswing in prices until the autumn after a sluggish start

In the first few months of 1989 the favourable basic tone of the share market was adversely affected at times by uncertainties about further interest rate and exchange rate movements. The share price increase which had been in progress since the end of January 1988 consequently came to a temporary halt. In the course of the spring the strength of the economic upswing, which was emerging more and more clearly, affected sentiment in the stock market. In the early summer, when interest rate fears abated and stimuli imparted by foreign stock exchanges gave the German market an additional boost, a downright bullish mood arose for a while. Foreign investors, in particular, increasingly purchased German equities, the prices of which were now rather moderate by international standards. At the beginning of October 1989 share prices — as measured by the index of the Federal Statistical Office — were just over one-quarter higher than at the end of 1988.

Prices are highly erratic in October and "sky-rocket" around the turn of the year

A little later, the German share market came under the impact of the slump in prices on the New York Stock Exchange on Friday, October 13. This "mini-crash" resulted in panic selling on the following Monday by many domestic private investors — selling which was probably due to their experience of the stock market crash of October 1987. The upshot was the steepest fall in share prices on a single day since the Second World War, at more than –12%. In point of fact, market conditions were much more stable than in 1987, because one-half of the price losses was made good again as early as the following day. In the further course of 1989 a positively euphoric sentiment gained ground in the share market at times in connection with the upheavals in the GDR. Fuelled by foreign investors' strong demand, which more than offset the simultaneous sales by domestic private investors, share prices reached all-time highs on several occasions. In the middle of April 1990 they were about 7% above their peak value of April 1986; compared with the low of January 1988, the price level had virtually doubled by that time.

Strengthening of domestic private investors' longer-term propensity to invest very urgent

The ups and downs of share prices are undoubtedly a characteristic feature of the stock market. However, this should not cause one to lose sight of the fact that exaggerated price swings, even if – as in October 1989 – they are quickly cancelled out by succeeding events, involve a danger of adversely affecting the share market in its macro-economically important functions. On the other hand, any attempt to steady share price movements by means of purely organisational/technical measures, such as by discontinuing trading in the event of major price leaps, is questionable, if only in the light of regulatory considerations. Still larger purchases by domestic institutional investors, even in the event of the full utilisation of the existing investment opportunities, can only be expected to make a limited contribution to steadying the share market. In the final analysis, therefore, there seems to be no alternative to efforts to strengthen the standing of the share as a long-term investment instrument in the eyes of the general public, so as to reduce the dependence of the narrow German share market on foreign investors, who invest primarily at short term.

Record amount of funds raised

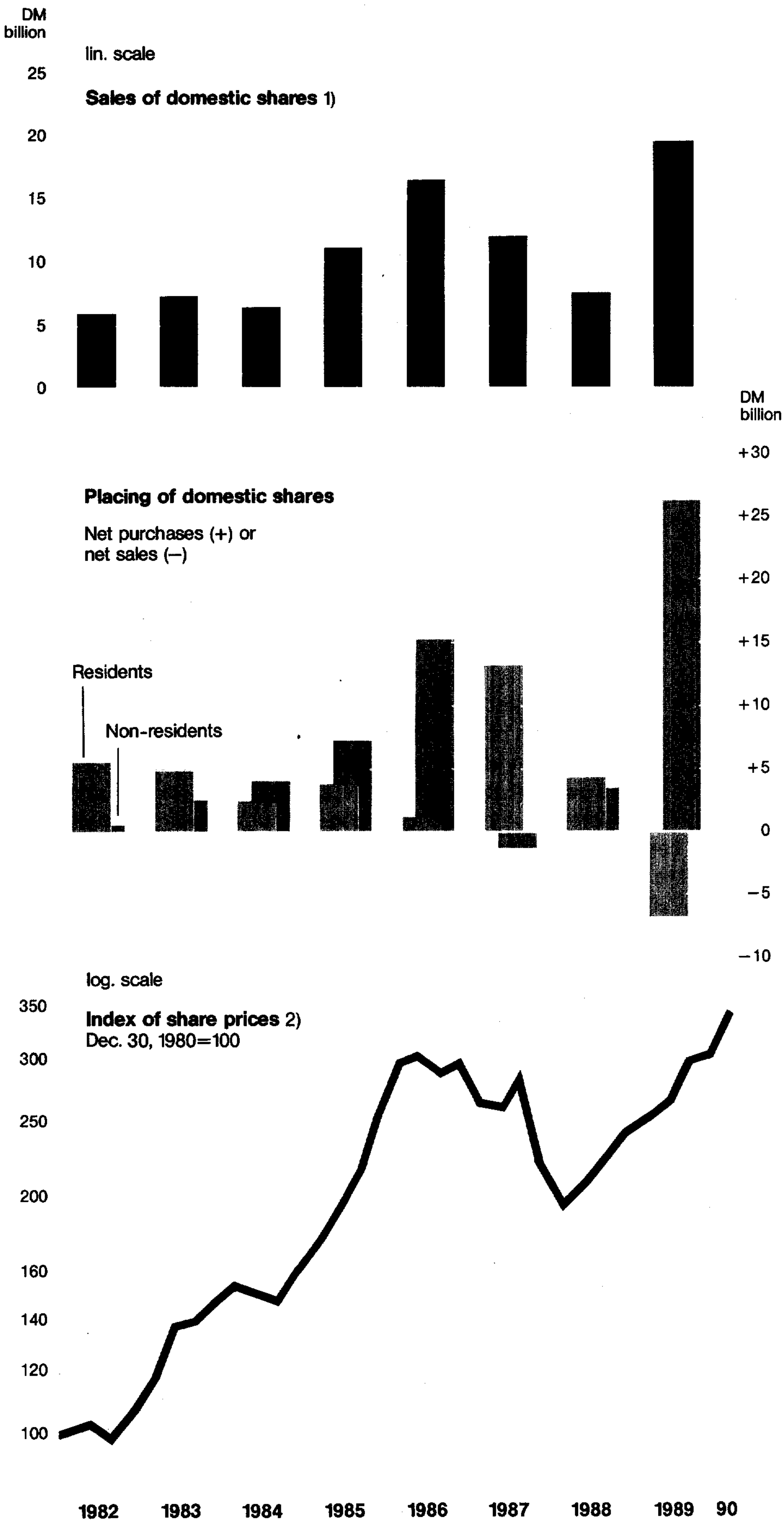
Against the background of the buoyant investment activity and rising share prices, many enterprises raised more capital through the stock exchange in 1989. Altogether, domestic enterprises placed new shares to the record amount of DM 19.5 billion (market value); in the previous record year 1986, sales had come to DM 16.5 billion. What is gratifying is that 26 enterprises "went public" last year. In addition, more than 50 enterprises (mostly private limited companies) decided to transform their previous legal form into that of a public limited company. As a result, the total amount of shares in circulation increased by a further DM 4 billion (nominal value). It would be desirable for even more firms, out of the "pool" of about 400,000 private limited companies in the Federal Republic of Germany, to apply for listing on the stock exchange in future.

(d) The "financial centre Germany" strengthened

Amendment of the Stock Exchange Act comes into force

In 1989, just as in the previous years, important measures were taken to enable the financial centre Germany to adjust to the constantly changing requirements in the field of financial services and to enhance its attractiveness in competition with foreign financial centres. The amendment of the German Stock Exchange Act which came into force on August 1, 1989 provides the statutory framework for successful operations by the German Financial Futures Exchange. In particular, a major obstacle to banks' option dealings and futures contracts with private investors has been done away with through the curtailment of the so-called "time and difference plea". Under the new provisions, the capacity to enter into futures contracts "by virtue of information" has been introduced. This implies that individuals, too, have to meet their obligations if their bank has informed them in a legally prescribed manner about the risks posed by option dealings and futures contracts. Moreover, through the amendment of the Stock Exchange Act, the EC Directive on the mutual recognition of stock exchange admission prospectuses in the European Community has been incorporated in German law; this facilitates access to the German capital market for issuers from other EC countries, and indirectly for issuers from third (non-EC) countries as well. Finally, the way has been paved for listing securities on

Conditions in the share market



1) At issue prices.- 2) Quarterly averages; source: Federal Statistical Office.

BBk

German stock exchanges in foreign currencies or in a unit of account (ECU or SDR). Since January 1990 the Bundesbank has no longer been raising objections to issues of bonds or borrowers' note loans denominated in foreign currencies or ECUs in Germany or by residents, and since then the private use of special drawing rights has been permissible to the same extent as the private use of ECUs. These measures provide additional options for issues of and trading in securities in Germany. At the same time, conditions for the inclusion of the German stock markets in international share placements are eased.

A new chapter opens in the history of the German stock market

The opening of the German Financial Futures Exchange *(Deutsche Terminbörse – DTB)* in Frankfurt in January 1990 marked the beginning of a new chapter in the history of the German stock market. This may well have far-reaching consequences for the future pattern of the stock exchanges in Germany. By its range of internationally familiar instruments, which is to be extended step by step (instruments which can be used at comparatively low cost for hedging and speculative purposes), a gap in the financial centre Germany from which competing foreign financial centres have hitherto profited will be closed. In contrast to official spot dealing, which in Germany is traditionally carried out on the stock exchange floor and by auction, the new futures exchange is fully computerised and operates by the "market-maker system". In addition, bilateral off-the-floor trading, partly using different, competing visual information display systems, is also being practised at present. Which forms of organisation will ultimately become generally accepted for stock exchange dealing can only be decided under conditions of competition.

Financial Market Promotion Act enters into effect

Through the Financial Market Promotion Act, which entered into effect on March 1, 1990, the abolition of capital transfer tax, which has long been called for, is being implemented in stages. According to this Act, securities transfer tax will be abolished as from January 1, 1991, and company tax and stamp duty will follow one year later. As a result of the abolition of securities transfer tax, in the case of certain securities transactions a not inconsiderable cost disadvantage relative to foreign stock exchanges will be removed. At the same time this will lead to equal treatment of public bonds, which are mostly issued as value-rights and which have not been subject to securities transfer tax hitherto, and the other types of securities traded in the German market. Together with the Bill on the Abolition of the Issue Authorisation Procedure pursuant to sections 795 and 808a of the German Civil Code (which Bill is still under discussion in Parliament), this opens up an opportunity of establishing a market for short-term debt instruments in Germany in future. With the abolition of Company Tax, a long-standing type of discrimination against the procurement of capital relative to financing by incorporated enterprises through borrowed funds will disappear as from 1992. Finally, the abolition of stamp duty included in the Act will permit lower-cost financing for small and medium-sized enterprises. The Financial Market Promotion Act also contains amendments of investment fund legislation in the context of the Investment Fund Directive Act; these will considerably extend investment funds' business opportunities, especially by allowing them access to financial futures contracts on the German Financial Futures Exchange and by granting the option in future of holding liquid resources in specific money market instruments rather than in bank balances. A good deal still remains to be done, however, to foster the financial centre Germany. In this connection it is to be welcomed that a discussion group has been formed under the direction of the Federal Ministry of Finance in which all the responsible bodies are to work together in order to further strengthen the standing of the financial centre Germany in the global competitive environment.

1. Exchange rates and exchange rate policy

US dollar on the ascent in the first half of 1989

In 1989 trends in the foreign exchange markets as well as the exchange rate policies of major countries were dominated for a long time by the regained strength of the dollar. According to the method of calculation used by the Bundesbank, the weighted external value of the US currency rose by 13 % from the end of 1988 to mid-June 1989 and subsequently declined only a little up to mid-September. The firming of the dollar reflected particularly strong rises in its rate vis-à-vis the yen and the pound sterling as well as in relation to the Deutsche Mark and the currencies that participate along with it in the exchange rate mechanism of the EMS. By contrast, the US dollar declined slightly against the Canadian dollar. International interest rate movements initially fostered the general recovery of the US dollar. Up to March 1989 short-term interest rates rose distinctly more strongly in the United States than in Japan and the United Kingdom. The dollar benefited in addition from the withholding tax temporarily introduced in the Federal Republic of Germany. It also gained from various political factors; repeated government crises in Japan as well as the events in China made themselves particularly felt.

US dollar weakens again from September 1989 onwards after a shift in sentiment in favour of the Deutsche Mark

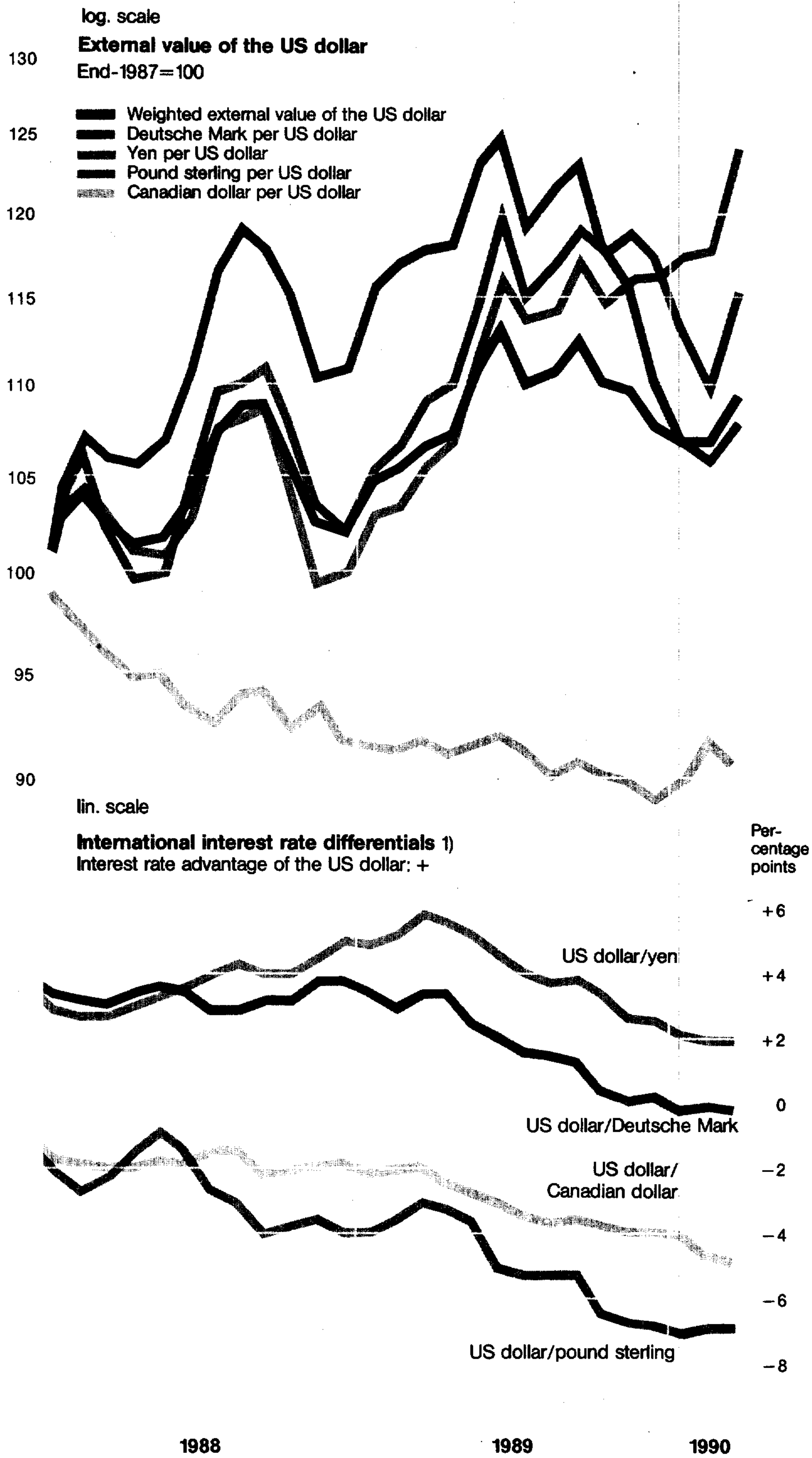
From mid-September 1989 onwards the dollar declined again markedly. In March 1990 its weighted external value was only 6 % above the level it had registered at the end of 1988. The shift in sentiment in favour of the Deutsche Mark from the autumn of 1989 that was pointed out in an earlier section of this Report led to a decline in the dollar rate vis-à-vis all the major currencies of Europe. This development was also influenced by the fact that from spring 1989 onwards interest rates in the United States went down, whereas in Germany they continued to rise at the same time; this gradually eliminated the yield advantage of dollar assets, which had been an accepted fact up to then in Germany. By contrast, the previously very strong rise in the yen rate of the dollar was corrected to only a slight extent because the net outflows of capital from Japan continued on a large scale. Basically speaking, there were three reasons for this development: firstly, despite the fact that they had risen, interest rates in Japan were distinctly lower than those in the United States, with the result that the US currency remained attractive for Japanese investors for interest rate reasons. Secondly, at the same time the levelling of interest rates on assets denominated in dollars and Deutsche Mark, together with the positive assessment of the German share market, enhanced the interest of Japanese investors in DM-denominated assets. Since the US dollar serves as a vehicle currency in foreign exchange transactions, the dollar rate vis-à-vis the yen benefited directly from the demand for Deutsche Mark. Thirdly, recent political uncertainties in Japan have led to stronger outflows of capital from that country.

Monetary authorities counteract the strength of the dollar

The rise in the dollar in the exchange markets in 1989 was inconsistent with the persistently large current account deficits of the United States and the surpluses of major partner countries, especially those of Japan and Germany. This is all the more the case seeing that the external adjustment process in all three of the main industrial countries faltered in the second half of 1988 and even threatened to reverse itself. However, the recovery of the dollar not only jeopardised the adjustment process; the corresponding depreciation of other currencies at the same time made it more difficult for the countries concerned to combat inflation. The strengthening of the dollar therefore triggered resolute countermeasures on the part of the monetary authorities, with a role being played at times by concerted dollar sales, in addition to the interest rate policies they pursued primarily for domestic reasons. These sales were particularly effective after the finance ministers and central bank governors of the G-7 countries had publicly criticised the preceding rise in the dollar as being inappropriate at their meeting on September 23, 1989 — when the dollar

External value of the US dollar and international interest rate differentials

Monthly averages



1) As measured by the money market rates. USA: certificates of deposit with maturities of three months; Japan: securities repurchase transactions with maturities of three months; Federal Republic of Germany and United Kingdom: three-month funds; Canada: Treasury bills with maturities of three months.

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Deutsche Mark interventions in the EMS*

DM billion
+ = Deutsche Mark sales or expansionary impact on liquidity in Germany
− = Deutsche Mark purchases or contractionary impact on liquidity in Germany

Period		Compul-sory	Intra-marginal	Total	**Memo item** Affecting liquidity in Germany 1
1979 2	Purchases	–	− 2.7	− 2.7	− 2.4
	Sales	+ 3.6	+ 8.1	+11.7	+11.7
	Balance	+ 3.6	+ 5.4	+ 9.0	+ 9.2
1980	Purchases	− 5.9	− 5.9	−11.8	−11.1
	Sales	–	+ 1.0	+ 1.0	+ 0.6
	Balance	− 5.9	− 4.9	−10.8	−10.5
1981	Purchases	− 2.3	− 8.1	−10.4	−11.6
	Sales	+17.3	+12.8	+30.1	+25.3
	Balance	+15.0	+ 4.7	+19.7	+13.7
1982	Purchases	–	− 9.4	− 9.4	− 2.5
	Sales	+ 3.0	+12.8	+15.8	+ 6.1
	Balance	+ 3.0	+ 3.4	+ 6.4	+ 3.6
1983	Purchases	−16.7	−19.1	−35.8	−20.4
	Sales	+ 8.3	+12.9	+21.2	+12.6
	Balance	− 8.4	− 6.2	−14.5	− 7.8
1984	Purchases	–	−28.9	−28.9	− 3.0
	Sales	+ 4.7	+ 7.6	+12.3	+ 4.4
	Balance	+ 4.7	−21.4	−16.6	+ 1.4
1985	Purchases	–	−29.1	−29.1	− 0.2
	Sales	+ 0.4	+30.8	+31.1	–
	Balance	+ 0.4	+ 1.6	+ 2.0	− 0.2
1986	Purchases	−19.0	−33.6	−52.6	−12.2
	Sales	+ 4.1	+74.0	+78.1	+ 3.8
	Balance	−14.8	+40.4	+25.5	− 8.4
1987	Purchases	–	−47.8	−47.8	− 7.3
	Sales	+15.0	+61.7	+76.8	+25.4
	Balance	+15.0	+13.9	+28.9	+18.1
1988	Purchases	–	−26.8	−26.8	− 6.1
	Sales	–	+16.3	+16.3	–
	Balance	–	−10.5	−10.5	− 6.1
1989	Purchases	–	−20.4	−20.4	− 3.0
	Sales	+ 5.0	+ 8.6	+13.6	+ 3.0
	Balance	+ 5.0	−11.8	− 6.8	0.0
Selected periods, net					
December 20, 1988 to March 20, 1989 — Recovery of the dollar; calm in the EMS		–	− 8.2	− 8.2	–
March 21 to March 23, 1989 — Dollar firm; Danish krone at the lower intervention point in the EMS		+ 1.7	− 0.3	+ 1.4	–
March 24 to September 15, 1989 — Dollar rising further, with fluctuations; calm in the EMS		–	−10.6	−10.6	–
September 16, 1989 to January 11, 1990 — Dollar falling sharply against the Deutsche Mark; Deutsche Mark firm in the EMS		+ 3.4	+ 8.2	+11.5	0.0
January 12 to end of March 1990 — Dollar rising slightly; Deutsche Mark falling in the EMS		–	−10.7	−10.7	–

* Deutsche Mark interventions by other central banks participating in the EMS exchange rate mechanism and EMS interventions by the Bundesbank; classified by date of transaction. Partly revised figures. — 1 Indicates the extent to which Deutsche Mark interventions in the EMS and the settlement of creditor and debtor positions in the EMCF affected the net external position of the Bundesbank and thus the banks' provision with central bank money. — 2 From the beginning of the EMS on March 13, 1979.
Discrepancies in the totals are due to rounding. BBk

already appeared to be "overplayed" in the markets in any case for speculative reasons — and had reaffirmed the fact that their countries were willing to cooperate. In 1989 net sales of dollars by all the 19 countries that participate in the "concertations" amounted to no less than US$ 75 billion, with the United States and Japan contributing more than US$ 40 billion, and the Bundesbank over US$ 4 billion. The large-scale interventions by the United States were divided more or less equally between purchases of yen and Deutsche Mark. In the final analysis, adjustments in interest rates and foreign exchange market operations tended to bring the exchange rate movements of the Deutsche Mark and the dollar better into line again with the needs for international adjustment. By contrast, Japan's progress in reducing its current account surpluses through the considerable effective depreciation of the yen (by 20 % in real terms from the end of 1988 to March 1990) could be called into question if the movement of the exchange rate of the Japanese currency does not reverse itself in the near future. Economic policy in Japan thus continues to be faced with the need to take determined action to counteract the depreciation of the yen.

Accession of Spain to the exchange rate mechanism, narrowing of the margin of fluctuation for the lira and abolition of the two-tier foreign exchange market in Belgium-Luxembourg

The EMS has witnessed three striking developments: Spain's accession to the exchange rate mechanism in June 1989, the narrowing of the band for the lira in January 1990 and the abolition of the two-tier foreign exchange market in Belgium-Luxembourg in March 1990. Spain opted for the time being in favour of a wider margin of ± 6 %, thus making allowance for its current economic situation, characterised as it is by serious imbalances. Moreover, the central rate of the peseta vis-à-vis the Deutsche Mark was set at a level slightly below the market rate ruling at the time, after the peseta had already weakened distinctly from the end of May 1989 onwards. High interest rates in Spain, which were necessary in view of the country's inflation and balance of payments problems, made the peseta appear attractive again after it had joined the exchange rate mechanism. As a result, its rate vis-à-vis the Deutsche Mark firmed distinctly at first, but has weakened markedly again in the meantime. The Italian lira, which had participated in the EMS since 1979 with a wider margin of fluctuation of ± 6 %, is now among the currencies with a normal margin of fluctuation of ± 2.25 %. The adjustment was effected by Italy maintaining the previously existing lower intervention points vis-à-vis the currencies with a narrow fluctuation band, thus shifting the bilateral central rates of the lira correspondingly downwards by approximately 3.7 %. Since the market rates for the lira had previously fallen far below the relevant central rates, the correction in the central rates for the lira did not cause any renewed shift in market rates, but only consolidated the pattern of exchange rates that already existed in the markets. With the abolition of the two-tier foreign exchange market, in which the exchange rate margins of the EMS did not apply to financial transactions, Belgium and Luxembourg complied with a demand that had been being made by their partners for many years. Thus, Spain, Italy and Belgium-Luxembourg have undertaken major steps to take account of the requirements of the first stage of economic and monetary union, which is due to begin in July 1990; this includes not least the demand that all member states of the EC should participate in the EMS on the same conditions.

Deutsche Mark in a strong position within the EMS

Apart from these developments, trends within the EMS were characterised by repeated bouts of weakness on the part of the Danish krone, leading to compulsory Deutsche Mark sales. Excluding the special case of the peseta, most other currencies participating in the exchange rate mechanism moved below their central rate vis-à-vis the Deutsche Mark. However, within this general context the lira, in particular, initially strengthened until well into September, prompting the Banca d'Italia to undertake sizeable intramarginal Deutsche Mark purchases, only a small proportion of which was re-injected into the market in the subsequent period of weakness of the Italian currency. The mostly lower rates of the other currencies participating in the exchange rate mechanism vis-à-vis the Deutsche Mark, despite the rise in the dollar, were a sign of the innate strength of the Deutsche Mark, which was not generally reflected again in the foreign exchange markets until the autumn. It was, and still is, also mirrored in the fact that the partner currencies of the Deutsche

Components of global monetary reserves*

US$ billion

Type of reserves	Level at end of year			Change					
				Total		due to transactions **1**		due to valuation adjustment **2**	
	1987	1988	1989 **p**	1988	1989 **p**	1988	1989 **p**	1988	1989 **p**
Gold **3**	39.9	39.9	39.6	+ 0.0	− 0.3	+ 0.0	− 0.3	–	–
Special drawing rights	28.7	27.1	26.9	− 1.5	− 0.2	− 0.1	+ 0.4	− 1.4	− 0.6
Reserve positions in the IMF	44.6	38.0	33.5	− 6.6	− 4.6	− 4.4	− 3.7	− 2.2	− 0.8
Official ECU balances	76.1	63.6	62.0	−12.5	− 1.6	− 3.4	+ 0.0	− 9.1	− 1.6
– against gold	46.4	39.8	37.5	− 6.6	− 2.3	+ 0.2	− 0.0	− 6.8	− 2.3
– against US dollars	25.3	23.8	24.5	− 1.5	+ 0.7	+ 0.7	+ 0.1	− 2.2	+ 0.7
– arising from very short-term financing	4.4	–	–	− 4.4	–	− 4.2	–	− 0.2	–
Private ECU balances	5.2	12.8	20.4	+ 7.6	+ 7.6	+ 8.5	+ 7.3	− 1.0	+ 0.3
Foreign exchange	564.1	587.3	627.5	+23.2	+40.2	+39.1	+42.6	−15.9	− 2.4
US dollars **4**	376.0	376.6	381.4	+ 0.6	+ 4.9	+ 0.6	+ 4.9	–	–
Deutsche Mark **4**	87.8	101.0	130.3	+13.2	+29.4	+24.3	+23.9	−11.2	+ 5.5
Japanese yen **4**	43.2	45.8	51.2	+ 2.6	+ 5.4	+ 3.7	+11.7	− 1.1	− 6.3
Pounds sterling	14.0	17.4	18.6	+ 3.4	+ 1.2	+ 4.0	+ 3.3	− 0.6	− 2.2
French francs	6.2	9.2	10.9	+ 3.0	+ 1.7	+ 4.0	+ 1.2	− 1.0	+ 0.5
Swiss francs	8.5	8.9	8.7	+ 0.4	− 0.2	+ 1.8	− 0.0	− 1.4	− 0.2
Dutch guilders	6.1	5.9	5.8	− 0.3	− 0.1	+ 0.5	− 0.3	− 0.7	+ 0.2
Other and unidentified assets	22.3	22.6	20.5	+ 0.3	− 2.1	+ 0.3	− 2.1	–	–
Total reserves	758.6	768.8	810.0	+10.2	+41.1	+39.7	+46.3	−29.5	− 5.1

* Gross monetary reserves of all IMF member countries plus Switzerland and Taiwan. — **1** Where the monetary reserves are not denominated in gold and dollars, the changes in units of the reserve asset concerned have been converted into dollars at average rates based on the rates on the relevant reference dates. In the case of the other and unidentified assets, the changes due to transactions have been equated with the changes in levels. Where the ECU balances are based on the contribution of gold and dollars to the EMCF, the changes in these gold and dollar contributions are shown. — **2** Difference between the change in levels and the change due to transactions; also includes the gold-price-induced change in the ECU balances based on the contribution of gold to the EMCF as well as the exchange-rate-induced change in levels. — **3** Valued at US$ 42.22 per ounce of fine gold. — **4** Including partly estimated assets of Taiwan. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Sources: IMF; EMCF and Committee of EC Central Bank Governors. BBk

Mark are favoured by interest rate differentials above and beyond the extent of the respective inflation differentials. The interest rate policies of the other member states of the exchange rate system are partly directed towards avoiding the depreciation of their currencies but are also helping to inwardly strengthen the cohesion of exchange rates, despite, in some cases, the lack of convincing coordination with other policy areas, such as financial policy. The global economic upswing is conducive to these endeavours, in that it prevents any conflicts of aim from arising for the time being. In order to ensure that excessive demands are not made on monetary policy over the longer term, it is an urgent matter for it to be given greater support in all countries by general economic policy and financial policy, in particular.

Rise in global monetary reserves through large-scale interventions

Primarily as a result of the large-scale interventions in the foreign exchange markets by the monetary authorities, global monetary reserves rose by US$ 41 billion in 1989, when comparing the value of reserve holdings in terms of the US dollar at the end of 1988 and the end of 1989. This figure includes considerable valuation-induced changes in holdings of individual reserve assets. After eliminating these effects, global monetary reserves increased by US$ 46 billion. The major driving forces behind this growth in reserves were purchases of Deutsche Mark and yen by the United States, intramarginal purchases of Deutsche Mark by participants in the EMS exchange rate mechanism and Deutsche Mark purchases by a number of other countries in Europe. There was also a rise in balances of private ECUs resulting from diversification operations. Although the dollar interventions by Japan, Germany and other countries to support their respective currencies constituted a counterweight to this, these dollar sales were accompanied by inflows of dollars from outside the market, not least in the form of interest received on investments of reserve assets. On balance there was therefore a slight rise in US dollar reserves. Of the adjusted growth in global monetary reserves, however, the greater part was accounted for by the Deutsche Mark and the yen (US$ 24 billion and US$ 12 billion, respectively). Statistically recorded Deutsche Mark reserves thus increased to DM 221 billion, or US$ 130 billion. This corresponds to a share of 19.4% in global foreign exchange reserves; the dollars contributed to the EMCF and investments in private ECUs, which are comparable to foreign exchange reserves in some respects, have been included in the calculation.

2. International financial markets

Robust state of the international financial markets

In 1989 the international money and capital markets reflected the favourable macro-economic environment in the western industrial countries. Risks did, however, become apparent in a number of subsectors, inter alia in connection with the financing of corporate takeovers; they gave rise to disturbances at times, as could be seen, in particular, in the renewed increase in volatility in the share markets as the year progressed. But the combination of strong economic growth with simultaneous relatively low rates of inflation prevailing in most western industrial countries made the financial markets remarkably resilient with respect to sectoral problems. One sign of the basically stable state of the markets was, for instance, the fact that the sustained large current account imbalances of a number of industrial countries were largely financed by private capital flows. According to OECD statistics, all the fresh medium and long-term funds raised in the international financial markets in 1989 amounted to US$ 430 billion in gross terms, after US$ 450 billion in 1988. Judging by the figures for the first three quarters of the year, on a net basis and including short-term and undisclosed international bank loans, 1989 probably witnessed a renewed surge in aggregate borrowing in the international financial markets.

Steep rise in bond issues to strengthen capital ratios

The volume of international bonds issued in 1989 was 10% higher than in the preceding year. The main reason for this development was the doubling in comparison with 1988 of the volume of convertible and option bond issues, to approximately US$ 80 billion, 87% of which was accounted for by Japanese borrowers. They benefited from the rise in prices on the Tokyo stock exchange because purchasers of convertible and option bonds were content with low interest yields in the expectation of further price gains. The inflows of borrowed funds boosted Japan's capital exports, which were large anyway owing to the surplus on current account and were once again caused by the direct and portfolio investment of Japanese financial institutions and enterprises. Banks were also among the issuers of low-yielding convertible and option bonds in order to come closer to the improved capital ratios that were internationally agreed upon in 1988. However, in the recent past the growing volatility of the stock markets has imposed limits on the placement of bond issues designed to strengthen capital ratios.

Strong growth of international bank lending to industrial countries

The volume of net fresh international lending by banks to final borrowers in the first three quarters of 1989 also exceeded the figure for the preceding year. As in the past, it was almost exclusively industrial countries which benefited from the buoyancy of international lending activity. The banks further reduced their exposure to developing countries. Commercial banks also exercised restraint in their lending to eastern Europe, where only the Soviet Union was granted an appreciable amount of new funds. After the tempestuous rates of growth in the preceding years, interbank lending and deposit operations subsided again, this being a field of activity that was once again largely dominated by the balance sheet and arbitrage operations of Japanese credit institutions.

Greater financial risks posed by corporate takeovers

The banks showed greater caution than in earlier years with respect to the financing of large-scale corporate takeovers, after a number of spectacular cases of payment difficulties had materialised. The heightened awareness of the risks in this field was reflected above all in the massive falls in the prices of high-yielding junk bonds. Especially in the United States, and in the United Kingdom as well, paper of this kind was issued to raise a large part of the funds needed to buy up firms or replace the short-term interim financing of such funds. Foreign banks, too, purchased such paper. The sharp fall in the prices of junk bonds not only jeopardised the financing of current and planned takeovers and follow-up financing operations but also imposed new burdens on the earnings position of credit institutions that had acquired such paper. However, the risks of incurring losses on the estimated volume of some US$ 200 billion in junk bonds outstanding, which could grow even larger if there is a setback in economic activity or a rise in interest rates, are focused to a great extent on US banks and to a lesser degree on UK and Japanese financial institutions as well. A market in junk bonds has not established itself so far in continental Europe. The heyday of leveraged buy-outs, as this variation of corporate takeovers with a minimum capital input is called, is probably over in the United States, too. Today, there are quite a number of enterprises that have manoeuvred themselves to the brink of their borrowing capacity under the guidance of their investment banks, and whose ability to survive has become excessively dependent on the further trend in economic activity and interest rates. The fact that the investment firms operating in this market have assumed a considerable risk is reflected in the circumstance that one of the major operators in the United States has become insolvent in the meantime. There has been a marked rise in the number of corporate takeovers and mergers in Europe, too, as a consequence of new market strategies tailored to the needs of the Single EC Market. The buyers, however, are in most cases enterprises in a strong earnings position with correspondingly large liquid reserves. Bank loans, in particular, have played a major role in the financing of corporate takeovers in Europe.

Internationally harmonised capital adequacy standards needed for investment firms

The importance of capital as a buffer against risk is underlined by the developments described above. The supervisory authorities, too, are endeavouring to subject financing companies that conduct securities business to stricter capital adequacy standards. These companies, incidentally, are still not subject to any internationally harmonised rules, whereas credit institutions are already following a recommendation of the Basle Committee for Banking Regulations and Supervisory Practices. The provisions of a new EC Directive envisaging a capital ratio of at least 8 % as from 1993 with respect to a bank's assets and off-balance-sheet items, weighted according to the risk content, are at present being incorporated in national law. As far as Germany is concerned, a particular need is seen, as the negotiations in the EC progress, to subject investment firms that are not covered by the definition of a bank in countries with a specialised banking system (e.g. the United States, Japan) to the more restrictive capital standards that apply to banks. The aim behind these endeavours is to bring about the necessary safeguarding of the national and international financial systems in a way that is as neutral as possible in terms of competition and is non-discriminatory. In principle, what this means is that the same transactions imply the same risks and require the same supervisory rules. If less stringent criteria were to be applied to investment banks under systems with specialised banking services, universal banks could be forced for cost reasons to transfer their securities activities to legally independent subsidiaries abroad. Such a shift in the location of business operations would not only raise new supervisory problems but also be contrary to the trend towards "one-stop" financial institutions, i.e. the provision of all kinds of financial services "under a single roof". However, the growing together of the financial markets as well as the large number of financial innovations that have

Net lending in the international financial markets

US$ billion

Item	1986	1987	1988	1988 January to September	1989 January to September
A. International bond markets					
1. Gross issues	220	181	220	166	197
2. Redemptions and repurchases	59	71	82	58	63
3. Net issues	161	110	138	108	134
B. Net placements of Euro-notes	12	23	20	20	10
C. Net bank lending 1	180	300	225	175	235
D. Financing facilities, total					
1. Total net financing of the market segments (A3 plus B plus C)	353	433	383	303	379
2. Double-counting among the above market segments **2**	83	53	68	51	45
3. Total financing facilities, after adjustment for double-counting	270	380	315	252	334

1 Change in the cross-border claims on final borrowers of the banks reporting to the BIS, adjusted for exchange-rate-induced and statistical influences. — **2** Banks' bond purchases, as well as bonds and Euro-notes issued by banks to fund their lending.
Source: BIS. BBk

appeared in recent years have not only created a new need for regulation but have accelerated the process of liberalisation and deregulation at the same time. For example, in spring 1989 the industrial countries of the west agreed on extended liberalisation requirements under the relevant OECD codes governing capital movements and financial services. Endeavours are also being made in the context of the current round of negotiations within the General Agreement on Tariffs and Trade (GATT) to come closer to the object of ensuring neutral competitive conditions for financial services through the dismantling of protectionist regulations.

Changed prospects for the international financial markets through the upheavals in eastern Europe

After the radical changes in eastern Europe, the capabilities and stability of the international financial markets will be faced with new challenges. Over the longer term the objective will be to integrate the countries of eastern Europe into the western system of free, global financial markets that are the adjunct of a free global trading system. It will be necessary in the first instance to introduce structural reforms in keeping with a free market economy in these countries, together with a two-tier banking system comprising a central bank and commercial banks as well as money and capital markets. Not until the elementary prerequisites for a control of productive capacities through market prices and wages, market interest rates and the generation of corporate earnings in a free market system have been created will the countries of eastern Europe be able to mobilise the additional private venture capital in the international financial markets that they urgently need to rehabilitate their economies. In this context, government bridging loans, loan guarantees and interest rate subsidies provided by foreign countries can only give initial assistance and must be replaced as soon as possible by non-subsidised inflows of private capital since they best ensure that the resources will be utilised productively. It will also be necessary to avoid the mistakes that were made in granting unconditional loans to developing countries. Once there is a clear and convincing path of reform in eastern Europe along the lines of a free market economy, it must be expected that this will suck in sizeable flows of international finance which — viewed in global terms — could make it more difficult to finance balance of payments deficits in other countries. This makes further progress in the global adjustment process all the more urgent.

International indebtedness of developing countries unchanged

Last year there was no significant change in the overall debt situation of developing countries. At more than US$ 1,200 billion, the aggregate volume of Third World indebtedness at the end of 1989 was at the same level as it had been in the two preceding years. On balance, official and above all multilateral lenders granted additional loans in 1989. By contrast, private lenders reduced their exposure to developing countries. However, exchange rate influences understate the level of indebtedness. As was the case in 1988, too, the firmer US dollar led to a reduction in the dollar equivalent of debts denominated in other currencies in 1989. If the debt situation is measured in terms of macro-economic criteria, such as exports, it eased somewhat in 1989 for all developing countries, including the 15 major debtor countries; this is true both of the relative level of their debts and of their debt service payments.

Increase in the debts of the countries of eastern Europe

In tandem with the reform process in eastern Europe, the debt situation of this region attracted greater attention again. According to OECD estimates, since the end of 1984 the debts of the countries of eastern Europe in convertible currencies have grown considerably, namely from US$ 82 billion to US$ 133 billion gross at the end of 1988. They probably rose by a further US$ 10 billion last year. Even though the debt situation of the countries of eastern Europe can still be described as tolerable on the whole, in comparison with that of other problem regions, the debts of individual countries have reached a level that is quite comparable to that of various heavily indebted countries of Latin America. Poland, in particular, and also Hungary must be mentioned in this context.

Debt reduction as a new element in the debt strategy

Since the outbreak of the debt crisis in 1982, the debtor countries as a whole have not succeeded in servicing their foreign debt by themselves again, especially through a sufficiently high level of exports. The Baker Plan initiated in 1985 as a new guide-line for the international debt strategy (see the Report of the Deutsche Bundesbank for the Year 1985, pp. 77ff.), which was intended to give an additional impetus to growth in the indebted countries through rescheduling operations and fresh financial assistance, did not have the success expected of it, primarily owing to the lack of adequate structural reforms in the debtor countries. Conditions in a number of heavily indebted countries have actually worsened since then. In this way, the debt crisis, which was initially a liquidity problem, has for many countries become a solvency problem that can no longer be coped with by "debt management" (rescheduling) operations and the granting of fresh loans alone. For these reasons, the granting of fresh loans by commercial banks that operate internationally has limped considerably behind the expectations associated with the Baker Plan. In order to impart new momentum to the debt strategy and following an initiative from the Secretary of the US Treasury, Mr Brady, the major industrial countries considered it appropriate at the spring meeting of the IMF and World Bank in April 1989 to attach greater importance in the future to reductions in debt and debt service payments to be negotiated by market participants. According to this scheme, the IMF and World Bank are to give heavily indebted developing countries and their creditor banks the necessary inducements to reach agreements on reducing outstanding debts and debt service payments. Thus, the new debt initiative was a continuation of the market-related transactions with debt-reducing effects that had been initiated before, in particular debt-to-equity swaps and debt-to-bond swaps.

Initial results of the Brady initiative

Under the Brady initiative, the IMF and World Bank are to provide between US$ 20 billion and US$ 25 billion together over a period of three years for the purpose of reducing debts and debt service payments. Japan has declared its willingness to contribute up to US$ 10 billion as a kind of co-financing for the

External debt of developing countries*

US$ billion

Item	1985	1986	1987	1988	1989 **p**	Change in 1989 from 1988 **p**
External debt of all developing countries						
Public creditors	352	409	479	491	501	+10
Banks	483	506	541	517	504	−13
Other creditors	163	180	192	208	210	+ 1
Total	998	1,095	1,212	1,216	1,214	− 2
of which 15 major debtor countries **1**	422	448	486	468	464	− 4
Memorandum items						
Debt service payments	137	140	144	162	153	− 9
Interest	78	73	68	79	78	− 1
Repayment of long-term loans	60	66	76	84	75	− 9
Debt service as a percentage of receipts from exports of goods and services						
All developing countries	20.7	20.0	19.1	18.9	16.1	**2** − 2.8
15 major debtor countries	40.0	42.9	34.0	42.2	33.8	**2** − 8.4

* Excluding debt to the IMF. — **1** Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia. — **2** In percentage points. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Source: IMF. BBk

same purpose. Thus, all in all, about US$ 30 billion to US$ 35 billion could be raised, with which a reduction in debts to banks of the order of about US$ 100 billion could be achieved, according to official calculations. Corresponding decisions have been taken by the IMF and World Bank in only four cases up to the present, however, and in only two cases (Mexico and the Philippines) did a reduction in debt subsequently indeed materialise on the basis of agreements with the banks involved. In the case of Mexico debt-to-bond swaps dominated, whereas in the case of the Philippines buy-backs played the central role. In this way, the Philippines was able to buy back bank debts totalling US$ 1.3 billion at a discount of 50 %. Mexico used the funds it obtained from the IMF and World Bank to purchase zero bonds issued by the US Treasury; these bonds are intended to guarantee the payment of the bonds issued in exchange for the loan claims of the banks when they mature. In this way, the banks can acquire claims of a higher quality but, in undertaking the swap, they have to accept either a reduction of 35 % in the nominal value of their claims or a fixed rate of interest that is below the market rate. Only a few banks chose the third possibility that had been negotiated, namely that of granting fresh loans. As a result of these operations Mexico has been able to reduce its debt service payments vis-à-vis the banks by US$ 1.2 billion per annum in the years ahead. Overall, however, the reduction in the burden is considerably smaller because Mexico will have to pay interest in future to those who provided the security (the IMF and World Bank as well as Japan).

Prospects of success of the Brady initiative also dependent on greater adjustment efforts

The results achieved so far in the international efforts to reduce the burden borne by the heavily indebted countries have fallen distinctly short of the objectives associated with them. One of the reasons for this is that, besides reducing their debts, many countries require fresh capital for their further development. The commercial banks, however, are more reluctant than ever to extend fresh loans when, in the absence of really convincing adjustment efforts on the part of the debtor countries, they are being urged at the same time to forgo their existing claims. Since the banks have made large-scale valuation adjustments with respect to their loans to problem countries in recent years, many of them are evidently prepared if need be to accept payment arrears on the part of their debtors rather than finance interest payments through fresh loans. Thus, in the absence of resolute adjustment policies, the new debt initiative may aggravate a problem that has impaired the effectiveness of the Baker Plan, namely the lack of fresh loans. So far only a small number of countries have demonstrated a determination similar to that of Mexico to restructure their economies in line with the needs of international competition. The prerequisites for the IMF and World Bank to launch support operations designed to reduce country debt are thus frequently lacking. The expectations that many debtor countries have entertained of the Brady initiative will therefore be fulfilled only if they qualify themselves for debt relief operations and the provision of fresh capital through their own efforts, i.e. through the necessary corrections of their economic policies.

4. Recent trends in the IMF and among the international development banks

Despite the rise in fresh lending, net reflows continue

In 1989 there was a rise in the volume of new loans extended by the IMF in comparison with the previous year. There was a simultaneous slight decline in repurchases. Owing to the high level of lending at the beginning of the debt crisis, however, they continued to exceed the level of purchases. As a result, the volume of the Fund's loans outstanding declined once again (by SDR 1.4 billion) to SDR 24.1 billion. The net reflows of resources in recent years are in line with the monetary task of the Fund, which enables its resources to be employed only on a revolving basis, with the result that periods with a high level of purchases are automatically followed by repurchases, which are bunched in a similar manner. Moreover, people frequently fail to appreciate that the level of lending by the IMF is not decisive for the role it plays; what is most important is that, by providing its financial support, the Fund gives adjustment programmes a kind of seal of approval, and thus makes it easier for resources to be raised from other lenders (its role as a catalyst).

Stronger role of the IMF and World Bank in the debt strategy

In the context of the Brady initiative, the Fund declared that it was willing to support debt reduction measures in developing countries by granting loans subject to certain conditions. Depending on the circumstances of the individual case and within the existing drawing limits, about one-quarter of a loan from the Fund can be used exclusively for the purpose of reducing debts ("set-aside amount"). Moreover, besides the normal amount of a country's purchases the IMF can provide additional funds up to a maximum of 40 % of a country's quota to ensure its interest payments ("interest support") if guarantees of this nature have been negotiated under debt relief agreements between a debtor country and its creditors. Finally, the Fund can start disbursing a loan it has granted even if the overall financing of an adjustment programme is not yet completely assured (relaxation of the rules on "financing assurances"). In accordance with the decisions of the Executive Board, in implementing these new arrangements attention must be paid to the fact that the additional assistance granted by the Fund is complemented by appropriate contributions from the commercial banks and the debtor countries. In addition, in the event of the Fund's resources being disbursed at a very early date, a particularly thorough examination is required as to whether the borrowing country will be in a position to repay the loan from the Fund on time.

Continuation of the Policy on Enlarged Access with simultaneous endeavours to increase quotas

In the light of the persistent balance of payments problems of a large number of developing countries and the stronger role of the IMF under the debt strategy, the Fund decided to prolong its Policy on Enlarged Access to the Fund's Resources once again, with unchanged ceilings on purchases, until mid-1990. This policy has partly been financed up to now through large-scale

Purchases and repurchases under IMF credit facilities

SDR billion

Item	1985	1986	1987	1988	1989
Credit tranches	2.6	3.0	1.9	1.7	1.5
Extended Fund Facility	0.4	0.3	0.2	0.2	1.2
Compensatory and Contingency Financing Facility 1	0.9	0.6	1.2	0.7	0.8
Buffer Stock Facility	–	–	–	–	–
Structural Adjustment Facility 2	–	0.1	0.4	0.4	1.0
Total purchases	4.0	3.9	3.7	3.1	4.5
Total repurchases	3.6	5.7	7.9	6.7	5.9
Net purchases (net repurchases: –)	0.4	– 1.8	– 4.2	– 3.6	– 1.4

1 Comprising only the Compensatory Financing Facility up to August 1988. – 2 Including both the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF); both facilities are financed out of special accounts administered by the Fund and are available only to countries whose per capita income is particularly low.
Discrepancies in the totals are due to rounding.
Sources: IMF and Bundesbank calculations. BBk

additional loans from individual member countries. Since it cannot be expected that such loans will be permanently available in sufficient amounts, the Policy on Enlarged Access ought to be geared to the scope for financing that will be available after the current review of quotas has been concluded. From Germany's point of view, the size of the imminent increase in quotas should be such as to ensure that IMF loans can be largely financed again from the resources arising from the quotas in the Fund. Moreover, the relationships between the quotas of member countries should better reflect their actual economic strength. This implies, in particular, that Japan should move up in the hierarchy of quotas to second place behind the United States; Germany would remain in place three, as before. In the negotiations on the adjustment of quotas there are indications that an increase in quotas of about 50 % will be agreed to, as a compromise between the differing interests of the countries involved.

"Cooperative approach" to reduce payment arrears vis-à-vis the IMF

For some time there has been a continuous increase in payment arrears to the Fund; this applies, however, to only a small group of countries. Since 1983 the IMF has adopted a number of countermeasures, which were further strengthened by the "cooperative approach" agreed in 1988. Besides preventive measures designed to avoid new payment arrears as well as additional sanctions against countries that are unwilling to cooperate, this plan envisages additional assistance for the Fund's debtors which are in payment arrears and are making serious efforts to reduce them. These countries are being encouraged to enhance their creditworthiness through convincing adjustment efforts over a relatively long period under a "shadow programme" supervised by the Fund. This makes it easier to mobilise additional foreign assistance and enables the country concerned to settle its arrears with the Fund; an adjustment programme supported by loans from the Fund can then be agreed. Moreover, in order to protect its financial integrity the Fund is endeavouring to further increase its reserves and is placing additional amounts in its Special Contingent Account, which was set up at the beginning of 1987. The associated costs are being borne jointly by the Fund's creditors and debtors. Progress has already been achieved under this "cooperative approach". For example, the total number of countries in payment arrears to the Fund has declined in recent months. In addition, some of the Fund's debtors in arrears have repaid partial amounts and have at the same time made efforts to initiate economic reforms. However, in the light of the continuing high level of payment arrears it appears appropriate to intensify the "cooperative approach" by strengthening the preventive measures (strict adherence to loan conditionality) and resolutely applying the available sanctions.

Review of special facilities

The Compensatory and Contingency Financing Facility (CCFF) set up in August 1988 has hardly been utilised up to the present. This is ascribed, inter alia, to the relatively complicated conditions attached to it. However, they are necessary in order to prevent any abuse of the facility. Under the current review of the CCFF that is to be completed by summer 1990, a reform of the CCFF guide-lines is being aimed at. The Bundesbank supports these endeavours to the extent that they relate to possible simplifications, but objects to any softening of the lending conditions, such as has been demanded in various quarters. On the occasion of the review in March 1989 of the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF), which are financed through special accounts, concern was expressed about the fact that the results of the adjustment programmes financed by SAF resources were unsatisfactory in a number of cases. The IMF Executive Board therefore advocated additional efforts to ensure that SAF programmes are appropriately designed and resolutely implemented. The date by which the three-year ESAF programmes can be approved was prolonged by one year to the end of November 1990 in order to give the countries that qualify for them more time to make use of ESAF resources; in addition, the maximum access to SAF resources in the third year of a programme was increased from 13.5 % to 20 % of a country's quota, with the result that total access amounts to 70 % of the quota.

Considerable rise in the loan commitments of development banks

In 1989 there was in part a very strong rise in the loan commitments of major international development banks, reflecting the fact that increases in their capital led to a considerable widening of their scope for lending. Thus, the annual loan commitments of the World Bank Group (IBRD, IDA and IFC) increased by almost 13 % to approximately US$ 23 billion in its 1989 fiscal year. There was also a marked increase in the loan commitments of the regional development banks for Latin America, Africa and Asia; they went up by US$ 2 billion to US$ 9 billion. A decisive role was played here by the fact that, after two fiscal years with a distinct decline in its loan commitments, the Inter-American Development Bank (IDB) once again approached the high level of lending it had registered in the mid-eighties. Better prerequisites for helping the poorest developing countries were created with the ninth replenishment of the resources of the IDA. At the end of 1989 32 donor countries, including the Federal Republic of Germany, agreed to make resources equivalent to SDR 11.7 billion available to the IDA for lending on concessional terms between the middle of 1990 and the middle of 1993. Besides alleviating poverty, emphasis is to be placed on fostering economic reforms and on programmes to protect the environment.

Loan commitments by the World Bank for debt rescheduling operations

In order to gear the World Bank's lending activities more strongly to overcoming the debt problem, the guide-lines adopted in 1989 envisage that about one-quarter of the adjustment loans granted to a borrowing country over a three-year period can be utilised to reduce its debt. In addition, up to 15 % of a three-year loan programme can be used to assure interest payments in connection with the reduction of debts or debt service payments. These additional resources are not to exceed US$ 6 billion in the fiscal years 1990-2.

Borrowings by development banks at a consistently high level

At US$ 13.1 billion, the medium and long-term funds borrowed by the international development banks were only US$ 0.2 billion lower in the 1989 fiscal year than in the corresponding previous period. A distinct decline in the volume of fresh funds taken up by the IBRD was almost offset by larger borrowings on the part of the regional development banks, especially the IDB.

In the 1989 fiscal year the DM-denominated funds raised by the international development banks amounted to DM 2 billion. The proportion of borrowings denominated in Deutsche Mark, at about 8%, which was relatively small (in comparison with past years), is closely connected with the IBRD's policy of increasing the excessively low weight of the US dollar in the currency pool that determines how its loans are disbursed.

Part B: Notes on the Deutsche Bundesbank's annual accounts for 1989

1. Legal basis

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)* in the wording of December 19, 1985. In accordance with that section, the provisions of the Commercial Code *(Handelsgesetzbuch)* relating to corporations are to be applied as appropriate to the valuation.

2. Annual accounts

The annual accounts for 1989 are attached to this Report as an Appendix; as usual, the notes on them are presented in the order in which the items appear in the balance sheet and the profit and loss account. At the same time a report is rendered on the Bank's activities during 1989. The trends in the major balance sheet items in the course of the year are shown in the Weekly Returns of the Bank, which are published as Appendix 3 of the German original of this Report. The figures for the previous year are now shown in the balance sheet and profit and loss account and no longer in special tables. The transfers to provisions for pensions and the pension payments in respect of the Reichsbank are classified as staff costs.

Balance sheet

The balance sheet total at December 31, 1989 was DM 308,570.7 million, against DM 268,924.6 million at end-1988.

Assets

Gold

The gold holding, amounting to 95 million ounces of fine gold (excluding the gold reserves provisionally contributed to the European Monetary Cooperation Fund), is shown at December 31, 1989 at the same figure as at end-1988, viz. DM 13,687.5 million.

Reserve position in the International Monetary Fund and special drawing rights

At December 31, 1989 the level of drawing rights within the reserve tranche in the International Monetary Fund (IMF) amounted to DM 5,165.9 million (= SDR 2,315.3 million) against DM 5,957.1 million (= SDR 2,486.6 million) at end-1988. It represents the difference between the German quota of SDR 5,403.7 million and the Deutsche Mark balances equivalent to SDR 3,088.4 million at the disposal of the IMF at the end of the year. Increases equivalent to SDR 364.0 million due to other members' Deutsche Mark drawings and other Deutsche Mark payments to other members were accompanied by decreases equivalent to SDR 535.3 million due to other members' Deutsche Mark repayments and other transactions.

In the year under review the Bank did not grant any new loans to the IMF under special borrowing arrangements. At present there is only one credit line amounting to SDR 2.4 billion in favour of the IMF outstanding under the General Arrangements to Borrow (GAB), which the IMF can use, however, only subject to certain conditions.

The amount of special drawing rights (SDRs) held at December 31, 1989 was DM 3,062.8 million (= SDR 1,372.7 million) against DM 3,306.8 million (= SDR 1,380.3 million) at end-1988. It was composed of SDR 1,210.8 million of SDRs allocated, the counterpart of which is shown on the liabilities side, and SDR 161.9 million of SDRs purchased. Increases of SDR 157.3 million from interest payments and remunerations on the part of the IMF were accompanied by decreases of SDR 164.9 million in the context of freely agreed SDR transactions.

Claims on the European Monetary Cooperation Fund

This item comprises the Bank's ECU balances and the claims denominated in ECUs arising from recourse by other central banks to the very short-term financing mechanism.

The ECU balances amounting to DM 32,125.4 million arise mainly from the provisional contribution of 20% of the Bank's gold and dollar reserves to the European Monetary Cooperation Fund (EMCF) in the form of three-month swaps. In addition, these balances include to a minor extent the reserve ECUs transferred to the Bank by other central banks participating in the European Monetary System (EMS). The gold and dollar reserves provisionally contributed to the European Monetary Cooperation Fund, as part of the EMS, against the crediting of ECUs were transferred at market prices and therefore at values higher than those shown in the balance sheet. The resulting difference of DM 14,822.5 million is deducted from the ECU balances. At the end of 1989 there were no other ECU claims arising from loans under the very short-term financing mechanism.

Balances with foreign banks and money market investments abroad

The balances with foreign banks and money market investments abroad, the vast bulk of which are denominated in US dollars and bear interest, amounted to DM 58,283.1 million at the end of 1989 against DM 50,157.6 million at December 31, 1988 (excluding the dollar reserves provisionally contributed to the EMCF). The assets and liabilities denominated in US dollars were once again valued at the balance sheet rate of December 31, 1987 (US$ 1 = DM 1.5815).

Foreign exchange dealing

The Bank's turnover in spot foreign exchange deals (foreign currency against Deutsche Mark) diminished in the year under review owing to decreased activity in the US dollar-Deutsche Mark market to DM 29,877.7 million against DM 57,403.3 million in 1988. The number of deals declined from 6,771 in the previous year to 4,926. Specifically, the deals consisted of

	1988		1989	
	Number	DM million	Number	DM million
Purchases	2,070	8,027.1	1,761	8,748.7
Sales	4,701	49,376.2	3,165	21,129.0
	6,771	57,403.3	4,926	29,877.7.

The volume of cross deals (foreign currency against another foreign currency) fell from DM 3,009.5 million in the preceding year to DM 1,322.8 million in 1989. The number of deals likewise declined (from 173 to 47). The number and volume of SDR-US dollar and SDR-Deutsche Mark deals (there were 24 such transactions equivalent to DM 1,174.5 million in 1988) declined to 20 transactions equivalent to DM 391.1 million in 1989. In addition, 238 US dollar inter-centre switch transactions totalling US$ 67.8 million were entered into (1988: 248 transactions amounting to US$ 70.1 million).

For fine-tuning the money market, the Bank conducted 7 foreign exchange repurchase transactions equivalent to DM 2,204.8 million with domestic banks during the year under review in order to reduce liquidity.

External payments

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

External payments

Number of orders

Year	in foreign currencies	in Deutsche Mark	Total	of which Processed by automated standing order procedure	of which Processed automatically via SWIFT 1
	Outgoing external payment orders				
1988	384,350	2,546,523	2,930,873	2,673,343	177,088
1989	375,184	2,698,182	3,073,366	2,810,311	188,445
	Incoming external payment orders			of which Payments received via SWIFT	
1988	17,190	229,959	247,149	218,524	
1989	16,765	233,534	250,299	233,498	

1 Society for World-wide Interbank Financial Telecommunication.

Foreign cheques

During 1989 22,565 (1988: 20,490) foreign cheques payable to order totalling DM 191.1 million (1988: DM 214.1 million) were sold. In addition, the Bank sold 35,730 traveller's cheques amounting to DM 4.4 million (against 37,197 traveller's cheques totalling DM 4.5 million in 1988). In 1989 the number of cheques presented under the simplified collection procedure for foreign cheques was as high as in the preceding year.

Foreign commission business

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

	1988	1989
		Number
Bills, cheques, etc.	28,751	22,939
Foreign notes and coins	5,427	4,455
	34,178	27,394.

Foreign notes and coins

The amount of foreign notes and coins held at end-1989, at DM 25.0 million, was DM 0.5 million lower than at end-1988. During the year under review the Bank effected 19,577 purchases (1988: 19,379) and 44,526 sales (1988: 44,424) of foreign notes and coins.

External loans and other external assets

As in the preceding year, only loans to the World Bank (which were mostly granted against borrowers' notes denominated in Deutsche Mark) are included in this item. Loans under the EC medium-term monetary assistance arrangement and other loans to foreign monetary authorities were not granted in the year under review.

Lending to domestic banks

This item reflects domestic banks' recourse to the Bank's refinancing facilities.

Securities repurchase agreements

During the year under review the Bank regularly offered the banks, by tender, open market transactions in securities under repurchase agreements on a considerable scale in order to provide liquidity for a limited period. In these transactions the Bank bought securities eligible as collateral for lombard loans subject to the condition that the sellers repurchased them forward. At the end of the year the claims deriving from these transactions amounted to DM 108,828.4 million (end-1988: DM 77,980.2 million).

Domestic bills of exchange

At the end of 1989 the Bank's portfolio of domestic bills amounted to DM 34,102.4 million against DM 33,485.1 million at the end of 1988. The Bank's average holding of domestic bills on all return days, at DM 34,339 million, was likewise higher than in the preceding year (DM 31,786 million). The domestic bill portfolio comprised:

	Dec. 31, 1988	Dec. 31, 1989 DM million
Domestic bills discounted	30,575.6	32,168.3
Prime bankers' acceptances acquired in the course of open market operations	2,909.5	1,934.1
	33,485.1	34,102.4.

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

Land Central Bank	1988 Thousands	1988 DM million	1989 Thousands	1989 DM million
Baden-Württemberg	502	25,435.7	486	26,192.3
Bavaria	334	21,943.7	324	23,617.8
Berlin	18	2,993.8	14	2,408.4
Bremen	35	2,702.3	30	2,979.3
Hamburg	91	8,514.0	82	8,298.4
Hesse	278	24,926.1	260	30,243.8
Lower Saxony	131	10,838.1	121	10,661.7
North Rhine-Westphalia	493	35,854.7	474	36,910.4
Rhineland-Palatinate	85	4,851.2	82	5,179.1
Saarland	20	1,784.2	19	1,816.9
Schleswig-Holstein	26	2,086.6	26	2,071.8
Total	2,013	141,930.4	1,918	150,379.9

The average value of the bills purchased in the year under review was DM 78,400 (1988: DM 70,500).

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

	1988 Number	1988 DM million	1989 Number	1989 DM million
	7,089	96.2	6,167	79.4
as % of the total purchased	0.35	0.07	0.32	0.05.

Discount rate

During the year under review the Bank's discount rate for domestic and foreign bills was 3½% until January 19, 4% as from January 20, 4½% as from April 21, 5% as from June 30 and 6% as from October 6.

Prime bankers' acceptances

The total amount of prime bankers' acceptances which the Bank is prepared to purchase in the context of its open market operations remained unchanged during the year under review. By the structural adjustment of the refinancing facilities, however, the presentation facility was lowered to DM 2 billion as from January 1, 1990 and to DM 1 billion as from January 1, 1991; it will be abolished entirely at the end of 1991.

Throughout the year the Bank's buying rate for prime bankers' acceptances was 0.5 percentage point below the discount rate, and thus remained considerably below money market rates; hence recourse to prime bankers' acceptances as a source of funding continued to be heavy. During the year under review the Bank's purchases through *Privatdiskont-Aktiengesellschaft* totalled DM 12,963.2 million (1988: DM 13,866.3 million). There were, however, no repurchases.

DM 13,938.6 million remained in the Bank's portfolio until payment on maturity (1988: DM 14,335.6 million). At December 31, 1989 the Bank held prime bankers' acceptances deriving from open market operations totalling only DM 1,934.1 million (end-1988: DM 2,909.5 million); this was mainly because of the reduction of the presentation facility which came into force on January 1, 1990.

Foreign bills of exchange

At the end of 1989 the portfolio of foreign bills accumulated through purchases in Germany amounted to DM 27,206.9 million (end-1988: DM 22,027.0 million). The share of Deutsche Mark bills in the total value of the foreign bills purchased averaged 98.0% in 1989 (1988: 97.5%).

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

	1988		1989	
Land Central Bank	Number	DM million	Number	DM million
Baden-Württemberg	49,382	11,338.8	50,742	13,440.3
Bavaria	32,812	12,323.7	35,788	14,253.3
Berlin	3,170	5,408.0	4,262	7,505.1
Bremen	2,572	1,122.3	2,674	1,070.7
Hamburg	15,015	10,600.4	15,070	12,646.8
Hesse	30,463	23,951.7	34,431	29,679.3
Lower Saxony	8,421	3,653.8	9,796	4,955.1
North Rhine-Westphalia	42,473	20,832.1	45,902	24,299.6
Rhineland-Palatinate	8,446	1,863.1	8,865	2,112.4
Saarland	3,814	1,254.2	3,924	1,275.7
Schleswig-Holstein	2,939	1,377.0	3,784	1,782.5
Total	199,507	93,725.1	215,238	113,020.8

Lombard loans

At the end of 1989 the outstanding amount of lombard loans which the Bank had granted to banks was DM 5,187.2 million against DM 11,243.5 million at end-1988. As an annual average they amounted to DM 1,610 million compared with DM 691 million in the previous year. The use of lombard loans is normally subject to marked fluctuations; it was highest on October 5, 1989, at DM 38,017 million.

Lombard rate

In the year under review the lombard rate was 5½% until January 19, 6% as from January 20, 6½% as from April 21, 7% as from June 30 and 8% as from October 6.

Cash advances

Section 20 (1) 1 of the Deutsche 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.

Not only cash advances but also Treasury bills which the Bank holds in its portfolio or has undertaken to purchase are to be counted towards these credit ceilings.

Federal and Länder Governments

Cash advances outstanding

DM million

Borrower	December 31, 1988	December 31, 1989
Federal Government	–	–
Länder Governments		
Baden-Württemberg	–	–
Bavaria	279.0	323.3
Berlin	–	–
Bremen	55.3	43.8
Hamburg	–	–
Hesse	–	–
Lower Saxony	–	248.9
North Rhine-Westphalia	569.0	217.4
Rhineland-Palatinate	54.7	98.8
Saarland	42.7	34.4
Schleswig-Holstein	9.6	86.5
Total	1,010.3	1,053.1

The Equalisation of Burdens Fund and the ERP Special Fund took up no cash advances during the year under review.

Federal Railways and Federal Post Office

No cash advances to the Federal Railways or Federal Post Office were outstanding at December 31, 1989; any such advances, together with claims arising from the purchase of Treasury bills and Treasury discount paper, are to be shown in the item "Lending to the Federal Railways and Federal Post Office" on the assets side of the Bank's balance sheet.

Throughout the year under review, the interest rate charged for cash advances was identical to the Bank's discount rate.

Treasury bills and Treasury discount paper

For issues of Treasury discount paper *(U-Schätze)* in 1989, the Bank again acted as selling agent for the Federal Government. This paper, which serves financing purposes, is distinct from the mobilisation and liquidity paper issued pursuant to sections 42 and 42a of the Deutsche Bundesbank Act, which is reported on below. No Treasury bills serving financing purposes were issued during the year under review.

Federal Government

In 1989 Treasury discount paper which is not returnable before maturity was placed with domestic banks to the amount of DM 849.7 million (1988: DM 2,078.2 million). DM 7,941.2 million of "Treasury financing paper" was sold (1988: DM 786.6 million). DM 616.0 million of paper returnable before maturity (type "B") was redeemed and DM 600.0 million was newly issued.

After the redemption of DM 2,211.5 million (1988: DM 3,718.6 million) of matured Treasury discount paper (including "Treasury financing paper"), the total amount of Treasury discount paper of the Federal Government (types "B" and "BN") outstanding at December 31, 1989 was DM 12,897.7 million (end-1988: DM 5,718.3 million). Of this total, DM 1,440.0 million was repurchasable by the Bank (Treasury discount paper type "B").

Federal Railways

In the year under review — for the first time for some years — the Federal Railways issued non-returnable Treasury discount paper (type "BaN"); the amount issued (DM 590.7 million) was all still outstanding at the end of 1989.

The amount of returnable Treasury discount paper of the Federal Railways (type "Ba") which matured in 1989 (DM 131.0 million) was redeemed and re-issued. At December 31, 1989 — as at end-1988 — DM 131.0 million of this paper was therefore outstanding.

The total amount of Treasury discount paper of the Federal Railways (types "Ba" and "BaN") outstanding came to DM 721.7 million at the end of 1989 (end-1988: DM 131.0 million).

Federal Post Office

No Treasury discount paper of the Federal Post Office was outstanding during the year under review.

The total amount of money market paper issued for account of the Federal Government and its Special Funds outstanding at the end of 1989 was DM 13,619.4 million (end-1988: DM 5,849.3 million).

Money market paper issued for the account of the Federal Government and its Special Funds

DM million

	1988	1989		
Type of paper	Outstanding at December 31	Issued	Redeemed	Outstanding at December 31
Treasury discount paper of the Federal Republic of Germany types "B" **1** and "BN" **2**	5,718.3	9,390.9	2,211.5	12,897.7
of which: "Treasury financing paper"	(1,601.6)	(7,941.2)	(1,013.0)	(8,529.8)
Treasury discount paper of the Federal Railways types "Ba" and "BaN" **2**	131.0	721.7	131.0	721.7
Treasury discount paper of the Federal Post Office type "PN" **2**	—	—	—	—
Total	5,849.3	10,112.6	2,342.5	13,619.4

1 The letter "B" serves to distinguish these bonds from the mobilisation and liquidity paper dealt with below. — **2** The letters "BN", "BaN" and "PN" denote securities which cannot be returned before maturity.

Länder Governments

At end-1989, as in the preceding year, the Bank had no money market paper of the Länder Governments in its portfolio.

Equalisation claims

The Bank's equalisation claims on the Federal Government and the non-interest-bearing debt certificate in respect of Berlin remained unchanged during the year under review.

Lending to the Federal Railways and Federal Post Office

No loans to the Federal Railways or Federal Post Office were outstanding at December 31, 1989, as in the previous year. See also the notes on the items "Cash advances" and "Treasury bills and Treasury discount paper".

Securities

During the year under review the Bank's portfolio of securities (chiefly bonds of the Federal Republic of Germany, the Federal Railways and the Federal Post Office) declined by DM 654.0 million net to DM 4,262.2 million (end-1988: DM 4,916.2 million) on account of redemptions due to maturity and transactions in the open market.

Issue of bonds

In 1989 nine bond issues totalling DM 35,000 million (1988: eleven issues amounting to DM 39,000 million) were placed through the Federal Bond Consortium, which is under the direction of the Bank. Of these issues, an amount of DM 7,000 million was reserved for the issuers' own institutions and for market regulation purposes.

At the end of 1989 the outstanding amount of bonds of the Federal Republic of Germany was DM 195,765.8 million (end-1988: DM 172,060.2 million), that of the Federal Railways was DM 23,350.8 million (end-1988: DM 24,700.9 million) and that of the Federal Post Office DM 32,400.8 million (end-1988: DM 32,200.9 million).

Bond issues of the Federal Republic of Germany and the Federal Post Office in 1989

	Amount issued (DM million)		Terms				
Issuer	Total	of which Sold through Federal Bond Consortium	Nominal interest rate (% p.a.)	Maturity (years)	Issue price (%)	Yield (% p.a.)	Start of sales
Federal Republic of Germany	5,000	4,000	6.50	10	100.25	6.47	Jan. 2
Federal Republic of Germany	4,000	3,200	6.75	10	100.50	6.68	Feb. 1
Federal Republic of Germany	4,000	3,200	7.00	10	100.50	6.93	Mar. 6
Federal Post Office	2,000	1,600	7.00	10	100.75	6.89	Apr. 5
Federal Republic of Germany	4,000	3,200	7.00	10	101.00	6.86	May 10
Federal Republic of Germany	4,000	3,200	6.75	10	100.25	6.71	July 5
Federal Republic of Germany	4,000	3,200	7.00	10	101.25	6.82	Sep. 7
Federal Republic of Germany	4,000	3,200	7.00	10	100.25	6.96	Oct. 11
Federal Republic of Germany	4,000	3,200	7.125	10	100.25	7.09	Nov. 6

Issue of Federal savings bonds

With the assistance of the Bank (selling operations through banks and sales of its own), Federal savings bonds to the value of DM 7,254.5 million (gross) were placed with private purchasers in 1989 (1988: DM 8,680.2 million).

During the year under review the rate of interest paid on Federal savings bonds was raised five times and lowered once to bring it into line with market conditions.

During the year under review DM 5,826.7 million (1988: DM 665.0 million) of Federal savings bonds from earlier tranches were returned to the issuer before maturity, and a further DM 2,907.1 million were redeemed on maturity. The amount of Federal savings bonds outstanding accordingly fell from DM 34,904.0 million (at end-1988) to DM 33,424.7 million at December 31, 1989.

Gross sales, interest rates and yields of Federal savings bonds in 1989

Issue	Sales period 1989	Gross sales (DM million) Total	Federal savings bonds type A 1	Federal savings bonds type B 2	Interest rate (I) in, and yield (Y) after, the respective year after issue in % p.a.	1st	2nd	3rd	4th	5th	6th	7th
1989/ 1+2	Jan. 2– Jan. 23 3	4 522.3	222.1		I	4.00	5.00	6.00	6.00	6.50	8.00	
					Y	4.00	4.49	4.97	5.21	5.44	5.80	
				300.2	I	4.00	5.00	6.00	6.00	6.50	8.00	8.00
					Y	4.00	4.50	5.00	5.25	5.50	5.91	6.21
1989/ 3+4	Jan. 24– Feb. 22	450.0	216.6		I	4.50	6.00	6.00	6.50	7.00	8.00	
					Y	4.50	5.23	5.47	5.71	5.94	6.23	
				233.4	I	4.50	6.00	6.00	6.50	7.00	8.00	8.00
					Y	4.50	5.25	5.50	5.75	6.00	6.33	6.57
1989/ 5+6	Feb. 23– May 3	1,949.2	973.2		I	5.00	6.50	6.50	7.00	7.50	8.00	
					Y	5.00	5.73	5.97	6.20	6.43	6.65	
				976.0	I	5.00	6.50	6.50	7.00	7.50	8.00	8.00
					Y	5.00	5.75	6.00	6.25	6.50	6.75	6.92
1989/ 7+8	May 5– July 26	1,640.4	703.4		I	5.00	6.50	7.00	7.00	7.50	8.00	
					Y	5.00	5.73	6.13	6.32	6.53	6.73	
				937.0	I	5.00	6.50	7.00	7.00	7.50	8.00	8.00
					Y	5.00	5.75	6.16	6.37	6.60	6.83	7.00
1989/ 9+10	July 27– Sep. 19	776.9	355.6		I	5.00	6.50	6.75	7.00	7.25	8.00	
					Y	5.00	5.73	6.05	6.26	6.44	6.66	
				421.3	I	5.00	6.50	6.75	7.00	7.25	8.00	8.00
					Y	5.00	5.75	6.08	6.31	6.50	6.75	6.92
1989/ 11+12	Sep. 20– Nov. 6	382.3	157.4		I	5.00	6.75	7.00	7.25	7.50	8.00	
					Y	5.00	5.85	6.21	6.44	6.63	6.82	
				224.9	I	5.00	6.75	7.00	7.25	7.50	8.00	8.00
					Y	5.00	5.87	6.25	6.50	6.70	6.91	7.07
1989/ 13+14	Nov. 7– 5	1,533.4	690.5		I	6.50	7.25	7.50	7.50	7.75	8.00	
					Y	6.50	6.86	7.06	7.16	7.26	7.36	
				842.9	I	6.50	7.25	7.50	7.50	7.75	8.00	8.00
					Y	6.50	6.87	7.08	7.19	7.30	7.42	7.50
Total	Jan. 2– Dec. 31 5	7.254.5	3,318.8	3,935.7								

1 With annual payment of interest. — **2** With accrual of interest. — **3** Start of sales on December 1, 1988. — **4** Sales from December 1 to 31, 1988: FSB/A DM 187.2 million; FSB/B DM 227.0 million = total DM 414.2 million. — **5** Sales not completed on December 31, 1989.

Issue of five-year special Federal bonds

With the assistance of the Bank, newly-issued five-year special Federal bonds to the value of DM 11,205.9 million were sold in the year under review (1988: DM 12,699.1 million). In addition, an amount of DM 10,597.4 million was reserved for market regulation purposes. During the year under review the terms of these special Federal bonds were brought into line with market conditions on twenty-six occasions. Series 45 to 52 of these special Federal bonds, to the amount of DM 16,250.0 million, were redeemed upon maturity in the year under review. At the end of the year the amount of five-year special Federal bonds outstanding was DM 96,758.7 million (end-1988: DM 91,751.2 million).

Sales and terms of issue of five-year special Federal bonds in 1989

Designation of series	Start of sales	Amount issued (DM million): Sales: per issue price	Sales: Total	Price regulation share	Total	Terms: Nominal interest rate (% p.a.)	Issue price (%)	Yield (% p.a.)	Date of admission to stock exchange dealing
S. 81 of 1988 (1993)	Jan. 2 [1]	[2] 69.6	69.6	478.7	750	5.50	98.80	5.78	Jan. 18
S. 82 of 1989 (1994)	Jan. 5	365.9				6.00	100.00	6.00	
	Jan. 24	255.5	621.4	378.6	1,000		99.20	6.19	Feb. 22
S. 83 of 1989 (1994)	Feb. 8	85.7				6.50	100.40	6.40	
	Feb. 15	74.6					99.80	6.55	
	Feb. 23	1,645.0					98.80	6.79	
	Mar. 7	185.9					99.20	6.69	
	Mar. 8	129.7					99.60	6.60	
	Mar. 22	424.6					98.80	6.79	
	Apr. 6	312.6					99.20	6.69	
	Apr. 14	122.0	2,980.1	1,019.9	4,000		99.60	6.60	May 22
S. 84 of 1989 (1994)	May 5	145.9				6.75	100.00	6.75	
	May 22	828.8					99.00	6.99	
	June 5	680.7					99.20	6.94	
	June 6	214.3					99.60	6.85	
	June 19	1,444.8	3,314.5	1,685.5	5,000		99.80	6.80	July 25
S. 85 of 1989 (1994)	July 14	424.8				6.75	100.00	6.75	
	July 24	822.6					100.20	6.70	
	July 27	295.4					100.30	6.68	
	Aug. 1	257.6					100.40	6.65	
	Aug. 25	169.4					99.80	6.80	
	Sep. 11	85.1	2,054.9	2,945.1	5,000		99.40	6.90	Oct. 2
S. 86 of 1989 (1994)	Sep. 20	458.4				7.00	100.00	7.00	
	Oct. 13	452.0	910.4	4,089.6	5,000		99.20	7.20	Nov. 17
S. 87 of 1989 (1994)	Nov. 13	36.0				7.25	99.50	7.37	
	Nov. 17	991.1					98.60	7.60	
	Dec. 19	227.9	1,255.0	[3] ...	[3] ...		98.80	7.55	11.1.90

1 Start of sales on October 31, 1988. — 2 Sales from October 31 to December 31, 1988 = DM 201.7 million. — 3 Sales not completed on December 31, 1989.

Issue of Treasury paper

Through the agency of the Bank, DM 1,085.2 million of Federal Treasury paper — formerly known as Treasury notes (medium-term notes) of the Federal Republic of Germany — was sold in three issues by three tenders in 1989 (in the preceding year DM 6,688.0 million was sold in five issues). Treasury paper of the Federal Railways — formerly known as Treasury notes (medium-term notes) of the Federal Railways — was issued to the amount of DM 350.9 million.

The size of the Federal Treasury paper issues was augmented by DM 1,754.8 million by the Federal Ministry of Finance for its own portfolio, to a total of DM 2,840.0 million in all.

Federal Treasury paper and Treasury paper of the Federal Railways sold by tender in 1989

Issuer	Amount sold (DM million)	Nominal interest rate (% p.a.)	Maturity (years/ months)	Selling price (%)	Yield on issue (% p.a.)	Value date
Federal Republic of Germany	438.0	6.375	6/0	99.40	6.50	January 26
Federal Republic of Germany	411.5	7.625	4/0	98.90	7.95	
	235.7	7.625	6/0	98.60	7.93	December 1
Federal Railways	350.9	7.875	2/4	99.85	7.95	December 6

At the end of 1989 the amount of Federal Treasury paper outstanding was DM 43,366.9 million (end-1988: DM 44,202.0 million), that of the Federal Railways was DM 1,488.9 million (end-1988: DM 1,233.1 million) and that of the Federal Post Office remained unchanged at DM 200.0 million.

Admission to stock exchange dealing

In the year under review the Bank introduced the new bond issues of the Federal Republic of Germany, the Federal Post Office and the Reconstruction Loan Corporation, as well as the five-year special Federal bond series 81 to 86, to official dealing on all German stock exchanges. The Bank also introduced the new issues of Federal Treasury paper and Treasury paper of the Federal Railways to the Regulated Market on Frankfurt stock exchange. Furthermore, the Bank introduced the new issues of bearer bonds and Treasury notes of the Reconstruction Loan Corporation as well as a bond issue and bearer bonds of the *Deutsche Ausgleichsbank* to official dealing on particular German stock exchanges.

Price regulation operations

In the year under review, as in preceding years, the Bank conducted price regulation operations for account of the issuers on the eight German stock exchanges in respect of bonds issued by the Federal Government and its Special Funds, five-year special Federal bonds and bonds issued by the Reconstruction Loan Corporation, as well as in respect of issues of the *Deutsche Ausgleichsbank* and bearer bonds of the Reconstruction Loan Corporation and the *Deutsche Ausgleichsbank* introduced to official dealing on particular German stock exchanges.

The Bank as paying and collecting agent for bonds

The Bank continued to act as paying and collecting agent for bonds of the Federal Government and its Special Funds, and paid 272,243 interest coupons and matured bonds in 1989 (1988: 298,276).

German coins

The amount of German coins held by the Bank at the end of 1989 was DM 803.2 million (end-1988: DM 714.0 million). In 1989 DM 829.5 million was credited to the Federal Government in respect of coins received from the mints and DM 25.2 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1989 the Bank – acting for account of the Federal Government – received coins amounting to DM 14,184.4 million and redeemed coins which were no longer fit for circulation or had been called in to the value of DM 1,785.4 million.

The total amount of coins in circulation at the end of 1989 (DM 11,595.8 million), divided by the number of inhabitants of the Federal Republic of Germany including Berlin (West) on December 31, 1988 (61.7 million), yields a coin circulation per head of population of DM 188 (end-1988: DM 177).

During the year under review the commemorative coins "40 Years of the Federal Republic of Germany", "2000th Anniversary of the City of Bonn" and "800th Anniversary of the City and Seaport of Hamburg" were put into circulation.

Balances on postal giro accounts

At December 31, 1989 the balances on postal giro accounts, including the branch offices' transfers in transit to the postal giro account of the Bank (Central Office) in Frankfurt, amounted to DM 189.6 million (1988: DM 231.8 million). The Bank's credit balances on the latter account and on the postal giro account of the Land Central Bank in Berlin, other than those required for current payments, are offset daily against the giro account balances of the Central Cash Office of the Federal Post Office and the Berlin (West) Postal Giro Office.

Postal giro transactions with third parties

Area	1988				1989			
	Transfers received from third parties		Transfers made to third parties		Transfers received from third parties		Transfers made to third parties	
	Number	DM million	Number	DM million	Number	DM million	Number	DM million
Land Central Bank								
Baden-Württemberg	45,458	22,231.7	5,103	5,669.8	49,109	21,980.8	4,696	6,132.9
Bavaria	34,989	12,965.1	8,834	9,947.8	32,852	14,329.9	7,438	12,113.4
Berlin	6,199	3,473.9	889	2,394.5	6,953	3,459.6	750	2,701.9
Bremen	5,300	370.6	102	0.0	6,107	316.4	93	0.0
Hamburg	23,172	23,156.3	1,764	600.8	19,295	24,077.3	1,742	594.5
Hesse	49,078	7,395.2	3,994	11,305.2	49,325	6,964.0	3,798	12,177.4
Lower Saxony	36,345	8,991.1	4,351	5,717.4	33,418	8,204.2	3,946	5,903.3
North Rhine-Westphalia	112,643	20,760.9	7,156	4,028.5	109,126	20,995.3	7,084	4,423.3
Rhineland-Palatinate	64,459	969.9	3,946	1,338.9	71,822	1,600.9	3,783	1,695.3
Saarland	3,058	1,392.1	115	0.1	3,009	1,386.3	97	0.1
Schleswig-Holstein	21,839	134.4	300	0.3	25,941	109.8	236	0.1
Total	402,540	101,841.2	36,554	41,003.3	406,957	103,424.5	33,663	45,742.2
Bundesbank — Central Office —	7,443	1,664.6	1,252	12.7	8,440	1,435.1	1,023	8.6
Grand total	409,983	103,505.8	37,806	41,016.0	415,397	104,859.6	34,686	45,750.8

Land and buildings

After additions of DM 253.3 million and depreciation totalling DM 144.6 million, land and buildings are shown at DM 2,812.7 million (1988: DM 2,704.0 million).

Furniture and equipment

The balance sheet value of furniture and equipment, after additions totalling DM 149.1 million and depreciation amounting to DM 120.8 million, is DM 218.4 million (1988: DM 190.1 million).

Items in course of settlement

The "Items in course of settlement" mainly consist of the cheques and direct debits in transit within the Bank at the end of the year and the intercity credit and debit transfers in course of settlement. At December 31, 1989 the balance of items in course of settlement stood at DM 12,346.1 million against DM 6,081.4 million at end-1988.

Other assets

At the end of 1989 other assets amounted to DM 2,875.6 million (end-1988: DM 2,490.2 million). They primarily comprise the interest falling due in 1990 but assignable to the profit and loss account for the year under review on funds invested abroad and on securities (DM 2,564.3 million against DM 1,945.7 million at end-1988).

This item also includes the Bank's 30 % stake (DM 93 million in nominal terms) in the capital of the Liquidity Consortium Bank of Frankfurt am Main (set up as a private limited company). The provision 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 279 million.

Prepayments

The prepayments consist almost entirely of salary and pension payments made in the year under review but relating to 1990.

Banknotes in circulation

The amount of banknotes in circulation at December 31, 1989, at DM 150,548.0 million, was DM 6,606.3 million (4.6%) larger than at end-1988.

In the year under review the Bank again received new banknotes from the printing works and put them into circulation, or made them ready for that purpose.

The following banknotes (including monetary tokens) were destroyed as being no longer fit for circulation or after having been called in:

	1984	1985	1986	1987	1988	1989
Number (millions)	569.0	575.4	595.7	578.0	553.5	719.3
Value (DM million)	25,098.5	26,046.7	27,035.3	25,895.5	29,221.9	27,423.2.

The denominations of the banknotes and coins (currency) in circulation are shown in Appendix 4 to the German original of this Report.

Currency in circulation

DM million

End of	Currency in circulation	Banknotes	Coins
1984	109,592.1	100,636.0	8,956.1
1985	114,718.6	105,416.0	9,302.6
1986	123,732.8	113,983.0	9,749.8
1987	135,900.7	125,608.0	10,292.7
1988	154,822.4	143,941.7	10,880.7
1989	162,143.8	150,548.0	11,595.8

The number and amount of the counterfeit banknotes detained in payments in the Federal Republic of Germany and Berlin (West) in 1989 declined sharply against the previous year. In the case of counterfeit coins (it was mainly DM 5 coins that were seized) the downward trend continued.

Counterfeits detained in payments

	Banknotes		Coins	
Year	Number	DM thousand	Number	DM thousand
1980	2,421	183.4	9,428	25.1
1981	2,896	219.1	17,172	34.3
1982	3,317	250.7	19,975	43.3
1983	2,156	181.7	26,607	56.1
1984	7,318	710.3	21,365	49.3
1985	7,585	712.2	24,617	57.7
1986	8,257	807.4	17,111	46.6
1987	6,010	598.4	11,758	38.0
1988	6,232	538.8	9,861	31.5
1989	3,425	304.2	8,324	31.0

From October 1990 the Bank intends to start issuing the new banknotes whose final drafts were presented to the public in April 1989. To begin with, it is planned to issue the new DM 100 note and a DM 200 note, which is to appear for the first time; the other denominations are due to follow successively until – it is expected – the end of 1992. The precise dates of issue will be announced in due course.

The main reason for issuing new banknotes is the technical advances that have latterly been made in printing and copying techniques. They open up new possibilities of counterfeiting, which the Bank wishes to forestall by incorporating improved security features in its future banknotes. In addition, the new notes include machine-readable characteristics for automated cash payments, which are increasing in significance.

Even after the issue of the new banknotes, the banknotes at present in circulation will remain valid legal tender until further notice; they can be used unreservedly in payments. When they are withdrawn from circulation later on, the period set for the purpose will be long enough to give everybody ample time to exchange the old banknotes for new ones at any bank. But even after the expiry of the official deadline for exchange, the Bank will continue to replace the banknotes of the present series at their full face value. This applies, incidentally, to all the banknotes issued since 1948.

The general public will be informed in detail in due course about the appearance of the new banknotes and the security features they embody.

Deposits of banks

The banks' deposits on giro accounts mainly comprise the minimum reserves to be held at the Bank. The sub-item "Other" includes the deposits of domestic banks on US dollar accounts. At the end of the year the banks' deposits were made up as follows:

	Dec. 31, 1988	Dec. 31, 1989 DM million
Deposits on giro accounts	61,209.3	66,844.0
Other	31.5	30.2
	61,240.8	66,874.2.

Deposits of public authorities

This item contains the current balances of public authorities; they break down as follows:

	Dec. 31, 1988	Dec. 31, 1989 DM million
Federal Government	2,718.2	5,149.2
Equalisation of Burdens Fund and ERP Special Fund	107.8	2.9
Länder Governments	681.4	931.8
Other public depositors	27.3	44.7
	3,534.7	6,128.6.

Deposits of other domestic depositors

The deposits of other domestic depositors are composed as follows:

	Dec. 31, 1988	Dec. 31, 1989
		DM million
Federal Railways	10.4	17.5
Federal Post Office (including postal giro and postal savings bank offices)	4,259.0	4,692.6
Other depositors	739.4	805.7
	5,008.8	5,515.8.

Giro transactions, simplified cheque and direct debit collections

In the year under review virtually all of the collection and credit transfer orders presented were processed on an automated basis at the Bank's computer centres. The volume of payments executed through the paperless exchange of data media (EDM) was 8% greater than in the preceding year. Such payments now account for 70% of the payment items presented under the automated procedure. The steady increase in paperless payments is mainly due to the sustained trend in the banking industry towards replacing paper-based payments by paperless procedures and converting collection and credit transfer orders presented by the originators in paper-based form into data records. The ceiling for amounts for paperless collection (cheque truncation) has been raised; since the end of October 1989 cheques for less than DM 2,000.00 (previously: up to DM 1,000.00) have been converted into data records and channelled into the EDM procedure. Even so, the conversion of cheques into data records by the Bank's computer centres continued to decline; in all, 84 million cheques (1988: 88 million) to the value of DM 27 billion were thus converted. To speed up payments, not only telegraphic credit transfers but also credit transfers from DM 20,000 upwards (previously: DM 100,000) have been routed through the branch offices' data telecommunication network for express payments since the beginning of October 1989. During the year under review, the proportion of transfers processed by conventional methods in the direct transfers between branch offices declined further.

Automation of intercity transfers

	Collection orders presented							Intercity credit transfer orders presented						
		of which: Passed on							of which: Passed on					
				via computer centres							via computer centres			
	Total	in direct operations between branch offices		in automated paper-based operations		through the paperless exchange of data media		Total	in direct operations between branch offices		in automated paper-based operations		through the paperless exchange of data media	
Year	millions	millions	%	millions	%	millions	%	millions	millions	%	millions	%	millions	%
1980	873	11	1	473	54	389	45	230	7	3	125	54	98	43
1981	1,023	8	1	490	48	525	51	271	7	2	162	60	102	38
1982	1,098	7	1	512	46	579	53	291	6	2	180	62	105	36
1983	1,159	6	1	524	45	629	54	319	5	2	202	63	112	35
1984	1,226	6	1	533	43	687	56	335	4	1	216	65	115	34
1985	1,316	6	1	511	39	799	60	350	4	1	224	64	122	35
1986	1,405	5	0	412	29	988	71	372	3	1	238	64	131	35
1987	1,489	5	0	364	25	1,120	75	415	3	1	254	61	158	38
1988	1,568	3	0	355	23	1,210	77	464	3	1	270	58	191	41
1989	1,655	3	0	346	21	1,306	79	500	4	1	289	58	207	41

If local payments and clearing operations – which, apart from local credit transfers in Hamburg, are not yet processed automatically – are included in the calculation (as well as intercity transfers), about 88 % of the cashless payments at the Bank are automated. It should be borne in mind in this connection that, as part of the conventional clearing procedure, magnetic tapes containing payments are exchanged locally between banks on a considerable scale; however, only the total amounts of the magnetic tape data files are cleared in this way.

Liabilities arising from mobilisation and liquidity paper sold

Once again, mobilisation and liquidity paper pursuant to sections 42 and 42a of the Deutsche Bundesbank Act in the form of short-term Treasury bills (running as a rule for three days) was sold to domestic banks in the year under review in order to regulate liquidity. These transactions totalled DM 17,935.0 million (1988: DM 22,950.0 million).

In addition, just as in the preceding years, Treasury bills were issued to permit the revolving investment of funds by foreign institutions and the investment of funds by domestic public authorities. Altogether, sales amounting to DM 42,810.2 million (1988: DM 46,757.0 million) were accompanied by redemptions totalling DM 43,377.7 million (1988: DM 47,183.5 million), so that the amount outstanding decreased to DM 3,961.9 million (1988: DM 4,529.4 million).

Mobilisation and liquidity Treasury discount paper was not issued in the year under review (1988: DM 124.0 million); after redemptions totalling DM 100.0 million (1988: DM 201.5 million), the amount of such paper outstanding at the end of 1989 was DM 100.0 million (end-1988: DM 200.0 million).

At December 31, 1989 the total amount of liabilities arising from mobilisation and liquidity paper outstanding was DM 4,061.9 million (end-1988: DM 4,729.4 million).

Mobilisation and liquidity paper sold and redeemed

DM million

	1988	1989		
Type of paper	Outstanding at December 31	Sold	Redeemed	Outstanding at December 31
Treasury bills (running for up to 90 days)	4,529.4	42,810.2	43,377.7	3,961.9
Treasury discount paper (running for 6 to 24 months)	200.0	–	100.0	100.0
Total	4,729.4	42,810.2	43,477.7	4,061.9

Liabilities arising from external transactions

In the year under review the liabilities arising from external transactions doubled from DM 24,020.4 million to DM 48,471.3 million, almost entirely as a result of foreign monetary authorities' deposits. Specifically, DM 48,140.0 million of this sum (1988: DM 23,925.2 million) was accounted for by foreign banks' balances and DM 280.9 million (1988: DM 50.7 million) by balances of other depositors.

Counterpart of special drawing rights allocated

The counterpart of the special drawing rights allocated by the IMF and shown in sub-item 2.3 on the assets side of the balance sheet corresponds to the allocations to the Federal Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,210.8 million.

Provisions for pensions

After the withdrawal of DM 147.7 million for the payment of pensions and an increase of DM 187.7 million, the provisions for pensions amount to DM 2,273.0 million (end-1988: DM 2,233.0 million); they correspond to the actuarially calculated requirements.

Provisions for other purposes

At December 31, 1989 DM 151.7 million net was added to the provisions for other purposes, which serve primarily to cover general risks inherent in domestic and external transactions (see also the notes below on the expenditure item "Write-downs of monetary reserves"). As a consequence, they then amounted to DM 2,678.7 million against DM 2,527.0 million at end-1988.

Other liabilities

At the end of 1989 the other liabilities amounted to DM 758.2 million against DM 664.6 million at the end of 1988. The most significant factor here was the increase in the interest falling due in 1990 but relating to 1989. At the end of 1989 intra-German settlements (commercial payments under the "Berlin Agreement") gave rise to liabilities totalling DM 96.6 million (1988: DM 123.5 million). The regulations governing intra-German payments are outlined in Part A IV of the German original of this Report.

Accruals

Accruals amounted to DM 457.8 million at December 31, 1989 (end-1988: DM 275.5 million). This item mainly comprises the interest received in the year under review, but relating to the following year, on domestic and foreign bills of exchange and US Treasury notes.

Capital

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

Reserves

In accordance with the decision taken by the Central Bank Council on April 6, 1989, the legal reserves were increased by DM 1,430.5 million out of the net profit for 1988. After this increase, the legal reserves totalled DM 7,197.1 million; they thus again came up to the maximum level permissible by law of 5% of the amount of banknotes in circulation, which was DM 143,941.7 million at the end of 1988. The other reserves reached the statutory ceiling of DM 290 million as long ago as end-1980.

Unappropriated profit

See the notes on page 87 of this Report.

Expenditure

Staff costs

Staff costs increased against the previous year by DM 1.7 million to DM 1,066.0 million. The number of the Bank's employees again went up slightly (by 126) to 15,583 (+ 0.8%).

Staff of the Bank

Staff	Beginning of 1989					Beginning of 1990				
	Central Office	Land Central Banks	Total 1	of whom male	of whom female	Central Office	Land Central Banks	Total 1	of whom male	of whom female
Civil servants	956	5,647	6,603	5,963	640	995	5,711	6,706	5,997	709
Other salaried staff	1,638	6,116	7,754	3,611	4,143	1,624	6,166	7,790	3,631	4,159
Wage earners	235	865	1,100	214	886	229	858	1,087	204	883
Total	2,829	12,628	15,457	9,788	5,669	2,848	12,735	15,583	9,832	5,751

1 Including 945 (1989: 912) trainees, 718 (1989: 687) part-time salaried staff and 736 (1989: 749) part-time wage earners; 26 (1989: 22) staff members were seconded to work abroad. – Not included in the staff figures: 284 (1989: 250) members of the Bank released without pay.

Payments to serving members of the Central Bank Council and the Directorate of the Bank amounted to DM 9,173,404.60 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 of the Managing Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 8,621,493.09.

DM 201.2 million (1988: DM 222.7 million) of the staff costs was accounted for by old age pensions. These included the increase of DM 40 million in the provisions for pensions and the payments to members of the former Deutsche Reichsbank and other persons to whom the Act concerning Article 131 of the Basic Law applies, for whom the Bank is required to provide in accordance with section 41 of the Deutsche Bundesbank Act (DM 18.1 million).

Changes in staff regulations

In 1989 the Bank again entered into a number of wage and salary agreements, thereby bringing the legal status of its wage earners and salaried staff (other than civil servants) into line with the regulations applying to the wage earners and other salaried staff of the Federal Government, while paying due regard to the special conditions prevailing at the Bank. With effect from April 1, 1989 the number of regular weekly working-hours for all employees of the Bank was reduced from 40 to 39.

Administrative expenditure

During the financial year 1989 the other (non-staff) administrative expenditure increased by DM 19.3 million (+ 8.9%) to DM 236.9 million.

Banknote printing

Expenditure on banknote printing amounted to DM 109.7 million in 1989 against DM 152.8 million in the previous year.

Depreciation of fixed assets

Depreciation of land and buildings and of furniture and equipment was discussed in connection with the respective balance sheet items.

Write-downs of monetary reserves

This item contains the result of the valuation of the monetary reserves and other foreign currency positions. Valuation losses owing to changes in the rate for the Deutsche Mark had no effect on the result since provisions made for the purpose in earlier years could be released. Valuation losses over and above this level – after netting against the receipts accruing in the year under review from purchases and sales of foreign currencies – necessitated write-downs totalling DM 2,517.3 million.

Other expenditure

Other expenditure is shown at DM 208.9 million (1988: DM 98.0 million). It mainly results from write-downs of the Bank's own securities.

Receipts

Interest

In the year under review the net interest received, at DM 14,627.2 million, was DM 3,056.5 million higher than in 1988. The decisive factor here was interest income from lending to domestic banks, which rose – particularly because of more substantial securities repurchase agreements – by DM 5,263.1 million to DM 8,682.5 million. Interest income from securities and cash advances, amounting to DM 340.2 million and DM 118.2 million, respectively, had only a minor impact on the overall interest figure. The interest income from financial investment abroad, by contrast, declined from DM 8,593.7 million to DM 8,124.6 million, mainly as a result of the lower average level of external assets. Interest expenditure rose by DM 1,792.1 million against the previous year to DM 2,722.5 million, chiefly on account of higher liabilities arising from external transactions.

Fees

Fees, which mostly accrued in payments, totalled DM 21.1 million in the year under review (1988: DM 24.1 million).

Other receipts

The other receipts amounted to DM 80.6 million (1988: DM 117.2 million).

Unappropriated profit

The profit and loss account for 1989 shows a profit for the year of DM 10,324,653,405.65, which is entered in the balance sheet as unappropriated profit (net profit).

Proposed distribution of profit

In accordance with section 27 of the Deutsche Bundesbank Act, the Directorate proposes to the Central Bank Council that the following appropriations should be made:

		DM
to the legal reserves	330,300,000.00	
to the Fund for the Purchase of Equalisation Claims	30,000,000.00	360,300,000.00.
The balance of		9,964,353,405,65

is to be transferred to the Federal Government.

After this appropriation, the legal reserves will amount to DM 7,527,400,000.00; they will thus come up to the statutory ceiling of 5% of the amount of banknotes in circulation, which was DM 150,547,958,130.00 at the end of 1989. The other reserves reached the statutory ceiling of DM 290,000,000.00 at the end of 1980.

Frankfurt am Main, April 1990

Deutsche Bundesbank
The Directorate
Pöhl Prof. Dr. Schlesinger
Gaddum Prof. Dr. Köhler Dr. Storch Dr. Tietmeyer Werthmöller

Part D: Report of the Central Bank Council

The annual accounts of the Deutsche Bundesbank for 1989 and the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1989 have been audited by Treuarbeit Aktiengesellschaft Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft of Frankfurt am Main and Wollert — Elmendorff Deutsche Industrie-Treuhand GmbH Wirtschaftsprüfungsgesellschaft of Düsseldorf, whom the Central Bank Council appointed to be auditors in accordance with section 26 of the Deutsche Bundesbank Act.

In their certificates of audit the auditors confirmed without any qualifications that the annual accounts for 1989 and the bookkeeping comply with German law and present an accurate picture of the assets and liabilities, financial position and profit or loss, and that the Fund for the Purchase of Equalisation Claims has been properly administered.

The Central Bank Council approved the annual accounts for 1989 on April 19, 1990 and accepted the Directorate's proposal in respect of the profit distribution. At the same time it approved the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1989.

The following personnel changes took place between April 2, 1989 and April 1, 1990, i.e. since the publication of the Report for the Year 1988:

Retired

as at the close of April 30, 1989

Dr. Johann Baptist Schöllhorn
President of the Land Central Bank in Schleswig-Holstein,

as at the close of September 30, 1989

Prof. Dr. Dr. h. c. Leonhard Gleske
Member of the Directorate of the Deutsche Bundesbank,

Heinz-Georg Völlgraf
Member of the Managing Board of the Land Central Bank in Hesse,

as at the close of December 31, 1989

Eberhard Weiler
Vice-President of the Land Central Bank in Rhineland-Palatinate,

as at the close of February 20, 1990

Dr. Alfred Härtl
President of the Land Central Bank in Hesse;

Reappointed

with effect from June 16, 1989

Hans Gliem
President of the Land Central Bank in Saarland,

with effect from March 1, 1990

Dr. Dieter Hiss
President of the Land Central Bank in Berlin;

Appointed

with effect from May 1, 1989

Werner Schulz
to be President of the Land Central Bank in Schleswig-Holstein,

with effect from October 1, 1989

Dr. Hans Georg Fabritius
to be Member of the Managing Board of the Land Central Bank in Hesse,

with effect from January 1, 1990

Dr. Hans Tietmeyer
to be Member of the Directorate of the Deutsche Bundesbank,

Bolko Leopold
to be Vice-President of the Land Central Bank in Rhineland-Palatinate,

with effect from February 21, 1990

Dr. Karl Thomas
to be President of the Land Central Bank in Hesse.

The Central Bank Council, acting also on behalf of the Directorate and of the Managing Boards of the Land Central Banks, expresses its thanks to the entire staff of the Deutsche Bundesbank – civil servants, other salaried employees and wage earners alike – for their loyal and understanding efforts during 1989. The Council likewise wishes to record its appreciation of the continued excellent collaboration with the staff representative bodies.

Frankfurt am Main, April 1990

Karl Otto Pöhl
President of the Deutsche Bundesbank

Appendix to Part B

Balance sheet of the Deutsche Bundesbank as at December 31, 1989

Assets

			DM	31.12.1988 DM million
1 Gold			13,687,518,821.70	13,687.5
2 Reserve position in the International Monetary Fund and special drawing rights				
2.1 Drawing rights within the reserve tranche		5,165,871,122.75		(5,957.1)
2.2 Loans under special borrowing arrangements		–		(–)
2.3 Special drawing rights		3,062,801,344.68		(3,306.8)
			8,228,672,467.43	9,263.9
3 Claims on the European Monetary Cooperation Fund in connection with the European Monetary System				
3.1 ECU balances	32,125,431,085.40			
less Difference between the ECU value and the book value of the gold and dollar reserves contributed to the EMCF	14,822,531,604.66			
		17,302,899,480.74		(21,554.1)
3.2 Other claims		–		(–)
			17,302,899,480.74	21,554.1
4 Balances with foreign banks and money market investments abroad			58,283,116,582.24	50,157.6
5 Foreign notes and coins			25,033,276.30	25.5
6 External loans and other external assets				
6.1 Loans in connection with EC balance of payments assistance		–		(–)
6.2 Other loans to foreign monetary authorities		–		(–)
6.3 Loans to the World Bank		2,431,848,500.–		(2,437.4)
			2,431,848,500.–	2,437.4
7 Lending to domestic banks				
7.1 Securities bought in open market transactions under repurchase agreements		100,828,379,000.–		(77,980.2)
7.2 Domestic bills of exchange		34,102,367,324.40		(33,485.1)
7.3 Foreign bills of exchange		27,206,913,936.42		(22,027.0)
7.4 Lombard loans		5,187,217,300.–		(11,243.5)
			175,324,877,560.82	144,735.8
8 Cash advances				
8.1 Federal Government		–		(–)
8.2 Equalisation of Burdens Fund and ERP Special Fund		–		(–)
8.3 Länder Governments		1,053,048,428.–		(1,010.3)
			1,053,048,428.–	1,010.3
9 Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			8,683,585,988.93	8,683.6
10 Lending to the Federal Railways and Federal Post Office				
10.1 Cash advances		–		(–)
10.2 Treasury bills and Treasury discount paper		–		(–)
			–	–
11 Securities			4,262,178,857.43	4,916.2
12 German coins			803,182,876.37	714.0
13 Balances on postal giro accounts			189,609,016.56	231.8
14 Land and buildings			2,812,677,460.47	2,704.0
15 Furniture and equipment			218,434,037.96	190.1
16 Items in course of settlement			12,346,054,899.11	6,081.4
17 Other assets			2,875,607,152.28	2,490.2
18 Prepayments			42,323,515.63	41.2
			308,570,668,921.97	268,924.6

		DM	31.12.1988 DM million
1 Banknotes in circulation		150,547,958,130.–	143,941.7
2 Deposits of banks			
2.1 Deposits on giro accounts	66,844,051,380.71		(61,209.3)
2.2 Other	30,196,008.20		(31.5)
		66,874,247,388.91	61,240.8
3 Deposits of public authorities			
3.1 Federal Government	5,149,247,388.70		(2,718.2)
3.2 Equalisation of Burdens Fund and ERP Special Fund	2,906,721.88		(107.8)
3.3 Länder Governments	931,819,581.28		(681.4)
3.4 Other public depositors	44,666,359.28		(27.3)
		6,128,640,051.14	3,534.7
4 Deposits of other domestic depositors			
4.1 Federal Railways	17,460,938.52		(10.4)
4.2 Federal Post Office (including postal giro and postal savings bank offices)	4,692,598,238.22		(4,259.0)
4.3 Other depositors	805,705,025.38		(739.4)
		5,515,764,202.12	5,008.8
5 Liabilities arising from mobilisation and liquidity paper sold		4,061,900,000.–	4,729.4
6 Liabilities arising from external transactions			
6.1 Deposits of foreign depositors	48,420,889,715.84		(23,975.9)
6.2 Other	50,366,770.73		(44.5)
		48,471,256,486.57	24,020.4
7 Counterpart of special drawing rights allocated		2,701,423,496.80	2,900.7
8 Provisions			
8.1 For pensions	2,273,000,000.–		(2,233.0)
8.2 For other purposes	2,678,700,000.–		(2,527.0)
		4,951,700,000.–	4,760.0
9 Other liabilities		758,257,019.46	664.6
10 Accruals		457,768,741.32	275.5
11 Capital		290,000,000.–	290.0
12 Reserves			
12.1 Legal reserves	7,197,100,000.–		(5,766.6)
12.2 Other reserves	290,000,000.–		(290.0)
		7,487,100,000.–	6,056.6
13 Unappropriated profit		10,324,653,405.65	11,501.4
		308,570,668,921.97	268,924.6

Profit and loss account of the Deutsche Bundesbank for the year 1989

Expenditure

		DM	1988 DM million
1 Staff costs			
1.1 Wages and salaries	756,105,935.64		(738.1)
1.2 Social security contributions and spending on old age pensions and maintenance payments	309,915,600.87		(326.2)
		1,066,021,536.51	1,064.3
2 Operating expenditure		236,886,349.44	217.6
3 Note printing		109,664,667.77	152.8
4 Depreciation			
4.1 of land and buildings	144,659,020.34		(177.8)
4.2 of furniture and equipment	120,836,827.08		(110.2)
		265,495,847.42	288.0
5 Write-downs of monetary reserves and other foreign currency positions		2,517,273,980.29	–
6 Other expenditure		208,861,292.95	98.0
7 Profit for the year (= unappropriated profit)		10,324,653,405.65	11,501.4
		14,728,857,080.03	13,322.1

Receipts

	DM	1988 DM million
1 Interest	14,627,225,390.32	11,570.7
2 Fees	21,073,468.77	24.1
3 Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	–	1,610.1
4 Other receipts	80,558,220.94	117.2
	14,728,857,080.03	13,322.1

Frankfurt am Main, February 7, 1990

Deutsche Bundesbank
The Directorate

Pöhl Prof. Dr. Schlesinger

Gaddum Prof. Dr. Köhler Dr. Storch Dr. Tietmeyer Werthmöller

According to the audit which we have carried out in line with our mandate, the bookkeeping and annual accounts comply with German law. The annual accounts conform to the principles of orderly bookkeeping and present a picture of the assets, liabilities, financial position and profit or loss which is consistent with the actual state of affairs.

Frankfurt am Main, March 22, 1990

Treuarbeit Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

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