Report of the Deutsche Bundesbank

for the Year 1988

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Members on April 1, 1989

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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 1988

I. The global economic setting

Strong economic upswing in the industrial countries in 1988 1

Business activity in the Federal Republic of Germany developed against a favourable global economic background in 1988. Although the beginning of the year was still overshadowed by the slump in share prices of autumn 1987, it soon turned out that the economic upturn was relatively unaffected by the turmoil in the financial sector. In 1988 the industrial countries recorded their second best performance of the eighties, with real growth running at 4%; moreover, this result was achieved in the sixth consecutive upswing year. Production growth in the individual countries was accompanied by a strong expansion of world trade (+9% in real terms), which was more than twice as steep as the rise in the GNP of the industrial countries. Besides the sustained intensification of the global division of labour and world trade, a mounting role was played by the ever-higher utilisation of production capacity world-wide and the fact that countries were increasingly availing themselves of the option of drawing on their trading partners' resources.

Long-term conditions for growth improved

Under these buoyant conditions, the short and long-term economic driving forces often proved to be mutually reinforcing. In most countries monetary policy initially continued to pursue an expansionary course in 1988, since the possibility of a crisis of confidence owing to the stock market crash was to be forestalled by the provision of more liquid funds and the reduction of interest rates. The foreign exchange markets, which had been thrown somewhat off balance towards the end of 1987 by the depreciation of the dollar, also reverted to better equilibrium. The fruits of the longer-term improvements undertaken on the supply side likewise emerged more and more clearly. In particular, they included the fact that productivity was continuing to increase, contrary to the usual trend during a sustained upswing; this owed very much to enhanced capital formation and a trend in corporate profitability which fostered capital spending. In a number of countries, moreover, the economic policies geared to removing structural obstacles to growth which had already been pursued for some years began to pay off; the reduction of the marginal tax burden on income earned in the production process, which reduction was initiated in major countries, is worthy of special mention in this connection.

Economic growth in 1988 still generally free of tensions

Although spare capacity was gradually becoming scarcer in the industrial countries, economic growth in 1988 remained comparatively free of tensions for a long time. On the labour market demand picked up sharply; it generally met with a flexible manpower supply, so that employment expanded considerably. In some major countries, such as the United States and Japan, the demand for labour is meanwhile so high relative to the number of those registered as looking for work that any further increase in it would be likely to spark off additional domestic price and cost rises. In western Europe the number of unemployed remained comparatively high, however, notwithstanding the expansion of employment. But there is little evidence to suggest that this is due to any general lack of demand; it is, rather, attributable to intractable structural problems, not least including the fact that the adjustment of employment to industrial change is proceeding only relatively slowly owing to rigidities on the labour market. In specific fields – particularly in the case of qualified personnel in high-growth regions – there have already been increasing signs of a labour shortage. Unlike the situation in earlier boom periods, wage rises have generally remained moderate so far, even if the growth rate of actual earnings in some countries – especially in the United States and the United Kingdom – has accelerated distinctly. In the wake of impressive productivity gains, the cost pressure exerted by wages and salaries remained within strict limits for a fairly long time. In 1988, viewed as a whole, price rises in the industrial countries, at 3.2%, were comparatively low; they were only a little higher than in 1987 (3.0%).

Key macro-economic variables in selected industrial countries

Country	Real GNP 1		Real domestic demand		Consumer prices 2		Balance on current account	
	1987	1988 p	1987	1988 p	1987	1988 p	1987	1988 p
	Change from previous year in %						US$ billion	
Industrial countries 3	+ 3.3	+ 4.1	+ 3.7	+ 4.3	+ 3.0	+ 3.2	4 – 44.2	4 – 56.1
of which								
European industrial countries	+ 2.7	+ 3.6	+ 3.7	+ 4.1	+ 2.9	+ 3.2	+ 39.9	+ 18.7
of which								
Germany	+ 1.8	+ 3.4	+ 3.1	+ 3.5	+ 0.2	+ 1.2	+ 45.6 ° (+ 81.2)	+ 48.7 ° (+ 85.2)
France	+ 2.3	+ 3.4	+ 3.4	+ 3.7	+ 3.1	+ 2.7	– 4.1	– 3.8
United Kingdom	+ 4.3	+ 4.4	+ 4.3	+ 6.2	+ 4.2	+ 4.9	– 4.3	– 25.4
Italy	+ 3.1	+ 3.7	+ 4.6	+ 4.1	+ 4.7	+ 5.0	– 1.1	– 4.2
United States	+ 3.4	+ 3.8	+ 3.0	+ 3.0	+ 3.6	+ 4.1	– 154.0	– 135.3
Japan	+ 4.5	+ 5.7	+ 5.2	+ 7.7	+ 0.1	+ 0.7	+ 87.0	+ 79.5
Canada	+ 4.0	+ 4.2	+ 4.7	+ 5.1	+ 4.4	+ 4.1	– 8.0	– 7.3

1 Real GNP/GDP. — 2 Cost of living index. — 3 OECD countries excluding Greece, Portugal and 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 pronounced deficit, which, according to IMF calculations, came to roughly US$ 60 billion in 1988. — p Provisional. — ° Calculated in DM billion.
Sources: IMF and national statistics. BBk

Increase in inflationary risks in the course of 1988

Price conditions deteriorated world-wide, however, in the course of 1988, with the result that more attention had to be paid to inflationary risks again after several years of progressive containment of price rises, extending as far as complete price stabilisation in individual countries. The growing demand for raw materials associated with the expansion of output in the industrial countries (as well as some speculative stockbuilding) resulted in a considerable increase in commodity prices on world markets. After the OPEC conference at the end of November 1988, the oil price started to move upwards as well. In many countries whose currencies had depreciated during the year against the US dollar, the main transaction currency on the commodity markets, the imported inflationary trends were reinforced by exchange rate movements. The very high level of capacity utilisation, in conjunction with the plentiful supply of liquid funds, in many cases opened up scope for raising prices, which was increasingly exploited. At the end of 1988 consumer prices in the industrial countries were 3.6 % higher than a year before. In some countries current inflation rates have admittedly remained relatively low so far (as compared with previous upswings); however, there is a definite risk of imported and domestically generated inflationary tendencies there mutually reinforcing each other.

External disequilibria among the industrial countries remain pronounced

The pronounced external disequilibria which still exist constitute a potential handicap for the world economy. In the United States the current account deficit came to over US$ 135 billion in 1988 in spite of an exceptionally strong increase in exports; in Japan the current account surplus amounted to US$ 79.5 billion and in Germany it came to US$ 48.5 billion (or DM 85 billion). In the United States and Japan, admittedly, the current account deficits and surpluses, respectively, decreased in 1988 as a whole; more recently, however, the tendency towards a decrease has apparently come to a halt. Moreover, the United Kingdom has rejoined the ranks of the countries running substantial deficits; especially because of the heavy demand for imports on cyclical grounds and the decline in earnings from North Sea oil, a deficit of US$ 25.5 billion (or £ 14.5 billion) was incurred in 1988. It is difficult to believe that current account balances of these dimensions will not have an adverse impact on global economic trends in the long run. Surpluses and deficits entail international shifts in assets, which fact increases the risk of pronounced fluctuations in interest rates and exchange rates, particularly since crises of confidence in individual countries are possible. Furthermore, the risk of misallocations in the real economy is likewise increasing. It is true that a better-balanced current account pattern can be achieved only over the longer term. But if the external adjustment process were not resumed, a sustained preponderance both of the export sector in the surplus countries and of dependence on imports in the deficit countries would have to be expected, and any subsequent adjustment would be bound to turn out all the more painful.

Considerable strengthening of the US dollar in the course of the year

In 1988, unlike in the preceding year, the current account disequilibria did not weigh unduly heavily on the foreign exchange markets on balance. After the US dollar had reached its lowest level against a number of currencies around the turn of 1987-8, it stabilised comparatively quickly and thereafter appreciated considerably, albeit with fluctuations. As a weighted average against the currencies of 18 important industrial countries, the external value of the dollar went up by 8% from the end of 1987 to the end of March 1989. Signs of overheating in the US economy and fears of inflation gave rise to expectations of an upturn in interest rates which were fulfilled in the course of the year, owing partly also to a tightening of monetary policy. This made the dollar increasingly attractive to foreign investors, especially since interest rate rises in most countries temporarily lagged behind US interest rate trends. As the exchange rate risk for the dollar was rated low, the interest rate advantage of dollar investments resulted in massive inflows of funds into dollar assets, with the result that the US currency came under considerable upward pressure at times and central banks channelled substantial amounts of dollars into the market through concerted interventions. The dollar reserves of some surplus countries (particularly those of Germany) declined and the United States was able to accumulate monetary reserves. Speculative exaggerations in the foreign exchange market were admittedly interrupted briefly by the intervention purchases and sales, but the predominant feature in 1988 was the appreciation of the dollar.

Dollar appreciation slows down the external adjustment process

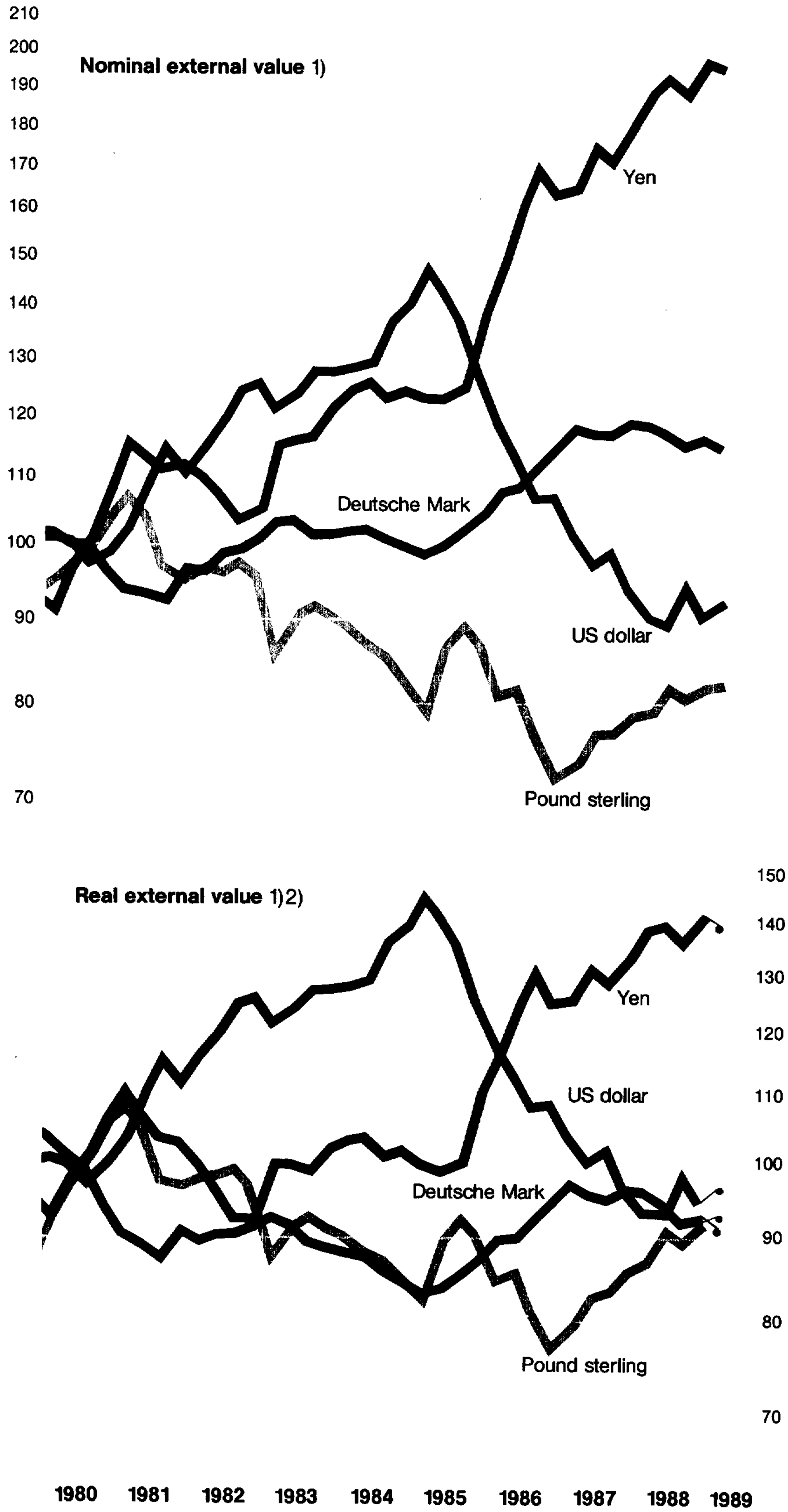
After the preceding turbulence in the foreign exchange market, the end of the dollar depreciation was certainly welcome. However, the subsequent upward movement of the dollar was at variance with global economic requirements inasmuch as the external adjustment process, in the sense of a reduction in the US current account deficit, was slowed down or even brought to a complete halt. Moreover, in the countries with depreciating currencies the fight against inflation was impeded, as a large part of imports is invoiced in dollars and dollar appreciations therefore have a direct impact on import prices. The pound sterling and the Canadian dollar have likewise appreciated since the beginning of 1988. By contrast, the Deutsche Mark has depreciated perceptibly against the currencies of 18 important industrial countries, significant factors here being not only the global interest rate and exchange rate situation but also, as analysed in more detail below, the high level of capital exports following the announcement of the levying of a withholding tax on domestic interest income as from the beginning of 1989.

All quiet in the European Monetary System

Within the exchange rate mechanism of the European Monetary System (EMS) exchange rates hardly changed at all. It is now more than two years since the last realignment. The main factor contributing to this exchange rate stability was that the EMS countries have meanwhile made substantial headway in stabilising their domestic price levels, so that no serious price discrepancies have arisen. Another significant circumstance was that considerable amounts of long-term funds flowed from Germany to the EMS partner countries in 1988, which correspondingly facilitated the financing of current account deficits with Germany.

Weighted external value of major currencies

1980=100, quarterly, log. scale



1) Geometrically weighted average against the currencies of 18 other industrial countries; the weighting pattern is based on the trade flows of industrial products from 1984 to 1986, after taking third-market effects into account.- 2) Nominal external value adjusted for differences in overall price movements in the respective economies (measured by the deflators of total sales).
• = Estimated.

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Tightening of monetary policy in the course of 1988

The generally favourable performance of the world economy in 1988 was bolstered by the economic policies of the industrial countries. Especially after the stock market crash of October 1987 the major industrial countries cooperated closely in order to prevent an impairment of confidence and to stabilise future expectations by means of a coordinated relaxation of monetary policy. Interest rates were lowered and money markets were amply supplied with liquid funds. In the course of 1988, however, there was a change of emphasis since, in view of the undiminished vigour of the economic upswing, attention was now focused more strongly on domestic and external risks. With the United States leading the way, monetary policy was tightened appreciably in the course of the year. Numerous central banks raised their interest rates and squeezed liquidity, with the result that – taken in conjunction with market trends – short-term money market rates and (to a lesser extent) long-term capital market rates started to move upwards. The interest rates paid on short-term assets approached those on long-term capital, and in some countries actually exceeded them. This change in the interest rate pattern attests, on the one hand, to the degree of restrictiveness of monetary policy, which primarily affects short-term interest rates. On the other hand, it also reflects the markets' confidence in the ability and determination of central banks to contain inflationary trends over the longer term. However, this tightening of monetary policy does not constitute an international "interest rate race". Instead, the interest rate increases are a reflection of common endeavours to prevent an acceleration of domestic cost and price rises as early as possible by means of monetary policy action. The prospects of achieving this objective are not bad, as is shown by the containment of monetary growth – especially in the United States, but also in a number of other countries. However, a good deal of stamina will be required if, under the changed global economic conditions, the stability successes achieved in earlier years are to be safeguarded, especially since there is a risk in some countries of the latent inflationary trends coming out into the open relatively quickly on account of the high level of liquid funds.

Monetary policy buttressed by fiscal policy

The efforts on the part of monetary policy to reduce the domestic and external economic tensions tended to be buttressed by fiscal policy last year in major countries. The signs of overheating which emerged here and there in 1988 were counteracted by the fact that the aggregate public sector deficit in the major industrial countries fell from 2½% of GNP to 1¾%, not least because of a strong expansion of tax revenue due to the growth of economic activity.[1] At the same time fiscal policy took due account of the requirements of external adjustment, even if a more spirited approach would have been desirable at times in the interests of a faster reduction of the disequilibria. In the United States the public sector deficit (including the social security funds and state and local governments) declined from 2.3% to 1.9% of GNP. In the final analysis, admittedly, the ceiling for the deficit as laid down in the Gramm-Rudman-Hollings Act was not quite observed in the Federal budget. Given the low private propensity to save in the United States and the high current account deficit, a further reduction in the public sector deficit – over and above the reduction achieved so far – would appear to be desirable; as a matter of fact, it is planned by the new Administration. In the United Kingdom, the country with the second highest external deficit, fiscal policy likewise moved in the right direction. After a deficit equivalent to 1.4% of GNP in 1987, the United Kingdom actually achieved a public sector surplus equivalent to 0.3% of GNP in 1988. By contrast, of the five largest industrial countries, Germany recorded relatively the highest public sector deficit in 1988, at 2.0%

1 These figures, as well as the following ones in this section, are based on the deficit as defined for national accounts purposes, as is customary in international comparisons.

of GNP;[1] thus it overshot the limits of the order of magnitude aimed at in the longer run. It is to be welcomed that fiscal policy has paved the way for a reduction of the deficit in 1989 (as well as in the years following the tax reform of 1990). In 1988, when it showed an even larger surplus on current account, Japan actually ran a sizeable overall public sector surplus.

Further progress required in dismantling the structural obstacles to growth

The favourable economic conditions should give cause for dismantling the structural obstacles to growth which still exist in many countries. Since economic policies were geared more strongly to medium-term requirements, some substantial successes have been achieved. More headway has been made in consolidating public sector budgets; tax rates have often been lowered and the pace of expenditure growth has been curbed, so that the share of public spending in GNP has declined, in some cases markedly. There have also been some encouraging first steps towards making the goods, services, financial and labour markets more flexible. In the field of foreign trade, however (contrary to the general trend towards strengthening market forces at home and in the global financial markets), the tendency towards protectionist measures appears to be growing, if anything. Bilateral disagreements over government intervention have become fiercer at times, and mutual increases in trade barriers have been threatened on occasion. Yet the prosperity-enhancing effect of expanding foreign trade will be attainable only if national markets are kept open for international competition. In the shape of its new trade bill, the United States has forged itself an instrument for setting up additional trade barriers; the important thing now is to wield this instrument as liberally as possible. In Europe it is essential to make sure that the European internal market, which is to be completed by the end of 1992, is used not as a pretext for insulating Europe from the rest of the world but rather as an opportunity for further intensifying economic integration world-wide. In order to remain credible in this context vis-à-vis our non-European trading partners, efforts to dismantle competition-distorting subsidies should also be continued.

Containment of inflationary risks presents a new challenge to international cooperation

Given the persistent global economic disequilibria, the ongoing international interdependence of the financial and goods markets and the latent threat posed by any expansion of protectionist trends, further close economic policy cooperation among the major industrial countries appears imperative in order to minimise the friction generated in the domestic and external adjustment process. After the agreements of earlier years had attracted considerable public attention (e.g. what became known as the "Louvre accord"), cooperation was continued rather unobtrusively in 1988. The earlier agreements on economic policy measures — backed up by coordinated intervention in the foreign exchange market — helped last year to contain exchange rate fluctuations and, quite generally, to strengthen confidence in favourable economic trends. Now, however, the global increase in inflationary risks is presenting a new challenge to international cooperation. To achieve a rate of economic growth that is satisfactory in the long run, too, particular attention must now be paid to safeguarding price stability. The prospects for a continuation of the upswing are not bad, provided that monetary and fiscal policy reinforce each other in a globally consistent manner in combating the signs of overheating.

New stimuli to integration in Europe

Notable stimuli to integration were generated in Europe in 1988. In the first place, the full liberalisation of capital movements was agreed upon after a certain transitional period (i.e. liberalisation not only among the EC member states but also vis-à-vis all non-Community countries), and a number of

1 In the budgetary definition, such as is used for the analysis beginning on p. 19, the deficit works out somewhat higher.

countries have already taken important steps in that direction. Secondly, further progress was made along the road towards the European internal market, which is to be realised by the end of 1992. Moreover, the prospect of ever-closer interdependence among the economies of Europe focused attention more strongly on the final objective of an economic and monetary union. The Heads of State and Government of the European Community set up a committee, chaired by the President of the EC Commission and composed mainly of the governors of the EC central banks, to examine the prerequisites and implications of such a union and propose concrete steps towards its implementation.

Parallel course of economic and monetary integration

The establishment of an economic and monetary union would be the logical corollary of the planned single market, but the necessary economic and political basis would have to be created first. A single European currency (or the irrevocable fixing of exchange rates in Europe) calls not only for a common monetary policy but, in parallel, for a substantial harmonisation of fiscal policy and general economic policy. This goal cannot be attained in a single step. It is true that greater economic policy convergence has been achieved in Europe in recent years. Considerable headway has been made (especially in the fight against inflation), and this has led to a reduction of the differences between the various countries with respect to price movements. But this reduction cannot be ascribed exclusively to the disciplinary pressures exerted by the European Monetary System or to European economic policy cooperation. It is, rather, a phenomenon of world-wide scope; for some time now the other industrial countries, too, have been assigning much higher priority to stabilisation policy than they used to. Furthermore, in some other major areas the differences between individual EC countries with respect to the orientation of economic and fiscal policy could not be reduced, so that a considerable need for adjustment still remains in these fields. For one thing, the volumes of the public sector budgets and particularly the levels of the public sector deficits still diverge markedly from each other. For another, some substantial external disequilibria have accumulated within the EC. Since economic discrepancies of this kind still exist between the individual EC member states, the possibility of exchange rate changes as an instrument of adjustment policy cannot be dispensed with in principle for the time being; after all, the adjustment pressure resulting from the implementation of the internal market, on account of the further intensification of competition, must be mitigated, as and when possible, by means of exchange rate adjustments. The notion that monetary policy should lead the way in the European integration process quite disregards the length of time required before production patterns durably change.

European monetary union only after the internal market has been implemented by treaties requiring ratification

In addition, the basic prerequisites for the envisaged final objective should be quite clear from the outset. In the German view, a European monetary union must be committed to safeguarding monetary stability. At the same time, this means that the decision-making body must wield its monetary policy instruments at its own discretion and independently of political instructions. In the light of practice in some countries, it is unacceptable for recourse to be had to a European central bank system for financing public sector deficits. As immediate steps, the provisions which have been only partially implemented as yet should first of all be realised in full. In particular, the participation of all EC countries in the European Monetary System on equal terms is desirable, i.e. including participation in the exchange rate mechanism. Upon the realisation of the European internal market for goods, services, labour and capital, the integration of the economies of the EC member states will be consolidated and stabilised, so that the long-range objective of a European monetary union with the necessary institutional set-up can also be contemplated. This will require new contractual arrangements, to be ratified by national parliaments. At all events, there seems to be no reason for subjecting oneself or being subjected to time pressure when taking the remaining and, in the final analysis, irrevocable steps towards an economic and monetary union, since integration is proceeding more or less continuously in the markets and is creating the appropriate foundation for the lasting attainment of these long-range goals.

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

1. Stronger growth in the domestic economy

Strong economic growth against a backdrop of generally stable prices

1988 was a rather successful year for the economy of the Federal Republic of Germany. At 3.4 %, growth in real GNP reached the highest level since the end of the seventies. This was accompanied by a further sharp increase in employment and, in the second half of the year, a drop in unemployment. The strong growth considerably exceeded the expansion in production potential, which had been reduced on trend by cuts in working hours, so that recourse was had to the capacity reserves still available. Price stability was largely maintained in 1988, viewed as a whole, but towards the end of the year increasing stability problems loomed on the horizon. Germany's performance was unsatisfactory last year, however, with respect to the external position: what was already a high surplus on current account increased still further. The external adjustment process did not make any more progress in 1988, even in real terms. Calculated at constant prices, the balance of exports of goods and services and corresponding imports remained almost unchanged; in 1986 and 1987, by contrast, it had declined by about 1 % of gross national product in each case.

Domestic demand still the main buttress of economic growth

The main buttress of economic growth in 1988 continued to be domestic demand. It went up by a nominal 5 % and a real 3½ %, this being a larger increment than in the previous year. Taking into consideration the fact that the resident population in Germany – unlike that in other countries – is virtually stagnating, this amounts to what is, even by international standards, an impressive real per capita growth in domestic demand. It went hand in hand with a considerable rise in imports. The dynamism of the German domestic economy can also be seen from the fact that no area of domestic demand was exempt from the strong upward trend. Along with private consumption, corporate investment increasingly became a driving force of economic activity in 1988. Moreover, demand for housing construction – in the preceding years a weak point of business activity – likewise became a mainstay of the economic upswing.

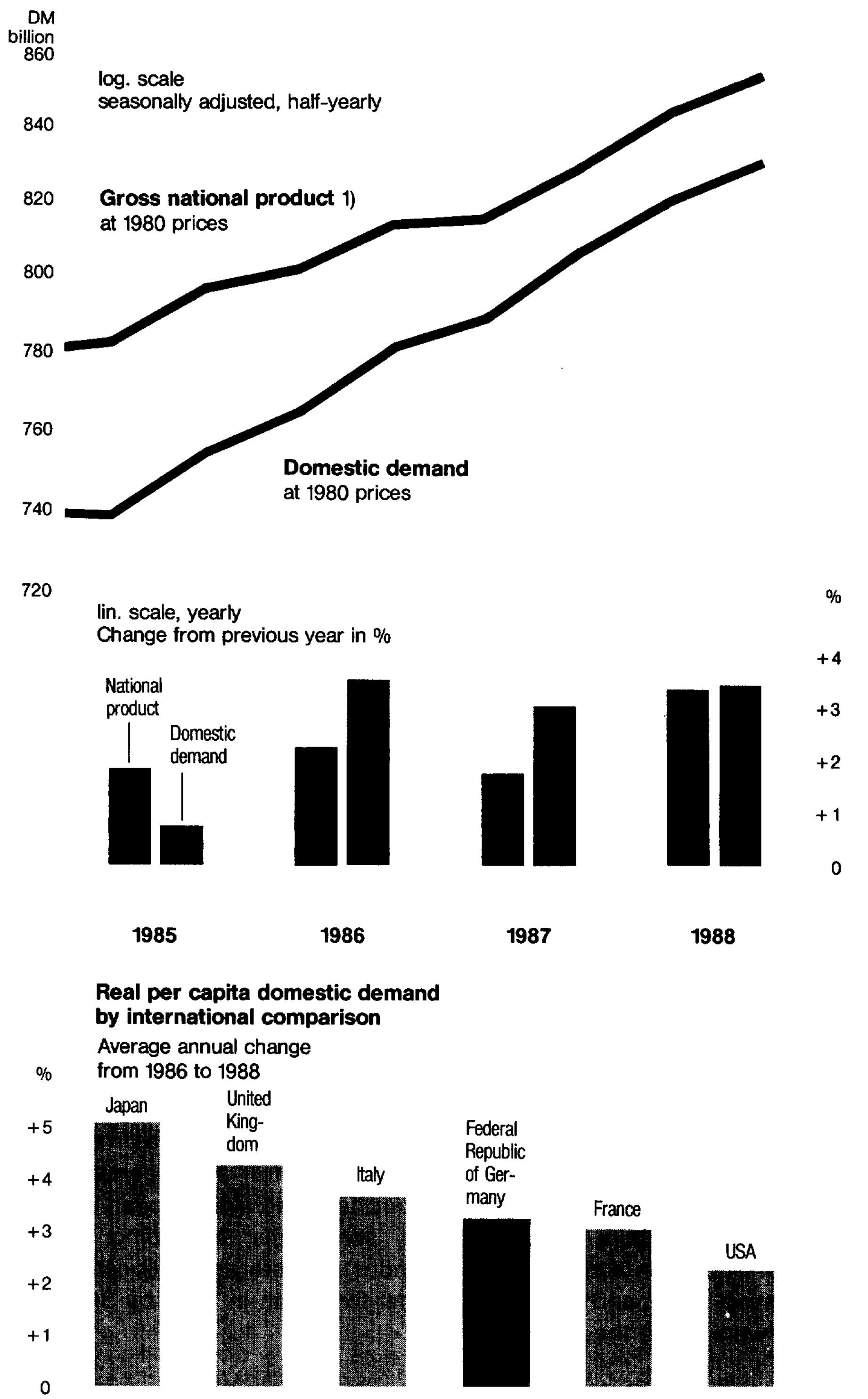
Growing investment propensity on the part of domestic enterprises

As late as the beginning of last year there were fears in many quarters that the turbulence in the share and foreign exchange markets in the autumn of 1987 would lead to investors being unsettled and, consequently, to a marked weakening in investment activity. In actual fact, however, it soon became clear that the economy was continuing to gather speed, not least as a result of the buoyancy of foreign demand. The upshot was that the readiness on the part of enterprises, particularly in the manufacturing sector, to undertake capital formation strengthened, after services enterprises had already been expanding their capital expenditure considerably for some time. According to the Ifo Investment Survey, in summer 1987 the industrial enterprises questioned had been planning to expand their fixed capital formation in 1988 by 3 %; a year later they were citing the figure of 6 %.

Dwindling capacity reserves

The growing investment propensity on the part of enterprises is to be seen in the light of the fact that, in view of the rapid rise in output, capacity utilisation went up strongly and production bumped up more and more against capacity limits. Thus, the Ifo Business Survey shows that from December 1987 to December 1988 the degree of capacity utilisation in the manufacturing sector rose by just under 4 percentage points to 88 % – a level last seen at the beginning of the seventies, i.e. during a marked boom. This caused enterprises to contemplate expanding capacity more, i.e. to undertake additional investment, especially as sales and earnings prospects remained good. Enterprises' readiness to invest was considerably fostered by the financial conditions. Corporate earnings improved further in 1988, as did, at the same time, the profitability of assets invested in firms. As a consequence of this profit

Real gross national product and domestic demand



1) Adjusted for working day-variations.

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situation, enterprises had ample internal resources and high liquid reserves. Overall, gross fixed capital formation by producing enterprises went up by over 8½% in value and 7½% in volume last year. This was the strongest rise since the beginning of the eighties. The sharp expansion in orders placed by enterprises indicates that the buoyant investment climate will continue after the end of 1988. There will be further emphasis on expanding capacity, as can also be seen from the strong increase in orders for industrial construction.

Housing construction again a buttress of construction activity

In the course of 1988 housing construction became an important element in domestic demand again. In the three preceding years the number of completed apartments had dropped sharply, even though expenditure on the modernisation of existing housing had continued to grow. As a consequence of the increase in the order inflow since mid-1987, investment in housing soared in 1988. It benefited from the mild weather at the start of the year, too, and exceeded its level of the previous year by about 7% in nominal terms and 4½% in real terms. The need for accommodation has increased appreciably, particularly in conurbations; this is suggested, inter alia, by some steep rises in rents in these areas, which in turn boost the profitability of new buildings. The most recent trend in housing construction orders and building permits implies that the favourable climate for housing construction will continue in 1989. It would be strongly promoted, moreover, by government measures, like those which are currently under discussion.

Relatively steep rise in public construction investment

The central, regional and local authorities expanded their construction investment in 1988 less strongly than did private building owners. The public sector per se, however, invested fairly heavily in construction – there was a rise on the year of 4% by value and 2½% by volume. The decisive factor in the rise in public capital expenditure was the more favourable financial situation of the local authorities, which also used the government low-interest-loan facility extended through the Reconstruction Loan Corporation to finance their capital formation.

Consistently favourable consumption climate

Last year saw strong stimuli to aggregate economic expansion being generated again by private consumption, which in 1986 and 1987 had been the most important driving force behind economic activity and thus a welcome counterbalance to the weaker trend in exports. In 1988 households spent almost 4% more than in the previous year on goods and services; calculated at 1980 prices, private consumption rose by 2½%. The buoyant consumption climate extended to practically all categories of expenditure. Furniture enjoyed particularly strong demand; furniture dealers were able to increase their turnover by 8½% in 1988. There continued to be strong interest in buying passenger vehicles, too. While new registrations of private passenger cars did not regain the record level of 1987, there was an increase in expenditure on new vehicles: firstly, prices were raised not inconsiderably; secondly, the trend towards more powerful and thus relatively expensive vehicles continued. Moreover, growing environmental awareness, degressive tax concessions and a wider range of products from automobile producers led to nearly 95% of the new vehicles purchased in 1988 being classified as "low-pollutant". A year before this figure had been about 80%, and in 1986 only roughly 50%. Last year even those sectors whose sales usually do not keep pace with income rises, such as food (including drink and tobacco), profited from the fact that consumers felt strongly inclined to spend. Services also experienced heavy demand. In 1988 German holiday-makers spent 4½% more than in the previous year on holiday trips abroad.

Strong growth in private income

The vigorous consumption boom was fuelled last year by strong growth in private income. It is true that the rise in monthly pay rates, at 2.7%, was lower than in 1987 (3.4%) as in the collective wage agreements, some of which had been concluded previously, further reductions in weekly working hours had been negotiated to the detriment of income increases that might otherwise have been possible. However, in view of the considerable expansion in demand seen in many areas of the economy, and so as to absorb the reductions in working hours (at least temporarily) increased overtime was worked, and paid

Key economic variables in the Federal Republic of Germany

Item	Unit	1985	1986	1987	1988	1985	1986	1987	1988
						Change from previous year in %			
Aggregate demand									
Private consumption	DM billion	1,038.3	1,068.6	1,113.8	1,157.2	+ 3.5	+ 2.9	+ 4.2	+ 3.9
Public consumption	DM billion	365.7	382.6	397.2	409.7	+ 4.4	+ 4.6	+ 3.8	+ 3.1
Fixed capital formation	DM billion	360.8	377.4	391.1	420.3	+ 1.7	+ 4.6	+ 3.6	+ 7.5
Machinery and equipment	DM billion	153.9	161.4	170.5	184.9	+ 11.8	+ 4.9	+ 5.6	+ 8.4
Construction	DM billion	207.0	216.0	220.6	235.4	− 4.7	+ 4.4	+ 2.1	+ 6.7
Increase in stocks	DM billion	− 0.7	+ 2.1	+ 6.9	+ 14.7	.	.	.	.
Domestic expenditure	DM billion	1,764.1	1,830.7	1,909.0	2,001.9	+ 2.9	+ 3.8	+ 4.3	+ 4.9
Foreign balance **1**	DM billion	+ 80.2	+ 114.5	+ 111.1	+ 119.6	.	.	.	.
Exports	DM billion	647.5	638.2	638.3	685.2	+ 9.6	− 1.4	+ 0.0	+ 7.3
Imports	DM billion	567.3	523.7	527.2	565.5	+ 5.9	− 7.7	+ 0.7	+ 7.3
GNP at current prices	DM billion	1,844.3	1,945.2	2,020.1	2,121.5	+ 4.2	+ 5.5	+ 3.9	+ 5.0
Memorandum items									
Orders received by the manufacturing sector	1980 = 100	127.8	127.9	128.2	140.6	+ 8.1	+ 0.1	+ 0.2	+ 9.6
Domestic orders	1980 = 100	116.4	119.1	118.8	128.6	+ 6.3	+ 2.4	− 0.3	+ 8.2
Foreign orders	1980 = 100	152.3	146.9	148.5	166.6	+ 11.1	− 3.5	+ 1.1	+ 12.2
Orders received by the construction industry	1980 = 100	87.4	95.3	92.7	101.4	− 1.7	+ 9.1	− 2.7	+ 9.3
Distribution of income									
Wage and salary income	DM billion	991.0	1,041.2	1,081.9	1,123.3	+ 3.9	+ 5.1	+ 3.9	+ 3.8
do. as a percentage of national income	%	69.8	69.0	69.0	68.0	.	.	.	.
Entrepreneurial and property income	DM billion	429.0	468.2	486.9	528.3	+ 6.2	+ 9.1	+ 4.0	+ 8.5
Memorandum items									
Gross income of producing enterprises	DM billion	329.4	374.0	395.1	433.3	+ 7.2	+ 13.5	+ 5.6	+ 9.7
do. as a percentage of national income	%	23.2	24.8	25.2	26.2	.	.	.	.
National income	DM billion	1,420.0	1,509.4	1,568.8	1,651.6	+ 4.6	+ 6.3	+ 3.9	+ 5.3
Output									
GNP at 1980 prices	DM billion	1,578.1	1,614.7	1,643.2	1,699.8	+ 1.9	+ 2.3	+ 1.8	+ 3.4
Productivity **2**	1980 = 100	112.4	114.8	117.2	121.5	+ 1.9	+ 2.1	+ 2.1	+ 3.6
Output in the producing sector (excluding construction) **3**	1985 = 100	100.0	101.8	102.4	106.4	+ 4.5	+ 1.8	+ 0.6	+ 3.9
Construction output **3**	1985 = 100	100.0	106.4	106.1	110.7	− 8.2	+ 6.4	− 0.3	+ 4.3
Employment									
Employed	Millions	25.5	25.8	26.0	26.2	+ 0.7	+ 1.0	+ 0.8	+ 0.6
Wage and salary earners	Millions	22.3	22.5	22.8	22.9	+ 0.8	+ 1.2	+ 0.9	+ 0.7
Memorandum item									
Total number of man-hours worked	1980 = 100	94.5	94.7	94.4	94.2	+ 0.0	+ 0.2	− 0.4	− 0.2
Unemployed	Thousands	2,304.0	2,228.0	2,228.8	2,241.6	+ 1.7	− 3.3	+ 0.0	+ 0.6
do. as a percentage of									
the total labour force	%	8.2	7.9	7.9	7.7	.	.	.	.
the dependent labour force	%	9.3	9.0	8.9	8.7	.	.	.	.
Prices									
GNP deflator	1980 = 100	116.9	120.5	122.9	124.8	+ 2.2	+ 3.1	+ 2.0	+ 1.5
Memorandum item									
Unit labour costs in the economy as a whole **4**	1980 = 100	110.7	113.5	115.7	115.9	+ 1.8	+ 2.5	+ 1.9	+ 0.2
Cost of living index for all households	1980 = 100	121.0	120.7	121.0	122.4	+ 2.2	− 0.2	+ 0.2	+ 1.2
Producer price index of industrial products	1985 = 100	100.0	97.5	95.1	96.3	+ 2.5	− 2.5	− 2.5	+ 1.3
Overall construction price level	1980 = 100	113.5	115.5	117.7	120.1	+ 0.9	+ 1.8	+ 1.9	+ 2.0
Index of import prices	1980 = 100	124.6	101.0	94.4	95.2	+ 1.5	− 18.9	− 6.5	+ 0.8

1 Balance of transactions in goods and services with other countries (including the GDR). — **2** GNP at 1980 prices per man-hour worked; calculated by the Bundesbank. — **3** Results for kinds of activity units. — **4** Index of gross wages and salaries per employee divided by index of real GNP per employed person. – The figures from the national accounts from 1986 onwards are provisional.

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for, in 1988. For this reason, among others, actual earnings rose by 3%, this being a stronger increase than that in negotiated pay rates; in the producing sector (excluding construction) as such, the so-called wage drift was even greater. Against the background of a further increase in employment, total gross wages and salaries went up by almost 4%. In addition, households profited from the second stage of the tax reductions which went into force at the start of 1988. The relief they afford is to be assessed at a total of nearly DM 14 billion. Consequently, overall net wages and salaries rose somewhat more than did gross wages and salaries. Current transfers from public cash offices, too, increased strongly again (+5%). In addition to there being higher pension payments as a consequence of the rise of 3% at mid-year and a further increase in the number of pensioners, what had an effect here were the higher payments of baby allowances and the expansion of vocational promotion measures. Including income from financial assets and private withdrawals from entrepreneurial income – the latter admittedly being a residual – households' disposable income grew last year by 4%, and thus virtually as fast as in 1987. After adjustment for inflation, the rise in private income in the last two years, at an average of 3%, was quite considerable and (leaving aside 1986, the year of the strong fall in the price of oil) steeper than in any year since the start of the current decade.

No change in households' saving ratio

Saving by households in 1988 was largely in line with the income trend. With a growth of 5½%, private saving rose only a little more strongly than disposable income, and the saving ratio therefore remained at the previous year's level of 13½%. The investment behaviour displayed by private savers revealed a strengthening in the trend which has predominated for a fairly long time towards an expansion of the liquid kinds of financial assets. Anticipation of the withholding tax on domestic interest income, which has gone into force in the interim, will no doubt have contributed to this. In 1988 an exceptionally large part of total newly-acquired private financial assets was channelled into very liquid investments. Holdings of currency and sight deposits, which – as is well known – yield very little or no interest, were the ones which were increased most. Savings accounts at statutory notice also saw strong inflows. While these accounts attract little interest, the interest on them is not subject to withholding tax. The overall money stock (M3) of households (currency, sight and time deposits and savings deposits at statutory notice) thus went up very strongly over a relatively short period. At the end of 1988 it was equivalent to some 60% of private disposable income, compared with only about 50% at the start of the eighties. Savers' interest in longer-term domestic financial assets continued to slacken last year, with the exception of contractual saving outside the banking sector. Saving with building and loan associations was revitalised in 1988, and the placing of funds with life insurance enterprises (income from which attracts a tax rate of 10% only on interest over and above 3½%) rose markedly. By contrast, new commitments in bank savings bonds and other non-marketable bank paper were no higher than the value of the paper maturing; and there were actually net outflows in the case of the special forms of saving offered by banks. Private investors probably reduced their portfolios of domestic bonds and of corresponding units of domestically-oriented investment funds open to the general public. In contrast, and probably not least under the impact of the withholding tax, they acquired large quantities of foreign fixed interest paper, either directly or indirectly through German investment funds open to the general public and operating internationally. Foreign currency bonds predominated here. Moreover, investors placed unusually high amounts in the units of foreign bond-based funds. Added together, these foreign purchases corresponded to an estimated one-third or more of private financial asset acquisition in 1988 – twice as large a share as a year before.

Strong expansion in foreign demand

The economic upswing in Germany per se received a strong boost from foreign demand, too, in 1988, although the likewise steep rise in imports provided a major counterweight in the economy as a whole. German exporters profited, firstly, from the generally rather buoyant state of global business activity, and particularly from the growing willingness on the part of non-residents to undertake capital formation; after all, the main emphasis of their product range on world markets is on capital goods. The spate of foreign orders booked by German firms in 1988 was focused, however, on their entire range of goods, especially as some compensation could be found in this way for foreign production bottlenecks. Secondly, exports were encouraged by the exchange rate of the Deutsche Mark, which depreciated noticeably in the course of last year against other major currencies (see p. 30). Overall, the domestic manufacturing sector booked 12% more foreign orders by value and 9½% more by volume in 1988. In January 1989 export orders were even further above the admittedly relatively low level of the previous year. Mechanical engineering in particular saw foreign customers' orders rise by leaps and bounds in the course of last year. Domestic motor vehicles, too, experienced strong demand on the export markets and the chemical industry continued to demonstrate its competitiveness. A new situation was created by the surge of foreign orders reaching steel producers, who, in view of the fact that domestic demand was buoyant at the same time (at least initially), no longer felt obliged to close down major factories, as they had previously been planning to do, since available capacity was being utilised more strongly than at any other time in this decade.

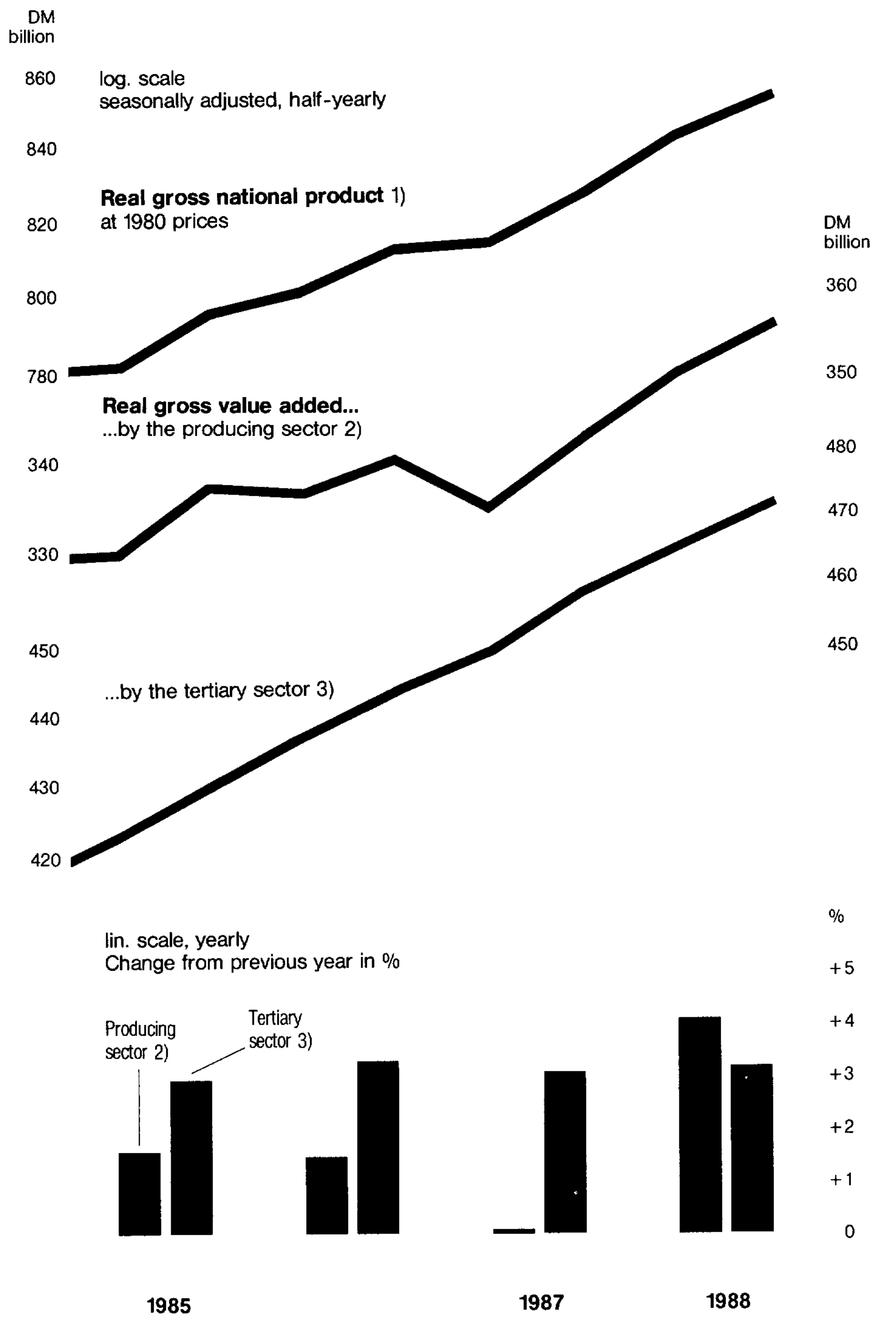
Considerable rise in aggregate output, partly owing to favourable external conditions

The ongoing buoyant domestic business situation and the rapid expansion of foreign demand generated unusually strong economic growth in 1988. Overall, the increase in real GNP, at 3.4%, was markedly steeper than the average figure for the preceding five years of the upswing. The rise in aggregate output was thus considerably above the growth in production potential – in part, however, only because the weather was very mild in winter 1987-8, so that production cuts which would otherwise have been unavoidable became unnecessary. The expansion in production potential per se, at 2%, was considerable and, moreover, capacity utilisation was increased. Fixed capacity was thus virtually fully utilised – at any rate in the sense that a further growth in output without a rise in costs would hardly have been possible. The very buoyant foreign business and strong domestic investment activity benefited the manufacturing sector in particular, output in which went up by 4% in 1988. Leading the way here was the basic and producer goods sector, especially the steel industry. The electrical engineering industry, too, stepped up production very markedly, while mechanical engineering output increased to only a relatively modest extent in spite of a surge in foreign and domestic orders. The manufacture of road vehicles was maintained at the record level reached in 1987, contrary to fears prevalent in some quarters at the start of the year. Trends in the individual areas of the consumer goods sector varied. In the textile and clothing industry, which is subject to strong competitive pressure from abroad, output in 1988 was down on the year, while in other sectors (e.g. in the manufacture of wood products, the processing of paper and among the producers of plastic products) output was substantially higher. In the services sector the considerable expansion in value added which has been apparent for a long time now continued in 1988, although export business plays only a subordinate role here.

Substantial improvement in the labour market situation

The strong upward trend in the economy also benefited the labour market last year. The average number of employed in 1988 was 155,000 (or 0.6%) above the 1987 figure and, at 26.16 million, reached a level last seen at the start of the eighties. The increase in employment continued beyond the turn of 1988-9. In January 1989 a seasonally adjusted 26.27 million persons were in employment in Germany, 190,000 more than a year before and 980,000 up on the trough in

Output



1) Adjusted for working-day variations.- 2) Including agriculture and forestry, fishing.- 3) Distribution and transportation, services, government, households and the like.

employment towards the end of 1983. As has been the case for a long time now, in 1988 by far the majority of the new jobs were created in the tertiary sector, particularly in distribution, in the banking and insurance industries and in the trades serving households. The manufacturing sector, too, took on additional labour again last year; in January 1989 about 35,000 more persons than a year before were employed in industry. On the other hand, in spite of the very much better situation in the construction industry, the fall in employment in the construction sector continued; this seems to have owed a great deal to the fact that it is apparently difficult to fill the vacancies in this field caused by

Conditions on the labour market

In thousands

Item	1985	1986	1987	1988	1987	1988
	Annual average				Change from December to December	
Employment						
Employed **p**	25,540	25,804	25,007	26,160	+ 120	+ 170
of whom						
Wage and salary earners **p**	22,274	22,543	22,757	22,926	**2** + 131	**2** + 176
Short-time workers	235	197	278	208	− 28	− 110
Vacancies	110	154	171	189	+ 7	+ 30
Unemployed	2,304	2,228	2,229	2,242	+ 90	− 118
Memorandum item						
Unemployment rate in % **1**	8.2	7.9	7.9	7.7	.	.
Movements on the labour market	Annual total				Change from previous year	
Increase in unemployed	3,750	3,637	3,726	3,669	+ 89	− 58
previously						
employed	2,659	2,554	2,606	2,425	+ 53	− 181
undergoing vocational training	145	145	147	133	+ 3	− 14
undergoing secondary/tertiary education	224	220	232	222	+ 13	− 10
other	723	719	741	888	+ 21	+ 147
Decrease in unemployed	3,728	3,766	3,636	3,786	− 130	+ 150
Increase in vacancies	1,553	1,841	1,823	1,934	− 18	+ 111
Job placements	1,876	1,965	1,998	2,116	+ 32	+ 118
Pattern of unemployment	End-September					
Unemployed, total	2,151	2,046	2,107	2,100	+ 61	− 7
by sex						
male	1,132	1,040	1,082	1,074	+ 42	− 9
female	1,019	1,006	1,025	1,026	+ 19	+ 1
by nationality						
Germans	1,907	1,803	1,843	1,837	+ 39	− 5
of whom						
from Eastern Europe, GDR	37	37	43	83	+ 6	+ 41
foreigners	244	243	264	262	+ 22	− 2
by vocational qualification						
unqualified	1,069	1,040	1,065	1,024	+ 25	− 40
qualified	1,082	1,006	1,042	1,075	+ 36	+ 33
by age						
up to 24 years	564	503	479	415	− 25	− 64
25 to 44 years	951	919	953	970	+ 34	+ 17
45 to 64 years	636	624	676	715	+ 52	+ 40

1 Unemployed as % of the total labour force; annual average. — **2** Change from fourth quarter to fourth quarter. — **p** As from 1986 provisional.
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employees leaving or retiring, as there is an insufficient supply of suitable personnel on the labour market. In some regions, sectors and occupations, the growing demand for labour last year met with a smaller labour supply, particularly as far as qualified manpower was concerned. An indication of this is the strong increase in the number of vacancies. In 1988 a total of 1.9 million requests for labour were received by the labour exchanges; this was a rise on the year of 110,000, or 6%. Although placements last year also increased markedly, an annual average of 190,000 vacancies remained unfilled; the level was thus almost 20,000 up on the year, and the highest since the start of the current decade. As always, these figures only give a certain indication of the change in the demand for labour; the absolute number of vacancies is less informative, because enterprises often see no point in reporting all vacancies if they know from experience that they cannot expect to be provided with the right type of labour.

Decline in unemployment since summer 1988

The strong increase in the demand for labour in 1988 led to a fall over the course of last year in the number of unemployed registered at the labour exchanges. Although the labour supply rose unexpectedly strongly as a consequence of the further increase in female participation in the labour force and of the heavy influx of ethnic Germans from Eastern Europe and of immigrants from the GDR, the number of those leaving unemployment, at 3.8 million, exceeded the number of newly registered unemployed. It is true that, on an average last year, the number of those registered as unemployed at the labour exchanges, at 2.24 million, was slightly higher than in 1987. Nevertheless, since mid-1988 the seasonally adjusted number of unemployed has been declining all the time. It also benefited from the mild winter weather; at the end of February 1989, at a total of 2.05 million (after adjustment for the seasonal influences otherwise normal at that time of year), it was 210,000 lower than at the beginning of last summer; it was down on the year by the same figure. Roughly half of this decline was accounted for by the category of persons under 25 years of age. An important reason for this is that, given German demography, it is now those born in low-birth-rate years who are entering the labour market. This is suggested for example by the fact that the number of applicants for apprenticeships has been decreasing steadily for a fairly long time now. In the vocational training year 1987-8, at just under 630,000, it fell short of its 1983-4 peak by 135,000. This trend was instrumental in the unfilled apprenticeships on the market at the end of September last year outnumbering the applicants throughout Germany to an even greater extent than in 1987. The improved situation on the labour market is also indicated by the fact that fewer of those who had previously been in employment became unemployed. In contrast to this, there was a sharp increase in the number of unemployed who had previously not been in the workforce, or at least not in the German workforce; this had to do principally with the above-mentioned high number of resettlers from Eastern Europe. It is also true of many women looking for work that they want to take up employment for the first time or after they have been out of the labour force for a lengthy period. The proportion of women in the total number of unemployed last year was 46½%; however, about one-quarter of them were looking for a part-time job, rather than a full-time one.

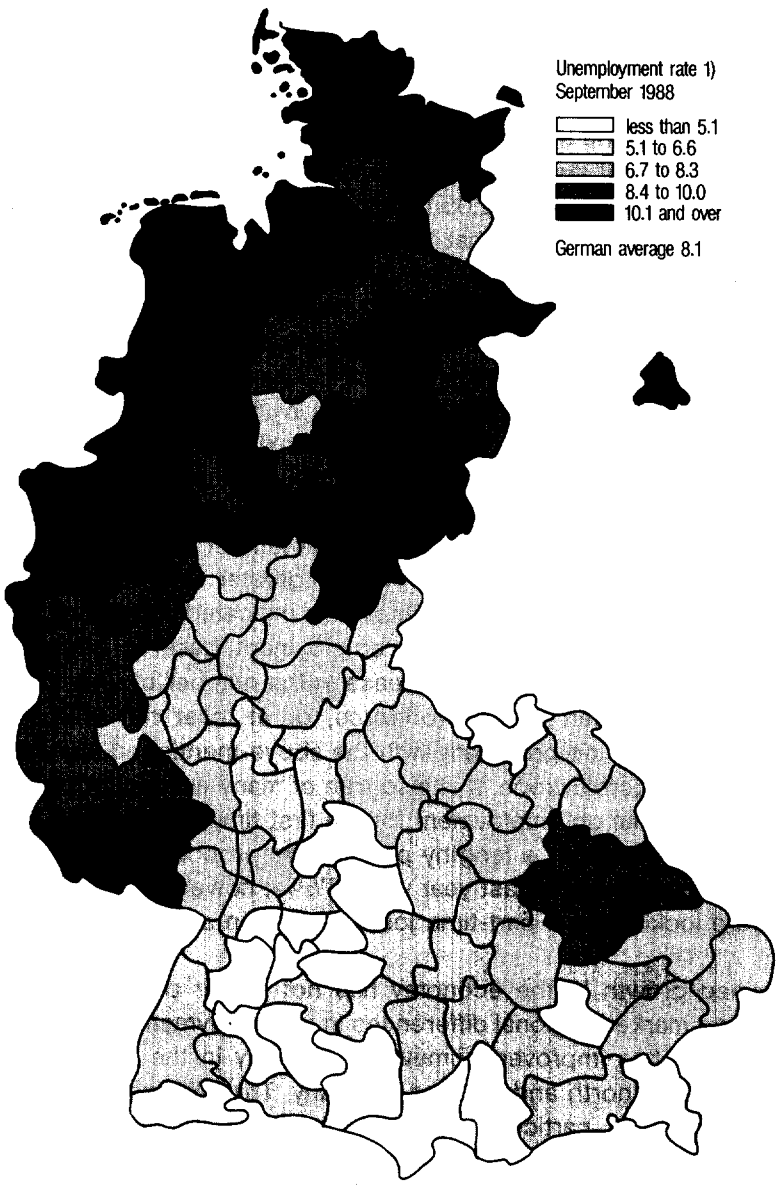
Continuing marked regional differences in unemployment

The sustained growth in the economy has not so far produced any radical changes in the marked regional differences in unemployment in Germany. Even so, the situation has improved somewhat, not only in the south but also, in many cases, in the north and west of Germany. The differences in unemployment rates, which in particular labour exchange districts in the north are sometimes two or three times as high as in the south, have been reduced somewhat. If mention is made of "rigidities" on the labour market (particularly in studies prepared by international agencies, such as the OECD and the International Monetary Fund), the reference is to a set of problems which has ultimately contributed to this differentiation.

Positive stability record in 1988 — but problems in the course of the year

Last year's stability policy record, viewed as a whole, appears quite positive, if one takes as an indicator the rise in consumer prices, averaging 1.2% over the year, or the increase in industrial producer prices, at 1.3%. However, the course of 1988 saw the arrival of certain problems for stability that derived from a variety of factors, in particular the surge in prices on world commodity markets and incipient inflationary trends in Germany — developments which, given the strong global expansion in the money stock in the past, took effect more easily than would otherwise have been the case.

Distribution of unemployment by region



1) Unemployed as % of the dependent labour force. Source: Federal Labour Office.

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Upsurge in commodity prices

On the international markets for raw materials (excluding energy), prices had already started to move upwards in 1987. Last year they surged ahead, with strong global business activity and possibly also speculative factors contributing to this phenomenon in the case of industrial commodities. In view of the weakening of the Deutsche Mark against the US dollar over the course of last year (the dollar being the main invoicing currency for commodities), these price rises had a fairly strong impact on Germany. Until well into autumn 1988 the ongoing fall in the price of oil counteracted the other price impulses generated abroad. This counterweight disappeared, however, towards the end of the year, when the oil price leapt upwards after the OPEC winter conference. The consequence was that import prices (calculated in Deutsche Mark) began to go up strongly, and this has remained the case ever since. In February 1989 imports into Germany were 5.9% more expensive than a year before (as against 0.8% on an annual average during 1988).

Change in the domestic price climate

On the domestic markets the price climate also changed in the course of 1988, influenced inter alia by external price impulses. Home-made threats to stability began to be more and more in evidence, resulting principally from the extensive recourse to production potential – as demonstrated by the high fixed capacity utilisation and the large amount of overtime being worked. The consequence of this heavy recourse was, inter alia, that wage costs in industry increased more strongly towards the end of the year.

"Price jump" at the start of 1989 due to excise tax increases

At the beginning of 1989 the excise tax increases decided on at the end of last year went into effect, as did a number of other administrative measures, and both tended to raise prices additionally at the consumer level. Accordingly, the consumer price index shot up in January 1989; it was 2.6% up on the year (as against 1.6% in November and December 1988). Seasonally adjusted, this represented an increase of 0.8%, over half of which is attributable to the price rises caused by the higher excise taxes. These resulted in a one-off increase in the price index. Afterwards, the pace of inflation slackened again; nevertheless, the price increase rate has been stronger since January than it was towards the end of last year. According to initial results from individual Länder, the year-on-year rate of price increase in March 1989 was 2.7%.

2. Fiscal policy as a mainstay of economic growth

Economic growth fostered by the income tax reduction

The fact that economic growth in 1988 was stronger than in the previous year owed much to fiscal policy and, in particular, to the income tax reduction. The tax relief of nearly DM 14 billion (the second stage of the three-stage tax reduction scheme) strengthened domestic demand; at the same time the marked levelling-off of the progression of the income tax scale was a further step towards improving the supply-side conditions. Business activity also benefited from the fact that the excise tax increase which was intended to offset the shortfalls in Federal revenue due to additional transfers to the EC was postponed until 1989 in the light of the uncertainty caused by the turmoil in the foreign exchange and stock markets in autumn 1987.

Only slight rise in the public sector deficit

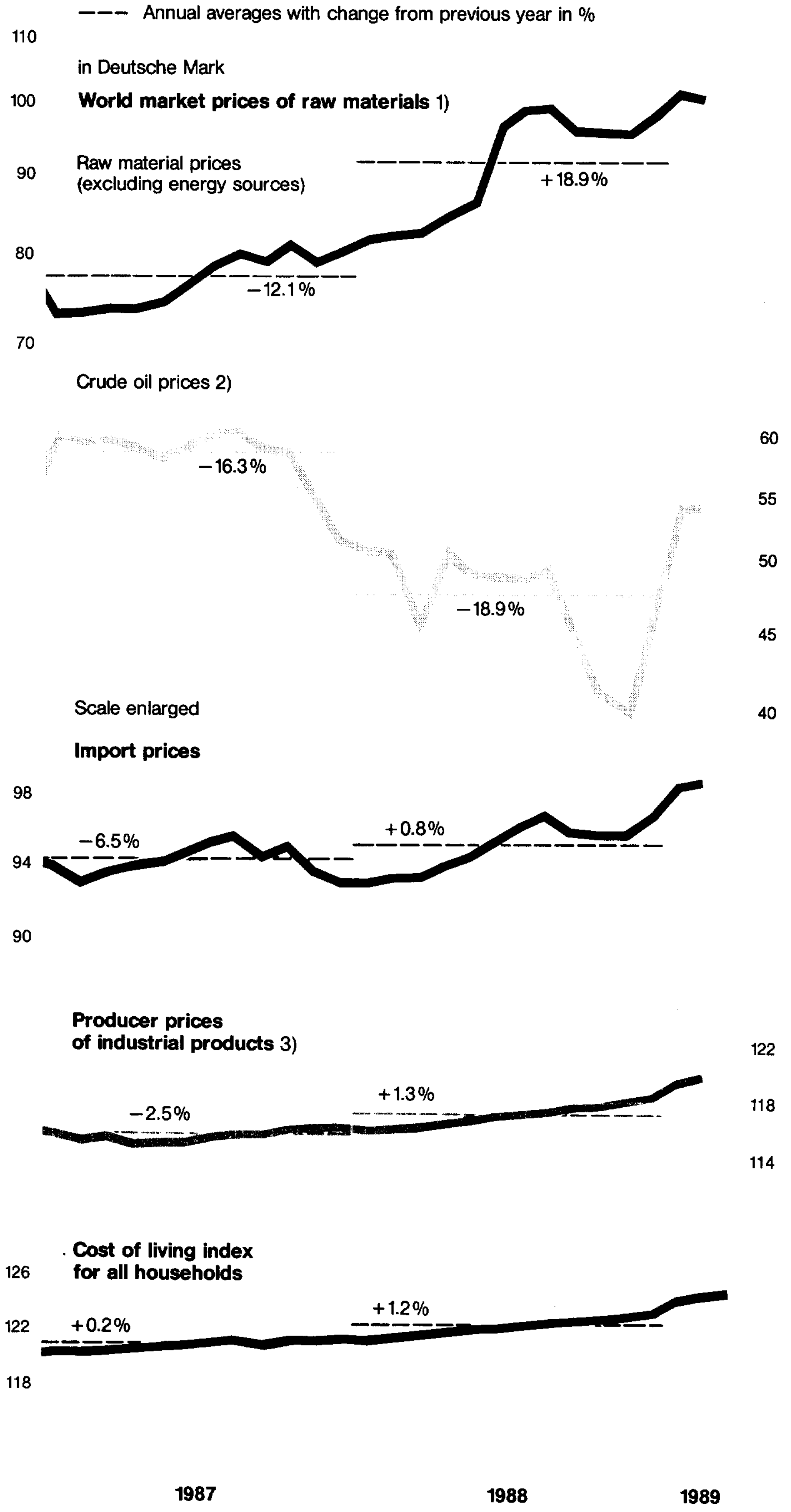
The strong upward trend in the economy in 1988 for its part boosted tax revenue, so that the deficit of the central, regional and local authorities rose only slightly, contrary to the original expectations. It amounted to DM 53.5 billion (compared with DM 50.5 billion in 1987), which was equivalent to about 2.5% of nominal GNP, just as in the previous year. After the deficit had expanded perceptibly in the first half of 1988, it actually declined towards the end of the year, since expenditure went up only slightly in the latter part of the year. At the different levels of government, budget trends varied considerably in 1988: the Federal deficit increased substantially compared with the previous year, mainly because the virtual absence of a profit transfer by the Bundesbank had to be borne by the Federal Government alone. The budget deficits of the Länder Governments, by contrast, were down on the year, and the overall finances of the local authorities were more or less in balance. The social security funds no longer recorded a surplus, as they had done in 1987, but ran a small deficit.

Increase in tax revenue stronger than expected owing to the upswing

In 1988 tax revenue expanded by 4%, despite the income tax reduction, and thus exceeded the forecast on which the budgets had been based by DM 8.5 billion. However, it did not rise as steeply as nominal GNP, so that the overall tax ratio went down, viz. by 0.2 percentage point to 23.0%, whereas it had

Prices

1980=100, seasonally adjusted, log. scale



1) HWWA index of raw material prices.- 2) Unadjusted.- 3) Domestic sales.

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amounted to as much as 23.7% before the first stage of the income tax cuts (in 1985). The tax relief mainly curbed the growth rate of wage tax revenue, which was as low as 2% in 1988. Receipts from assessed income tax, by contrast, went up by 8%. For one thing, high final payments for earlier years played a certain role here. In accordance with the assessment regulations, such payments were due not only from self-employed persons but, in certain circumstances, from wage and salary earners as well. For another, advance payments were increased, mainly no doubt because of the favourable trend in corporate profitability. For similar reasons, trade tax revenue expanded substantially, too (by nearly 10%). Corporation tax receipts increased nearly as vigorously, but in 1987 they had been diminished by a considerable tax refund, which strongly affected comparability. After adjustment for this special factor, these receipts went up by barely 3%. However, since mid-1988 advance payments of this tax, too, have been expanding strongly. In 1988 turnover tax revenue grew by just under 4%, mainly on account of the growth in private consumption.

Differing revenue trends at the various levels of government

An adverse factor influencing the revenue side in 1988 was the abovementioned very low profit transfer to the Federal Government by the Bundesbank (DM 0.2 billion compared with DM 7.3 billion in 1987). Together with the higher transfers to the EC, this was the main reason why total Federal Government revenue went down by ½%. The receipts of the Länder Governments, by contrast, expanded by just over 3½% and those of the local authorities by as much as 5%. In 1988 the receipts of the European Communities from Germany rose by DM 5 billion to just over DM 25 billion (with most of the increase deriving from the EC share in tax revenue). Overall, the receipts of the central, regional and local authorities went up by 3%. The receipts of the social security funds expanded rather more strongly, viz. by 5%. The social security funds recorded an upturn of 4½% in contribution receipts, their most important source of revenue; this was mostly due to the rise in wages and salaries and in employment, but it also owed something to further increases in contribution rates under the statutory health insurance scheme.

Muted growth in Federal and Länder Government spending – but considerable additional payments to the EC

The central, regional and local authorities exercised restraint in their spending policy in the light of the shortfalls in revenue brought about by the tax reduction. In 1988 the Federal Government and the Länder Governments restricted the growth rate of their spending to 2½% and 2¼%, respectively. The expenditure of the local authorities increased more steeply (viz. by 3½%), but less vigorously than in the preceding year, just like Federal and Länder Government spending. On the other hand, the restructuring of the EC financing system which was approved in February 1988 resulted in substantial additional outlays which must be included as what might be called a "fourth level" in the overall public sector budget, as far as the receipts and expenditure affecting Germany are concerned (especially since the EC performs tasks some of which would otherwise entail expenditure at the national level, particularly in the field of agriculture). EC expenditure financed out of German transfers went up by about 25% in 1988. Expenditure by all central, regional and local authorities, including the budget transactions arising from Germany's EC membership, increased by 3¼% last year, which was more or less in line with the budgets.

More funds required for social transfers, in particular

Of the major expenditure items, staff costs went up by 2½%. Their trend was determined, in particular, by the raising of wages and salaries for government employees by 2.4% from March 1988, which must be viewed in connection with the reductions in working hours agreed upon for 1989 and 1990. In 1988, social expenditure by the central, regional and local authorities was 4% higher than a year earlier. The decisive factors here were higher spending on baby allowances, higher Federal refunds to the pension insurance funds for child-

Finances of the public authorities*

Item	1985	1986	1987 **pe**	1988 **pe**	1985	1986	1987 **pe**	1988 **pe**
	DM billion				Change from previous year in %			
A. Budgetary trend								
Central, regional and local authorities								
Expenditure								
Personnel expenditure	193.6	202.5	211.2	216.5	+ 3.7	+ 4.6	+ 4.3	+ 2.5
Other operating expenditure	97.3	100.6	103.3	105	+ 4.4	+ 3.4	+ 2.6	+ 1.5
Transfers **1**	165.5	172.6	181.9	191.5	+ 2.9	+ 4.3	+ 5.4	+ 5.5
Interest	56.0	57.8	58.6	60.5	+ 4.5	+ 3.3	+ 1.4	+ 3
Fixed capital expenditure	52.0	55.6	56.8	58	+ 5.3	+ 7.0	+ 2.2	+ 2
Financial aid **2**	39.4	40.2	39.9	40.5	− 3.9	+ 1.9	− 0.7	+ 2
Total expenditure **3**	604.3	629.9	652.0	673	+ 3.3	+ 4.3	+ 3.5	+ 3
of which								
Federal Government	259.4	263.8	271.5	278.5	+ 2.2	+ 1.7	+ 2.9	+ 2.5
Länder Governments	243.3	254.1	263.8	269.5	+ 3.9	+ 4.4	+ 3.7	+ 2
Local authorities	162.9	172.5	178.8	185	+ 5.3	+ 5.9	**5** + 4.2	+ 3.5
EC **4**	18.4	19.6	20.2	25.5	+ 3.4	+ 6.2	+ 3.0	+ 25.5
Receipts								
Tax revenue	437.2	452.4	468.7	488	+ 5.4	+ 3.5	+ 3.6	+ 4
Other receipts	130.0	136.0	134.6	131.5	+ 4.2	+ 4.6	− 1.1	− 2
Total receipts **3**	565.0	587.8	601.5	619.5	+ 4.9	+ 4.0	+ 2.3	+ 3
of which								
Federal Government	236.7	240.6	243.6	242.5	+ 5.1	+ 1.6	+ 1.2	− 0.5
Länder Governments	226.2	236.4	244.5	253	+ 4.7	+ 4.5	+ 3.4	+ 3.5
Local authorities	163.6	170.8	176.4	185.5	+ 5.0	+ 4.4	**5** + 3.8	+ 5
EC	18.4	19.6	20.2	25.5	+ 3.4	+ 6.2	+ 3.0	+ 25.5
Surplus (+) or deficit (−)	− 39.3	− 42.1	− 50.5	− 53.5	.	.	.	
of which								
Federal Government	− 22.8	− 23.3	− 27.9	− 36	.	.	.	
Länder Governments	− 17.1	− 17.7	− 19.3	− 16.5	.	.	.	
Local authorities	+ 0.7	− 1.7	− 2.4	+ 0	.	.	.	
Social security funds								
Expenditure	341.7	353.7	370.8	394.5	+ 3.2	+ 3.5	+ 4.8	+ 6.5
Receipts	343.6	360.0	374.4	393	+ 4.7	+ 4.8	+ 4.0	+ 5
Surplus (+) or deficit (−)	+ 1.9	+ 6.3	+ 3.6	− 1.5	.	.	.	
Public authorities, total								
Expenditure	905.9	942.8	980.3	1,021	+ 3.3	+ 4.1	+ 4.0	+ 4
Receipts	868.5	907.0	933.4	966	+ 4.9	+ 4.4	+ 2.9	+ 3.5
Deficit (−)	− 37.4	− 35.8	− 46.9	− 55	.	.	.	
	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	497.7	486.2	489.8	503	+ 7.7	− 11.5	+ 3.6	+ 13.5
Securities	243.4	293.1	339.9	382	+ 38.3	+ 49.7	+ 46.8	+ 42
Other debt	19.1	21.7	19.2	18	− 3.3	+ 2.6	− 2.5	− 1
Total indebtedness	760.2	801.0	848.8	903.5	+ 42.7	+ 40.8	+ 47.8	+ 54.5
of which								
Federal Government	392.4	415.4	440.5	475	+ 25.1	+ 23.0	+ 25.1	+ 34.5
Länder Goverments	247.4	264.4	284.6	302.5	+ 16.9	+ 16.9	+ 20.3	+ 18
Local authorities	105.6	107.3	110.0	111.5	+ 0.8	+ 1.7	+ 2.7	+ 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 transactions). — **4** EC expenditure financed out of EC revenue in Germany. — **5** Adjusted growth rates, taking due account of the elimination of double-counting in one German Land. — **pe** Partly estimated.
Discrepancies in the totals are due to rounding. BBk

rearing benefits and the Federal grant to the Federal Labour Office which had become necessary. Moreover, local authority expenditure on social assistance continued to increase strongly. By contrast, the rise in the other operating expenditure of the central, regional and local authorities remained very limited (+1½%), thanks to the virtually stable price situation. Interest expenditure went up by 3%. Although the rate of increase in the central, regional and local authorities' indebtedness more or less doubled, the situation has so far been eased by the fact that loans at relatively high rates of interest expired and were replaced by loans at more favourable rates.

Expansion of public construction investment

In 1988 public construction activity was more buoyant again than in the previous year. Construction expenditure by the central, regional and local authorities went up by 3¼%. Early in the year, construction activity benefited considerably from the mild winter. During the rest of the year, the local authorities, in particular, which account for the major part of public construction investment, had more financial scope for the execution of construction projects owing to the unexpectedly favourable trend in tax revenue. To the extent that the own funds available to local authorities had to be supplemented by loans, the financing of certain projects was facilitated by credits, which were granted to local authorities by the Reconstruction Loan Corporation and whose interest rates were subsidised by the Federal Government (in accordance with the Federal Cabinet's decision of end-1987 to promote capital formation by the local authorities).

Strong rise in spending by the social security funds

Expenditure by the social security funds went up by 6½% last year; this was twice as fast as in the case of the central, regional and local authorities. The Federal Labour Office incurred high additional expenditure on unemployment benefits (owing to the extended period of entitlement) and on vocational assistance measures. Furthermore, among the statutory health insurance institutions there was a sharp increase in the course of 1988 in the demand for benefits which, under the Health Reform Act, have been subject to a higher personal contribution by insured persons since the beginning of 1989. Expenditure by the pension insurance funds, too, expanded quite vigorously.

Since 1986 only slight progress in reducing the government spending ratio

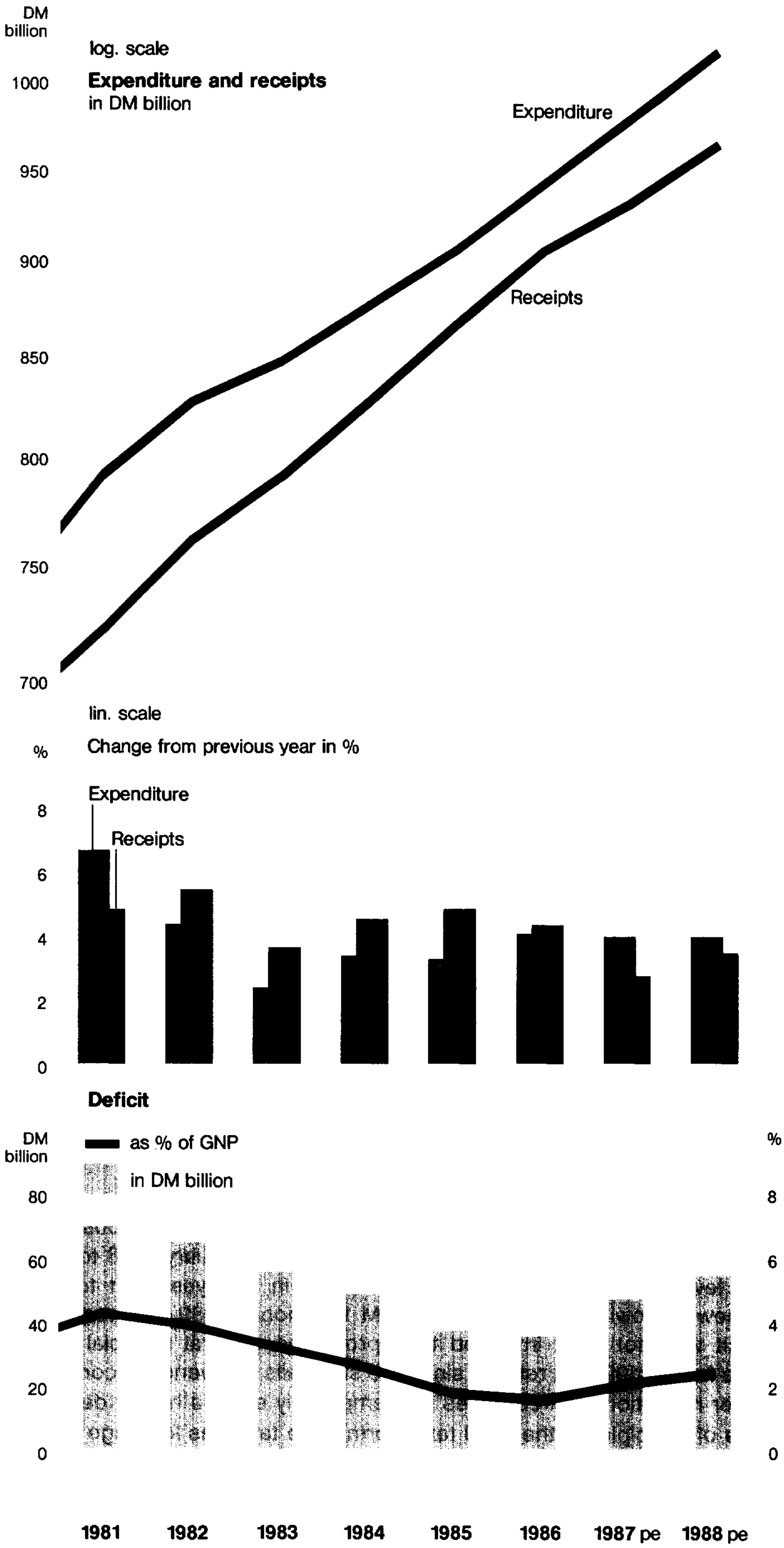
In 1988 total public sector expenditure went up by 4%, which is just as much as in 1987 and 1986. Hence in the last three years the growth in expenditure has not been as subdued as it was in the period from 1983 to 1985, when the rise was limited to an annual average of 3%. Since 1986, therefore, the fiscal policy makers have not been as successful as before in reducing the government spending ratio (i.e. the ratio of government expenditure to GNP). From its peak of 52% in 1982, the government spending ratio went down by a total of 3 percentage points up to 1985, but only by 1 more percentage point (to 48%) between 1986 and 1988.[1]

Setting the fiscal policy course for 1989

Since the Federal budget deficit was expected to expand vigorously at the beginning of last year, the Federal Cabinet decided in January 1988 to tolerate a higher level of new debt for cyclical reasons in that year, but to reduce Federal new borrowing again by at least DM 10 billion in 1989. This reduction in the deficit was not least intended to improve the general financial point of departure for the 1990 tax reform, since the shortfalls in revenue accompanying the further reduction in direct taxes will temporarily entail a higher deficit. The decisions of principle on the 1990 tax reform were taken as long ago as 1987;

1 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 government spending ratio is slightly lower (mainly because loans granted out of budget funds are counted there as financial transactions rather than as expenditure), though the decline is roughly the same.

Finances of the public authorities*



* Central, regional and local authorities and social security funds.- pe Partly estimated.

BBk

the Tax Reform Act was passed by Parliament early in the summer of 1988. Both the decision to reduce the deficit in 1989 and the Federal Government's medium-term financial plan (which was presented in July 1988) affirm that the renewed rise in new borrowing is to remain an exceptional development and that the aim of consolidating the budget is to be adhered to in the medium run. In the context of drawing up the 1989 Federal budget, excise tax increases were agreed upon as an important contribution to the reduction of the deficit in 1989. They are intended to offset the budgetary pressures imposed on the Federal Government by the higher transfers to the European Communities since 1988 and by the additional structural assistance granted to financially weak Länder Governments to finance capital formation. Moreover, the newly introduced withholding tax on interest income will yield revenue for the first time in 1989. Since, in addition, tax revenue in the base year 1988 developed more favourably than had originally been expected, and since a profit transfer by the Bundesbank (of DM 5 billion) has been included in the 1989 budget, the deficit envisaged in the 1989 Federal budget could be reduced to DM 28.5 billion (compared with an actual deficit of DM 36 billion in 1988), despite the above-mentioned structural assistance and higher grants to the Federal Labour Office. In fact, the profit being transferred by the Bundesbank in 1989 amounts to DM 10 billion, according to the 1988 annual accounts as approved early in April. In accordance with the 1989 Budget Act, receipts from the Bundesbank's profit which exceed the estimate must be used to redeem maturing debt. This emphasises the intention of the fiscal policy makers not to implement any lasting rises in expenditure as a consequence of additional receipts which may be only temporary. From an economic point of view the cash deficit (and the net borrowing requirement, too) will work out correspondingly lower in 1989. At Länder Government level, as well, the deficits can be expected to decline this year, and the local authorities might even record a slight surplus (as they did in 1984 and 1985).

Public sector deficit expected to decline sharply in 1989

According to the official tax estimate of November 1988, the tax revenue of the central, regional and local authorities as a whole (taking account of the excise tax increases) will go up by about 7% in 1989. This forecast is based on the assumption that GNP will rise by between 2% and 2½% in real terms and between 4% and 4½% in nominal terms. From today's standpoint these estimates rather seem to mark the lower limit. On the expenditure side, an increase of 3½% to 4% is implied by the budget. Given these conditions, the deficit of the central, regional and local authorities in 1989 could decline by between DM 15 billion and DM 20 billion compared with the previous year. In 1989 the finances of the social security funds, too, are likely to develop more favourably than they did in 1988, since expenditure will rise less steeply after the reform in the health service has come into effect and after the expenditure cuts which were adopted by the Federal Labour Office. On the whole, this could mean an improvement of about DM 25 billion in the public sector financial balance (in the definition of the financial statistics), provided that the cyclical trend and consequently tax revenue are more or less in keeping with the expectations entertained at the beginning of the year, and that the improvement in the budget outlook does not give rise to any new spending decisions.

Reduction in the deficit overstates the cyclical effect

This year the public sector budgets will have a rather dampening effect on domestic demand in Germany, although this effect should be rated lower than might be inferred from the decline in the deficit alone, since a substantial part of this decline is due to the high profit transfer by the Bundesbank (of DM 10 billion) and to this extent does not reflect any stronger absorption of income in the private sector. Moreover, the additional receipts from the excise tax increases and from the "minor investment income tax" are unlikely to affect the growth in real private consumption to the same extent; it is to be assumed that households will react by cutting back their saving, too, in some measure (and there are indeed initial signs confirming this assumption). From a cyclical point of view, the actual dampening effects of fiscal policy inhibit an overburdening of the production potential. However, the excise tax increases have the disadvantage that at least in 1989 the growth rate of consumer prices will be about ½ percentage point higher than it would have been in the absence of any such tax measures. What matters now is that this does not lead to a spiral of adjustment movements on the part of wages and salaries, which would subsequently be followed by pensions.

3. Faltering external adjustment

Sustained large current account surpluses

The external adjustment process in the Federal Republic of Germany did not continue at the pace desired either at home or abroad in 1988. At DM 85 billion, the surplus on the current account of the balance of payments – calculated at current prices – was actually somewhat higher than in the year before (DM 81 billion). Even when calculated at constant prices, the surplus did not fall – in contrast to 1986 and 1987 – but seems to have reached the level of the previous year again. At 4 % of gross national product, the current account surplus represents a magnitude which – were it to continue over the longer term – would certainly not fail to pose problems. Of course, as the experience of 1988 has shown, it is perfectly possible for high surpluses on current account to be associated with large exports of capital, thus avoiding financing problems for the global financial system.

Large current account surpluses problematic over the long term

For reasons which will be explained below, Germany's capital exports in 1988 were actually far greater than the surplus on current account. This, in fact, is one of the reasons why the Deutsche Mark did not appreciate – as one might perhaps have expected in different circumstances – but depreciated somewhat. To this extent, developments in 1988 did not work out adversely for the rest of the world; where inflationary tendencies prevailed in customer countries, the flow of goods from Germany helped to contain them. The question posed by the present surplus levels therefore does not relate so directly to 1988 and the beginning of 1989 but rather refers to whether this situation is sustainable in the long term for both Germany and its partners, and the answer is presumably not in the affirmative. It is true that Germany has basically been a surplus country for 3½ decades, and the consequent net transfer of goods and capital to the rest of the world is quite appropriate for it. But previously these surpluses never reached the present scale, and certainly not over a number of consecutive years. It had become clear in the past that the overall economy would be threatened if the export sector expanded too quickly or if the competition from imports was not strong enough, since adjustment processes – especially, at one time, sudden and sharp appreciations of the Deutsche Mark – have always necessitated a correction so far. In fact, the duration of Germany's large surpluses is to a large extent due to external factors over which Germany itself has little control, such as the fall in oil prices from 1985, the sharp depreciation of the US dollar up to the end of 1987 and the consequent improvement in Germany's terms of trade. On the basis of the terms of trade (i.e. the relationship of export prices to import prices) obtaining in 1985, a current account surplus equivalent to less than 1 % of gross national product would have been likely in 1988. The question now arises as to how the present large surpluses can be reduced. In the past, this was done with the help of exchange rate changes, with the exception of developments in 1988.

Steep rise in German exports

German exports rose by 7½ % in value and by just over 5 % in volume in 1988. Furthermore, the growth in exports accelerated distinctly in the course of the year, with the result that German exporters – after sustaining losses in their market shares for two successive years – were once again able to participate fully in the growth of their markets. The consolidation of Germany's competitive

Major items of the balance of payments

DM billion

Item	1981	1982	1983	1984	1985	1986	1987	1988
A. Current account								
1. Foreign trade								
Exports (f.o.b.) **1**	396.9	427.7	432.3	488.2	537.2	526.4	527.4	567.8
Imports (f.o.b.) **1**	357.3	365.2	378.5	421.4	451.1	403.0	399.5	428.9
Balance	+ 39.6	+ 62.6	+ 53.8	+ 66.8	+ 86.0	+ 123.4	+ 127.9	+ 138.9
2. Supplementary trade items and merchanting trade **2**	– 0.2	+ 0.8	+ 3.3	– 1.1	– 1.3	– 1.5	– 1.8	– 0.2
Balance of trade	+ 39.4	+ 63.3	+ 57.0	+ 65.8	+ 84.7	+ 121.9	+ 126.1	+ 138.6
3. Services								
Receipts	106.0	116.6	118.8	133.5	142.5	140.9	143.8	149.9
Expenditure	128.6	141.6	137.1	141.6	149.7	150.5	159.7	171.4
Balance	– 22.6	– 25.0	– 18.3	– 8.1	– 7.3	– 9.5	– 15.9	– 21.4
4. Transfer payments	– 24.8	– 25.9	– 25.2	– 29.7	– 29.1	– 27.3	– 29.1	– 32.0
of which								
Remittances of foreign workers	– 8.3	– 8.3	– 8.3	– 9.0	– 8.0	– 7.5	– 7.3	– 7.4
Transfers to the European Communities	– 6.5	– 7.5	– 6.1	– 7.5	– 8.2	– 7.9	– 9.9	– 12.2
Balance on current account	– 8.0	+ 12.4	+ 13.5	+ 27.9	+ 48.3	+ 85.1	+ 81.2	+ 85.2
B. Capital account								
1. Long-term capital transactions								
(a) German investment abroad (increase: –)	– 26.9	– 28.3	– 36.5	– 45.0	– 61.7	– 55.4	– 62.5	– 96.3
Direct investment	– 8.7	– 6.0	– 8.1	– 12.5	– 14.1	– 20.9	– 16.2	– 18.3
Foreign securities	– 6.0	– 11.4	– 10.4	– 15.7	– 31.5	– 21.3	– 25.0	– 72.8
Advances to non-residents	– 9.6	– 8.7	– 14.7	– 14.2	– 13.1	– 10.3	– 18.5	– 2.5
Other investment abroad	– 2.5	– 2.3	– 3.3	– 2.6	– 3.0	– 3.0	– 2.7	– 2.8
(b) Foreign investment in Germany (increase: +)	+ 35.3	+ 14.2	+ 29.5	+ 25.2	+ 48.8	+ 89.2	+ 39.2	+ 11.4
Direct investment	+ 0.8	+ 2.0	+ 4.5	+ 1.6	+ 1.7	+ 2.4	+ 3.5	+ 2.9
Domestic securities and official domestic borrowers' notes	+ 23.3	+ 12.2	+ 25.5	+ 21.7	+ 36.3	+ 69.0	+ 21.0	– 3.2
Securities	+ 1.0	+ 2.8	+ 13.6	+ 17.4	+ 38.3	+ 74.1	+ 33.2	+ 7.7
Borrowers' notes	+ 22.3	+ 9.4	+ 11.9	+ 4.3	– 2.0	– 5.1	– 12.2	– 10.9
Advances to residents **3**	+ 11.2	+ 0.1	– 0.3	+ 1.9	+ 10.9	+ 18.0	+ 14.8	+ 11.9
Other investment in Germany	– 0.0	– 0.1	– 0.2	– 0.0	– 0.1	– 0.1	– 0.1	– 0.2
Balance of long-term capital transactions	+ 8.4	– 14.2	– 7.0	– 19.8	– 12.9	+ 33.8	– 23.3	– 84.9
2. Short-term capital transactions (net capital exports: –)								
(a) Banks	– 10.3	+ 8.1	+ 1.8	+ 0.1	– 27.7	– 59.0	– 6.2	– 20.1
Assets	– 11.2	+ 4.3	+ 5.3	– 17.8	– 33.4	– 65.8	– 15.4	– 30.1
Liabilities	+ 0.9	+ 3.8	– 3.6	+ 17.8	+ 5.7	+ 6.8	+ 9.3	+ 10.0
(b) Enterprises and individuals	+ 5.8	+ 3.2	– 8.9	– 16.1	– 14.1	– 53.8	– 12.8	– 18.1
Financial relations with foreign banks	+ 8.3	+ 7.1	– 2.5	– 3.3	– 13.5	– 46.4	– 12.9	– 7.7
Financial relations with foreign non-banks	+ 0.7	– 2.0	– 0.6	– 4.0	+ 2.8	– 2.2	– 1.8	– 2.0
Trade credits	– 3.2	– 1.9	– 5.9	– 8.7	– 3.5	– 5.2	+ 1.9	– 8.4
(c) Official	+ 1.8	– 0.3	– 4.3	– 1.6	+ 0.1	– 0.9	+ 0.9	+ 2.3
Balance of short-term capital transactions	– 2.6	+ 11.0	– 11.5	– 17.7	– 41.7	– 113.7	– 18.1	– 36.0
Balance on capital account	+ 5.8	– 3.2	– 18.4	– 37.5	– 54.6	– 79.9	– 41.3	– 120.9
C. Balance of unclassifiable transactions (balancing item)	– 0.0	– 6.2	+ 0.8	+ 6.5	+ 8.1	+ 0.7	+ 1.4	+ 1.0
D. Balancing item in respect of the Bundesbank's external position 4	+ 3.6	– 0.4	+ 2.4	+ 2.1	– 3.1	– 3.2	– 9.3	+ 2.2
E. Change in the Bundesbank's net external assets 5 (increase: +) (A plus B plus C plus D)	+ 1.3	+ 2.7	– 1.6	– 1.0	– 1.3	+ 2.8	+ 31.9	– 32.5

1 Special trade. – **2** Mainly warehouse transactions for account of residents and deduction of goods returned and of cross-border 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: allocations of IMF special drawing rights 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.

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position was assisted by the fact that the disadvantages for exports deriving from the sharp real appreciation of the Deutsche Mark between 1985 and 1987 had come to an end. As the Deutsche Mark depreciated slightly from the beginning of 1988, the previous upward movement in its external value was therefore partially corrected. Moreover, German exporters (see p. 14) profited from the buoyant investment activity in the main customer countries. There was a particularly strong growth in exports to western European industrial countries. Prices for German products in those countries, too, rose less strongly than the corresponding domestic prices, not least because the Deutsche Mark hardly appreciated at all against the currencies of some of these countries (such as the countries participating in the EMS exchange rate mechanism, Switzerland and Austria). Against the pound sterling, the Spanish peseta and the Swedish krona the Deutsche Mark actually suffered exchange rate losses, leading to an exchange-rate-induced improvement in the price competitiveness of German exporters in the countries concerned. Exports to the United States, on the other hand, fell strongly once more (by 8% in 1988 overall) in the wake of the depreciation of the dollar up to the end of 1987. However, exports to the United States evidently stabilised in the second half of the year.

Import penetration of the German market continues

Germany's imports likewise rose strongly in 1988, viz. by 7½% in value; at 6½% in volume, they actually went up somewhat more than exports. Towards the end of the year imports were positively sucked in, apparently also because of an increased build-up in domestic stocks. Recently, imports of non-energy raw materials and semi-finished goods as well as of products for further processing have risen much faster than would normally have been consistent with the growth in domestic output and the consumption of raw materials and primary products. The growth in imports of end-products was particularly vigorous throughout the year. In many cases the products in question are not, or no longer, produced in Germany or are available at more favourable prices abroad. Besides, German enterprises in manufacturing and distribution resorted increasingly to foreign resources as domestic capacity was largely exhausted. In any case, the upturn in domestic demand involved a disproportionately sharp increase in imports. The penetration of the German market by foreign finished products not only tends to foster the external adjustment process in Germany but also imparts quite considerable growth stimuli to foreign suppliers. Imports from countries supplying finished products — especially from the United States and East Asia, but also from some western European industrial countries — grew particularly strongly. On the other hand, imports from oil-producing countries were fairly low in 1988; however, this was mainly a consequence of the sharp reduction in oil prices compared with the previous year. Although there was little change in the volume of energy imports, their value declined by 14%. However, towards the end of the year oil prices rose sharply again, thus precluding any further relief for Germany's import bill from this angle.

Trade surplus rises, especially vis-à-vis the EC countries

Despite the considerable growth in imports overall, Germany's trade surplus, calculated on an f.o.b.-f.o.b. basis, rose by DM 11 billion to DM 139 billion in 1988 as a result of the improvement in export business (freight and insurance costs payable on imports are classified under services in this calculation — as is customary world-wide when compiling balances of payments). However, it was almost exclusively the export surplus vis-à-vis other EC countries which rose, the improvement being accentuated in the case of the energy suppliers — the United Kingdom and the Netherlands — by the fall in oil and natural gas prices. Obviously there has been a further strengthening of the competitive position of German industry compared with that of suppliers from other EC countries. On the other hand, Germany's export surplus vis-à-vis the United States fell strongly again in 1988 as a result of the previous depreciation of the dollar.

Growing deficits on services and transfer payments accounts

Germany's growing trade surplus was accompanied, however, by rising deficits on services and transfer payments accounts. The total deficit in these two sectors, including the freight and insurance costs payable on imports, amounted to DM 53 billion in 1988; that was DM 8.5 billion more than in the previous year. The contractual payments to the European Communities rose particularly strongly (by DM 2.5 billion net to over DM 12 billion) as a result of the increase in the EC's financial requirements, which was taken into account in the revision of the way in which the EC is financed. In addition, Germany's deficit on foreign travel went up again (by DM 1 billion to over DM 29 billion) following the improvements in real income in Germany. A contributory factor to the larger deficits on "invisible" current transactions was the decline in net receipts from construction and assembly work undertaken abroad, as a consequence of the increase in competition from the newly industrialising countries and the reduction in building activity (particularly in the oil-producing countries) following the decline in oil prices. On the other hand, the trend towards growing deficits on services account has recently been restrained owing to the steadily rising receipts of investment income from abroad. In 1988 net receipts in this sector came to DM 8 billion, which was equivalent to a rise of just over DM 1 billion. This was mainly due to the increase in Germany's net external assets associated with the large current account surpluses, while the renewed rise in the interest rate level in the course of 1988 has probably not yet influenced the investment income payments which are still to be made.

Tendency towards "over-recycling" the current account surplus

Germany's continued large current account surplus was accompanied in 1988 – in contrast to the previous year – by equally large net long-term capital exports, at DM 85 billion net. Germany's basic balance was therefore roughly in equilibrium, whereas in the preceding year it had shown a surplus of DM 58 billion. In addition, there was an outflow of short-term funds totalling DM 35 billion (including the balancing item of the balance of payments). Overall, the balance of payments pattern in 1988 suggests that there was a tendency to "over-recycle" the current account surpluses, which contributed to the weakening of the exchange rate for the Deutsche Mark; while the Bundesbank was able to moderate this downward trend by deploying considerable amounts of its monetary reserves, it was unable to stop it. Despite the increases in interest rates which have meanwhile occurred in Germany, there were further massive outflows of capital at the beginning of 1989.

Large long-term capital exports

The trend in capital transactions in 1988 was influenced, firstly, by the fact that the market had little expectation of an appreciation of the Deutsche Mark, which would have countered the higher interest rates for assets in major foreign currencies. Secondly, the withholding tax on domestic interest income, which was announced in the autumn of 1987 and introduced in January 1989, represented a handicap, especially from the point of view of German investors. Against this background, residents acquired high-yielding foreign currency bonds, which are exempt from withholding tax, to the record amount of DM 42.5 billion in 1988 (for details see the section beginning on p. 47). Further resources flowed into foreign securities (DM 13 billion) through the investment funds established in Luxembourg by German banks. Similarly, purchases of foreign Deutsche Mark bonds by residents were fairly high (over DM 12 billion) as a result of the withholding tax. Including purchases of foreign shares (other than participations), a total of no less than DM 73 billion was invested in foreign securities. (For the significance of these capital exports for the private acquisition of financial assets, see p. 48.) In addition to these exports of portfolio capital, there were outflows of capital, as usual, through other transactions such as direct investment and development aid loans; at a total of DM 23.5 billion, however, these capital exports, some of which were "autonomous", were far smaller in 1988 than in the previous year. In particular, there were no exports of funds through long-term bank loans last year, as foreign demand for long-term Deutsche Mark funding was evidently met primarily through the strongly expanding sales of relatively low-yielding foreign Deutsche Mark bonds.

Decline in long-term capital imports

The dwindling attractiveness of domestic Deutsche Mark investments also led to a substantial decline in Germany's long-term capital imports (from DM 39 billion to DM 11.5 billion in 1988). Whereas non-residents had invested a total of DM 23 billion in German fixed interest securities (including official borrowers' notes) in 1987, they sold such paper to the extent of DM 9 billion net in the course of 1988. Instead, non-residents invested more heavily in foreign Deutsche Mark bonds, which are exempt from withholding tax and were offered in greater numbers last year. However, part of the funds raised through the issue of foreign Deutsche Mark bonds flowed to domestic banks through their foreign financing subsidiaries, which generally passed on the proceeds of the bonds they had issued to their German parent banks in the form of deposits. The growth (of DM 10 billion) in banks' long-term external deposits last year is primarily a reflection of such transactions. Otherwise, Germany imported significant amounts of funds last year only through the share market (DM 5.5 billion, excluding participations). In view of the positive reports on the economy and on enterprises, and despite the depreciation of the Deutsche Mark, German shares appeared to non-residents to be an attractive investment again (at least at times), after considerable funds had been withdrawn from the German share market in the wake of the stock market crash of October 1987.

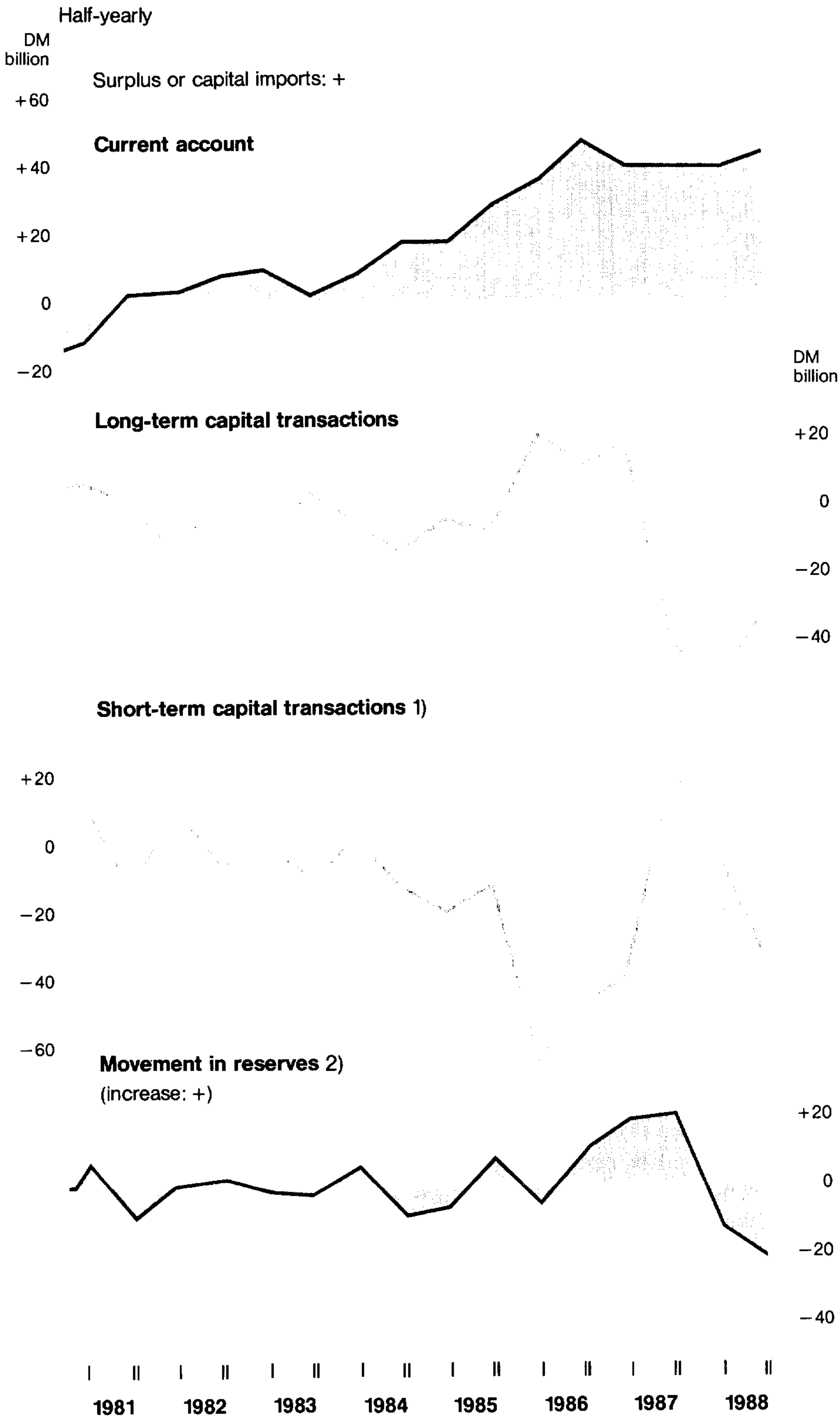
Increase in short-term capital outflows

There was also an increase in short-term capital outflows in 1988; they grew from DM 17 billion to DM 35 billion (including the balancing item of the balance of payments). To some extent, these capital movements were directly associated with current transactions: as a result of the rapid expansion in export turnover, there was a net outflow of DM 8.5 billion through trade credits last year. In most cases, however, the net exports of funds were a result of the Bundesbank's foreign exchange sales (and the Deutsche Mark purchases of the US monetary authorities), which were undertaken in 1988 to support the exchange rate of the Deutsche Mark. In the context of the balance of payments, such central bank interventions – when the holding of Deutsche Mark becomes less attractive as a result of interest rate and exchange rate conditions – are mostly accompanied by outflows of funds in short-term capital transactions, which are reflected above all in an increase in the short-term claims of German banks on non-residents. Accordingly, such claims rose by DM 30 billion in the course of last year.

Deutsche Mark tends to depreciate in the foreign exchange market

In 1988 the Deutsche Mark mostly tended to depreciate in the foreign exchange market. From the beginning of 1988 to the end of March 1989 it fell in value, particularly against the US dollar (– 16 %) as well as against the Japanese yen (– 9 %), the pound sterling (– 7 %), the Swedish krona (– 7 %), the Norwegian krone (– 8 %) and the Spanish peseta (– 9 %). This may have owed something to the marked tightening of monetary policy in most of these countries. Furthermore, as already mentioned, the introduction of withholding tax on domestic interest income in Germany encouraged capital exports, a factor which put further pressure on the Deutsche Mark exchange rate relative to the freely floating currencies. Within the European Monetary System, on the other hand, the situation remained relatively quiet in view of the depreciating tendency of the Deutsche Mark against third currencies; the pattern of exchange rates – apart from a few comparatively minor moments of tension – has not been seriously threatened since the last realignment more than two years ago. Overall, the external value of the Deutsche Mark against the average of the currencies of 18 major industrial countries declined by 5 % between the beginning of 1988 and the end of March 1989. Since prices in Germany continued to rise more slowly than those in most of its partner

Balance of payments pattern



1) Including balancing item of the balance of payments.- 2) Change in the net external assets of the Bundesbank resulting from transactions.

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countries at the same time, the depreciation of the Deutsche Mark in real terms, i.e. after taking the accumulated price differentials into account, was markedly higher, at 7%.

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

DM billion; increase in foreign exchange: +

Period		Net external position, total	Operations in the foreign exchange market 1: Deutsche Mark/dollar market	EMS: Total	EMS: Inter-vention	EMS: Debt settle-ment 2	Other foreign exchange movements
1987	January	+ 18.3	+ 1.1	+ 15.8	+ 15.8	–	+ 1.4
	February	+ 0.4	–	– 0.9	–	– 0.9	+ 1.3
	March	– 4.5	– 0.1	– 5.7	–	– 5.7	+ 1.3
	April	+ 3.4	+ 0.7	–	–	–	+ 2.7
	May	+ 2.7	+ 0.5	– 0.7	–	– 0.7	+ 2.8
	June	– 0.3	+ 0.7	–	–	–	– 1.0
	July	– 2.4	–	–	–	–	– 2.4
	August	– 0.7	– 1.7	–	–	–	+ 1.0
	September	+ 1.6	+ 0.6	–	–	–	+ 1.0
	October	+ 2.7	+ 1.0	–	–	–	+ 1.7
	November	+ 16.0	+ 3.4	+ 10.0	+ 10.0	–	+ 2.6
	December	+ 4.0	+ 2.9	–	–	–	+ 1.0
	Total	+ 41.2	+ 9.2	+ 18.5	+ 25.8	– 7.3	+ 13.5
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 **p**	– 4.1	– 2.4	+ 0.2	+ 0.2	–	– 1.9
	1st quarter **p**	– 9.1	– 8.7	+ 0.2	+ 0.2	–	– 0.5

* 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. — **p** Provisional.
Discrepancies in the totals are due to rounding. BBk

Exchange rate movements inconsistent with the economic fundamentals

These exchange rate movements, however, were inconsistent with the economic fundamentals in Germany. Firstly, a downward movement of the Deutsche Mark was out of line with the higher degree of stability in Germany compared with other countries; there was therefore a danger of inflationary trends abroad being imported into Germany to a greater extent through the loss in the external value of the Deutsche Mark. Secondly, as explained above, the depreciation of the Deutsche Mark impeded the reduction in the current account surpluses because it was accompanied by an improvement in the price competitiveness of German industry relative to that of foreign competitors on both domestic and foreign markets. From the point of view of economic policy, it was therefore necessary to resist such a counterproductive weakening of the Deutsche Mark by adopting national measures, and particularly by raising interest rates. At the same time, however, cooperation among major industrial countries with the objective of slowing down any further appreciation of the US dollar also contributed to this end.

Decline in the net monetary reserves as a result of intervention

The Bundesbank intervened, especially last summer, by selling fairly large amounts of dollars when the US dollar threatened to reach, and overshoot, the DM 1.90 mark. The US monetary authorities undertook parallel interventions; the Deutsche Mark purchased were placed with the Bundesbank, with the result that the latter's external liabilities rose accordingly. In the wake of such coordinated support operations for the Deutsche Mark, the Bundesbank's net

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Der SCAN des vorhergehenden Schriftstückes wurde wiederholt, um volle Lesbarkeit zu gewährleisten. Das Schriftstück erscheint unmittelbar nach diesem Hinweis.

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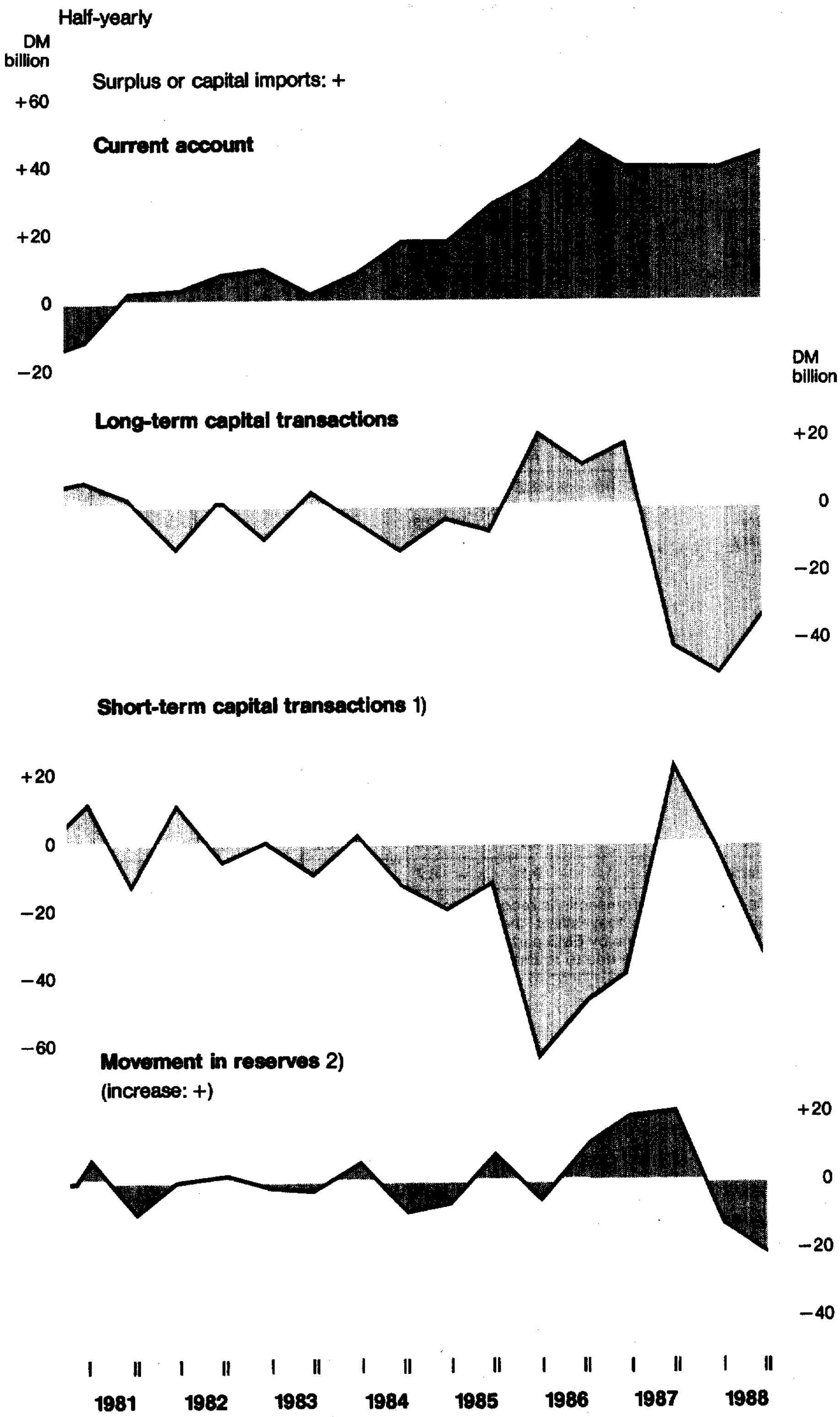
Balance of payments pattern



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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	
1987	January	+ 18.3	+ 1.1	+ 15.8	+ 15.8	–	+ 1.4
	February	+ 0.4	–	– 0.9	–	– 0.9	+ 1.3
	March	– 4.5	– 0.1	– 5.7	–	– 5.7	+ 1.3
	April	+ 3.4	+ 0.7	–	–	–	+ 2.7
	May	+ 2.7	+ 0.5	– 0.7	–	– 0.7	+ 2.8
	June	– 0.3	+ 0.7	–	–	–	– 1.0
	July	– 2.4	–	–	–	–	– 2.4
	August	– 0.7	– 1.7	–	–	–	+ 1.0
	September	+ 1.6	+ 0.6	–	–	–	+ 1.0
	October	+ 2.7	+ 1.0	–	–	–	+ 1.7
	November	+ 16.0	+ 3.4	+ 10.0	+ 10.0	–	+ 2.6
	December	+ 4.0	+ 2.9	–	–	–	+ 1.0
	Total	+ 41.2	+ 9.2	+ 18.5	+ 25.8	– 7.3	+ 13.5
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 p	– 4.1	– 2.4	+ 0.2	+ 0.2	–	– 1.9
	1st quarter p	– 9.1	– 8.7	+ 0.2	+ 0.2	–	– 0.5

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The Bundesbank intervened, especially last summer, by selling fairly large amounts of dollars when the US dollar threatened to reach, and overshoot, the DM 1.90 mark. The US monetary authorities undertook parallel interventions; the Deutsche Mark purchased were placed with the Bundesbank, with the result that the latter's external liabilities rose accordingly. In the wake of such coordinated support operations for the Deutsche Mark, the Bundesbank's net monetary reserves declined relatively sharply; in 1988 as a whole they fell – calculated at transaction rates – by DM 35 billion, whereby they were simply restored to their level at the end of 1986. The effect of the sizeable foreign exchange sales on the exchange rate level, however, was relatively small. As past experience in the foreign exchange market has shown, a basically adverse sentiment with respect to a given currency cannot be reversed through intervention alone. Instead, an economic policy which restores confidence in the domestic currency and prevents the emergence of specific pressures in the capital market is required for this purpose.

4. Monetary policy in a changed overall economic setting

(a) Change of stance in the money market in the course of the year

Neutralisation of the foreign exchange inflows while initially maintaining the expansionary basic stance

The considerable uncertainty prevailing in the financial markets in the aftermath of the stock market crash of October 1987 prompted the Bundesbank after the turn of 1987-8 to continue the expansionary monetary policy stance it had adopted towards the end of 1987. It tried, however, to prevent any build-up of pressure in the domestic money market and to stem the rise in liquidity in the banking system deriving from heavy exchange market intervention by the Bundesbank and other central banks. The Central Bank Council's decision to cut the banks' rediscount quotas by DM 5 billion from February 1, 1988 and the lowering of a number of special credit lines by some DM 1 billion neutralised part of the liquidity effects of the foreign exchange inflows and enabled the Bundesbank to manage the money market more effectively again by employing securities repurchase agreements. After the turn of the year, revolving securities repurchase agreements continued to be offered in the shape of volume tenders at a fixed rate of 3.25 %, unchanged from this low level since November 1987; throughout the period up to the end of May these transactions were gauged in such a way that the banks' ongoing demand for central bank balances could be met at unchanged money market rates. There were signs, however, that the liquidity needs resulting from the growth of currency in circulation and of the minimum reserve requirements and reflecting the expansion of the money stock were considerably above the target range envisaged for the year as a whole. As a consequence of this liquidity policy the call money rate ran at the level of the repurchase rate throughout this period. Money market rates for longer maturities tightened perceptibly, however, in the late spring of 1988.

Transition to a less expansionary course and interest rate increases around mid-year

This stiffening of time deposit rates primarily reflected the interrelation with the average bond yield, which was tending to go up distinctly against the background of rising US dollar rates and the incipient weakening of the Deutsche Mark. At the same time, the pace of monetary growth accelerated markedly and domestic business activity picked up strongly. The Bundesbank therefore preferred not to counteract a further tightening of money market rates from the early summer onwards. Despite the fact that liquidity needs in the banking system rose sharply on account of heavy foreign exchange outflows from the Bundesbank, the ongoing provision of funds through securities repurchase agreements tended to be tight, forcing the banks at times to rely more heavily on comparatively expensive short-term assistance and lombard loans from the Bundesbank. The repurchase rate for open market operations, which at first continued to come in the form of volume tenders, was raised to 4.25 % in a number of steps. In addition, and largely in line with similar measures taken by several major partner countries, the Bundesbank then put up the discount rate from 2.5 % to 3 % with effect from July 1 and the lombard rate from 4.5 % to 5 % with effect from July 29. These measures virtually reversed the relaxations introduced in the wake of the turbulence in the financial and foreign exchange markets in the autumn of the preceding year,

Record of economic policy measures

	I. Domestic and external monetary policy
1988	
January 7	The Bundesbank cuts the banks' rediscount quotas (including a number of special credit lines, some of which are cut with effect from a later date) by about DM 6 billion as from February 1. This measure is designed to ensure that money market management through securities repurchase agreements remains possible after the increase in liquidity in the banking system deriving from exchange market intervention.
January 21	The Bundesbank announces the 1988 monetary target. According to the decision taken by the Central Bank Council, the Bundesbank will conduct its monetary policy in 1988 in such a way as to maintain monetary stability and promote the growth of domestic demand. It considers an increase of 3 to 6% in the money stock between the fourth quarter of 1987 and the fourth quarter of 1988 to be consistent with this objective. On this occasion, the target is formulated for the first time in terms of the money stock M3.
April 7	The Bundesbank approves its annual accounts for the financial year 1987; DM 0.2 billion of its net profit is transferred to the Federal Government.
June 24	The Finance Ministers of the twelve EC states adopt a Directive on the full liberalisation of intra-Community capital transactions. All restrictions on foreign exchange and capital movements within the EC are to be lifted by mid-1990, with Spain, Portugal, Greece and Ireland being subject to transitional arrangements which will be phased out not later than the end of 1992 and the end of 1995. At the same time, the member states agree to apply the same degree of liberalisation to non-Community countries as to EC countries.
June 27-8	At their summit meeting in Hanover, the Heads of State and Government of the twelve EC states review the progress made on the way to the European internal market, which is to be completed by the end of 1992. Moreover, a committee is set up to submit proposals on the implementation of economic and monetary union.
June 30	The Bundesbank raises its discount rate from 2.5% to 3% with effect from July 1. By this decision the Bundesbank takes account of the strong rise in domestic business activity, the acceleration of monetary growth and the weakening of the Deutsche Mark in the foreign exchange markets.
July 28	With effect from July 29 the lombard rate is raised from 4.5% to 5%. By this measure the Bundesbank takes account of the trend in market interest rates and the tensions in the foreign exchange markets.
August 25	With effect from August 26 the discount rate is raised from 3% to 3.5%. This measure primarily serves to consolidate the preceding increase in interest rates in the financial markets.
September 1	For the first time, the Bundesbank uses the "US-style" allotment procedure for securities repurchase agreements. By this method banks have to pay exactly what they bid for their funds, rather than an average computed on the basis of all bids, so that more market-related rates are henceforth applied to these transactions.
October 25	The Bundesbank announces an increase of some DM 5 billion in the banks' rediscount quotas with effect from November 2. This enables the banks to somewhat reduce the large amount of their securities repurchase agreements on a durable basis by recourse to the rediscount facility.
December 15	The Bundesbank announces the 1989 monetary target. It considers an expansion of about 5% in the money stock M3 between the fourth quarter of 1988 and the fourth quarter of 1989 to be consistent with the objective of its monetary policy of maintaining the degree of price stability already achieved while ensuring the continuance of satisfactory economic growth. By raising the lombard rate from 5% to 5.5% as from December 16 the Bundesbank regains greater scope for its money market management following the increase in money market rates.
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. By these measures the Bundesbank continues its policy of restraining monetary growth and counteracting any upward trends in prices and any further weakening of the exchange rate of the Deutsche Mark.
	II. General economic and fiscal policy
1988	
January 1	The second stage of the 1986-8 tax reductions, supplemented by the Act on the Extension of Tax Reductions, comes into effect. The main element in the tax relief is a levelling-off of the progressive effects of the income tax scale; moreover, some allowances (including, in particular, the basic allowance) are raised and the special depreciation allowances for small and medium-sized businesses are improved. In all, the tax reductions in 1988 are estimated to amount to almost DM 14 billion.

January 7	The Federal Cabinet discusses questions of fiscal and budgetary policy. As there will be hardly any profit transfer by the Bundesbank, and as more funds will probably have to be transferred to the European Communities, new debt amounting to around DM 40 billion (rather than DM 29.5 billion, as originally envisaged) is in prospect for the Federal budget. This is to be accepted in 1988. In the 1989 financial year net borrowing by the Federal Government is to be reduced by at least DM 10 billion.
January 29	In its 1988 Annual Economic Report the Federal Cabinet sees a good chance of real GNP being 1½ to 2% higher than a year before. While this will permit a further rise in employment, the unemployment rate will probably go up slightly all the same because of the persistently large number of people looking for work. Consumer prices should increase by no more than 1%. A further marked lowering of the real foreign balance would help to reduce the international balance of payments disequilibria.
February 11-12	The European Council takes decisions on agricultural, structural and fiscal policy issues. In particular, the financial situation of the EC is improved, as a result of which the Federal Government incurs additional financial burdens, rising from DM 4 billion in 1988 to about DM 10 billion in 1992.
March 22	The Federal Cabinet approves the 1990 Tax Reform Bill. Gross tax relief totalling approximately DM 40 billion is accompanied by some DM 19 billion of additional tax receipts deriving from the dismantling of tax concessions and from measures designed to tax receipts more evenly (net relief in the first twelve months of operation: almost DM 21 billion).
April 27	The Federal Cabinet approves the Health Reform Bill. The purpose of this Bill is to enhance the sense of personal responsibility of those insured with the statutory health insurance institutions and to improve the cost-effectiveness of benefits in order to cut costs. The envisaged savings and/or additional receipts are expected to rise from DM 7.5 billion in 1989 to DM 14 billion in 1992 (when all the measures will be in full effect). About one-half of the amount saved is to be devoted to new benefits (mainly in the field of nursing care at home); the other half is intended to provide scope for lowering the contribution rates.
May 18	The Financial Planning Council discusses the economic and fiscal policy assumptions underlying the 1989 draft budgets and the financial plans until 1992. As in March, it agrees unanimously that strict expenditure restraint continues to be necessary at all budget levels. The overall growth rate of the central, regional and local authorities' spending should be distinctly below 3% a year.
June 23	The Bundestag approves the 1990 Tax Reform Act with slight amendments relative to the Bill. The relief now totals DM 19 billion net.
July 7	The Federal Cabinet approves the draft Federal budget for 1989 and the financial plan for the period from 1988 to 1992. The budget volume in 1989 amounts to DM 288.2 billion (4.6% more than the estimate for 1988) and the financial deficit comes to DM 32.9 billion. Over the medium term, expenditure is to rise by 2 to 2½% a year. After increasing to just under DM 37 billion in 1990, the deficit is to drop back again to about DM 30 billion by 1992. At the same time the Federal Cabinet approves drafts of an Act Accompanying the Budget and an Act Amending Excise Taxes, whereby mineral oil tax on petrol and heating oil, motor vehicle tax on diesel passenger cars, tobacco tax and insurance tax are raised and a tax on natural gas/liquid gas is introduced (expected additional receipts in 1989: about DM 8.5 billion). In the draft of the supplementary Federal budget for 1988, which is approved at the same time, the deficit amounts to DM 39.7 billion. In accordance with the subsequent decision of the Bundestag, the financial balance totals DM 39.1 billion.
November 24	In its Annual Report the German Council of Economic Experts expects the upswing to continue in 1989, too, after the surprisingly buoyant trend in business activity in 1988. In its estimation, the driving forces will again come from abroad as well as from the home market, and especially from capital formation. The Council estimates that the growth rate of real GNP in 1989 will average 2½%.
November 24	The Bundestag approves the 1989 Federal Budget (with an expenditure volume of DM 290.3 billion (+ 5.4%) and a financial deficit of DM 28.7 billion) the Act Accompanying the Budget and the Act Amending Excise Taxes.
November 25	The Bundestag approves the Health Reform Act. Most of its provisions will come into effect on January 1, 1989.
1989	
January 1	Along with the excise tax increases, some elements of the 1990 Tax Reform Act (including, in particular, the 10% withholding tax on interest income) take effect.
January 25	In its 1989 Annual Economic Report the Federal Cabinet notes that the economic situation in Germany at the beginning of the year is characterised by a strong upswing. In 1989 real GNP is expected to grow by about 2½% and thus once again at the medium-term trend rate of the last few years. This economic expansion will be accompanied by a rise of just over ½% in the number of persons employed and a slight decline in the unemployment rate. The Federal Cabinet expects that it will be possible to limit the average annual upturn in consumer prices in 1989 to 2 to 2½%, after taking due account of the excise tax increases which came into effect at the beginning of the year.

notably the lowering of the discount rate to an all-time low. A further raising of the discount rate (from 3% to 3.5%), which became effective on August 26, marked the start of a period of consolidation of the previous rise in interest rates.

Further advance and more market-related management of securities repurchase agreements

Substantial net foreign exchange sales by the Bundesbank in support of the Deutsche Mark pushed the amount outstanding under securities repurchase agreements up exceptionally sharply in the second half of 1988. It reached its peak for the year in October, at an average of DM 76 billion. In the light of these developments, the Bundesbank sought to steady its provision of funds through repurchase agreements, simultaneously adopting a somewhat longer-term approach. In August it introduced a fourth regular monthly securities repurchase tender, and from September it occasionally offered tranches running for two months alongside the usual one-month maturities. In addition, the banks' rediscount quotas were raised by DM 5 billion with effect from November 2. This enabled the banks to somewhat reduce the large amount of their securities repurchase agreements on a durable basis by recourse to the rediscount facility. Moreover, from the end of October last year, the tender method for the one-month securities repurchase agreements as well was changed to the "US-style" allotment procedure, after this had been tested successfully for the longer-term tenders. By this method — in contrast to the previously applied "Dutch" auction method or a volume tender — the banks have to pay exactly what they bid for their funds, rather than an average computed on the basis of all bids. As the new procedure is "shadowing" market conditions, repurchase rates are now closer to current money market rates and to that extent better reflect the current overall situation in the money market. The new procedure did not in itself spark off a rise in interest rates last autumn; to begin with, shorter-term money market rates actually eased somewhat following the change-over described above. At the end of November the Bundesbank for the first time employed a "quick tender" for its securities repurchase agreements. Besides the fact that all such transactions are basically at short term, this special form of securities repurchase agreement differs from "ordinary" open market operations in that the transactions are settled promptly, involving only banks which are active in the money market. Quick tenders thus further supplement the tools available to the Bundesbank for fine-tuning the money market.

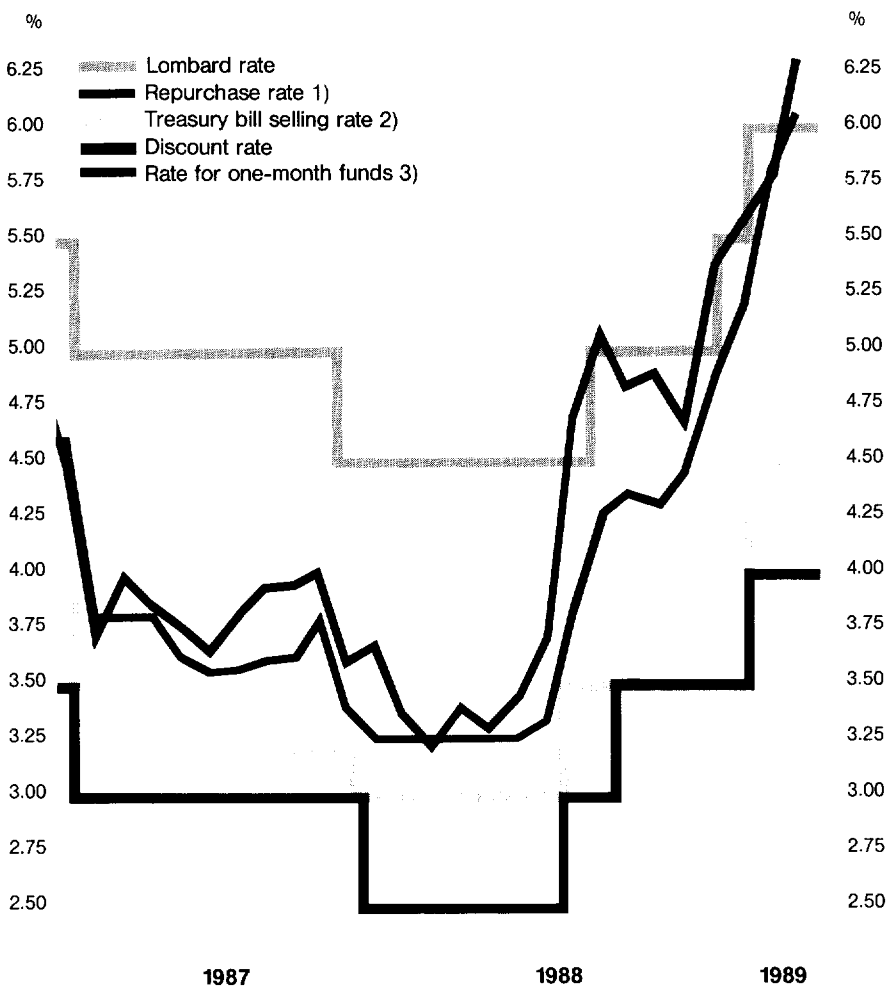
Renewed tightening of interest rates towards the end of the year

In December bank liquidity decreased more sharply than would have been consistent with the seasonal pattern, as the exceptionally rapid rise in currency in circulation deprived banks of substantial amounts of funds. The Bundesbank abstained from easing the pressure that was consequently building up in the money market. When money market rates started to edge up, banks stepped up their lombard borrowing. Eventually, the Bundesbank raised the lombard rate from 5% to 5.5% with effect from December 16, thus restoring, at the higher level money market rates had reached meanwhile, the usual interest rate leeway for its money market management. To forestall any further-going speculative lombard borrowing by banks during this period, the Bundesbank for a time (until the beginning of January 1989) offered one-month securities repurchase agreements in the shape of volume tenders, at a fixed rate of 5%.

Interest rate increases prompted mainly by domestic considerations at the beginning of 1989

In January 1989 the Bundesbank tightened the monetary policy reins a little further still, raising the discount and lombard rates by ½ percentage point each to 4% and 6%, respectively, with effect from January 20. By these interest rate policy measures, in which other central banks joined, it continued its policy of restraining monetary growth, counteracting any emergent inflationary tendencies at an early date and resisting any further weakening of the Deutsche Mark in the exchange market. At the beginning of the new year the price climate in Germany worsened, as discussed above (p. 19), inter alia for domestic

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



1) Average monthly interest rate for securities repurchase agreements, uniform allotment rate (volume tenders, "Dutch" interest rate tenders) or weighted allotment rate ("US-style" interest rate tenders), excluding quick tenders.- 2) Normally for 3 days.- 3) Monthly averages.

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reasons, so that it seemed appropriate to emphasise unequivocally the corrective basic stance of monetary policy.

(b) Ample liquidity after yet another overshooting of the monetary target

1988 monetary target rebased to the money stock M3

For 1988 the monetary target was for the first time expressed in terms of the broadly defined money stock M3. The main reason for abandoning the central bank money stock, which had previously been used as the target variable, was that currency carries a smaller weight in the money stock M3, which shows a less marked response to interest-rate and exchange-rate-induced disruptions and extreme situations (such as had been seen in 1987 and were also expected for 1988) than does the central bank money stock.[1] Viewed over the somewhat longer term, both monetary aggregates have moved broadly parallel to one another in the past, so that the procedure previously used for deriving the target in a medium-term framework could virtually be retained for the money stock M3. In deriving the target, the Bundesbank made allowance for an average annual increase of some 2% in real production potential in 1988 and

1 See "Methodological notes on the monetary target variable 'M3'" in Monthly Report of the Deutsche Bundesbank, Vol. 40, No. 3, March 1988, p. 18.

Monetary developments

Change during year 1

Item	1982	1983	1984	1985	1986	1987	1988
	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: –)	– 7.5	– 10.1	– 7.1	– 6.6	– 13.1	– 15.5	– 18.6
Foreign exchange movements (excluding foreign exchange swaps and repurchase agreements)	+ 1.7	– 2.0	– 3.9	– 0.7	+ 8.7	+ 38.7	– 30.6
Cash transactions of the central and regional authorities (including shifts of Federal balances under section 17 of the Bundesbank Act)	– 4.1	+ 1.7	+ 1.3	– 4.2	– 0.2	+ 1.8	+ 2.3
Transfer of the Bundesbank's profit to the Federal Government	+ 10.5	+ 11.0	+ 11.4	+ 12.9	+ 12.7	+ 7.3	+ 0.2
Other factors	– 12.1	– 9.7	– 12.1	– 14.0	– 8.0	– 8.9	– 8.3
Total 1	– 11.4	– 9.0	– 10.6	– 12.5	+ 0.0	+ 23.3	– 54.9
2. Liquidity policy measures							
Change in minimum reserves 4	+ 5.4	– 0.2	– 0.4	+ 0.1	+ 7.4	– 6.1	+ 0.2
Change in refinancing facilities	+ 7.7	– 0.7	+ 7.8	+ 3.3	– 5.6	– 7.6	+ 0.4
Open market operations (with non-banks, in "N paper" – excluding short-term sales of Treasury bills – and in long-term securities)	+ 1.5	+ 2.4	– 3.9	+ 0.1	+ 1.4	– 1.0	+ 0.4
Securities repurchase agreements	– 1.4	+ 6.6	+ 7.7	+ 16.5	– 9.5	– 5.5	+ 50.4
Other assistance measures in the money market 5	+ 1.6	– 3.4	± 0.0	+ 0.6	+ 1.5	– 2.3	+ 0.4
Total 2	+ 14.8	+ 4.7	+ 11.3	+ 20.6	– 4.8	– 22.5	+ 51.8
3. Remaining deficit (–) or surplus (+) (1 plus 2)	+ 3.4	– 4.3	+ 0.7	+ 8.1	– 4.8	+ 0.8	– 3.1
covered or absorbed by							
Recourse to unused refinancing facilities (reduction: +)	– 3.5	+ 3.3	– 1.0	– 3.1	+ 4.2	+ 0.1	+ 0.9
Raising (+) or repayment (–) of lombard or special lombard loans	+ 0.1	+ 1.0	+ 0.3	– 5.0	+ 0.6	– 0.9	+ 2.2
	%						
B. Key monetary indicators							
Money stock M3 6	+ 7.2	+ 5.7	+ 4.5	+ 5.3	+ 6.8	+ 6.1	+ 6.7
Money stock M2 (= M3 excluding savings deposits)	+ 5.1	+ 2.5	+ 4.9	+ 4.8	+ 6.1	+ 5.9	+ 7.4
Money stock M1 (= currency in circulation and sight deposits)	+ 6.8	+ 7.9	+ 5.3	+ 5.5	+ 7.6	+ 7.7	+ 10.3
Lending by banks and the Bundesbank to domestic non-banks	+ 6.5	+ 6.7	+ 5.9	+ 5.1	+ 4.0	+ 4.1	+ 6.3
Memorandum item: Central bank money stock 2, 7	+ 6.0	+ 6.9	+ 4.7	+ 4.4	+ 8.3	+ 8.2	+ 8.7
	DM billion						
C. Money stock and its counterparts							
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 54.8	+ 45.3	+ 41.3	+ 45.4	+ 65.7	+ 62.6	+ 76.1
Counterparts in the balance sheet							
1. Volume of credit 8	+104.4	+113.2	+108.1	+ 98.1	+ 81.7	+ 87.0	+138.2
of which							
Bank lending to domestic non-banks	+106.1	+111.3	+110.0	+100.6	+ 77.8	+ 89.8	+137.6
– to enterprises and individuals 9	+ 30.0	+ 44.0	+ 47.4	+ 48.5	+ 39.9	+ 38.6	+ 69.7
– to the housing sector 10	+ 36.1	+ 48.1	+ 43.5	+ 33.2	+ 33.7	+ 22.6	+ 26.4
– to public authorities	+ 40.0	+ 19.3	+ 19.1	+ 18.9	+ 4.2	+ 28.6	+ 41.5
2. Net external assets 11	+ 4.5	+ 1.2	+ 0.8	+ 30.0	+ 55.9	+ 53.2	– 5.2
3. Monetary capital	+ 46.5	+ 67.1	+ 69.7	+ 75.0	+ 69.8	+ 70.7	+ 42.8
of which							
Savings deposits at agreed notice	+ 4.3	– 2.0	+ 6.0	+ 11.2	+ 15.3	+ 9.7	– 5.7
Bank savings bonds	+ 11.9	+ 13.0	+ 16.3	+ 10.4	+ 9.9	+ 9.8	– 0.1
Time deposits and funds borrowed for 4 years and over	+ 7.2	+ 27.2	+ 26.3	+ 34.5	+ 37.6	+ 43.1	+ 46.4
Bank bonds outstanding 12	+ 14.1	+ 22.6	+ 13.2	+ 9.3	– 4.7	– 2.0	– 5.9
4. Central bank deposits of domestic public authorities	+ 0.5	+ 0.9	– 1.2	+ 1.3	– 1.1	+ 3.5	– 1.1
5. Other factors	+ 7.2	+ 1.0	– 1.0	+ 6.5	+ 3.2	+ 3.4	+ 15.2

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 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 by domestic non-banks at domestic banks. — **7** Reserve component calculated at constant reserve ratios (base: January 1974); excluding reserve-carrying bank bonds. — **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

for an unchanged annual inflation rate not exceeding 2%. An increment of ½ percentage point was included to take account of the fact that, according to calculations made by the Bundesbank, the money stock M3 is rising somewhat faster in the long run than nominal production potential. Allowing for a target range of 3 percentage points, which above all was meant to take account of presumed instabilities in the money creation process, a four-quarter target for the expansion of the money stock was derived as usual from the benchmark figures mentioned above. This provided that the Bundesbank was to aim at allowing the money stock M3 to expand by 3 to 6% between the fourth quarter of 1987 and the fourth quarter of 1988. Setting this target for 1988 involved the intention of maintaining monetary stability and fostering the growth of domestic demand.

Strong monetary expansion in the first half of the year and again in autumn 1988

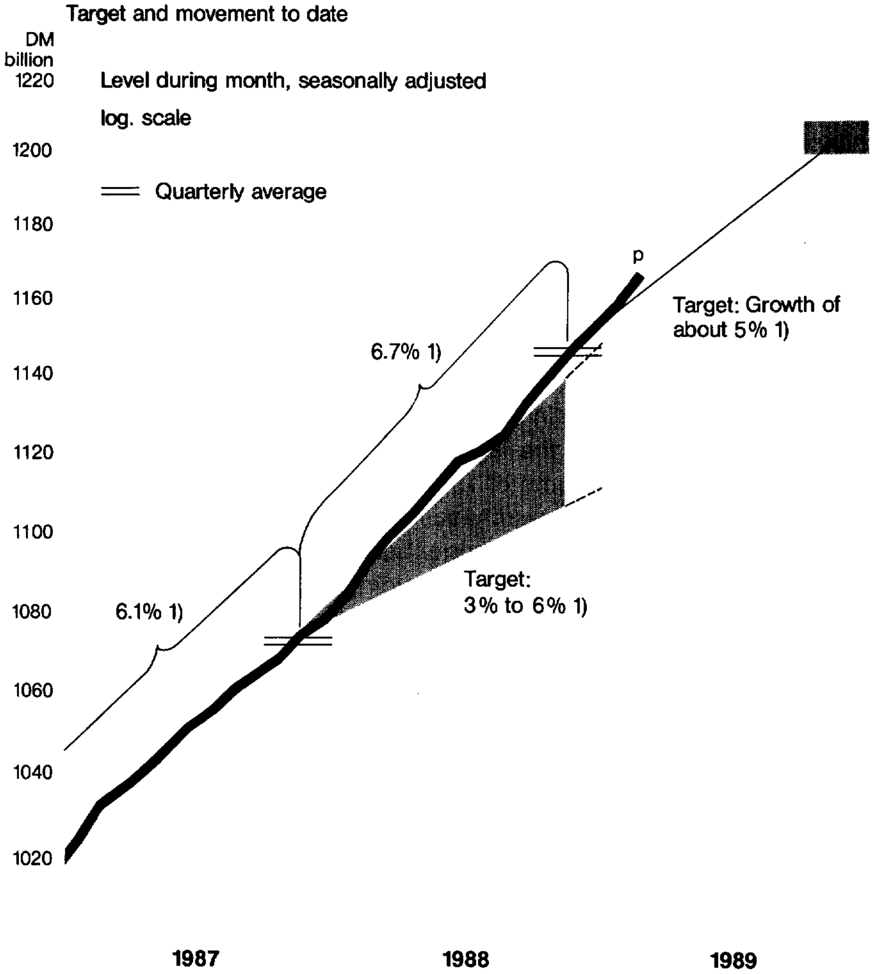
As early as the first half of the year the growth of the money stock M3 quickened sharply, taking it distinctly above the top of the target corridor. For one thing, this trend reflected the lagged effects of the cuts in central bank interest rates from the late autumn of 1987 and domestic investors' continuing wait-and-see attitude towards purchases of German bonds. For another, monetary expansion was given an "exogenous" stimulus as longer-term bank deposits were switched into liquid money holdings, such as currency and sight deposits, on tax grounds. External factors may also have played a part in this, e.g. the increased holding of Deutsche Mark notes abroad (though such influences cannot be quantified). In the wake of the adjustment of the monetary policy stance last summer, monetary growth slackened temporarily. In the autumn, however, it gathered considerable momentum again as domestic monetary capital formation was low and money creation was increasingly being boosted by lending. Towards the end of the year monetary expansion was given an extra fillip by an increase in currency in circulation which was completely out of line; motivated by uncertainties associated with the introduction of withholding tax, domestic investors resorted to a downright "flight" into cash. In the event, the four-quarter growth rate of the money stock M3 in 1988 – between the fourth quarter of 1987 and the fourth quarter of 1988 – came to 6.7%, thus overshooting the 1988 monetary target.

Disproportionate monetary growth

This outcome meant that the Bundesbank's monetary target was overshot in 1988 for the third consecutive year. Overall money balances expanded considerably more strongly than would have been consistent with the medium-term real growth potential of the economy, which is measured in terms of the estimated growth of production potential. After the years 1982 through 1985 had seen a rate of monetary growth that was broadly matched by potential output growth, the expansion of the money stock M3 (including an annual increment of ½ percentage point to take account of the rise in trend) outpaced the rate of growth of production potential, calculated at current prices, by a total of 5 percentage points up to 1988. This development, on past experience, implies a potential risk to the stability of the Deutsche Mark. It should be borne in mind, however, that under the special conditions obtaining in recent years excessive monetary growth does not "mechanistically" translate into price rises. Hence it is not impossible that, following several years of uninterrupted decline in inflation rates, households and enterprises came to have greater confidence in monetary stability and therefore did not expect to see interest rates move as erratically again as they had done in the seventies and early eighties, and thus considered the opportunity cost of holding liquid funds to be small. Since the autumn of 1987, i.e. since the start of the "withholding tax debate" in Germany, private demand for money has apparently been given an additional boost by investors remaining undecided as to whether they should hold their funds in the form of foreign or domestic assets, in interest-bearing instruments such as savings deposits (which are exempt from withholding tax) or for the time being just in the form of banknotes. As far as monetary policy is

Growth of the money stock M3*

Target and movement to date



* Mean of the levels at the end of the current and the preceding month.- 1) Between the 4th quarter of the preceding year and the 4th quarter of the current year.- p Provisional.

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concerned, the decisive factor is then whether the cash reserves accumulated will continue not to be channelled into expenditure or the money supply if there is a change in the underlying economic conditions. In this connection, significant points might be, for instance, whether a marked deterioration in the price climate is to be expected, whether assets denominated in foreign currencies yield high rates of interest while no exchange losses are likely to be incurred, or whether or not German investors must brace themselves for changes still to come in the withholding tax rate. The large supply of liquidity would certainly become relevant to monetary policy if resident financial asset holders were to slacken in their willingness to hold on to their large liquid reserves over the long term.

Monetary target for 1989 and the reasons behind it

Against the backdrop of a changing overall economic setting, the Bundesbank defined its basic monetary policy stance for 1989 by saying that the degree of price stability already achieved was to be maintained under conditions of continuing satisfactory economic growth. The commitment to stability that this implies was reaffirmed in December last year by the announcement of another target for the growth of the money stock M3. This target was based on the assumption of an average annual increase in overall production potential, calculated at current prices, of 4 to 4½% in 1989. At the same time, it was taken into account that, if capital formation increased, real production potential might grow at a slightly (but, because of the contractionary impact of the reduction in working hours, not so very much) faster rate than in the preceding years. At the same time, allowance was made for an inflation rate of about 2%, unchanged from the previous year. It was taken into account in this context that in 1989 it would be rather more difficult than in earlier years to keep the inflation rate down to this benchmark figure, as "exogenous" price increases deriving from the tax changes were in the pipeline at the beginning of the year. The (average annual) increment of about ½ percentage point for the long-term change in the relationship between the money stock M3 and the production potential at current prices was also retained. The above-mentioned economic benchmark figures yielded in arithmetical terms an average annual rise of just under 5% for the money stock M3 in 1989 – a figure which, all in all, appears appropriate. For the reasons mentioned above, the Bundesbank – in line with corresponding recommendations by the Council of Economic Experts and other bodies – continued not to include a "discount" for the monetary carry-over which had accumulated in the years before. The monetary target, formulated as usual in terms of a four-quarter increase – from the fourth quarter of 1988 to the fourth quarter of 1989 – was in the event set by the Central Bank Council at "about 5%". The new monetary target reflects the Bundesbank's intention of keeping monetary growth in the current year down to a rate that is compatible with monetary stability. The monetary policy measures which have been taken since December last year underline this intention.

(c) Details of the money creation process in 1988

Strong growth of money balances and especially of currency in circulation

In 1988 the money stock in all definitions once again increased more rapidly than production potential at current prices. While, as mentioned above, the money stock in the broad definition M3 was 6¾% up on the year at the end of 1988, the narrower monetary aggregates M2 (M3 excluding savings deposits at statutory notice) and M1 (currency and sight deposits) rose even more steeply over 1988 as a whole, at 7½% and 10½%, respectively. In the event, domestic investors thus showed a pronounced liquidity preference for the third successive year. For the past year this applies in particular to currency in circulation, which positively soared, at 15%, a rate which is out of all proportion to the long-term determinants of currency in circulation, such as the rise in income and in households' expenditure. Moreover, currency in circulation, unlike bank deposits (which are likewise included in the money stock), did not respond perceptibly to the rise in shorter-term bank deposit rates from mid-1988 onwards and the associated higher opportunity cost of holding liquid, non- or low-interest-bearing funds. On the contrary, its rate of expansion actually accelerated further towards the end of the year. As already suggested, this "atypical" reaction may be primarily attributable to the introduction of withholding tax on interest income at the beginning of 1989. It evidently prompted many investors to switch from domestic bank deposits, bank savings bonds and bonds to banknotes, and to hold currency until they had made up their minds about new investments or purchases. Some currency is also likely to have been taken abroad; however, such cash normally flows back quickly from foreign banks. Sight deposits, too, expanded disproportionately fast in 1988, although their rate of growth slackened perceptibly when interest rates rallied in the second half of the year. Savings deposits at statutory notice followed a similar pattern. As interest income from such deposits is not subject to withholding tax, they increased vigorously in the first half of the year, probably also for tax reasons. Subsequently, however, their growth slackened. Since the basic savings rate remained at its 2% all-time low despite the upturn in deposit and long-term interest rates, their yield became even more unattractive. Shorter-term time deposits and borrowed funds, whose growth had previously been sluggish and whose interest rates were raised by some 1½ percentage points during the second half of the year, went up at a more rapid pace again. Over the year as a whole, however, the expansion of these deposits was fairly moderate.

Rise in the Euro-deposits of domestic non-banks

The impression of strong monetary growth still remains if the deposits held by German non-banks in the Euro-market are included in the analysis. In 1988 such deposits with German banks' offices abroad alone increased by DM 10 billion (compared with DM 8 billion in the preceding year). Especially at the end of the year, domestic individuals evidently added a major amount to their Euro-deposits in connection with the withholding tax which became effective at the beginning of 1989. If the money stock M3 is extended to include domestic non-banks' Euro-market deposits and their short-term bank bond portfolios, the increase in this extended money stock M3 over 1988 as a whole slightly outstripped that of the traditional domestic aggregate M3.

Domestic driving forces behind monetary growth

The driving forces behind the money creation process shifted to the domestic economy in 1988. Domestic non-banks' external payments, which were a major determinant of monetary expansion in 1986 and 1987, had no expansionary impact on the money creation process last year. The net external assets of the banks and the Bundesbank, which had risen by over DM 50 billion in each of the two preceding years, declined marginally – by just over DM 5 billion – in 1988 (owing to the "over-recycling" of the current account surpluses; see p. 29). But this swing in external payments did not have any discernible restraining influence on monetary growth. In part, the heavy capital exports merely reflected the fact that – on interest rate, exchange rate and tax grounds – the focus of longer-term financial asset acquisition was on foreign rather than domestic assets. On the other hand, domestic credit expansion, which invariably runs counter to non-banks' external payments, accelerated. In the final analysis it turned out last year that outflows of funds abroad may have only a minor contractionary effect on monetary growth if money market rates and thus also short-term lending rates and the opportunity cost of holding cash are kept at a low level at the same time. Only in the summer, when the rise in short-term interest rates for a time stimulated domestic monetary capital formation, did the outflows of funds exert a short-lived contractionary impact; but this impact was soon more than offset again by expansionary domestic factors.

Increased lending to domestic non-banks

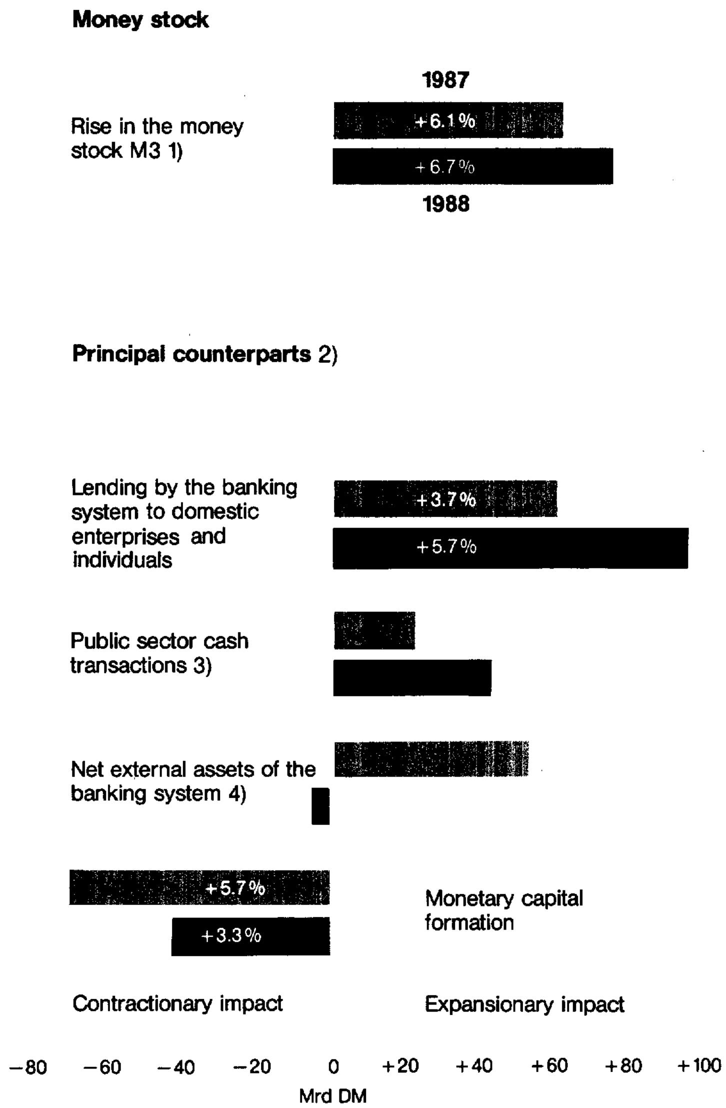
Bank lending to domestic non-banks picked up markedly in 1988, with the low level of interest rates and outflows of funds being contributory factors. Lending by the banking system (including the Bundesbank) to domestic non-banks rose by 6¼ % and thus much faster than in 1987. In terms of the absolute amount, it went up by DM 138 billion, as against DM 87 billion a year before. Even if allowance is made for the decline in the net external assets of the banking system, the expansionary stimulus which overall bank lending gave to monetary expansion was quite substantial.

Heavier bank borrowing by the public sector

The switch from domestic to external securities transactions indirectly increased official borrowers' interest in domestic bank loans. This is particularly conspicuous in the case of those public authorities which normally use the bond market for the major part of their funding. In 1988 sales of public bonds to non-residents were barely half as large as a year before. At the same time, public authorities were faced with a slightly higher budget deficit and a marked reluctance on the part of domestic non-banks to buy domestic, and notably government, bonds. The public sector thus borrowed primarily from banks (DM 42 billion). About two-fifths of this amount was accounted for by bank purchases of government bonds. The acquisition of public bonds apparently seemed attractive to the banks in the light of the fact that the margin between short-term deposit rates and long-term bond yields remained fairly wide until well into the summer. When short-term interest rates tightened further towards

The money stock and its principal counterparts

Change during year in DM billion or in %



1) Currency and sight deposits, time deposits for less than four years and savings deposits at statutory notice held by domestic non-banks at domestic banks.- 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.- 4) Banks and the Bundesbank.

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the end of the year and maturity transformation risks emerged more clearly, the banks slightly reduced their public bond portfolios.

Greater demand for credit on the part of non-banks

Lending by the banking system to enterprises and individuals increased by DM 96 billion (or 5¾%) in 1988 as against 3¾% a year before. Because of the buoyancy of economic activity and the outflows of funds, it was especially enterprises' working fund needs which increased. Direct bank lending to enterprises and self-employed persons grew by 6½% last year (compared with 2½% in 1987); this was the steepest rise for seven years. Lending to individuals went up slightly more still, at 7%, obviously reflecting the buoyant state of consumption, in particular the brisk demand for passenger cars. Housing loans, by contrast, continued to be fairly slack.

Buoyant demand for long-term loans, while short-term lending catches up

Against the background of low interest rates, with expectations of rising interest rates emerging from time to time, the demand for long-term fixed rate loans remained buoyant in the year under review. Enterprises' growing propensity to invest likewise encouraged the expansion of long-term lending. On the other hand, the interest rate risk was perceived by the banks, especially later in the year, as having risen slightly, and they became increasingly reluctant to enter into long-term interest rate commitments. Altogether, longer-term direct lending by banks to enterprises and individuals grew at a rate of 5½ % in 1988, unchanged from the preceding year. In retail operations, lending continued to be all at longer term on balance, although enterprises' demand for short-term credit also picked up again. Over the year as a whole, the growth rate of short-term bank lending, at 6 %, was in fact somewhat higher than that of longer-term lending, but the chief reason for this was the trend at the end of the year, when short-term lending to trade and industry really shot up.

Slight rise in interest rates during the year

By the spring of 1988 some bank lending rates had dropped to all-time lows. In the wake of a global upturn in interest rates they subsequently tightened, first of all those for longer maturities. After the Bundesbank had followed the rise in market rates around mid-year, there was some consolidation at the longer end of the market, while short-term bank lending rates began to firm slightly more. At the end of the year they were ⅔ to just over 1 percentage point up on their trough in the spring, while the overall rise in long-term lending rates was somewhat lower (the cost of loans with interest locked in for ten years, for instance, going up by a mere ⅓ percentage point). Compared with enterprises' profit expectations and interest rate conditions abroad, however, lending rates in Germany remained low.

Monetary capital formation very subdued owing to interest rates and withholding tax

Given the low level of long-term interest rates, investors preferred not to enter into longer-term commitments in 1988. It was only in the summer, when the average bond yield rose to 6½ % and the Bundesbank, abandoning its easy money market policy, helped to dampen expectations of rising interest rates and inflation rates, that the propensity to acquire longer-term financial assets increased slightly for a time. With the ensuing decline in long-term interest rates, however, it decreased markedly again. Apart from the fact that investors considered the average bond yield to be low (by both historical and international standards), the low level of domestic long-term monetary capital formation last year undoubtedly owes a great deal to the withholding tax on interest income from domestic capital investments, which was introduced at the beginning of 1989. As mentioned before, this tax triggered massive shifts out of domestic long-term financial assets into currency and (to a smaller extent) into liquid bank deposits which are exempt from withholding tax, and also into investments in foreign securities (see pp. 48 and 53-4). Overall, monetary capital formation at domestic banks amounted to only DM 43 billion in 1988, compared with some DM 70 billion in the two preceding years, when it had been relatively low anyway for interest rate reasons (in 1981, when disposable income was much lower, it had come to DM 86 billion). It thus provided a remarkably small counterweight to the expansionary impact which the banks' lending business had on monetary growth. The main reason for this was a "slump" in the assets which are held mainly by households. Specifically, savings deposits at agreed notice (including the interest credited) fell by DM 5.5 billion, compared with a rise of some DM 10 billion in 1987. Sales of bank savings bonds, which in 1987 had likewise yielded DM 10 billion, virtually dried up, notwithstanding the fact that the rates paid on them — unlike savings rates — roughly kept pace with the movement in capital market rates. The volume of bank bonds in the hands of domestic non-banks, which had already diminished in the preceding years, was reduced even more sharply (by DM 6 billion) in 1988. Particularly at the end of the year, investors adopted more of a "wait-and-see attitude" towards risk-carrying bonds. Long-term time deposits and borrowed funds, by contrast, which come primarily from institutional investors, produced record inflows to banks last year, at DM 46.5 billion. In periods when interest rates are low, insurance enterprises in particular switch to borrowers' note loans and registered bank bonds (which are included here) because these, unlike bonds, do not have to be written down in the balance sheets if prices decline later on. Insurance enterprises' investment decisions were as little affected by the withholding tax as were those of banks, since it does not imply any additional tax burden for them.

(d) The business and profit situation of the individual categories of banks

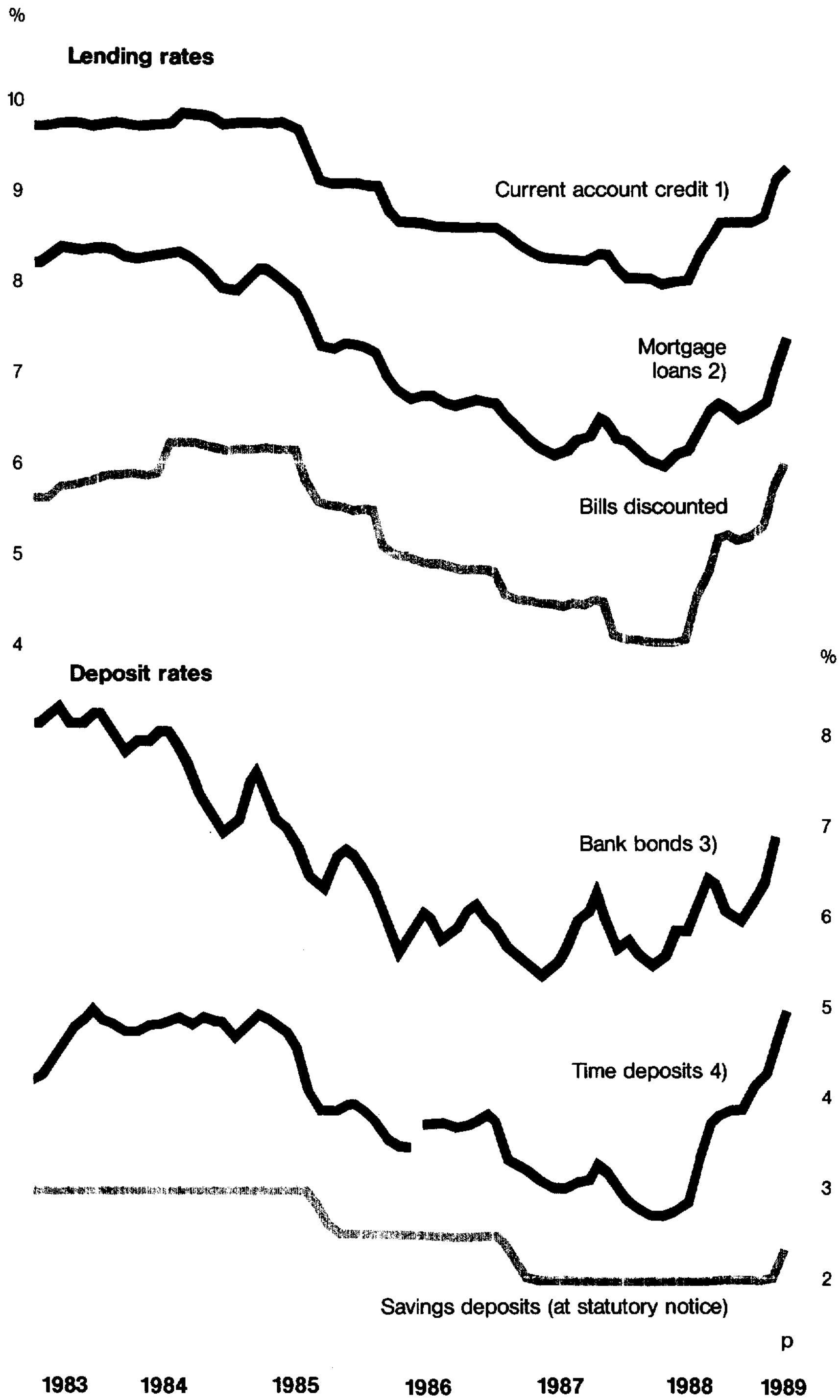
Further gains in commercial banks' market shares in lending business

The increased domestic demand for credit benefited most categories of banks in 1988, albeit to varying degrees. Commercial banks registered further gains in market shares. They stepped up their lending to domestic customers by 8.8 %, and thus much more strongly than all banks taken together (6.1 %). Within the commercial bank category, the lending volume of big banks rose by 10.2 %, that of regional banks and other commercial banks by 7.6 % and that of private bankers by 10.6 %. Commercial banks profited especially strongly from the fact that the focus of borrowing shifted in 1988 to the enterprise sector, their main customers; this applied particularly to the upsurge in short-term lending to trade and industry at the end of the year. Private bankers, moreover, increased their public sector lending. Much the same strong performance was registered by savings banks, which again expanded their lending at an above-average rate, viz. by 6.4 %. They primarily benefited from the greater borrowing requirements of medium and small-sized firms. The steepest relative growth was recorded in 1988, as in 1987, by the lending of the regional institutions of credit cooperatives (+ 20.7 %). This was primarily due to substantial purchases of public bonds, some of which represented an alternative outlet for the massive inflows of funds. The volume of lending by banks with special functions also grew at a faster pace (by 8.8 %). Low-interest lending programmes for trade and industry and local authorities probably played a major part in this. Credit cooperatives, by contrast, did not quite keep pace with the general trend (5.9 %); this was chiefly because of weaker growth of short-term lending to trade and industry. Private mortgage banks, whose short-term lending business is traditionally insignificant, likewise dropped slightly behind their competitors. Their lending volume increased at a rate of 4.5 % in 1988, unchanged from the previous year. An even slower expansion was registered by regional giro institutions, whose lending grew by 1.9 % in 1988, i.e. only about half as fast as in the previous year. They were the only category of banks whose lending to the private sector declined.

Continued satisfactory growth of profits in the banking industry

After having fallen in 1987, overall bank profits seem to have risen again in 1988, though more slowly than the volume of business. While interest margins narrowed further, claims on customers increased strongly in 1988. In contrast to the preceding years, more profitable short-term lending picked up again. The advance of "traditional" lending business, as compared with securities transactions and interbank lending, admittedly boosted net interest received but, as earning margins continued to be squeezed in corporate and consumer lending business, the improvement in profitability did not match volume growth in this line of business either. While the rapid rise in non- or low-interest-bearing deposits counteracted the squeeze on margins, banks were increasingly forced to see to their lending being funded at matching maturities as far as possible, so as to limit their interest rate exposure. Net commissions received – after having fallen slightly in 1987 – probably recovered somewhat in the year under review. There are indications that staff costs and other operating expenses – relative to the volume of business – grew at a disproportionately low rate. Overall, in 1988 average operating results in the banking industry (which include the expenditure and receipt items mentioned) presumably made

Movement of 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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good the decline suffered in the preceding year. Profits for the year (overall results) improved even more strongly. But their increase, too – as mentioned above – is likely to have remained below the growth rate of the volume of business. The risk content of the domestic loan book is more likely to have decreased, and only minor additional provisioning for country risks was required after the considerable value adjustments made in previous years. Moreover, smaller amounts had to be written off securities trading portfolios. On the other hand, the price gains in own account securities trading increased.

Adjustment to new capital standards

In 1988 banks which engage more heavily in securities business tended to derive relatively more benefit from these developments than those which do not. This is possibly one of the reasons why they found it easier to increase their reserves from internally generated funds than did banks whose securities business is less significant. This "internal strengthening" of the capital base also occurred in the light of the capital standards which have to be calculated by internationally operating banks for the first time in 1989, in accordance with the capital recommendation of the Basle Committee on Banking Regulations and Supervisory Practices. An increase in banks' liable capital – if the capital ratio is to remain the same – will moreover be unavoidable once banks' off-balance-sheet swap and forward transactions are included in the foreseeable future in the Solvency Principles I and Ia pursuant to sections 10 and 11 of the Banking Act.

5. The capital market faced with unusual problems

(a) Radical structural shifts in the overall flow of funds

Setback in the domestic capital market

In 1988, after several years of strong growth, the capital market in Germany suffered a severe setback. Domestic and foreign investors' propensity to invest slackened unprecedentedly, both in the markets for domestic securities and in major areas of the "non-organised" capital market. On the other hand, record amounts of domestic funds flowed to non-residents or, as described above, were held in Germany in liquid forms.

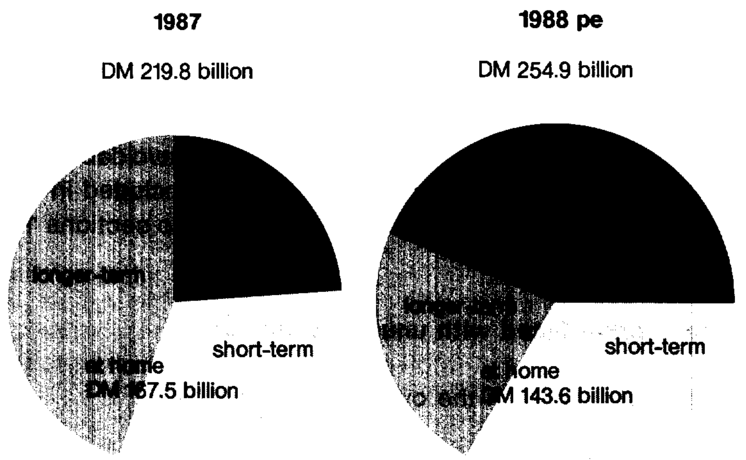
Uncertainties in the global economic environment and changes in tax conditions

This radical change in financial flows was sparked off by a number of factors. Firstly, changes in the global economic environment were detrimental to the financial markets in Germany. A sustained rise in interest rates in other major countries made Deutsche Mark assets appear more and more unattractive, especially as the Deutsche Mark was tending to be weak. Secondly, the announcement in Germany of a withholding tax on domestic interest income, which came as a surprise in many quarters, was felt by domestic and foreign investors to be a grave impairment of the tax conditions for investment in Germany. As early as the first few months of 1988, when it began to emerge that the stock market crash had been overcome faster and more easily than had generally been expected, the announced introduction of the withholding tax increasingly became the focus of market participants' attention. It was in fact not difficult to foresee what adverse market reactions this tax would lead to, at least in the case of foreign investors, after a measure which was in many respects the "converse", namely the abolition of "coupon tax" for non-residents, had made investments in German bonds more attractive, and thus had contributed to a lowering of interest rates, only a few years previously. Under the impact of the above-mentioned adverse changes in international interest rate, currency and tax differentials, non-residents' longer-term acquisition of financial assets in Germany fell by no less than DM 30 billion in 1988 to just under DM 10 billion. Such a low figure as this was not even recorded during the period of pronounced weakness of the Deutsche Mark at the beginning of the eighties.

Steep decline in the longer-term acquisition of financial assets in Germany

Domestic investors' reactions had no less marked an impact. Thus, the longer-term acquisition of financial assets by the domestic non-financial sectors (households, public sector and non-financial enterprises) shrank from DM 98 billion in 1987 to DM 59 billion last year, even though they expanded their overall acquisition of financial assets remarkably strongly – by DM 35 billion to DM 255 billion – at the same time. Barely one-quarter of this sum was accounted for by longer-term domestic financial assets. Their contribution to the inflow of longer-term financial resources would probably have been even lower if the contractual forms of saving in the context of saving with building

Acquisition of financial assets by the domestic non-financial sectors*



* Households, enterprises (incl. housing sector), government (incl. social security funds).- pe Partly estimated.

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Sharp expansion of financial assets abroad

Virtually as a mirror image of the weak trend in the longer-term acquisition of financial assets in Germany, domestic private investors and enterprises sharply expanded their longer-term financial assets abroad. Their holdings, which were already exceptionally high in 1987 by historical standards, at DM 43 billion, more than doubled in 1988 (DM 88 billion). This was equivalent to one-third of their overall acquisition of financial assets last year, compared with corresponding shares of about one-fifth in the three years from 1985 to 1987 and barely one-tenth at the beginning of the eighties.

Pronounced domestic accumulation of liquidity

At the same time domestic investors sharply increased their short-term domestic investments, including notably their liquid money holdings. Their holdings of liquidity were focused on monetary components that are exempt from withholding tax, such as, in particular, currency and sight deposits, and savings deposits at statutory notice (see p. 41 above). In 1988 short-term financial assets accounted for more than 40% of the overall acquisition of financial assets by the domestic non-financial sectors.

Preference for longer-term resources on the part of debtors

Viewed in themselves, the changes in the pattern of borrowing by the domestic non-financial sectors were much less spectacular. In the light of the relatively low level of capital market rates, they continued to show a distinct preference

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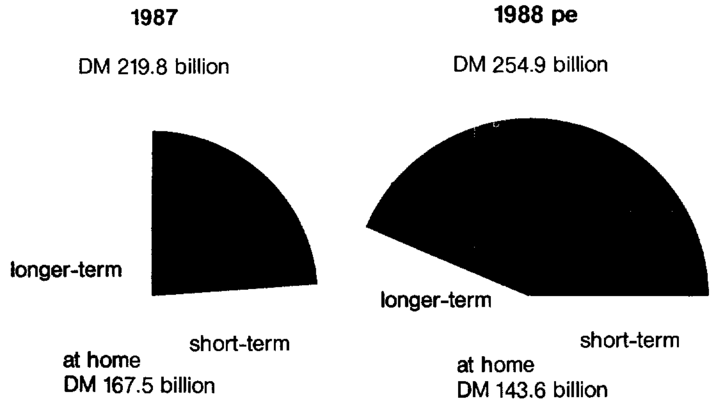
Acquisition of financial assets by the domestic non-financial sectors*



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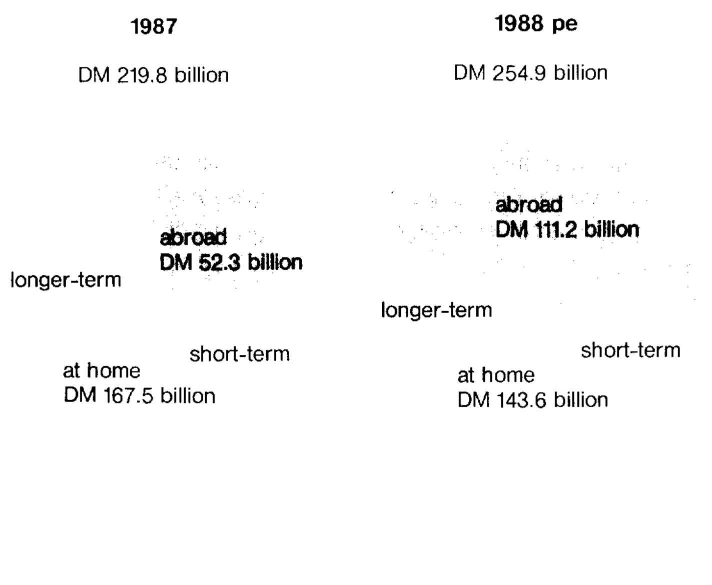

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for longer-term resources in 1988. However, the trend discernible in the preceding two years towards replacing previously raised short-term funds by long-term loans and new liable capital, and thus towards improving the capital structure, did not persist. For the rest, the large share of domestic financial resources in overall borrowing was rather conspicuous. This mirrored, among other things, non-residents' waning interest in investing in longer-term financial assets in Germany, as a result of which private and public borrowers were forced to rely more heavily on domestic sources of funds.

Extensive maturity transformation by the banks

The low and inadequate propensity to invest longer-term funds in Germany and the comparatively heavy domestic demand for longer-term resources confronted the German financial sector with unusual challenges in 1988. The challenge applied especially to the banks' willingness to engage in maturity transformation. For a long time the extreme fanning-out of the maturity pattern of interest rates from the short to the long end of the markets, as reflected in the steepness of the yield curve, provided a noticeable incentive. Given this interest rate pattern, the banks were able to employ the funds raised at low interest rates for longer-term lending and for securities purchases with attractive margins. In 1988 more than one-half of the longer-term borrowing in Germany of the domestic non-financial sectors was provided from shorter-term funds through the intermediation of banks. This may be seen, on the one hand, as impressive testimony of the German financial sector's efficiency and resilience. On the other hand, in the long run maturity transformation on this scale is not without its risks for the participating banks and thus also for the financial system as a whole, especially since banks' short-term funding costs have meanwhile risen much faster than long-term interest rates. Over the long term, at all events, banks cannot fill a gap of these dimensions left by the absence of propensity to invest at long term in Germany. Domestic and foreign investors' interest can probably only be regained by offering more attractive investment opportunities.

(b) Capital market rates under the impact of a wait-and-see attitude at home and fears of inflation world-wide

Stagnation of the downward trend in interest rates

In the course of last year interest rate movements reflected more and more strongly the unfavourable change in investors' behaviour and the extreme differences in conditions at the short and long ends of the German financial markets. To begin with, the transition to the stock market year 1988 proceeded in the bond market really auspiciously. The world-wide shifts from shares to bonds in the wake of the stock market crash of October 1987, and not least the accommodating monetary policy stance of the major central banks, had markedly stimulated the propensity to buy in the domestic and international bond markets towards the end of 1987. Until well into the early months of 1988, these favourable influences shaped developments in the German bond market. In the major financial centres abroad, however, renewed fears of inflation and the expectations of rising interest rates associated with those fears soon gained the upper hand again. This was not without an influence on the German market. In the light of the growing interest rate advantage of foreign markets and as the upward pressure on the Deutsche Mark was weakening, the interest rate reduction process increasingly met with resistance in the German capital market, too. The nosedive in long-term capital market rates, as measured by the yield on Federal bonds with a remaining period to maturity of more than 8 to 15 years, came to a temporary halt in March 1988, at just under 6¼%.

Inflexibility of interest rates at the long end of the market

Despite numerous "attempts", however, it had never proved possible – not even in the preceding three years – to go below the 6% mark in the long-term field for any length of time. That initially came as a surprise to some market watchers. In the first place, there has been no lack of liquidity-boosting and

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

Item	1986 DM billion	1986 Percentage of total	1987 DM billion	1987 Percentage of total	1988 pe DM billion	1988 pe Percentage of total	Memo item Change from the previous year DM billion 1987	Memo item Change from the previous year DM billion 1988 pe
Acquisition of financial assets								
Longer-term	125.3	58.3	141.4	64.3	147.0	57.7	16.1	5.6
at home	89.1	41.4	98.2	44.7	58.9	23.1	9.1	– 39.3
of which								
in bonds **1**	12.0	5.6	8.7	3.9	– 9.2	– 3.6	– 3.4	– 17.9
in shares	– 9.2	– 4.3	4.4	2.0	– 3.2	– 1.3	13.6	– 7.6
at banks **2**	34.4	16.0	32.3	14.7	7.6	3.0	– 2.1	– 24.7
at building and loan associations and insurance enterprises	34.6	16.1	33.0	15.0	40.2	15.8	– 1.6	7.2
abroad	36.2	16.8	43.2	19.7	88.1	34.6	7.0	44.9
of which								
in bonds	11.9	5.5	23.3	10.6	64.2	25.2	11.4	40.9
in shares	12.2	5.7	4.1	1.9	11.3	4.4	– 8.0	7.2
Short-term	89.8	41.8	78.4	35.7	107.9	42.3	– 11.4	29.5
at home	53.7	24.9	69.3	31.5	84.7	33.2	15.7	15.4
of which								
at banks **2, 3**	66.1	30.7	58.4	26.6	74.1	29.1	– 7.6	15.6
abroad	36.2	16.8	9.1	4.1	23.1	9.1	– 27.1	14.1
of which								
at banks	35.5	16.5	11.0	5.0	5.3	2.1	– 24.5	– 5.8
Total	215.2	100	219.8	100	254.9	100	4.7	35.0
Incurrence of liabilities and issue of shares								
Longer-term	162.1	111.0	174.3	111.4	165.9	87.0	12.2	– 8.4
at home	100.5	68.9	148.1	94.6	153.6	80.5	47.6	5.5
of which								
in bonds	9.7	6.6	27.5	17.6	31.1	16.3	17.9	3.6
in shares	– 2.7	– 1.9	10.5	6.7	2.0	1.1	13.2	– 8.5
at banks and other institutional investors	77.7	53.2	91.6	58.5	98.4	51.6	13.9	6.8
abroad	61.5	42.1	26.2	16.8	12.4	6.5	– 35.3	– 13.8
of which								
in bonds	48.3	33.1	33.2	21.2	15.1	7.9	– 15.1	– 18.1
in shares	15.2	10.4	– 1.5	– 1.0	3.3	1.7	– 16.7	4.8
Short-term	– 16.1	– 11.0	– 17.8	– 11.4	24.7	13.0	– 1.7	42.6
at home	– 1.2	– 0.8	– 19.3	– 12.3	16.2	8.5	– 18.1	35.5
of which								
at banks	– 0.2	– 0.1	– 16.0	– 10.2	15.9	8.3	– 15.8	31.9
abroad	– 14.9	– 10.2	1.5	0.9	8.6	4.5	16.4	7.1
of which								
at banks	– 11.7	– 8.0	– 0.9	– 0.6	– 0.1	– 0.1	10.8	0.8
Total	146.0	100	156.5	100	190.7	100	10.5	34.2

* Households, enterprises (including housing sector), government (including social security funds). — **1** Including bank bonds. — **2** Excluding bank bonds. — **3** Liquid financial assets including cash balances. — **pe** Partly estimated.
Discrepancies in the totals are due to rounding. BBk

accommodating measures on the part of the monetary policy makers in recent years. Thus, the Bundesbank reduced the short-term money market rates, which it controls, from about 4½% at the beginning of 1986 to approximately 3¼% in spring 1988, a very low level by historical standards. Secondly, after the successful stabilisation of prices in the mid-eighties, which was assisted by a fiscal policy geared to consolidation over the medium term and by a sustained appreciation of the Deutsche Mark, there was no acute concern about inflation in the German market for a fairly long while. If, nevertheless, the view gained ground among domestic investors and borrowers that the level of long-term interest rates prevailing from 1986 to the beginning of 1988 was exceptionally low and would probably not be durable, this assessment was substantiated by historical interest rate experience in Germany. In addition, there appeared to be some justification for the fears of those domestic financial asset holders who plan well ahead that the calm price climate, which was benefiting from special factors (such as the low level of commodity and energy prices), would not last, especially since the major central banks had tolerated a relatively strong expansion of the money stock for quite a long time. To this extent, some domestic market participants seemed to be prepared for a reversal in the interest rate trend as early as the start of 1988. This was reflected in an unusually steep yield curve in the bond market. As measured by the difference between the yields on Federal bonds with remaining periods to maturity of one and ten years, the rise in the yield curve reached a historical peak, at more than 3 percentage points, in spring 1988. In view of the existing interest rate uncertainty in the bond market, the announcement of the introduction of a withholding tax on domestic interest income and domestic and foreign investors' consequent reactions proved to be additional serious handicaps. Moreover, the German bond market was ultimately affected by the upsurge in interest rates in the international financial markets, even though the Bundesbank adhered to its accommodating monetary policy stance in the money market until the early summer.

Levelling-off of the yield curve after the tightening of monetary policy

In the early summer of 1988 the Bundesbank took account of the changed general economic and monetary situation by making an initial alteration to its monetary policy stance (see p. 33 above) and, starting at the short end of the market, initiated a gradual levelling-off of the yield curve. The progressive tightening of monetary policy in Germany and other major industrial countries probably led — at least in the first instance — to a relaxation of expectations about future price rises and increases in interest rates.

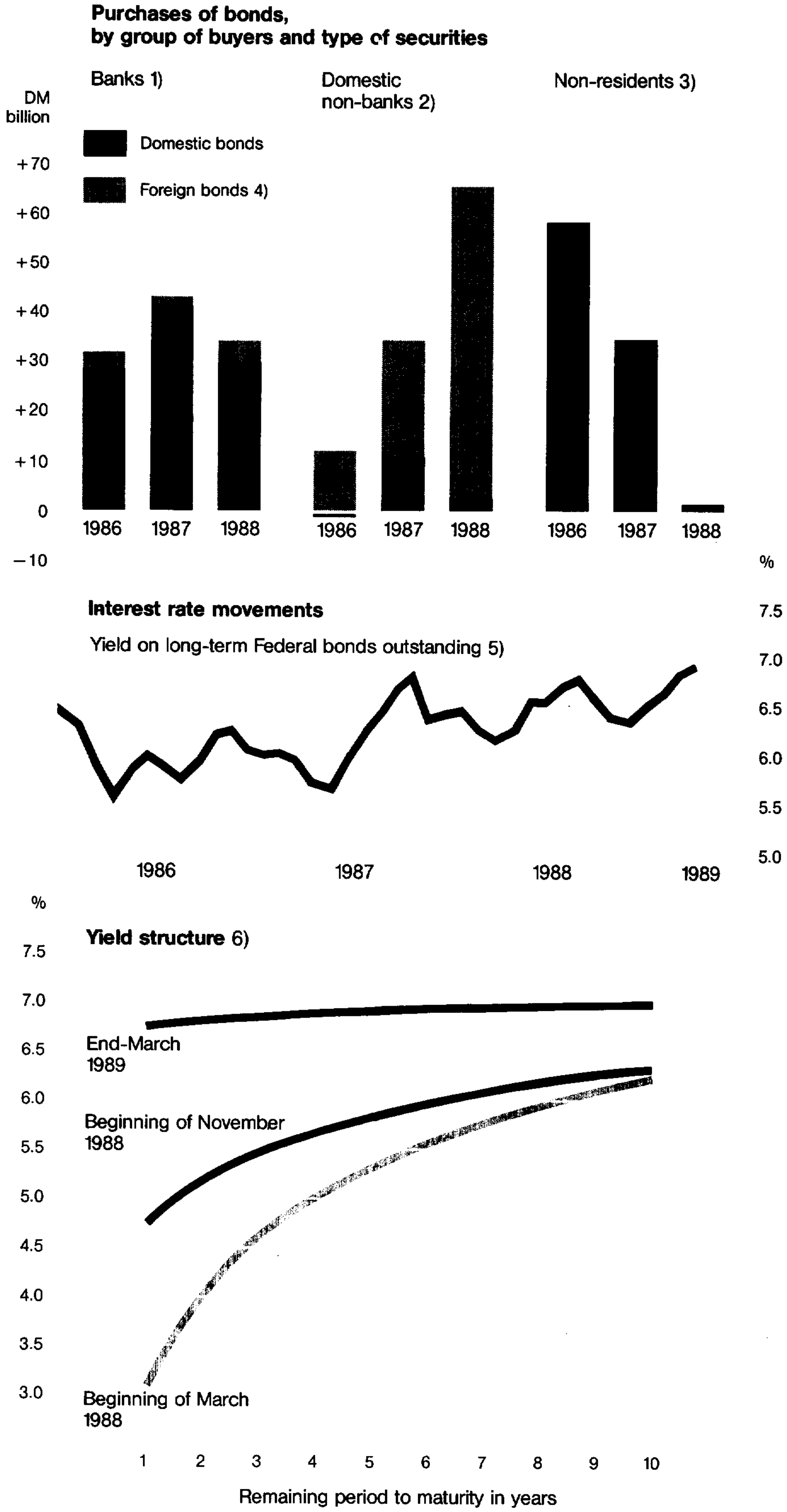
World-wide increase in interest rates towards the end of 1988

The subsequent process of calming-down in the capital market came to a standstill again at the end of October, however, and interest rate trends moved upwards once more world-wide. In some countries there were signs of monetary and general economic exaggerations which necessitated resolute monetary policy countermeasures. In the final two months of last year, though, the German market was hit once again by massive reactions to the withholding tax which came into effect at the beginning of 1989.

Unsettled start to 1989

Domestic investors' increased tendency to wait and see and non-residents' stagnating interest overshadowed the start to 1989, too, in the stock market. The interest rate rises continued beyond the turn of 1988-9. At the beginning of March yields at the long end of the market were just over 7%. The increase in interest rates was particularly pronounced at the short end, especially since the Bundesbank, like other central banks, progressively continued the monetary policy changes of stance which were started last summer. The yield curve in Germany has almost completely levelled off as a result of these further interest rate adjustments without there having been any strong increases at the long end of the market in this connection; at the end of March ten-year Federal bonds were yielding 7%, which was only a little more than similar paper with shorter remaining periods to maturity. Developments were similar in the markets of many other industrial countries. The flat and in some countries "inverse" yield curves (with higher interest rates for short-term assets than for long-term ones) reflect on the one hand the increasingly restrictive stance of monetary policy, which influences the short end of the market especially strongly. On the other hand, the remarkable "strength" of the interest rates for long-term assets can also be interpreted as a reflection of the fact that the

Trends in the bond market



1) Including the Bundesbank; book values.- 2) Residual.- 3) Net purchases of domestic bonds by non-residents; transaction values.- 4) Including foreign investment fund units.- 5) With remaining periods to maturity of 8 to 15 years; monthly averages.- 6) Regression lines for Federal bonds, adjusted for coupon effects.

BBk

markets appreciate central banks' efforts to achieve stabilisation and in the final analysis are counting on their being successful.

(c) Issuers under adjustment pressure

Sluggish issuing activity in the bond market

Investors' withdrawal from the German capital market had a distinct impact on last year's issuing activity. In 1988 overall borrowing in the bond market by domestic issuers declined by more than DM 50 billion to DM 35 billion. Within a single year, the financing volume from sales of domestic bonds dwindled to a level that has not been recorded since the seventies. The individual groups of investors were affected by this fall to very different degrees.

Slump in bank bonds

There was an especially dramatic decline in sales of the bonds of banks, which in 1988 for the first time effected more redemptions in a year than they received from new gross sales. In all their net repayments totalled DM 11 billion, after net borrowing amounting to DM 28.5 billion a year before. However, this affected the banks' opportunities for expanding lending business to a smaller extent than might be expected at first sight. Instead, structural shifts in the issuing institutions' borrowing and deposit business, such as had already been observed in earlier years, increased. In particular, at times of comparatively low capital market rates domestic institutional investors prefer investments in unlisted securities, because these are shown in the balance sheet unchanged at the nominal value — even in the event of rising interest rates and correspondingly falling stock market prices — and hence do not involve any risk of write-downs. Instead of the usual marketable bearer bonds, in 1988 the issuing institutions therefore often placed with this group of investors debt instruments that are made out in the buyer's name but are treated like bearer bonds as regards their cover. Last year banks raised almost DM 30 billion (net) in all through sales of registered bank bonds. They mainly consisted of registered mortgage bonds (DM 9.5 billion) and communal bonds (DM 18.5 billion).

Shift of emphasis in favour of Federal Government issues

The amount raised by bond issuers from the public sector also went down in 1988, viz. by the considerable sum of DM 13.5 billion, to a total of DM 46 billion (net). The Federal Government (the principal public issuer) was affected relatively little, however, by this decline. It probably benefited most from the fact that the slackening, albeit not completely disappearing, interest of major foreign investors in Deutsche Mark paper continued to focus on public sector bonds, including in particular issues by the "central government" (in Germany meaning the Federal Government). For the rest, issues by the Federal Government are of a special "quality" on account of their heavy turnover, which owes much to the preferential tax treatment of public bonds. For practical purposes, government issues are exempt from securities transfer tax, unlike bank bonds and industrial bonds, the turnover in which is subject to tax at the rates of 1‰ and 2.5‰, respectively. Especially at times of somewhat uncertain interest rate expectations, the prompt and low-cost realisability of this paper is a much-appreciated advantage. In 1988 almost the entire amount raised from sales of public bonds accrued to the Federal Government, at DM 43.5 billion. By contrast, the other issuers from the public sector had conspicuously little recourse to the German bond market.

Record sales of foreign bonds

The main beneficiaries of the changes in investors' behaviour after the announcement of the withholding tax were the markets for foreign issues. Last year domestic funds totalling DM 55 billion net flowed into foreign bonds; this is more than twice as much as in 1987, when the previous record was set up (at DM 25 billion). It was high-yielding foreign currency bonds that attracted the most interest (DM 42.5 billion). Under the impact of the strong demand, however, the foreign Deutsche Mark bond market also picked up markedly in

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

DM billion

Year	Sales, total	Sales of domestic bonds 1: Total	of which: Bank bonds	of which: Public bonds	Sales of foreign bonds 2	Sales of foreign investment fund units 2	**Memo item** Balance of transactions with non-residents 3
1984	86.7	71.1	34.6	36.7	15.7	– 0.1	– 1.8
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	113.4	88.2	28.4	59.8	24.8	0.4	+ 9.8
1988	102.9	35.1	–11.0	46.2	54.8	13.0	– 65.8
		Purchases by					
			domestic non-banks 5				
Year	Purchases, total	banks (incl. the Bundesbank) 4	Total	Domestic bonds	Foreign bonds	Foreign investment fund units	non-residents 2
1984	86.7	23.0	50.0	34.2	15.8	– 0.1	13.8
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	113.4	43.6	34.8	11.3	23.1	0.4	35.0
1988	102.9	34.6	66.3	2.9	51.1	12.3	2.1

* 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

1988. Raising more than DM 28.5 billion in this market segment, issuers set up a new record in this field, too, after sales in this sector had dropped to less than DM 9 billion (net) only a year before. As usual, the major part of the sales of foreign Deutsche Mark bonds were placed with foreign investors. However, with purchases totalling over DM 12 billion (compared with DM 3.5 billion in 1987) domestic sales of such paper, too, reached a record level. Among the issuers, a significant role was played by the subsidiaries of German banks, which took advantage in this way of the brisk demand for Deutsche Mark assets not subject to withholding tax. Depending on the market situation, the cost advantage of long-term borrowing in this sector over the domestic market ranged between ¼ and ½ percentage point.

Investment funds on the advance

The quick and flexible response of many investors to the changed economic and tax conditions, as observed, would presumably not have been possible without the growing enlistment of the services of professional asset managers. Thus, the funds of domestic investment companies which are open to the general public increased their sales in 1988 by DM 6 billion, to a total of more than DM 20 billion. The fund managements invested these resources in foreign markets; in addition, they switched out of parts of their domestic securities holdings and into foreign bonds. At the end of 1988 almost two-thirds of the assets of all bond-based funds were invested abroad, compared with a share of about two-fifths in each of the two preceding years. The success of foreign investment companies, which had been virtually insignificant in the German market before the announcement of the withholding tax in autumn 1987, was even more striking. In 1988 they registered receipts from Germany amounting to DM 13 billion (net). These were mainly purchases of the units of funds newly established by the subsidiaries of German banks domiciled abroad (especially in Luxembourg), which funds invest primarily in foreign bonds exempt from withholding tax.

Beginning of 1988 overshadowed by the stock market crash

1988 was a rather eventful year for the international share markets. The beginning of the year was still overshadowed by the stock market crash of October 1987, in the wake of which share prices in the United States and Japan fell by roughly one-quarter on average, and those in Germany and the United Kingdom by as much as about one-third. Developments in the German market at the beginning of the year were characterised by comparatively low turnovers, with pronounced short-term fluctuations in the price level and declining prices overall. The widespread uncertainty about further economic trends and enterprises' earnings prospects severely depressed sentiment durably, and kept share prices under pressure even after the acute phase of the stock market crisis had passed. From foreign investors' point of view, the bout of weakness of the US dollar which was evident after the stock market crash mainly impaired the earnings prospects of well-known German standard equities and thus again proved to be a particular handicap for the domestic share market. This may have been one of the reasons why the nosedive in share prices in Germany continued on a broad front beyond the turn of 1987-8, whereas in some other share markets upward price trends had already gained the upper hand again by that time. At the end of January 1988 German shares were being quoted on average 36 % below their level of mid-October 1987, on the eve of the global stock market crash. At that point they were at the same time no less than 46 % below their level of April 1986, when the peak of a bull market which had lasted for several years was reached.

Strong recovery in prices in the wake of the surprisingly robust economic upswing

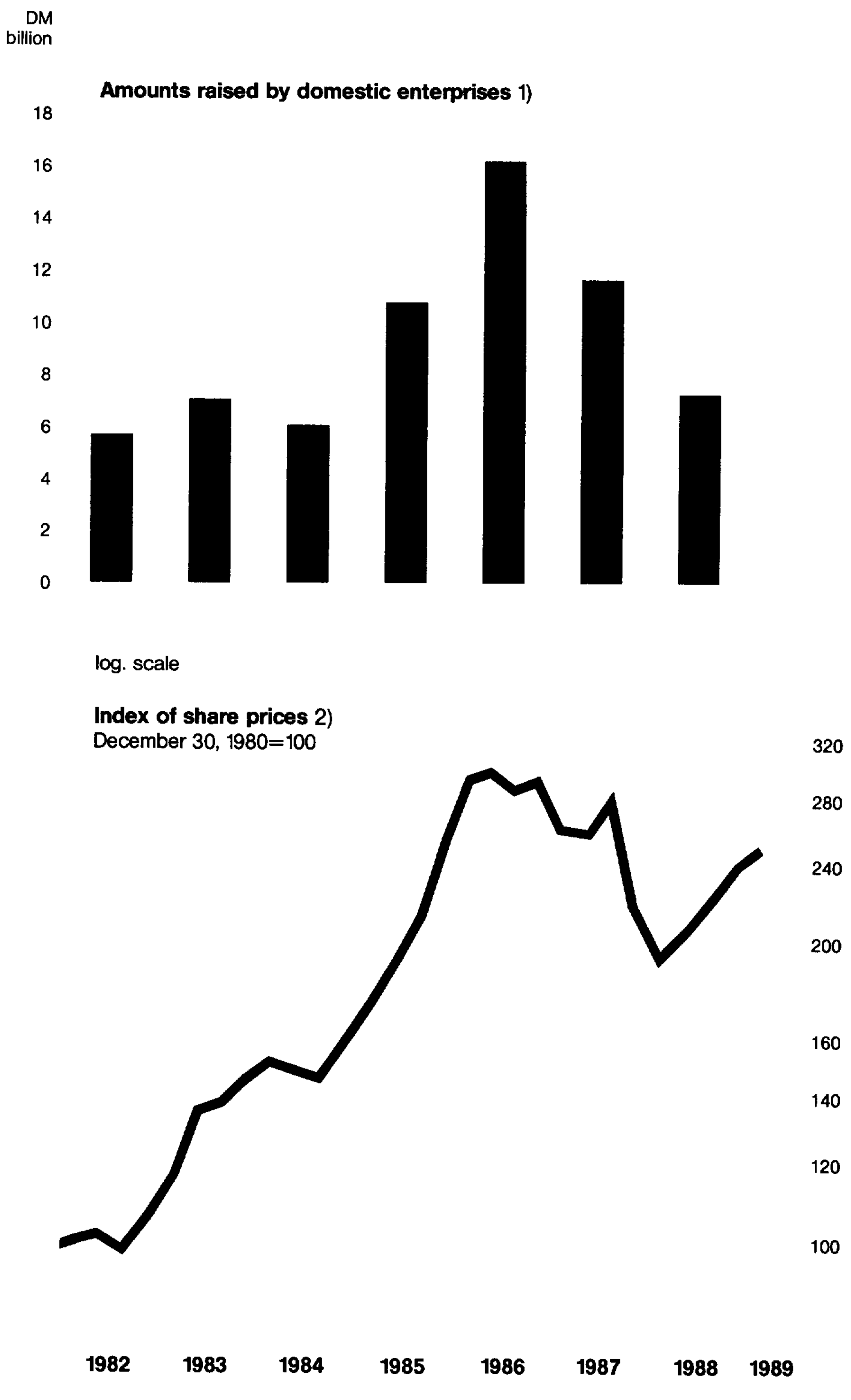
In an initial analysis of the possible consequences of the massive slump in share prices, the Bundesbank came to the conclusion in December 1987 that serious repercussions on consumption and investment behaviour in Germany were hardly to be feared.[1] This optimistic appraisal was exceeded, if anything, in the first few months of 1988 by a world-wide change for the better in general economic conditions and the subsequent recovery in the share markets. Unexpectedly favourable economic trends, the initially easy price climate, comparatively low interest rates and the gradual calming of the foreign exchange markets resulted in a change of mood in the German share market at the beginning of February 1988. The upward trend, which was hesitant at first, continued on a broad front as the year progressed. Short periods of consolidation, connected with the interest rate and exchange rate disturbances which flared up at times, failed to impair durably the strong recovery in prices in the German share market, especially since the pronounced economic momentum emerged more and more clearly in the course of last year. At the end of 1988 share prices were on average almost 40 % above their nadir at the end of January. Just over a year after the stock market crash, the German share market had thus almost completely made good the massive price falls. In the first few weeks of 1989, too, the price trend continued to point upwards. Only recently has the market tended to be somewhat weaker again. At the end of March 1989 German share prices were again running at about the same level as at the beginning of this year.

Differing price trends in the individual sectors

In the individual economic sectors, characteristic special movements were registered in 1988. Measured by the indices of the Federal Statistical Office, the sectors whose share prices had been particularly under pressure in 1987 were in the leading group of price gainers last year. This is especially true of the shares of the construction industry, which suffered relatively the largest price losses in 1987 (at an average of 53 %). After years of stagnation, the construction sector benefited particularly last year from the fact that – as the

1 See Monthly Report of the Deutsche Bundesbank, Vol. 39, No. 12, December 1987, p. 20.

Trends in the share market



1) Sales of new domestic shares at issue prices.- 2) Quarterly averages; source: Federal Statistical Office.

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utilisation of available production capacity was increasing – enterprises invested substantial sums in enlarging their plants, including a considerable construction component. Residential construction, too, picked up markedly. Buttressed by the favourable trend in construction activity, construction shares rose by an average of 71 % last year. In 1988 the shares of firms in the iron and steel industry, however, went up by as much as 88 %, after having fallen by 28 % a year before. This sector, which is sensitive to changes in business activity and is being shaken by structural crises, profited above all from a strong increase in the demand for steel, due partly to general economic factors and partly to movements in the stock cycle. Shares of mechanical engineering enterprises, which are faced with fierce international competition, also held up exceptionally well. The strong inflow of domestic and foreign orders was reflected in distinctly higher earnings on the part of many mechanical engineering firms, which investors took into account by paying premiums averaging 49% on share prices. In 1988 the shares of public utilities and of consumption-related sectors fell distinctly short of the general trend. In the previous year, admittedly, they had reported only comparatively small price losses.

Borrowing on the decrease

The standing of the share as a financing instrument has diminished perceptibly since the stock market crash – despite the above-mentioned tendencies towards recovery in the share market. At DM 7.5 billion (market value), the amount raised from sales of new shares in 1988 was well below the large sums of the mid-eighties, when enterprises took advantage of the favourable price level to strengthen their capital base appreciably. But the greater restraint shown in raising liable capital in the market was also a reflection of enterprises' favourable profitability, which made growing internal financing possible. Thus, since 1981 producing enterprises' self-financing ratio has risen from 72½% to 95½% in 1988. Despite the price reversal in autumn 1987 and the subsequent break of about six months in issuing, in 1988 14 enterprises in all were newly listed on the stock exchange, 11 of them in the newly created Regulated Market. Enterprises are thus apparently well aware of the advantages of "going public". Last year, however, some listings were deleted too, so that the number of domestic public limited companies quoted on German stock exchanges declined from 507 at the beginning of 1988 to 503 at the end of the year. From the point of view of competition and regulatory policy it remains desirable for as many enterprises as possible to apply for listing on a stock exchange. This not only guarantees the regular monitoring of performance by the market and thus behaviour which is in line with market conditions; it also permits at the same time a wider spreading of overall productive assets and thus fosters their anchoring and acceptance in society. In this connection it is to be welcomed if the Government as a shareholder increasingly withdraws from those sectors of the economy which do not need special governmental influence. In 1988 government-owned shares amounting to more than DM 2 billion (market value) were placed in the market, which further consolidated the basis of the share market from this angle, too.

(e) Future outlook for the German securities markets

Financial centre Germany subject to fierce international competition

With regard to the international competitiveness of the financial centre Germany, the stock market year 1988, viewed as a whole, must be appraised critically, if anything. In comparison with major financial centres abroad, domestic securities markets – despite the considerable breadth and depth of the bond market – display weaknesses in their tax, organisational and legal/institutional structure which put them at a disadvantage when competing with major foreign financial centres.

Structural dislocations due to tax burdens

The announcement and introduction of the withholding tax on domestic interest income and the consequences thereof constitute a striking example of this. The decline of over one-half in borrowing in the domestic bond market and the soaring of the outstanding amount of foreign Deutsche Mark bonds exempt from withholding tax in 1988 must be considered grave setbacks for the market in domestic bonds. Against this background it seems to be imperative to put an end to the markets' uncertainty deriving from the discussions in the EC area about a possible reorganisation as well as from proposals to increase the rate of withholding tax applying in Germany. In addition, the still existing securities transfer tax has prevented the establishment of a market for money-market-related Deutsche Mark securities in Germany and encouraged the switching of secondary trading in Deutsche Mark paper to foreign stock market centres. Another reason why the existence of this tax is problematic is that it one-sidedly favours public sector bonds, which are issued in the form of value-rights and hence are exempt from securities transfer tax. Furthermore, a considerable amount of these securities are traded outside the stock exchange. Following the introduction of consecutive trading in a limited number of Federal bonds last autumn, there does not appear to have been any fundamental change in the great significance of off-the-floor trading. The tight time limits to stock exchange dealing in Germany may have played a role here. However, transaction costs on the German stock exchanges still seem to be comparatively high, although the turnover in public sector securities, which are traded especially actively, is often in large lots. For the sake of the highest possible transparency of the market, it would be desirable for a large part of securities trading to be effected through the stock exchange.

Administrative impediments

Administrative impediments are probably among the reasons why the external financing of industrial enterprises in the domestic bond market has been virtually negligible for a fairly long time. The issue authorisation procedure under sections 795 and 808a of the Civil Code – which the Federal Government no longer wishes to preserve in its present form and which can hardly be justified any more by reference to the protection of investors – together with other factors (such as, in particular, tax considerations) has resulted in German industrial enterprises virtually ceasing to figure as issuers in the domestic bond market and, instead, preferring to issue foreign Deutsche Mark bonds, which are not subject to such authorisation, indirectly through financing companies domiciled abroad. The exemption of these issues from the newly introduced withholding tax actually increased the inducement to act in this way because, since that time, the interest cost of foreign Deutsche Mark bonds has from the outset been lower than that of domestic issues. A revival of issuing and trading activity in the market segments which have so far been neglected or unattractive will be possible only if established administrative impediments are rapidly dismantled and the fiscal burdens on stock exchange transactions are reduced to a level that has no impact on competitive conditions.

Paving the way for the future

Despite the above-mentioned setbacks and impediments, it should not be forgotten that a number of forward-looking developments have recently been initiated in the German securities market. These include in particular the establishment of a German financial futures exchange, which is due to start operation at the beginning of 1990. Thus, in future it will be possible in the "home port" of the Deutsche Mark, too, to hedge at low cost exchange risks arising from commitments in Deutsche Mark securities. Parliament will have to take all the necessary legislative measures to ensure an early and successful start for this market. Further urgent steps towards an up-to-date, transparent and low-cost stock market are under discussion. These efforts should not be impeded by particularist interests. With all the efforts to bring about legislative and organisational improvements, it must not be forgotten that the international attractiveness and competitiveness of the financial centre Germany are ultimately rooted in the stability of the Deutsche Mark and the soundness of the German financial system. At the same time, this implies a constant challenge to those responsible for monetary policy and financial supervision to continue to ensure stable underlying monetary and financial conditions in the domestic capital market and, in the process, to examine from case to case how far innovations in the financial sector meet these overall economic requirements.

III. International monetary developments and policy

1. Exchange rates and exchange rate policy

Recovery of the US dollar

In 1988 the movement of the exchange rates of the major currencies was primarily characterised by the recovery of the US dollar. Relative to the pattern of exchange rates ruling at the end of 1987, by the end of March 1989 the dollar had risen by 8% on average against the currencies of 18 other industrial countries, according to the method of calculation used by the Bundesbank. However, its movements against individual currencies and over the course of the year varied widely. The dollar strengthened by between 19% and 21% against the currencies participating in the exchange rate mechanism of the European Monetary System and appreciated even more strongly (by 29%) against the Swiss franc. The dollar rose by only 11% against the pound sterling and 8% against the yen and actually fell by 8% against the Canadian dollar.

Dollar also benefits from interest rate levels and expectations

The recovery of the dollar in the foreign exchange markets peaked in August 1988. Until then the US currency benefited from marked progress in reducing the US trade deficit. Moreover, as a result of higher interest rates in the United States, the dollar profited from an increasing interest rate advantage over the yen and, with a buoyant state of economic activity in the United States and a gradual increase in inflationary tensions, dollar interest rates were expected to go up. However, the dollar weakened again slightly in autumn 1988, owing partly to the fact that the improvement in the foreign trade position of the United States stalled, inter alia because of the preceding, at times considerable, appreciation of the US currency. The renewed strengthening of the dollar as from December 1988 was mainly due to the continued economic growth in the United States.

Appreciable success of concerted exchange market operations

Cooperation among monetary authorities in the field of foreign exchange policy contributed to the avoidance of exaggerated movements in the dollar rate in 1988. For instance, large-scale purchases of dollars at the beginning of 1988 (carried out on a coordinated basis among the major central banks) helped the US currency to recover. Conversely, considerable dollar sales were undertaken in the summer in order to slow down an excessive strengthening of the dollar that was inhibiting the necessary adjustment in the global pattern of current account positions. Internationally coordinated dollar sales at the end of 1988 and the beginning of 1989, too, served to dampen the renewed rise in the dollar. Taking the year 1988 as a whole, however, central banks' sales and purchases in the dollar market practically cancelled out, as was also the case with their other transactions in dollars, whereas in 1987 official entities had acquired large amounts of dollars on balance and, in the absence of net inflows of private capital to the United States, had ultimately "financed" the US current account deficit.

Limited recovery of the dollar in line with international agreements

After the heavy exchange rate losses sustained in 1987, a limited recovery of the dollar was in line with international agreements. The "Louvre accord" of February 1987, in view of the economic policy commitments contained in it, was aimed at stabilising exchange rates between major currencies around the levels they had reached at that time. As a matter of fact, the present exchange rate of the dollar against the Deutsche Mark does not deviate substantially from that level. By contrast, the rate of the dollar in terms of the yen is distinctly lower than its "Louvre level", but this is probably quite appropriate in the light of the level of Japan's surpluses on current account, which largely stem from trade with the United States. An important objective behind the agreements reached among the major industrial countries is to make progress in the necessary reduction of global external imbalances.

Weighted external value of the yen virtually unchanged

The comparatively small rise in the dollar against the yen since the end of 1987 resulted in the Japanese currency appreciating against most other currencies together with the dollar. Thus, its weighted external value remained virtually unchanged between the end of 1987 and the end of March 1989, in spite of the yen's decline against the dollar, whereas the Deutsche Mark depreciated by 5% on average over the same period.

Canadian dollar in the forefront of the currencies that have appreciated since end-1987

The Canadian dollar, which appreciated against the US dollar, rose all the more strongly against all other currencies. Up to the end of March 1989 its weighted external value therefore increased by 13%. The Canadian currency benefited above all from a level of interest rates that has for a long time been considerably higher than that in the United States. These high interest rates are a reflection of budgetary problems as well as of the strong rise in economic activity in Canada and the efforts of the monetary authorities to achieve price stability over the medium term. Confidence in the Canadian currency was also strengthened by the circumstance that Canada's current account, though in deficit, did not deteriorate any further, at least for the time being. The strong cyclical increase in imports was accompanied by a boom in passenger car exports to the United States and a considerably higher level of exports of raw materials, coupled with rising prices for them.

Exchange rate stability within the EMS helped by the recovery of the dollar

The recovery of the dollar facilitated the cohesion of the currencies participating in the exchange rate mechanism of the EMS. However, the better internal harmony among the EMS currencies is also a consequence of economic and monetary policies being geared more strongly than in the past to domestic stability. At the same time, distinctly higher interest rates in comparison with those for Deutsche Mark assets have assisted in stabilising the existing pattern of exchange rates. They will be necessary, despite all the progress made on the way to stability, as long as the individual currencies continue to be rated differently by market participants as a result of experience to the contrary gained over many years.

Basle-Nyborg agreement successful

Moreover, in order to avoid temporary tensions within the EMS as far as possible, the monetary policy instruments of the EMS member central banks were employed in a flexible manner, and greater use than before was made of the scope for exchange rates to move within the fluctuation margins. As was intended under the Basle-Nyborg agreement of September 1987, this resulted in speculation on exchange rate realignments becoming more risky. In contrast, a comparatively minor role was played by intramarginal interventions; our partners undertook such operations chiefly in order to bolster their Deutsche Mark reserves and to settle liabilities arising from earlier interventions. However, central banks' willingness to cooperate in the fields of monetary and foreign exchange policy needs to be effectively supported by financial and economic policy measures if the success achieved in terms of stabilisation is to be durable.

Strong rise in pound sterling and peseta

Among the EC currencies that have not hitherto participated in the EMS exchange rate mechanism for various reasons, there was very strong movement in the rates of the pound sterling and the Spanish peseta, in particular, in the course of last year. From the end of 1987 to the end of March 1989 the pound sterling rose against the Deutsche Mark by 8%, and hence to a similarly marked extent against the other currencies participating in the exchange rate mechanism. Since prices and costs in the United Kingdom went up relatively strongly over the same period, the pound sterling appreciated even more in real terms, which in turn probably contributed to the considerable shift into deficit of the current account position of the United Kingdom. The rise in the rate for sterling was essentially due to the high level of UK interest rates, which constitutes part of the endeavours to combat inflation. The rise in the rate of the Spanish peseta against the Deutsche Mark was similarly strong and was attributable to much the same reasons.

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	Obligatory	Intra-marginal	Total	**Memo item** Affecting liquidity in Germany **1**
A. By calendar years				
1987 Purchases	–	–48.1	–48.1	– 7.3
Sales	+15.0	+62.7	+77.7	+25.4
Balance	+15.0	+14.6	+29.7	+18.1
1988 Purchases	–	–28.2	–28.2	– 6.1
Sales	–	+16.8	+16.8	–
Balance	–	–11.4	–11.4	– 6.1
B. By selected periods; net				
October 15, 1987 to January 14, 1988				
Dollar under marked downward pressure; Deutsche Mark strong within the EMS	–	+21.5	+21.5	+10.0
January 15, 1988 to March 8, 1988				
Recovery of the dollar; easing of tensions within the EMS	–	– 9.9	– 9.9	– 6.1
March 9, 1988 to May 12, 1988				
Further slight strengthening of the dollar; weakening of some partner currencies within the EMS	–	+ 6.1	+ 6.1	–
May 13, 1988 to August 23, 1988				
Sharp rise in the dollar; easing of tensions within the EMS	–	–11.7	–11.7	–
August 24, 1988 to December 19, 1988				
Dollar weaker again; some EMS currencies repeatedly under downward pressure	–	+ 4.5	+ 4.5	–
December 20, 1988 to end-March 1989				
Renewed recovery of the dollar; weakening of the Danish krone	+ 1.7	–10.8	– 9.1	+ 0.2

* 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. — **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. Discrepancies in the totals are due to rounding. BBk

Full participation of the United Kingdom in the EMS still a controversial issue

In the case of the countries which joined the EC last, there is general agreement that there is still a considerable need for them to adjust in both domestic and external terms before the participation of their currencies in the EMS exchange rate mechanism can be contemplated. With reference in particular to recent experience, the full participation of the United Kingdom in the EMS, too, continues to be described as premature and problematical by official UK sources. This belief contrasts, however, with the view that UK participation in the exchange rate mechanism would have helped to strengthen the stability policy pursued.

2. The development of global monetary reserves

Further rise in global monetary reserves

The tendency for global monetary reserves to rise continued in 1988, albeit at a distinctly slower pace. A special role was played in this process by reserve assets other than the US dollar, also owing to diversification operations. Expressed in terms of the dollar, global monetary reserves went up in 1987 by US$ 206 billion, i.e. more strongly than ever before in a single year; in 1988, according to IMF statistics, they increased by only US$ 12 billion. At approximately US$ 770 billion, global holdings of monetary reserves at the end of 1988 were almost twice as large as they had been at the end of 1982. They were accompanied, of course, by liabilities of a number of monetary authorities whose currencies are held as reserves by other countries. However, the increases in global monetary reserves, expressed in terms of the dollar, were considerably distorted in both years by exchange rate effects. The countervalue in dollars of reserve holdings not denominated in the US currency rose distinctly in 1987 owing to the depreciation of the dollar in the foreign exchange markets, and declined in 1988 as a result of the appreciation of the dollar. After eliminating these exchange-rate-induced fluctuations in holdings of global monetary reserves, there was still a rise of as much as US$ 152 billion, or 28 %, in 1987 and an increase of US$ 39 billion, or 5 %, in 1988. Thus, taking both years together, the adjusted increase in global monetary reserves was about twice as large as the corresponding rise in world trade in real terms.

Strongest rise registered in Deutsche Mark reserves

Over four-fifths of the exchange-rate-adjusted increase in global monetary reserves last year was accounted for by a rise in the statistically recorded Deutsche Mark balances of central banks and other foreign monetary authorities. In 1988 their reserves held in the form of Deutsche Mark went up by DM 54 billion to the record level of DM 192 billion. Both the monetary authorities of the United States and European countries purchased considerable amounts of Deutsche Mark in the market, partly against US dollars and partly against other currencies. In doing so, they wished to counteract the appreciation of their currencies against the Deutsche Mark and also to strengthen their Deutsche Mark reserves. A comparatively minor role was played in this process by Deutsche Mark purchases by partner central banks participating in the EMS exchange rate mechanism. Although other EMS member states purchased an amount of over DM 11 billion net in 1988 through intramarginal interventions, over half of this sum was utilised to settle remaining liabilities with the Bundesbank resulting from interventions. In particular, a number of developing countries greatly built up their official Deutsche Mark holdings. As a result of the considerable overall increase in reserve holdings of Deutsche Mark, their share in global foreign exchange reserves rose further to some 17 %. In this calculation, the large quantities of dollars held by EMS countries that were contributed to the EMCF against the creation of official ECU balances have been added to global foreign exchange reserves.

Increase also in reserves held in yen, pounds sterling and "private" ECUs

There was also a distinct increase in 1988 in monetary reserves held in yen and pounds sterling, although this rise was far less than that for Deutsche Mark. Official holdings in yen and pounds sterling went up by the countervalue of together approximately US$ 10 billion. As a result, their shares in global foreign exchange reserves rose slightly to 8 % and 3 %, respectively. Moreover, many monetary authorities in Europe considerably enlarged their investments in "private" ECUs (which are not recorded separately in the IMF statistics) by US$ 9 billion to over US$ 13 billion, although this corresponds to a share of only 2 % in global monetary reserves. These shifts were primarily at the expense of the dollar. Transactions of this nature can foster endeavours to achieve greater exchange rate stability if they help to balance the market, as was the case in 1988, when the dollar was generally stronger. On the other hand, diversification operations are inappropriate if they strengthen undesirable developments in the market and impair the effect of exchange rate policy measures taken by other countries, particularly exchange market interventions.

Stagnation in the dollar reserves

In comparison with the increase in investments in Deutsche Mark, yen, pounds sterling and "private" ECUs, there was only a small rise in statistically recorded official dollar balances, including the holdings contributed to the EMCF. Their growth was slowed down in particular by the large-scale dollar sales through which the central banks of Europe above all counteracted the appreciation of the US currency, in part through concerted operations. In addition, a role was played by the diversification operations mentioned above, as well as by purchases of gold in the market by Taiwan; the monetary authorities of Taiwan used about US$ 2.5 billion from their dollar reserves for this purpose. As a result, the share of the dollar in global foreign exchange reserves declined

Components of global monetary reserves*

US$ billion

Type of reserves	Level at end of year		Change					
			due to transactions 1		due to valuation adjustments 2		Total	
	1986	1988 **p**	1987	1988 **p**	1987	1988 **p**	1987	1988 **p**
Gold **3**	40.1	39.9	− 0.2	+ 0.0	−	−	− 0.2	+ 0.0
Special drawing rights	23.8	27.1	+ 0.9	− 0.1	+ 3.9	− 1.5	+ 4.8	− 1.5
Reserve positions in the IMF	43.2	38.0	− 5.1	− 4.4	+ 6.5	− 2.2	+ 1.4	− 6.6
Official ECU balances	48.7	62.4	+ 11.2	− 3.3	+ 12.8	− 7.0	+ 24.0	− 10.4
− against gold	33.9	39.8	+ 0.1	+ 0.2	+ 12.4	− 6.8	+ 12.5	− 6.6
− against US dollars	14.3	22.6	+ 7.6	+ 0.7	−	−	+ 7.6	+ 0.7
− arising from very short-term financing	0.5	−	+ 3.5	− 4.2	+ 0.5	− 0.2	+ 3.9	− 4.4
Foreign exchange	396.4	603.2	+ 145.2	+ 47.0	+ 30.7	− 16.1	+ 175.9	+ 30.9
US dollars	269.7	379.0	+ 107.4	+ 1.9	−	−	+ 107.4	+ 1.9
Deutsche Mark	55.2	107.8	+ 17.6	+ 32.0	+ 14.5	− 11.5	+ 32.1	+ 20.5
Yen	28.4	46.7	+ 5.1	+ 4.8	+ 9.5	− 1.1	+ 14.6	+ 3.7
Pounds sterling	10.6	19.5	+ 1.0	+ 5.5	+ 3.0	− 0.6	+ 4.0	+ 4.9
French francs	4.4	9.1	− 0.0	+ 4.7	+ 0.9	− 0.9	+ 0.9	+ 3.8
Swiss francs	7.1	8.2	− 0.5	+ 1.2	+ 1.8	− 1.4	+ 1.3	− 0.2
Dutch guilders	4.1	6.0	+ 0.8	+ 0.7	+ 1.1	− 0.7	+ 1.9	+ 0.0
Unidentified assets	16.9	26.9	+ 13.8	− 3.8	−	−	+ 13.8	− 3.8
Total reserves	552.2	770.6	+ 152.0	+ 39.2	+ 53.9	− 26.8	+ 206.0	+ 12.3

* 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. 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 on a dollar basis 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. — **3** Valued at US$ 42.22 per ounce of fine gold. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Sources: IMF, EMCF and Committee of EC Central Bank Governors. BBk

further to 64%. A dampening effect on the growth of global monetary reserves was also exercised by the above-mentioned debt repayments by our partner central banks within the EMS and by net redemptions of IMF credits, as a result of which the reserve positions of the countries whose currencies had been used for lending declined again.

Widely varying developments in the reserves of major industrial countries

Movements in monetary reserves varied widely among individual countries, especially within the group comprising the industrial countries. Valued at current exchange rates, there was a further strong increase of US$ 16 billion in Japan's reserve holdings. Operations to support the dollar as well as sizeable interest receipts deriving from investments of reserve assets contributed materially to this rise. The reserve holdings of Canada, Spain, Australia and Italy also grew considerably, viz. by US$ 23 billion in all. By contrast, the increasing sales of dollars by the Bundesbank led to a reduction of US$ 20 billion in its gross monetary reserves, which — according to the IMF definition — include the ECU balances valued on the basis of the current gold price. If the decline due to valuation adjustments in the ECU balances created against the contribution of gold to the EMCF is eliminated, Germany's gross reserves fell by US$ 18 billion; on this basis, with a simultaneous rise in the liabilities to foreign monetary authorities, Germany's net reserve position dropped by about US$ 20 billion (after increasing by US$ 22 billion in 1987). The reserve holdings of France also went down (by US$ 8 billion). As regards the developing countries, the increase of US$ 9 billion in South Korea's monetary reserves is particularly striking, reflecting this country's strong current account position. By contrast, Mexico's reserves decreased by US$ 7 billion owing to the fall in the world market prices of crude oil in the second half of 1988 and the surge in imports in the wake of marked reductions in Mexico's customs duties. Taiwan's reserve holdings, which had risen by over US$ 30 billion in 1987, also fell

Regional distribution of global monetary reserves*

US$ billion

Country/Group of countries	Level at end of year 1986	1988 p	Change 1987	1988 p
A. Industrial countries 1				
United States	48.5	47.8	− 2.7	+ 2.0
Japan	43.3	97.8	+ 38.7	+ 15.8
Canada	4.1	16.0	+ 4.0	+ 8.0
Germany	55.8	62.5	+ 27.0	− 20.2
France	34.9	28.8	+ 1.6	− 7.7
United Kingdom	19.2	44.9	+ 23.3	+ 2.4
Italy	22.8	37.5	+ 10.2	+ 4.5
Other industrial countries	109.0	163.7	+ 47.4	+ 7.3
Total	337.6	499.1	+ 149.5	+ 12.0
B. Developing countries				
Africa	9.1	10.3	+ 1.5	− 0.3
Europe	13.7	21.7	+ 2.7	+ 5.3
Latin America	33.8	32.9	+ 4.6	− 5.5
Middle East **2**	58.6	55.2	+ 6.1	− 9.5
Rest of Asia	99.4	151.4	+ 41.7	+ 10.3
of which				
Taiwan	46.5	74.6	+ 30.5	− 2.5
Memorandum item				
15 major debtor countries **3**	34.4	31.5	+ 3.9	− 6.9
Total	214.6	271.5	+ 56.6	+ 0.3
C. All countries (A plus B)	552.2	770.6	+ 206.0	+ 12.3
Memorandum items				
Total reserves, excluding ECU balances created against the contribution of gold **4**	521.9	734.7	+ 193.7	+ 19.1
of which				
All industrial countries	307.6	465.1	+ 137.2	+ 20.3
Germany	47.4	53.5	+ 24.0	− 17.9
France	27.7	21.0	− 1.0	− 5.7
United Kingdom	17.6	43.1	+ 22.7	+ 2.8
Italy	17.0	31.2	+ 8.1	+ 6.1

* Gross monetary reserves of all IMF member countries plus Switzerland and Taiwan. The gold has been valued at US$ 42.22 per ounce. — **1** OECD countries excluding Greece, Portugal and Turkey. — **2** Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates, Yemen, People's Republic of Yemen. — **3** Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia. — **4** The gold underlying the ECU balances has been included in the other gold holdings again. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Sources: IMF and EMCF. BBk

slightly last year, reflecting a distinct reduction in its current account surplus and a relaxation of its controls on capital exports.

Expansionary influence on reserve supply owing to multiple reserve holdings

The development of global monetary reserves in 1988 implies that the trend towards multiple reserve holdings that has been apparent for a number of years, as compared with the earlier reserve policy of most countries, which was geared very strongly to the US dollar, may have considerable expansionary effects on the longer-term supply of global reserves. Formerly, when periods of weakness in the dollar were followed by periods of strength, it was safe to assume that an excessive increase in monetary reserves would be corrected again. Accordingly, it would have been quite desirable if, in the wake of the explosive increase in global monetary reserves in 1987 due to the pressure on the dollar at the time, the subsequent recovery of the dollar had acted as a corrective. While the sales of dollars by the Bundesbank were consistent with this, other countries purchased Deutsche Mark and other reserve assets at the same time. This helped to counteract undesirable exchange rate developments, but ultimately led to a further increase in global monetary reserves.

3. International financial markets

Vigorous pace of international lending

In 1988 the international financial markets showed themselves to be in a better state than could have been expected after the turmoil at the end of 1987. Although developments at the beginning of 1988 were marked by uncertainties and restraint, the markets returned to a vigorous pace of activity as the year progressed. At approximately US$ 450 billion, the gross volume of international bond issues, newly granted Euro-note facilities and international syndicated credits was in the end 15% higher than in 1987. By providing the banks with ample liquidity and reducing their interest rates from the end of 1987 onwards, the central banks countered the dangers that could have arisen from the drop in prices in the share markets, both for the banking and financial system and for economic developments. When it became apparent that the economic upswing was continuing at an unabated pace, however, the major countries returned to a less expansionary monetary policy stance. The monetary authorities thus made it quite plain that they were determined to resist new inflationary tendencies. This restored the confidence of the international financial markets in a generally satisfactory course of economic activity.

Strong rise in issuing business

The international bond markets, in particular, benefited from this recovery of confidence. After the gross volume of issues had declined considerably in 1987, it rose by approximately one-quarter to US$ 227 billion (in the definition used by the OECD) in 1988, thus running at about the record level of 1986. The market for fixed interest dollar bonds grew to an above-average extent. In 1987 this sector had been particularly hard hit by uncertainties surrounding exchange rates and interest rates. Floating-rate notes also met with rather more interest again; however, their share in the aggregate volume of issues remained slight. This reflected the dampening effect of the growing competition from short and medium-term Euro-notes and from the possibilities of conducting swap transactions between fixed interest and floating-rate financing facilities.

Renewed advance of the Deutsche Mark among the currencies of issue

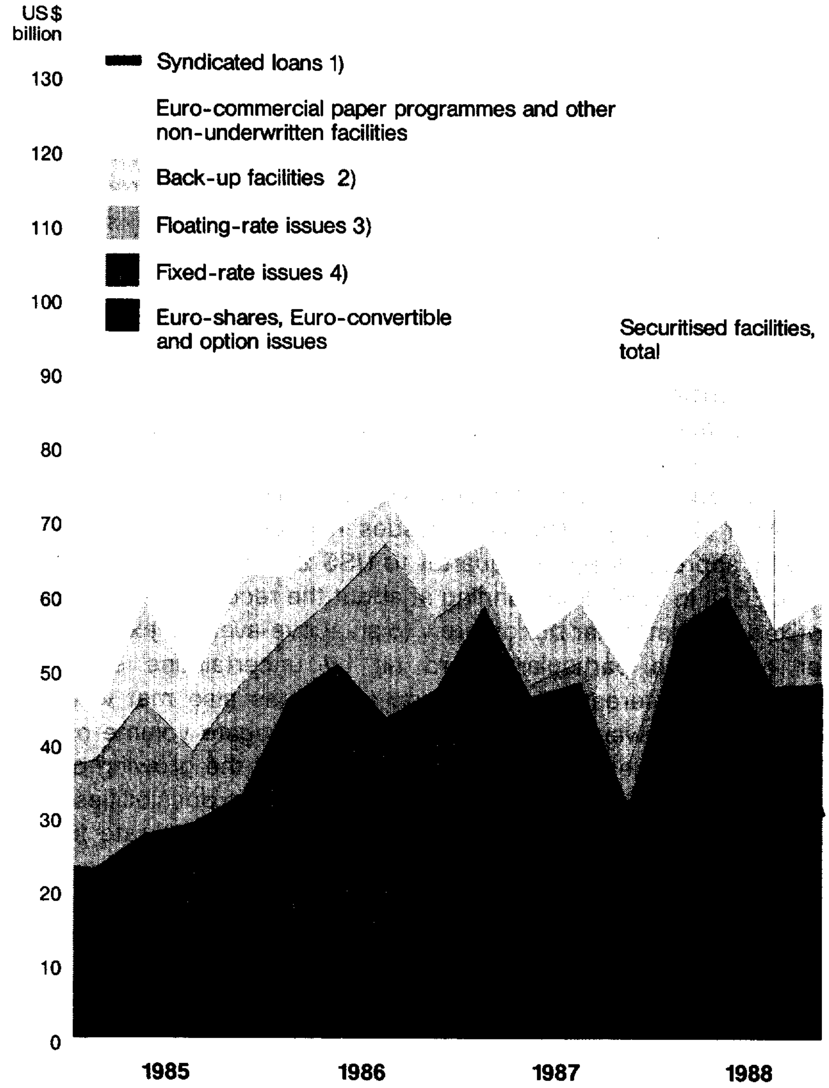
By far the largest borrowers in the international bond markets were issuers in Japan, followed by issuers in the United Kingdom, the United States, France, Canada, and Germany. Just under one-quarter of the new issues were accounted for by banks, with Japanese institutions making use of the international markets mainly in order to strengthen their capital base by issuing convertible bonds and bonds with warrants. The share of the dollar in the total volume of new international issues, which had fallen to 36% in 1987, rose to 39% in 1988. However, the US currency continued to dominate the international bond markets to a distinctly smaller extent than in earlier years; as recently as 1986 its share had amounted to 55%. At just over 10% of the aggregate volume of issues, the Deutsche Mark moved back into third place behind the dollar and the Swiss franc, a place it had ceded to the yen in 1987. This also owed something to the introduction of the withholding tax on domestic interest income accruing from financial investments in Germany.

Fresh bank lending concentrated in the industrial countries

The scale of fresh lending at the long and short ends of the market by banks operating internationally was also considerable in 1988, even though it did not quite regain the unusually high level of new lending registered in the preceding year. However, the buoyancy of lending was accounted for almost entirely by international financing operations among the industrial countries as a group, with a particular role being played by credits granted in the context of corporate mergers. At the same time, newly industrialising countries in a strong balance of payments position, such as Taiwan and South Korea, utilised their surpluses in order to reduce their liabilities to banks.

Securities issues, other securitised financing facilities and syndicated loans in the international financial markets

Quarterly figures



1) Publicised newly granted loans with maturities of over one year, but not necessarily drawn down yet.- 2) Facilities to back up the revolving placement of money market paper by international bank syndicates.- 3) Including medium and long-term floating-rate certificates of deposit.- 4) Including zero bonds, currency bonds and special placements.- Source: OECD.

BBk

Banking business stimulated by Japan's role as a financial turntable

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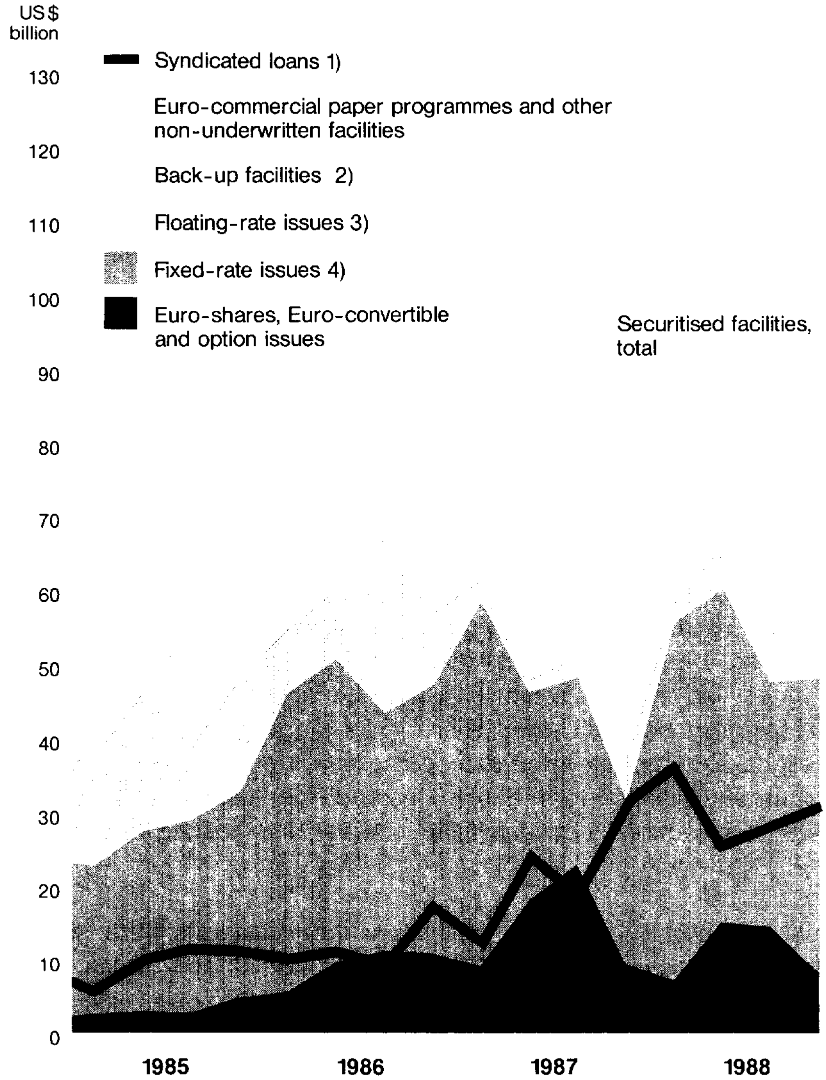

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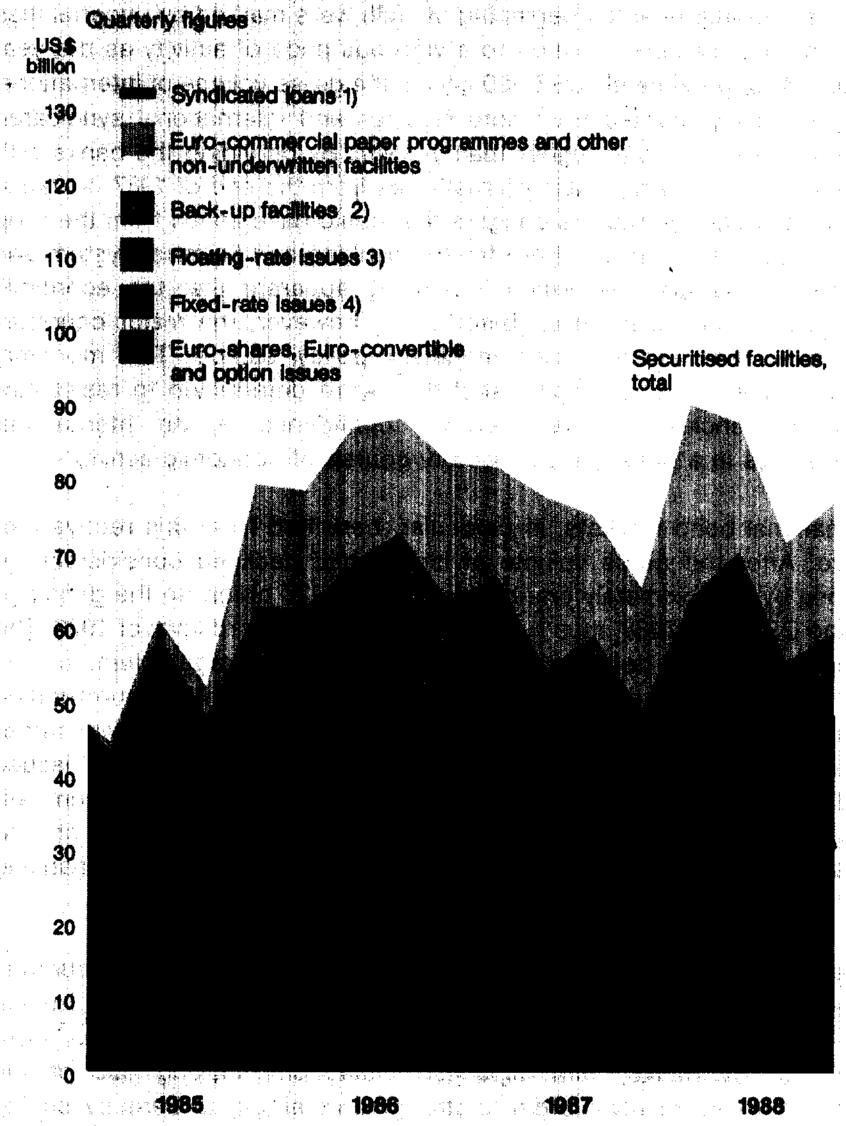

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Endeavours to achieve greater transparency and efficiency in the securities markets

Last year the supervisory authorities stepped up their cooperation in a number of international bodies with the intention of enhancing the transparency and efficiency of the securities markets. Considerable differences still exist among the major industrial countries with respect to concepts of supervision and trading. A reduction of these differences would conduce to both investor protection and international competition. The international discussions initially centred on issues relating to interconnections between the securities markets and the relatively new and strongly growing markets for options and interest rate futures. Later on, attention was also turned to problems in other sectors of the market, including the settlement of securities transactions, where dangers to the smooth functioning of the markets were perceived.

Strengthening of the banks' capital ratios

As explained in greater detail on p. 82 of the German original of this Report, progress has meanwhile been achieved in the international harmonisation of capital adequacy regulations for banks. Although the recommendations of the BIS Committee responsible for these questions will not be fully applicable until 1992, the banks reacted to them as early as 1988. As a result, international lending business as a whole proceeded at a subdued pace because it did not appear possible for several banks operating at the international level to bring about the required strengthening of their capital base immediately. However, Japanese banks, which have accounted for the great bulk of new international lending business for some time, only temporarily cut back their international lending operations somewhat. Aided by the rise on the Tokyo stock exchange, they appear to be succeeding unexpectedly quickly in improving their capital ratios. At all events, international lending by Japanese banks has been distinctly expansionary of late. Over the longer term, though, the more stringent capital requirements could not least lead to a shift in lending towards securitised forms, either because the agreed minimum capital ratios do not include securities houses in countries with single-purpose banks, such as the United States and Japan, or because recourse can be had to securitised forms of credit that are granted outside the banking system.

New kinds of risk through the financing of corporate takeovers

The necessity of imposing more stringent capital requirements would indeed be underlined if credit institutions were to opt to a greater extent for higher-yielding, but very risky, transactions. In this context, the financing of an increasing number of corporate takeovers and mergers, which, given the scale of these operations, play a special role in the international markets, too, and accounted for about one-third of new international syndicated lending last year, appears to be posing some problems. A special form of takeover practices, namely "leveraged buyouts", which are particularly widespread in the United States, is frequently aimed at selling off, at a good price, parts of the company that has been taken over, but mostly presupposes payments of large amounts of cash to existing shareholders, substantial borrowing and correspondingly high interest and commission payments to the banks involved. A low level of capital on the part of the company conducting the takeover operation relative to the amount of borrowed funds (the leverage effect) naturally makes such a practice particularly prone to miscalculations at the micro or the macro level. For instance, a rise in interest rates alone could jeopardise some such practices based on a low level of capital. Operations of this nature thus demonstrate that the growing efficiency of today's financial markets frequently entails new kinds of risks that need to be monitored carefully both by the banks and by the supervisory authorities.

Net lending in the international financial markets

US$ billion

Item	1985	1986	1987	1987 January to September	1988 January to September
A. International bond markets					
1. Gross issues	165	220	181	146	166
2. Redemptions and repurchases	40	59	71	50	56
3. Net issues	125	161	110	96	110
B. Net placements of new Euro-notes	10	12	23	23	20
C. Net bank lending 1	105	180	285	200	170
D. Financing facilities, total					
1. Total net financing of the market segments (A3 plus B plus C)	240	353	418	319	300
2. Double-counting among the above market segments **2**	60	83	53	46	50
3. Total financing facilities, after adjustment for double-counting	180	270	365	273	250

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

4. The debt problems of the developing countries

Marked slowdown in the growth of indebtedness

The widely varying situation of the developing countries has improved in recent years in a number of respects. In comparison with 1986, there was a distinct decline in the aggregate current account deficit of the countries with debt problems and there was also a marked fall in their debt service payments in terms of the share in their exports of goods and services. Moreover, the year 1988 witnessed a pronounced slowdown in the nominal increase in the long and short-term external indebtedness of the developing countries as a group. Whereas such debt rose by as much as US$ 116 billion (or 10%) in 1987, it went up in 1988 by only US$ 12 billion (or 1%). However, this distinct slowdown in the growth of foreign debt is essentially due to exchange rate effects which led to a marked rise in the dollar countervalue of debts denominated in other currencies in 1987 and to its decline in 1988. But the slight increase in foreign debt last year also owes something to the fact that greater use was made, in the context of international debt management, of techniques designed to reduce debt levels.

Advance of sophisticated techniques to reduce debt levels

The instruments designed to reduce debt levels are largely geared to the secondary market for claims on developing countries. This market has grown considerably in recent years, as larger banks have endeavoured to divest themselves of these claims, too. Depending on the standing of the debtor country involved and the situation in the market, the sellers accept more or less large discounts from the nominal value of their claims. By taking advantage of this market it was possible, for example, to reduce Mexico's liabilities by over US$ 1 billion when in March 1988 the creditor banks swapped part of their claims at a certain discount for collateralised bonds. However, greater importance has been gained by techniques whereby foreign enterprises purchase claims of banks at a discount and then convert them into national currency in order to acquire participations in the debtor country ("debt-equity swaps"). Moreover, some debtor countries have utilised liquid funds in order to redeem their liabilities on favourable terms ("debt repurchases"). According to World Bank statistics, the foreign debt of the developing countries involved was reduced by such transactions, which were in line with market conditions and were entered into voluntarily, by almost US$ 19 billion in 1988, against only US$ 8 billion in 1987.

Partial success in reducing debt no substitute for determined adjustment policies

It would, however, be problematical if, in view of possibilities of such debt reductions, individual countries were to slacken in their efforts to pursue confidence-inspiring economic and monetary policies. The partial success in reducing debts, which has dampened the rise in the aggregate external liabilities of the developing countries, cannot spare problem countries the need to pursue determined adjustment policies. Policies of this kind are absolutely essential if the debt problems are really to be defused. It is only in this way that the danger of additional capital flight can be averted and, simultaneously, a return of flight capital be expected. Moreover, the strong rate of economic growth in the industrial countries is fostering the efforts of the debtor countries to adjust. In addition, the latter have been benefiting for some time from higher world market prices for non-energy raw materials. But if the "adjustment fatigue" that has emerged here and there were to become more widespread, then the great opportunity of combining the inescapable reduction in domestic imbalances with export-led economic growth would be missed. In the final analysis there would be a danger of the necessary adjustment measures having to be adopted at a later date, and under less favourable basic conditions in the world economy. However, the industrial countries will have to further underpin the developing nations' adjustment efforts by systematically opening up their markets.

Return by Brazil to orderly debt management

In addition to their involvement in debt reduction, the banks also helped to overcome new financing problems in 1988 by employing the traditional instruments of debt management. This included, in particular, the conclusion of a financing package with Brazil, in which the banks rescheduled outstanding debts falling due by 1993 and totalling US$ 62 billion, while at the same time granting fresh loans amounting to over US$ 5 billion. This agreement, reached in September 1988, marked the end of a period in which the largest debtor country of the Third World had adopted a stance of confrontation with its creditors. The difficulties in managing Brazil's debts had begun in March 1987, with a unilateral declaration of an interest rate moratorium, and were not eased until the conclusion of an interim agreement in December 1987. The ensuing comprehensive arrangement with the banks was not least the prerequisite for Brazil's ability to conclude new financing agreements with all its other major creditors as well last year.

Banks hesitate to grant fresh loans

In all, however, the banks have hardly contributed in recent years towards meeting the major debtor nations' need for new finance. By contrast, the "Baker initiative" of 1985 envisaged that all groups of creditors should ensure in an appropriate manner that the inflows of funds considered necessary were set in motion. Although there has meanwhile been a basic improvement in the balance sheets of most internationally operating banks, the majority of these institutions evidently do not feel able to fulfil the expectations placed in them. This reflects not least the continuing negative appraisal of the efforts being undertaken by many debtor countries. The importance of bilateral and multilateral development aid therefore was and is all the greater. In this respect, the poorest developing countries were further assisted by Germany and other industrial countries last year through a debt remission operation, after initial measures of this kind had been adopted as long ago as the late seventies.

Limited financial role of the World Bank and the IMF

Given the dimensions of the international debt problems, the World Bank and particularly the IMF can make only a limited financial contribution. Any attempt to durably offset the present stagnation in inflows of funds to developing countries from private sources by means of correspondingly larger credits from these institutions appears to be neither realistic nor — in the light of their

External debt of the developing countries*

US$ billion

Item/Group of countries 1	1984	1985	1986	1987	1988 p	Change in 1988 from 1987 p
A. **Long-term**	767	862	944	1,038	1,044	+ 6
Public creditors	296	346	400	468	491	+23
Banks	275	314	340	363	354	− 9
Other creditors 2	197	201	205	208	200	− 8
B. **Short-term**	180	162	170	192	198	+ 5
C. **Total** (A plus B)	947	1,023	1,114	1,230	1,242	+12
D. **Group of countries**						
Africa	134	147	171	194	195	+ 2
Europe	113	128	144	166	161	− 5
Latin America	359	370	384	415	412	− 3
Middle East	124	131	138	148	153	+ 6
Rest of Asia	217	248	277	308	320	+13
15 major debtor countries (already included above)	410	423	447	482	477	− 5
Memorandum items						
Debt service payments	141	145	150	158	172	+14
Interest	83	82	77	72	84	+12
Repayment of long-term loans	58	63	73	86	88	+ 3
Debt service as a percentage of receipts from exports of goods and services						
All developing countries	20.0	21.3	23.0	20.3	19.7	3 − 0.6
15 major debtor countries	41.9	40.5	45.2	35.5	39.8	3 + 4.3

* Excluding debt to the IMF. — **1** For the definition of the groups of countries see the table on page 64. — **2** Including those liabilities of public and private entities which are not guaranteed by the debtor country in question. — **3** In percentage points. — **p** Provisional.
Discrepancies in the totals are due to rounding.
Source: IMF. BBk

functions — appropriate. In particular, they cannot relieve the banks of the burden of the loans they extended in the past. Instead, their prime contribution towards overcoming the debt problems consists in helping to bring about convincing adjustment programmes and in assisting in their implementation. In normal circumstances this ought to act as a catalyst ensuring a sufficiently large flow of funds to the debtor countries from other sources.

Exaggerated criticism of the lending conditions of the Bretton Woods institutions

The function performed by the IMF and the World Bank of bringing about efficient adjustment programmes frequently meets with a lack of understanding in public debates. Both institutions are often accused of making excessive demands on the debtor countries by imposing overly harsh economic policy conditions when extending loans to them, and hence of being partly responsible for poverty in the Third World. Views of this kind were also expressed vociferously on the periphery of the latest Annual Meeting of the IMF and the World Bank in Berlin. Such accusations disregard the complex causes behind the debt problems, and they are frequently based on false conceptions as to the tasks and functioning of the Bretton Woods institutions, and especially of the IMF. To the extent that the domestic and external economic problems of a large number of countries in the Third World are associated with shortcomings in their own economic policies or with other causes of their own making, they can be lastingly overcome only through greater efforts on the part of those countries themselves. In order to help them in this respect the IMF and the World Bank have to tie their loans to corresponding conditions. At the same time, this is an important precondition for both these institutions remaining creditworthy in the eyes of their own creditors.

5. Recent developments in the IMF and among the international development banks

Creation of a Contingency Financing Facility

Not least under the impact of the debt problems of the developing countries, the IMF further developed its facilities for providing balance of payments assistance again in 1988. In addition to the Structural Adjustment Facility created as early as March 1986 in favour of the poorest developing countries, which was considerably increased by the Enhanced Structural Adjustment Facility of December 1987, the Extended Fund Facility was modified in May 1988. Finally, a Compensatory and Contingency Financing Facility (CCFF) was established in August 1988. This new facility combines the previous Compensatory Financing Facility in modified form with a new kind of assistance. It is designed to protect adjustment programmes financially supported by the IMF in the event of unforeseen external burdens for which the borrowing country is not responsible. In this way the Fund is taking account of the experience that, in the event of adverse external developments, a country's adjustment policy can easily be blown off course. As a rule, additional adjustment measures have to be adopted in such circumstances. Since under its new Contingency Financing Facility the Fund promises from the outset to provide additional funds if certain circumstances arise, it can help to implement the necessary additional adjustment measures in an orderly manner. Some aspects of the new facility are, however, controversial. For instance, if the CCFF is activated too readily, it could lead to necessary adjustment measures being delayed. Moreover, it can foster endeavours to oblige international financial institutions to "guarantee" the developing countries (to the extent possible) the financing of steady economic growth. Misgivings also exist with respect to the fact that increases in interest costs can be offset as well. This gives rise to the concern that the allocational function of interest rates could ultimately cease to operate. Much will therefore depend on how the Contingency Financing Facility is managed. For this reason, a number of arrangements were made to avert these dangers as far as possible. They envisage, inter alia, that as a rule the release of funds is tied to a decision by the Executive Board of the IMF on a case-by-case basis, thus avoiding automatic drawings to a large extent. Moreover, contingency financing is in principle to be combined with additional adjustment measures. Furthermore, it must not quite compensate for the balance of payments burdens associated with unfavourable external developments. The borrowing countries are also obliged to seek "parallel" financial assistance from other lenders — above all the commercial banks — and to add non-disbursed funds to their monetary reserves or to have less recourse to the Fund's resources if their economic situation improves.

Access to the Extended Fund Facility eased

As a result of the modification of the Extended Fund Facility, access to the resources available under it was made easier. In future, it will be possible for comprehensive adjustment programmes to be supported by greater financial assistance from this facility, and in special cases the period for drawing can amount to four years instead of the usual three. The long periods of repayment for such drawings of between four and ten years from the date of each drawing continue to apply. At the same time, a number of procedural changes were introduced that will probably lead to a reduction of the average interest cost and a simultaneous lengthening of the average borrowing period. The maximum amount that can be borrowed from the IMF under this facility remains unchanged at the existing ceilings.

Credits extended from the Enhanced Structural Adjustment Facility for the first time

In 1988 six loans totalling just over SDR 600 million were approved under the above-mentioned Enhanced Structural Adjustment Facility, which has existed since the end of 1987. The resources for this facility are being provided in the main by the industrial countries and managed through a loan account administered by the Fund as trustee. Germany's contribution is available in the form of a credit line totalling SDR 700 million granted to the Fund by the Reconstruction Loan Corporation. In addition, donor countries – including Germany – will contribute non-repayable grants from budgetary resources so that the loans can be extended to the particularly poor developing countries covered by this facility at the very low level of interest that has been envisaged.

Renewed net reflows to the IMF

Despite the extended scope for granting finance, 1988 again witnessed net reflows to the IMF. As in the two preceding years, this was primarily a consequence of the strong rise in lending between 1981 and 1984, which has led for some time to a correspondingly high level of redemptions. However, the fact that, in the case of a number of major debtor countries, new adjustment and financing agreements came about only slowly or not at all also contributed to the level of net reflows. Moreover, some countries have meanwhile achieved substantial progress in their adjustment efforts with the assistance of the IMF and therefore do not need additional assistance from the Fund for the time being. On the other hand, loan redemptions (repurchases) declined again, for the first time since 1985. As a result, reflows to the IMF decreased on balance from SDR 4.2 billion in 1987 to SDR 3.6 billion last year. In the process, Fund credit outstanding fell to SDR 25.5 billion. This switch between outflows from and reflows to the Fund is in line with its monetary task, in the context of which the IMF can grant its balance of payments assistance over the short and medium term on a case-by-case basis but cannot provide it as a permanent source of financing. This is the only way to ensure that the financial resources of the Fund are available to all members of the Fund on a revolving basis in the form of temporary balance of payments assistance. More important than the absolute level of IMF loans is certainly their function as a catalyst, as mentioned elsewhere in this Report.

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

In view of the persistent balance of payments problems faced by many countries, the Fund decided to continue its "Policy on Enlarged Access to the Fund's Resources" with its temporarily increased drawing facilities again in 1988, with unchanged ceilings on drawings. However, this policy on Enlarged Access is placing excessive demands on the Fund's own resources. In the past the resultant "financing gap" was closed by large-scale additional loans from individual member countries. Since it cannot be expected that credit lines of a similar magnitude will be available to the IMF on a durable basis in the future, too, it is intended to allow the policy on Enlarged Access to expire upon the next increase in quotas, without impairing the absolute volume of drawing facilities to any noteworthy extent in the process. At all events, it is desirable for the IMF to return to financing its activities from subscriptions, in line with its character of a "cooperative". The current 9th General Review of Quotas should originally have been concluded in spring 1988. This period was then prolonged, however, because no agreement could be reached on a number of basic issues. Clarification is still being sought, in particular, on the extent of the increase in quotas as well as on the question of the extent to which individual quotas should be adjusted to reflect the changed weight of the countries concerned in the world economy. Whereas a number of countries do not consider an increase in quotas to be urgent, or feel that a relatively small rise in quotas is sufficient, most countries – including Germany – are in favour of a substantial increase in quotas in the near future.

Growing payment arrears vis-à-vis the IMF

As in the preceding years, a number of member countries did not meet their debt service obligations to the Fund in 1988, with the result that these payment arrears have meanwhile reached significant proportions. If this development were to continue, not only the financial integrity of the Fund but also its ability to function could suffer. For these reasons, as long ago as 1983 the Fund adopted a number of measures in order to encourage countries with overdue debt service to fulfil their payment obligations. At the same time, the Fund's

Purchases and repurchases under IMF credit facilities

SDR billion

Item	1984	1985	1986	1987	1988
Credit tranches	3.1	2.6	3.0	1.9	1.7
Extended Fund Facility	3.3	0.4	0.3	0.2	0.2
Compensatory Financing Facility **1**	0.8	0.9	0.6	1.2	0.7
Buffer Stock Facility	0.0	–	–	–	–
Structural Adjustment Facility **2**	–	–	0.1	0.4	0.4
Total purchases	7.3	4.0	3.9	3.7	3.1
Total repurchases	2.3	3.6	5.7	7.9	6.7
Net purchases (net repurchases: –)	5.0	0.3	– 1.7	– 4.2	– 3.6

1 Continued as from August 1988 as the Compensatory and Contingency Financing Facility. – **2** Including the Enhanced Structural Adjustment Facility; 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.
Source: IMF. BBk

provisions against contingencies were improved by strengthening its reserves. These endeavours were enhanced last year by a "cooperative approach" involving in part difficult questions of detail that still have to be clarified. On the one hand, this approach envisages designing new Fund credits in such a way that payment arrears are prevented from arising as far as possible. On the other hand, it includes three stages for eliminating existing payment arrears. Based on convincing adjustment measures on the part of the debtor countries (termed "shadow programmes"), their credit standing is to be strengthened to such an extent that foreign creditors provide funds again with which the payment arrears vis-à-vis the IMF can be settled and their adjustment efforts can be additionally fostered. Finally, this would pave the way for new recourse to the assistance of the Fund on the basis of regular adjustment programmes. In addition, the Fund is endeavouring to strengthen its provisioning further. For this purpose, it is intended to increase the Fund's reserves and allocate additional amounts to the Special Contingent Account that was set up at the beginning of 1987. The associated costs will be borne jointly by the Fund's creditors and debtors.

Increase in the World Bank's capital

In contrast to the IMF, there has been a continuous rise in recent years in the financial demands made on the multilateral development banks; this is in line with the functions of these banks in the field of development policy. Particularly heavy demands have been placed on the World Bank in this context. In order to further strengthen its role, the World Bank's capital was increased by US$ 74.8 billion to US$ 171.4 billion through a decision of its Board of Governors in April 1988. Germany contributed about 5% to the increase, with its share in the World Bank's total capital remaining at a virtually unchanged level. The Bank's new capital base is the prerequisite for a considerable increase in its loan commitments in the next five to six years. However, whether this scope can be utilised will depend on the extent to which the developing countries are willing and able to adopt the reforms fostered by the World Bank through its structural and sector-adjustment loans. At all events, any fixation on growth rates in its loan commitments or disbursements would not be compatible with the important and more basic task of the development banks. They have to foster necessary structural reforms through efficient consultancy work. Like the IMF, they can in this way also help to mobilise funds for the developing countries from other lenders. This role of a catalyst is actually increasing in importance against the background of the limited own resources of the World Bank and the regional development banks.

Establishment of the MIGA

In order additionally to encourage the flow of funds to the developing countries from private sources, the Multilateral Investment Guarantee Agency (MIGA) was established in 1988. This institution of the World Bank group is designed to insure foreign direct investment, particularly in the developing countries, against non-commercial risks such as expropriation, war or political unrest. For this purpose, it has authorised capital totalling US$ 1.1 billion. The MIGA thus complements the activities of the International Finance Corporation, whose task it is to foster private participations in enterprises in developing countries.

General rise in the loan commitments of the international development banks

The World Bank group — which, besides the International Bank for Reconstruction and Development (IBRD), comprises the International Development Association and the International Finance Corporation - increased its new loan commitments to developing countries by US$ 1.9 billion to US$ 20.5 billion in the 1987-8 fiscal year. The loan commitments of the IBRD alone went up by US$ 0.6 billion to US$ 14.8 billion. Approximately one-third of the IBRD's new loans were accounted for by the major debtor countries of Latin America. The Asian Development Bank expanded its loan commitments by US$ 0.7 billion to US$ 3.1 billion in 1988. In the case of the African Development Bank, its loan commitments, at US$ 2.2 billion, slightly exceeded the figure for the preceding year, with adjustment loans playing a particularly important role. In contrast, the Inter-American Development Bank (IDB) was not able to play the part assigned to it under the "Baker initiative" last year either. Delays in increasing its capital in connection with very far-reaching demands by the United States for changes in this development bank's decision-making procedures materially contributed to the fact that its loan commitments declined by US$ 0.7 billion to US$ 1.7 billion in 1988. In terms of the volume of loan commitments, the IDB thus lost its leading position among the regional development banks, at least for a temporary period.

New refinancing policy of the World Bank

In their 1988 fiscal year, the medium and long-term borrowings in Deutsche Mark of the international development banks did not regain the levels registered in previous years. They totalled DM 2.3 billion in 1988 against DM 3.3 billion a year before. The main reason for this decline was the fact that the IBRD, which denominates its loans in accordance with its pool of currencies, has been increasing the share of US dollars in its borrowings again since the 1988 fiscal year. In the preceding years relatively large-scale borrowings or newly incurred swap obligations of the IBRD in yen, Swiss francs and Deutsche Mark led to a considerable increase in dollar terms in the borrowing costs and debt service payments of the developing countries owing to the appreciation of these currencies against the US dollar. In future, the influence of exchange rates on the burden borne by debtors is to be kept smaller through a more balanced composition of the currency pool.

6. Monetary integration in the EC

Perceptible progress on the path to the European internal market

In the Single European Act that entered into force in July 1987 the European Community set itself the objective of completing the Community's internal market by the end of 1992. This market is intended to be free of internal frontiers and permit the free movement of goods, labour, services and capital. The Community has already proceeded a good way towards this objective. However, in an interim report on the progress achieved so far, the EC Commission points out that, of the almost 300 Directives, drafts of which it submitted or still has to submit (according to its 1985 White Paper), in order to bring about the internal market, only a good one-third had been adopted by the end of 1988. Far-reaching importance attaches to the Directive of the EC Council of Ministers of June 1988 on the complete liberalisation of capital movements. After a long period of stagnation and even of setbacks, this marked a decisive breakthrough on the path to a European financial market. The common financial market is one of the most important elements of the envisaged internal market.

Agreement on the principle of complete liberalisation of capital transactions

Whereas earlier Directives had set obligations to liberalise only some types of capital movements, the new Directive on capital transactions is based on the principle of complete liberalisation. Freedom of capital movements has to be brought about in principle by the end of June 1990. Capital transactions have already been liberalised for quite some time in Germany as well as in the United Kingdom and the Benelux countries. Denmark also lifted its remaining restrictions with effect from October 1988. Longer transitional periods are, however, envisaged for Ireland, Greece, Portugal and Spain. According to the new Directive, cross-border financial credits, in particular, as well as capital transactions classified as being in the short-term category (e.g. money market transactions, maintaining bank accounts, imports and exports of assets) are liable to liberalisation without exception. In principle, recourse to multiple exchange rates is no longer permissible either; Belgium and Luxembourg were granted a transitional period to abolish their two-tier foreign exchange market by the end of 1992.

Special safeguard clause applicable only restrictively

The Directive envisages a special safeguard clause for the event that short-term capital movements give rise to serious tensions in the foreign exchange markets and thus disturb the monetary and foreign exchange policy of a member state to a considerable extent. Although it is intended that recourse should be had to this special provision only under restrictive conditions in the context of a procedure at Community level, a special safeguard clause nevertheless contravenes the principle of complete liberalisation. Short-term capital movements with disturbing effects on monetary and foreign exchange policies should be countered primarily by measures of monetary and foreign exchange policy and not by renewed restrictions of capital movements. In the event of serious balance of payments difficulties, the safeguard clauses already envisaged in the Treaty of Rome ought as a rule to provide sufficient protection.

Liberalisation "erga omnes"

The freedom of capital movements is not limited to the area comprising the EC but will also apply to relations with third countries. The member states are called upon to bring about the same degree of liberalisation in capital transactions with countries outside the Community as applies to transactions within the Community. Thus, the principle of liberalisation "erga omnes" has been incorporated for the first time in a Directive on capital movements. At the same time, what is known as the "Regulation Directive", which was introduced in 1972 especially to ward off disturbing inflows of capital from third countries, was abolished. This reflects in a particularly striking manner the fact that the Community intends to remain open to the rest of the world.

Single system of financial support

As a measure accompanying the Liberalisation Directive, the Council of Ministers adopted a single system of medium-term financial support for the event of balance of payments difficulties on the part of individual member states. The existing facilities – the medium-term financial assistance arrangement and the system of Community loans – were combined in the new system. The ceiling for the sum total of loans outstanding was set at ECU 16 billion, including ECU 14 billion in the case of Community loans. Although under the new system access by the member states to balance of payments credits from the Community has been made generally easier, an increasing degree of conditionality with the disbursement of the loans in tranches is intended to ensure that the balance between adjustment and financing is maintained.

Endeavours to achieve uniform general conditions for the European financial area

In addition to the liberalisation of capital movements, the creation of a European financial area also requires uniform general conditions. These include the freedom of establishment for financial institutions and the possibility of being able to provide financial services across national borders; only through the fulfilment of both these conditions will the liberalisation of capital movements come to full fruition. The minimum standards for the supervision of financial institutions as well as for the protection of savers and creditors should be harmonised to ensure fair competition and should also be defined at a sufficiently high level. This seems necessary both with respect to as smooth a development of the Common Market as possible and in the interests of the stability of the international financial system. Besides questions relating to the taxation of investment income and the associated danger of capital flight, the public debate is currently centred above all on the effects a European financial area will have on third countries. In particular, the proposal for a second Directive on the coordination of banking legislation and the reciprocity clause envisaged in it have given rise to fears of the Community insulating itself against the outside world. As in the case of the liberalisation of capital movements, owing to the close trading ties the Community has with the world economy these harmonisation measures must likewise not lead to it erecting barriers vis-à-vis other countries. Besides, the benefits of integration will come to full fruition only in a market that is open to the rest of the world. For these reasons, access to the Community by financial institutions from third countries as well as the scope of their business activities should in principle not be restricted. The Community has repeatedly stated that the internal market is intended to benefit countries both inside and outside the Community; the internal market will be not a "Fortress Europe" but a "Partner Europe".

Close interrelationship between the liberalisation of capital movements and monetary integration

Progress in bringing about a European financial area is closely interrelated with progress towards economic and monetary integration. Just as the progress towards economic convergence made in recent years laid the economic basis for bringing about freedom of capital movements, the increasing liberalisation of capital transactions is exerting disciplining effects on the economic and monetary policies of member states. This will also strengthen the pressure to coordinate policies geared to the objective of achieving monetary stability and foster exchange rate stability. Thus, the completion of the internal market in the financial sphere will also create a major material basis for the Community to be able to develop further towards an economic and monetary union.

High-ranking study group set up to examine issues relating to economic and monetary union

At their summit meeting in Hanover in June 1988 the Heads of State and Government of the European Community reaffirmed their will to work towards economic and monetary union. They commissioned a committee chaired by the President of the EC Commission and consisting mainly of the governors of the EC central banks to study the prerequisites for and consequences of such a union and to propose concrete steps towards achieving it. The committee's report will be submitted to the Heads of State and Government at their meeting in June 1989.

No over-hasty proceeding

The further development of the Community into an economic and monetary union resides in the logic of the process of integration. However, this objective would not be served if the economic prerequisites for a monetary union were to be neglected by taking over-hasty steps that might, moreover, impair the functioning of the EMS. This would be the case if exchange rate changes were dispensed with and the adjustment constraints inherent in the EMS were thus weakened at the expense of monetary stability in individual countries. Changes in central rates in the EMS cannot be ruled out as long as economic and monetary developments among the countries participating in the exchange rate mechanism still diverge considerably. Proposals designed to bring about joint interventions in the foreign exchange markets against third currencies and the mutual holding of Community currencies do not appear appropriate to strengthen the cohesion of the exchange rate mechanism either. The opposite could be the case if the monetary policy of individual partners were to be influenced in an undesirable way as a result. Nor is the idea of advancing monetary integration via a stronger role of the ECU very promising. To the extent that banks and other financial institutions conduct business in ECUs, as is increasingly the case, this development should be left to market forces and should be neither inhibited nor artificially fostered.

Economic and monetary union possible only with adequate Community responsibilities

The transition to economic and monetary union requires decisions with far-reaching political implications because the measures involved will as a rule be associated with a renunciation of national responsibilities. This applies not only to the field of monetary and exchange rate policy but also to major aspects of the fiscal sovereignty of the individual member states if the transition to economic and monetary union is really meant seriously. For these reasons, clarity should exist from the outset about the final state being aimed at as well as about the prerequisites and conditions for achieving it. Although the scope for national economic and monetary policy is already being significantly curtailed in the increasingly integrated global economic environment (and this applies particularly to the close ties within the European Community and the EMS), the transition to economic and monetary union would have consequences of a much more far-reaching nature. In an economic and monetary union the formulation of economic and monetary policy and the associated decision-making process would largely be transferred to Community institutions. Although each member state would participate in such decisions, it would also have subsequently to respect them. In line with the far-reaching consequences of such a step, the Single Act subjects all future institutional changes to the procedure envisaged in article 236 of the Treaty of Rome. This means that in such cases the agreement of national parliaments is needed.

Patient and painstaking detailed work required

At all events, the creation of an economic and monetary union calls for patient and painstaking detailed work. The main emphasis is currently being placed on bringing about the internal market by the end of 1992 and with it the liberalisation of capital movements and the creation of a single financial market. It would also be very desirable for all EC member states to participate in the exchange rate mechanism of the EMS on the same conditions. In monetary terms, the EMS in its present form would then provide sound underlying conditions for the internal market to function smoothly. Apart from this, a considerable amount of catching-up needs to be done in creating adequate conditions for convergence in the field of general government budgets, seeing that individual countries have extremely large budget deficits. The easing of pressure on the capital markets associated with a consolidation of general government budgets would not least increase the scope of the countries concerned in the field of monetary policy. Precisely at the present point in time, as inflationary dangers are advancing again throughout the world, this appears to be of particular urgency.

Part B: Notes on the Deutsche Bundesbank's annual accounts for 1988

1. Legal basis

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)*. Section 26 (2) of that Act, as amended by the Act Concerning the EC Annual Accounts Directive *(Bilanzrichtlinien-Gesetz)* of December 19, 1985, applied for the first time to the annual accounts for 1987. In accordance with that section, the provisions of the Commercial Code relating to corporations are to be applied as appropriate to the valuation.

2. Annual accounts

The annual accounts for 1988 are attached to this Report as an Appendix; as usual, the notes on them are presented in the same order as the items appear in the balance sheet and profit and loss account. At the same time a report is rendered on the Bank's activities during 1988. 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.

Balance sheet

Comparison of balance sheet figures

The balance sheet total at December 31, 1988 was DM 268,924.6 million, against DM 230,474.6 million at end-1987.

Assets

Gold

The gold holding at December 31, 1988, 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, 1988 at the same figure as at end-1987, viz. DM 13,687.5 million.

Reserve position in the International Monetary Fund and special drawing rights

At December 31, 1988 the level of drawing rights within the reserve tranche in the International Monetary Fund (IMF) amounted to DM 5,957.1 million (= SDR 2,486.6 million) against DM 5,778.8 million (= SDR 2,575.7 million) at end-1987. It represents the difference between the German quota of SDR 5,403.7 million and the Deutsche Mark balances equivalent to SDR 2,917.1 million at the disposal of the IMF at the end of the year. Increases equivalent to SDR 371.3 million due to other members' Deutsche Mark drawings and other Deutsche Mark payments to other members were accompanied by decreases equivalent to SDR 460.4 million due to other members' Deutsche Mark repayments and other transactions.

In the year under review the Bank did not grant any new loans under special borrowing arrangements to the IMF. The loans to the IMF outstanding at the end of 1987, totalling DM 388.4 million (= SDR 173.1 million) and arising from the financing of other members' drawings under the Supplementary Financing Facility, were repaid within the appointed period during the year under review. 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, which the IMF can use, however, only subject to certain conditions.

Comparison of balance sheet figures

DM million

Assets	December 31 1987	December 31 1988
Gold	13,687.5	13,687.5
Reserve position in the International Monetary Fund and special drawing rights		
Drawing rights within the reserve tranche	5,778.8	5,957.1
Loans under special borrowing arrangements	388.4	–
Special drawing rights	3,105.6	3,306.8
Claims on the European Monetary Cooperation Fund in connection with the European Monetary System		
ECU balances 1	21,947.5	21,554.1
Other claims	7,005.0	–
Balances with foreign banks and money market investments abroad	68,253.9	50,157.6
Foreign notes and coins	25.6	25.5
External loans and other external assets		
Loans to the World Bank	2,437.4	2,437.4
Lending to domestic banks		
Securities bought in open market transactions under repurchase agreements	27,639.7	77,980.2
Domestic bills of exchange	33,744.2	33,485.1
Foreign bills of exchange	20,206.5	22,027.0
Lombard loans	765.8	11,243.5
Cash advances	808.4	1,010.3
Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin	8,683.6	8,683.6
Securities	4,500.0	4,916.2
German coins	737.4	714.0
Balances on postal giro accounts	168.9	231.8
Land and buildings	2,425.8	2,704.0
Furniture and equipment	185.7	190.1
Items in course of settlement	5,065.4	6,081.4
Other assets	2,873.9	2,490.2
Prepayments	39.6	41.2
Balance sheet total	230,474.6	268,924.6

Liabilities	December 31 1987	December 31 1988
Banknotes in circulation	125,608.0	143,941.7
Deposits of banks	60,490.7	61,240.8
Deposits of public authorities		
Federal Government	3,877.1	2,718.2
Equalisation of Burdens Fund and ERP Special Fund	8.6	107.8
Länder Governments	753.4	681.4
Other public depositors	25.1	27.3
Deposits of other domestic depositors		
Federal Railways	14.4	10.4
Federal Post Office	2,474.9	4,259.0
Other depositors	773.2	739.4
Liabilities arising from mobilisation and liquidity paper sold	5,233.4	4,729.4
Liabilities arising from external transactions	17,078.2	24,020.4
Counterpart of special drawing rights allocated	2,716.5	2,900.7
Provisions	4,287.1	4,760.0
Other liabilities	332.5	664.6
Accruals	184.9	275.5
Capital	290.0	290.0
Reserves	5,989.1	6,056.6
Unappropriated profit	337.5	11,501.4
Balance sheet total	230,474.6	268,924.6

1 After deduction of the difference between the ECU value and the book value of the gold and dollar reserves contributed to the EMCF.

The amount of special drawing rights (SDRs) held at December 31, 1988 was DM 3,306.8 million (= SDR 1,380.3 million) against DM 3,105.6 million (= SDR 1,384.2 million) at end-1987. It was composed of SDR 1,210.8 million of SDRs allocated, the counterpart of which is shown on the liabilities side, and SDR 169.5 million of SDRs purchased. Increases of SDR 395.7 million were accompanied by decreases of SDR 399.6 million. Of the increases, SDR 118.8 million was accounted for by freely agreed purchases, SDR 136.4 million by loan repayments and SDR 140.5 million by interest payments and remunerations on the part of the IMF. The decreases were all accounted for by sales 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 37,969.4 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 revolving swaps. In addition, these balances include 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, in connection with 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 16,415.3 million is deducted from the ECU balances. At the end of 1988 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 great majority of which are denominated in US dollars and bear interest, amounted to DM 50,157.6 million at the end of 1988 against DM 68,253.9 million at December 31, 1987 (excluding the dollar reserves provisionally contributed to the EMCF). The assets and liabilities denominated in US dollars were valued once again at the balance sheet rate of December 31, 1987 (US$ 1 = DM 1.5815).

Foreign exchange dealing

Mainly owing to US dollar transactions, the Bank's turnover in spot foreign exchange deals (foreign currency against Deutsche Mark) increased in the year under review to DM 57,403.3 million against DM 39,093.5 million in 1987. The number of deals rose from 6,001 in the previous year to 6,771. Specifically, the deals consisted of

	1987		1988	
	Number	DM million	Number	DM million
Purchases	3,347	22,861.7	2,070	8,027.1
Sales	2,654	16,231.8	4,701	49,376.2
	6,001	39,093.5	6,771	57,403.3.

The volume of cross deals (foreign currency against another foreign currency) fell from DM 4,592.3 million in the preceding year to DM 3,009.5 million in 1988. The number of deals likewise declined (from 225 to 173). The volume of SDR-US dollar and SDR-Deutsche Mark deals (there were 24 such transactions) was equivalent to DM 1,174.5 million (1987: 77 transactions equivalent to DM 1,654.4 million). In addition, 248 US dollar inter-centre switch transactions totalling US$ 70.1 million were entered into (1987: 201 transactions amounting to US$ 42.0 million).

For fine-tuning the money market, the Bank conducted 17 US dollar swaps equivalent to DM 3,045.8 million with domestic banks during the year under review in order to increase liquidity (against 66 transactions equivalent to DM 10,928.0 million in 1987).

External payments

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

External payments

Number of orders

Year	Outgoing external payment orders: in foreign currencies	in Deutsche Mark	Total	of which: Processed by automated standing order procedure	Processed automatically via SWIFT[1]
1987	392,450	2,391,280	2,783,730	2,533,987	175,231
1988	384,350	2,546,523	2,930,873	2,673,343	177,088
	Incoming external payment orders			of which Payments received via SWIFT	
1987	16,350	225,604	241,954		216,305
1988	17,190	229,959	247,149		218,524

1 Society for World-wide Interbank Financial Telecommunication.

Sales of foreign cheques

During 1988 20,490 (1987: 20,082) foreign cheques payable to order totalling DM 214.1 million (1987: DM 238.5 million) were sold. In addition, the Bank sold 37,197 traveller's cheques amounting to DM 4.5 million (against 41,086 traveller's cheques totalling DM 4.9 million in 1987).

Simplified collection procedure for foreign cheques

In 1988 the number of cheques presented under the simplified collection procedure for foreign cheques was again lower than in the preceding year. Details are given in Appendix 4 of the German original of this Report.

Foreign commission business

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

	1987	1988
		Number
Bills, cheques, etc.	27,718	28,751
Foreign notes and coins	7,468	5,427
	35,186	34,178.

Foreign notes and coins

The amount of foreign notes and coins held at end-1988, at DM 25.5 million, was DM 0.1 million lower than at end-1987. During the year under review the Bank effected 19,379 purchases (1987: 19,370) and 44,424 sales (1987: 45,829) of foreign notes and coins.

External loans and other external assets

As in the preceding year, only loans to the World Bank (most of which were 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 under repurchase agreements in securities 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 77,980.2 million (end-1987: DM 27,639.7 million).

Domestic bills of exchange

At the end of 1988 the Bank's portfolio of domestic bills amounted to DM 33,485.1 million against DM 33,744.2 million at the end of 1987. The Bank's average holding of domestic bills on all return days, at DM 31,786 million, was distinctly lower than in the preceding year (DM 35,367 million). The domestic bill portfolio comprised:

	Dec. 31, 1987	Dec. 31, 1988
		DM million
Domestic bills discounted	30,365.4	30,575.6
Prime bankers' acceptances acquired in the course of open market operations	3,378.8	2,909.5
	33,744.2	33,485.1.

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

Land Central Bank	1987		1988	
	Thousands	DM million	Thousands	DM million
Baden-Württemberg	523	25,852.2	502	25,435.7
Bavaria	348	22,947.8	334	21,943.7
Berlin	19	3,876.4	18	2,993.8
Bremen	36	3,135.7	35	2,702.3
Hamburg	99	10,038.0	91	8,514.0
Hesse	299	26,145.3	278	24,926.1
Lower Saxony	141	11,579.0	131	10,838.1
North Rhine-Westphalia	528	37,430.2	493	35,854.7
Rhineland-Palatinate	89	5,109.4	85	4,851.2
Saarland	21	1,902.7	20	1,784.2
Schleswig-Holstein	29	2,360.3	26	2,086.6
Total	2,132	150,377.0	2,013	141,930.4

The average value of the bills purchased in the year under review — as in the previous year — was 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:

	1987		1988	
	Number	DM million	Number	DM million
	10,163	172.7	7,089	96.2
as % of the total purchased	0.48	0.11	0.35	0.07.

Discount rate

During the year under review the Bank's discount rate for domestic and foreign bills was 2½% until June 30, 3% as from July 1 and 3½% as from August 26.

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 was lowered by DM 500 million to DM 3.0 billion with effect from May 2, 1988. 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 the 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 13,866.3 million (1987: DM 15,821.5 million). There were, however, no repurchases.

DM 14,335.6 million remained in the Bank's portfolio until payment on maturity (1987: DM 15,953.3 million). At December 31, 1988 the Bank held prime bankers' acceptances deriving from open market operations totalling DM 2,909.5 million (end-1987: DM 3,378.8 million).

Foreign bills of exchange

At the end of 1988 the portfolio of foreign bills accumulated through purchases in Germany amounted to DM 22,027.0 million (end-1987: DM 20,206.5 million). The share of Deutsche Mark bills in the total value of the foreign bills purchased averaged 97.5% in 1988 (1987: 97.3%).

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

	1987		1988	
Land Central Bank	Number	DM million	Number	DM million
Baden-Württemberg	48,384	10,440.3	49,382	11,338.8
Bavaria	30,967	11,158.2	32,812	12,323.7
Berlin	3,317	5,204.8	3,170	5,408.0
Bremen	2,310	1,060.1	2,572	1,122.3
Hamburg	14,978	10,236.8	15,015	10,600.4
Hesse	31,258	24,447.5	30,463	23,951.7
Lower Saxony	7,884	3,257.5	8,421	3,653.8
North Rhine-Westphalia	44,879	20,775.9	42,473	20,832.1
Rhineland-Palatinate	9,399	1,955.3	8,446	1,863.1
Saarland	3,673	1,360.3	3,814	1,254.2
Schleswig-Holstein	2,868	1,354.0	2,939	1,377.0
Total	199,917	91,250.7	199,507	93,725.1

Lombard loans

At the end of 1988 the outstanding amount of lombard loans which the Bank had granted to banks was DM 11,243.5 million against DM 765.8 million at end-1987. The average level of such loans on all return days was DM 1,427 million compared with DM 626 million in the previous year. As in earlier years, the outstanding amount of such loans was subject to marked fluctuations; it was highest on December 15, 1988, at DM 15,016 million.

Lombard rate

In the year under review the lombard rate was 4½% until July 28, 5% as from July 29 and 5½% as from December 16.

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.

Cash advances outstanding

DM million

Borrower	December 31, 1987	December 31, 1988
Federal Government	–	–
Länder Governments		
Baden-Württemberg	117.0	–
Bavaria	239.0	279.0
Berlin	–	–
Bremen	–	55.3
Hamburg	144.0	–
Hesse	–	–
Lower Saxony	186.0	–
North Rhine-Westphalia	–	569.0
Rhineland-Palatinate	–	54.7
Saarland	41.1	42.7
Schleswig-Holstein	81.3	9.6
Total	808.4	1,010.3

Federal and Länder Governments

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, 1988; 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 1988 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 1988 Treasury discount paper which is not returnable before maturity was placed with domestic banks to the amount of DM 2,078.2 million (1987: DM 582.5 million). DM 786.6 million of "Treasury financing paper" was sold (1987: DM 1,016.2 million). DM 840.0 million of paper returnable before maturity (type "B") was redeemed and newly issued.

After the redemption of DM 3,718.6 million (1987: DM 5,508.5 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, 1988 was DM 5,718.3 million (end-1987: DM 5,732.1 million). Of this total, DM 1,456.0 million was repurchasable by the Bank (Treasury discount paper type "B").

Federal Railways

At December 31, 1988 – as at end-1987 – the amount of returnable Treasury discount paper of the Federal Railways (type "Ba") outstanding was 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 the account of the Federal Government and its Special Funds outstanding at the end of 1988 was DM 5,849.3 million (end-1987: DM 5,863.1 million).

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

DM million

	1987	1988		
Type of paper	Outstanding at Dec. 31	Issued	Redeemed	Outstanding at Dec. 31
Treasury discount paper of the Federal Republic of Germany types "B" [1] and "BN" [2]	5,732.1	3,704.8	3,718.6	5,718.3
of which: "Treasury financing paper"	(1,899.8)	(786.6)	(1,084.8)	(1,601.6)
Treasury discount paper of the Federal Railways types "Ba" and "BaN" [2]	131.0	–	–	131.0
Treasury discount paper of the Federal Post Office type "PN" [2]	–	–	–	–
Total	5,863.1	3,704.8	3,718.6	5,849.3

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-1988, 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, 1988, 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) increased by DM 416.2 million net to DM 4,916.2 million (end-1987: DM 4,500.0 million) owing to transactions in the open market, after deduction of redemptions due to maturity.

Issue of bonds

In 1988 eleven bond issues totalling DM 39,000 million (1987: sixteen issues amounting to DM 43,300 million) were placed through the Federal Bond Consortium, which is under the direction of the Bank. Of these issues, an amount of DM 7,750 million was reserved for the issuers' own institutions and for market regulation purposes.

At the end of 1988 the amount of bonds of the Federal Republic of Germany outstanding was DM 172,060.2 million (end-1987: DM 143,069.7 million), that of the Federal Railways was DM 24,700.9 million (end-1987: DM 23,451.0 million) and that of the Federal Post Office DM 32,200.9 million (end-1987: DM 28,223.2 million).

Bond issues of the Federal Republic of Germany, the Federal Railways and the Federal Post Office in 1988

	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	6.375	10	100	6.38	Jan. 4
Federal Republic of Germany	4,000	3,200	6.25	10	100	6.25	Feb. 4
Federal Republic of Germany	4,000	3,200	6.125	10	99.75	6.16	Mar. 22
Federal Post Office	2,000	1,600	6.25	10	99.75	6.28	Apr. 20
Federal Republic of Germany	4,000	3,200	6.50	10	99.50	6.57	May 30
Federal Republic of Germany	4,000	3,200	6.75	10	100	6.75	Aug. 8
Federal Republic of Germany	4,000	3,200	6.75	10	100.50	6.68	Sep. 7
Federal Post Office	2,000	1,600	6.625	10	100	6.63	Sep. 22
Federal Republic of Germany	4,000	3,200	6.375	10	100.50	6.31	Oct. 31
Federal Railways	2,000	1,650	6.375	10	99.75	6.41	Nov. 17
Federal Republic of Germany	4,000	3,200	6.375	10	99.75	6.41	Dec. 1

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 8,680.2 million (gross) were placed with private purchasers in 1988 (1987: DM 6,441.5 million).

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

During the year under review DM 665.0 million (1987: DM 92.7 million) of Federal savings bonds from earlier tranches were returned to the issuer before maturity, and a further DM 4,264.3 million were redeemed on maturity. The amount of Federal savings bonds outstanding accordingly rose from DM 31,153.1 million to DM 34,904.0 million at December 31, 1988.

Gross sales, interest rates and yields of Federal savings bonds in 1988

Issue	Sales period 1988	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
1987/ 11+12	Jan. 2– Jan. 28 3	4 2,340.3	1,119.2		I	3.50	5.00	5.50	6.00	7.00	7.50	
					Y	3.50	4.23	4.64	4.95	5.32	5.63	
				1,221.1	I	3.50	5.00	5.50	6.00	7.00	7.50	7.50
					Y	3.50	4.25	4.66	5.00	5.39	5.74	5.99
1988/ 1+2	Jan. 29– March 1	1,934.8	900.3		I	3.50	5.00	5.50	6.00	6.50	7.50	
					Y	3.50	4.23	4.64	4.95	5.23	5.55	
				1,034.5	I	3.50	5.00	5.50	6.00	6.50	7.50	7.50
					Y	3.50	4.25	4.66	5.00	5.29	5.66	5.92
1988/ 3+4	March 2– May 9	1,244.6	555.0		I	3.00	4.00	5.00	6.00	6.50	7.50	
					Y	3.00	3.49	3.97	4.45	4.82	5.20	
				689.6	I	3.00	4.00	5.00	6.00	6.50	7.50	7.50
					Y	3.00	3.50	4.00	4.49	4.89	5.32	5.63
1988/ 5+6	May 10– July 29	924.8	370.9		I	3.00	4.50	5.00	6.00	7.50	8.00	
					Y	3.00	3.74	4.14	4.57	5.10	5.51	
				553.9	I	3.00	4.50	5.00	6.00	7.50	8.00	8.00
					Y	3.00	3.75	4.16	4.62	5.19	5.65	5.98
1988/ 7+8	Aug. 1 – Oct. 14	1,428.5	522.7		I	4.00	5.50	6.00	6.50	7.50	8.00	
					Y	4.00	4.73	5.13	5.45	5.81	6.12	
				905.8	I	4.00	5.50	6.00	6.50	7.50	8.00	8.00
					Y	4.00	4.75	5.16	5.50	5.89	6.24	6.49
1988/ 9+10	Oct. 17– Nov. 30	393.0	148.6		I	3.50	5.00	5.50	6.00	6.50	8.00	
					Y	3.50	4.23	4.64	4.95	5.23	5.62	
				244.4	I	3.50	5.00	5.50	6.00	6.50	8.00	8.00
					Y	3.50	4.25	4.66	5.00	5.29	5.74	6.06
1989/ 1+2	Dec. 1– 5	414.2	187.2		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	
				227.0	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
Total	Jan. 2– Dec. 31 5	8,680.2	3,803.9	4,876.3								

1 With annual payment of interest. – 2 With accrual of interest. – 3 Start of sales on November 12, 1987. – 4 Sales from November 12 to December 31, 1987: FSB/A DM 544.7 million; FSB/B, DM 640.1 million = total DM 1,184.8 million . – 5 Sales not completed on December 31, 1988.

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 12,699.1 million were sold in the year under review (1987: DM 16,787.0 million). In addition, an amount of DM 4,809.7 million was reserved for market regulation purposes. During the year the terms of these special Federal bonds were brought into line with market conditions on twenty-three occasions. Series 36 to 44 of these special Federal bonds, to the amount of DM 11,450.0 million, were redeemed on maturity in the year under review. At the end of the year the amount of five-year special Federal bonds outstanding was DM 91,751.2 million (end-1987: DM 85,692.4 million).

Sales and terms of issue of five-year special Federal bonds in 1988

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. 74 of 1987 (1992)	Jan. 4[1]	[2] 1,334.4	1,334.4	472.7	2,600	5.50	101.00	5.27	Feb. 17
S. 75 of 1988 (1993)	Jan. 29	664.8				5.25	100.00	5.25	
	Feb. 5	762.9					100.30	5.18	
	Feb. 12	1,461.5	2,889.2	710.8	3,600		100.70	5.09	Mar. 14
S. 76 of 1988 (1993)	Mar. 2	424.7				5.00	100.00	5.00	
	Apr. 28	79.9	504.6	495.4	1,000		99.30	5.16	May 25
S. 77 of 1988 (1993)	May 10	72.6	72.6	427.4	500	5.25	99.70	5.32	June 13
S. 78 of 1988 (1993)	May 30	1,224.6				5.50	99.80	5.55	
	June 7	725.1					100.00	5.50	
	June 15	56.7					100.30	5.43	
	June 28	168.0					99.40	5.64	
	July 14	95.7	2,270.1	729.9	3,000		98.60	5.83	Aug. 16
S. 79 of 1988 (1993)	Aug. 1	301.3				6.00	99.70	6.07	
	Aug. 23	2,553.9					99.00	6.24	
	Sep. 6[3]	1,004.9	3,860.1	1,139.9	5,000		100.00	6.00	Sep. 21
S. 80 of 1988 (1993)	Oct. 3	74.0				5.75	100.00	5.75	
	Oct. 11	457.7					100.20	5.70	
	Oct. 17	6.0					100.40	5.66	
	Oct. 18	37.2					100.60	5.61	
	Oct. 24	991.5	1,566.4	833.6	2,400		101.00	5.52	Nov. 14
S. 81 of 1988 (1993)	Oct. 31	4.2				5.50	100.40	5.41	
	Nov. 1	45.6					100.60	5.36	
	Dec. 1	76.4					99.50	5.62	
	Dec. 14	75.5	201.7	[4] ...	[4] ...		98.80	5.78	18.1.89

1 Start of sales on November 12, 1987 — 2 Sales from November 12 to December 31, 1987 = DM 792.9 million. — 3 Sales temporarily suspended from September 8 to 30, 1988. — 4 Sales of series not completed on December 31, 1988.

Issue of Treasury paper

With the assistance of the Bank, DM 6,688.0 million of Federal Treasury paper — formerly known as Treasury bonds (medium-term notes) of the Federal Republic of Germany — was sold in five issues by two tenders in 1988 (in the preceding year, DM 12,103.2 million was sold in eight issues by the Federal Republic of Germany and the Federal Railways).

The amounts issued were augmented by DM 1,712.0 million by the Federal Ministry of Finance for its own portfolio, to a total of DM 8,400.0 million.

At the end of 1988 the amount of Treasury paper of the Federal Republic of Germany (Federal Treasury paper) outstanding was DM 44,202.0 million (end-1987: DM 38,458.3 million), that of the Federal Railways DM 1,233.1 million (end-1987: DM 2,452.1 million) and that of the Federal Post Office DM 200.0 million (end-1987: DM 589.0 million).

Federal Treasury paper sold by tender in 1988

Amount sold (DM million)	Nominal interest rate (% p.a.)	Maturity (years/months)	Selling price (%)	Yield on issue (% p.a.)	Value date
1,451.0	5.00	3/11	99.80	5.06	
1,330.1	5.375	5/0	99.70	5.45	
1,276.1	5.75	6/0	99.50	5.85	January 29
940.7	6.00	3/10	99.50	6.15	
1,690.1	6.25	5/0	99.60	6.35	August 31

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 Railways, the Federal Post Office and the Reconstruction Loan Corporation, as well as the five-year special Federal bond series 74 to 80, to official dealing on all German stock exchanges.

The Bank also introduced the new issues of Federal Treasury paper 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 and bearer bonds of the Deutsche Ausgleichsbank to official dealing on individual German stock exchanges.

Price regulation operations

In the year under review, as in preceding years, the Bank conducted price regulation operations for the 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 and the Deutsche Ausgleichsbank, as well as in respect of bearer bonds of the Reconstruction Loan Corporation and the Deutsche Ausgleichsbank introduced to official dealing on individual German stock exchanges.

The Bank as paying and collecting agent for bonds

As paying and collecting agent for bonds of the Federal Government and its Special Funds, the Bank paid 298,276 interest coupons and matured bonds in the year under review (1987: 315,999).

German coins

The amount of German coins held by the Bank at the end of 1988 was DM 714.0 million (end-1987: DM 737.4 million). In 1988 DM 581.0 million was credited to the Federal Government in respect of coins taken over from the mints and DM 16.4 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1988 the Bank – acting for the account of the Federal Government – took over coins amounting to DM 13,354.9 million and redeemed coins which were no longer fit for circulation or had been called in to the value of DM 1,760.2 million.

The total amount of coins in circulation at the end of 1988 (DM 10,880.7 million), divided by the number of inhabitants of the Federal Republic of Germany including Berlin (West) on December 31, 1987 (61.3 million), yields a coin circulation per head of population of DM 177 (end-1987: DM 168).

During the year under review the DM 10 commemorative coins "Arthur Schopenhauer" and "Carl Zeiss" were put into circulation.

Balances on postal giro accounts

At December 31, 1988 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 231.8 million (1987: DM 168.9 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	1987				1988			
	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	45,700	22,074.1	5,181	4,554.8	45,458	22,231.7	5,103	5,669.8
Bavaria	37,964	13,492.1	9,012	10,167.0	34,989	12,965.1	8,834	9,947.8
Berlin	6,533	3,536.7	1,049	2,326.6	6,199	3,473.9	889	2,394.5
Bremen	4,857	356.6	107	0.1	5,300	370.6	102	0.0
Hamburg	23,358	20,602.0	1,727	664.3	23,172	23,156.3	1,764	600.8
Hesse	44,720	7,290.6	4,149	10,065.7	49,078	7,395.2	3,994	11,305.2
Lower Saxony	35,149	8,633.7	4,270	4,870.7	36,345	8,991.1	4,351	5,717.4
North Rhine-Westphalia	110,411	19,782.2	7,422	5,094.8	112,643	20,760.9	7,156	4,028.5
Rhineland-Palatinate	47,140	988.2	4,429	1,154.0	64,459	969.9	3,946	1,338.9
Saarland	2,883	1,487.6	118	0.1	3,058	1,392.1	115	0.1
Schleswig-Holstein	15,651	115.7	354	0.3	21,839	134.4	300	0.3
Total	374,366	98,359.5	37,818	38,898.4	402,540	101,841.2	36,554	41,003.3
Bundesbank – Central Office –	6,231	2,375.4	1,916	3.2	7,443	1,664.6	1,252	12.7
Grand total	380,597	100,734.9	39,734	38,901.6	409,983	103,505.8	37,806	41,016.0

Land and buildings

After additions of DM 456.0 million and depreciation totalling DM 177.8 million, land and buildings are shown at DM 2,704.0 million (1987: DM 2,425.8 million).

Furniture and equipment

The balance sheet value of furniture and equipment, after additions totalling DM 114.6 million and depreciation amounting to DM 110.2 million, is DM 190.1 million (1987: DM 185.7 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 being cleared. At December 31, 1988 the balance of items in course of settlement stood at DM 6,081.4 million against DM 5,065.4 million at end-1987.

Other assets

At the end of 1988 other assets amounted to DM 2,490.2 million (end-1987: DM 2,873.9 million). They primarily consist of the interest due in 1989 but assignable to the profit and loss account for the year under review on funds invested abroad and securities (DM 1,945.7 million against DM 2,095.6 million at end-1987) and claims arising from securities commission business amounting to DM 261.1 million (1987: DM 298.9 million).

This item also contains the Bank's 30% share (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 included in the articles of association of that bank that, if necessary, further capital is to be paid up in proportion to the existing share entails for the Bank a maximum commitment of DM 279 million.

Prepayments

The prepayments almost entirely comprise salary and pension payments made in the year under review but relating to 1989.

Banknotes in circulation

The amount of banknotes in circulation at December 31, 1988, at DM 143,941.7 million, was DM 18,333.7 million (+ 14.6%) larger than at end-1987.

In the year under review the Bank again took over 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:

	1983	1984	1985	1986	1987	1988
Number (millions)	582.9	569.0	575.4	595.7	578.0	553.5
Value (DM million)	24,938.5	25,098.5	26,046.7	27,035.3	25,895.5	29,221.9.

The denominations of the Bundesbank notes 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
1983	104,692.3	96,073.0	8,619.3
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

The number of counterfeit banknotes detained in payments in the Federal Republic of Germany and Berlin (West) increased slightly against the previous year. The total amount involved declined because fewer DM 100 notes, but at times more counterfeit DM 50 notes, were detained. The number and value of the counterfeit coins detained declined further in the year under review.

Counterfeits detained in payments

	Banknotes		Coins	
Year	Number	DM thousand	Number	DM thousand
1979	3,388	296.6	7,405	24.3
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

Deposits of banks

The banks' deposits on giro accounts mainly comprise the minimum reserves to be held at the Bank. The sub-item "Other" contains 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, 1987	Dec. 31, 1988 DM million
Deposits on giro accounts	60,461.1	61,209.3
Other	29.6	31.5
	60,490.7	61,240.8.

Deposits of public authorities

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

	Dec. 31, 1987	Dec. 31, 1988 DM million
Federal Government	3,877.1	2,718.2
Equalisation of Burdens Fund and ERP Special Fund	8.6	107.8
Länder Governments	753.4	681.4
Other public depositors	25.1	27.3
	4,664.2	3,534.7.

Deposits of other domestic depositors

The deposits of other domestic depositors are composed as follows:

	Dec. 31, 1987	Dec. 31, 1988 DM million
Federal Railways	14.4	10.4
Federal Post Office (including postal giro and postal savings bank offices)	2,474.9	4,259.0
Other depositors	773.2	739.4
	3,262.5	5,008.8.

Giro transactions, simplified cheque and direct debit collections

The entries on giro accounts increased by 5.6% in 1988 against 1987; the total turnover went up by 9.4%. As in the preceding years, almost 100% of the turnover was processed on a cashless basis.

Annual turnover on the giro accounts of the Bank

Type of turnover	1987 Number of transactions (Thousands)	1987 Total amount (DM million)	1987 Average amount (DM thousand)	1988 Number of transactions (Thousands)	1988 Total amount (DM million)	1988 Average amount (DM thousand)
(a) Credits						
Cash payments	1,068	263,783	247.0	1,059	281,357	265.7
Clearings with account-holders	3,756	6,660,664	1,773.3	3,646	7,325,595	2,009.2
Local transfers	66,439	6,306,472	94.9	51,210	6,732,086	131.5
Intercity transfers	414,275	7,085,292	17.1	463,603	7,856,980	16.9
Cheque and direct debit collections (total presented)	1,489,272	2,685,991	1.8	1,567,694	2,958,035	1.9
Total	1,974,810	23,002,202	–	2,087,212	25,154,053	–
(b) Debits						
Cash payments	1,560	276,756	177.4	1,584	301,529	190.4
Clearings with account-holders	2,750	6,884,308	2,503.4	2,661	7,607,974	2,859.1
Local transfers	66,439	6,306,472	94.9	51,210	6,732,086	131.5
Intercity transfers	415,009	6,840,706	16.5	464,812	7,560,274	16.3
Cheque and direct debit collections (total paid)	1,483,520	2,691,380	1.8	1,556,305	2,956,763	1.9
Total	1,969,278	22,999,622	–	2,076,572	25,158,626	–
(c) Percentage of total turnover (credits and debits)						
Cash payments	0.07	1.18	–	0.06	1.16	–
Clearings with account-holders	0.16	29.44	–	0.15	29.68	–
Local transfers	3.37	27.42	–	2.46	26.76	–
Intercity transfers	21.03	30.27	–	22.30	30.64	–
Cheque and direct debit collections (total presented and paid)	75.37	11.69	–	75.03	11.76	–
Total	100.00	100.00	–	100.00	100.00	–

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 almost 10% greater than in the preceding year. Such payments now account for 69% of the payment items presented under the automated procedure. The further increase in paperless payments is mainly due to the fact that there is a continuing trend in the banking industry towards replacing paper-based payments by paperless procedures and converting collection and credit transfer orders presented by the originator in paper-based form into data records. The conversion by the Bank's computer centres of the cheques presented in paper-based form into data records for paperless collection accordingly continued to decline; in all, only 88 million (1987: 103 million) cheques to the value of DM 26 billion were so converted. To speed up payments, EDM credit transfers and EDM direct debits from DM 2,000.00 upwards are being transmitted between the Bank's computer centres by means of data telecommunication (DTC). In addition, the Bank's branch offices have now been equipped with a DTC network. Since mid-1988 telegraphic transfers and transfers of currently DM 100,000.00 and more (express payments) have been transmitted through the DTC network. In the year under review they were already equivalent to about one-third of the volume of credit transfers processed between the branch offices by traditional techniques.

Automation of intercity transfers

Year	Collection orders presented							Intercity credit transfers presented						
		of which: Passed on							of which: Passed on					
				via computer centres							via computer centres			
	Total	in direct operations between the branch offices		in automated paper-based operations		through the paperless exchange of data media		Total	in direct operations between the branch offices		in automated paper-based operations		through the paperless exchange of data media	
	millions	millions	%	millions	%	millions	%	millions	millions	%	millions	%	millions	%
1979	775	15	2	441	57	319	41	192	13	7	95	49	84	44
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

If local payments and clearing transactions – which, apart from local credit transfers in Hamburg, are not yet processed automatically – are also included in the calculation (as well as intercity transfers), then about 87% of 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

To regulate liquidity, 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 again in the year under review. These transactions totalled DM 22,950.0 million (1987: DM 46,890.0 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 46,757.0 million (1987: DM 71,979.0 million) were accompanied by redemptions totalling DM 47,183.5 million (1987: DM 71,564.3 million), so that the amount outstanding was reduced to DM 4,529.4 million (1987: DM 4,955.9 million).

Mobilisation and liquidity Treasury discount paper to the amount of DM 124.0 million (1987: DM 200.5 million) was issued in the year under review; after redemptions totalling DM 201.5 million (1987: DM 190.0 million), the amount of such paper outstanding at the end of 1988 was DM 200.0 million (end-1987: DM 277.5 million).

At December 31, 1988 the total amount of liabilities arising from mobilisation and liquidity paper outstanding was DM 4,729.4 million (end-1987: DM 5,233.4 million).

Mobilisation and liquidity paper sold and redeemed

DM million

Type of paper	1987 Outstanding at December 31	1988 Sold	1988 Redeemed	1988 Outstanding at December 31
Treasury bills (running for up to 90 days)	4,955.9	46,757.0	47,183.5	4,529.4
Treasury discount paper (running for 6 to 24 months)	277.5	124.0	201.5	200.0
Total	5,233.4	46,881.0	47,385.0	4,729.4

Liabilities arising from external transactions

At the end of the year the liabilities arising from external transactions amounted to DM 24,020.4 million (1987: DM 17,078.2 million). It was the liabilities to foreign monetary authorities which increased most. Specifically, the liabilities arising from external transactions were composed as follows:

	Dec. 31, 1987		Dec. 31, 1988 DM million	
Deposits of foreign depositors				
Banks	16,962.6		23,925.2	
Other depositors	103.5	17,066.1	50.7	23,975.9
Other				
Provision of cover for letters of credit, etc.	4.7		4.9	
Miscellaneous liabilities	7.4	12.1	39.6	44.5
		17,078.2		24,020.4.

Counterpart of special drawing rights allocated

The counterpart of the special drawing rights allocated by the IMF and shown on the assets side of the balance sheet in sub-item 2.3 corresponds to the allocations of SDRs 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 144.7 million for the payment of pensions and an increase of DM 206.7 million, the provisions for pensions amount to DM 2,233.0 million (end-1987: DM 2,171.0 million); they correspond to the actuarially calculated requirements.

Provisions for other purposes

At December 31, 1988 DM 410.9 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 receipts item "Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions"). As a consequence, they then amounted to DM 2,527.0 million against DM 2,116.1 million at end-1987.

Other liabilities

At the end of 1988 the other liabilities amounted to DM 664.6 million against DM 332.5 million at the end of 1987. Besides higher liabilities arising from securities commission business, the increase resulted from intra-German settlements (commercial payments under the "Berlin Agreement"). At the end of 1988 these gave rise to liabilities amounting to DM 123.5 million, against net assets totalling DM 233.4 million at end-1987, which were shown in the item "Other assets". The regulations governing intra-German payments are outlined in Part A IV of the German original of this Report.

Accruals

Accruals amounted to DM 275.5 million at December 31, 1988 (end-1987: DM 184.9 million). This item mainly comprises 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 7, 1988, the legal reserves were increased by DM 67.5 million out of the profit for 1987. The increase accounted for 20% of the net profit. After this increase, the legal reserves totalled DM 5,766.6 million; they thus fell short of the maximum level permissible by law of 5% of the amount of banknotes in circulation, which came to DM 125,608.0 million at the end of 1987. The other reserves reached the statutory ceiling of DM 290 million as long ago as end-1980.

Unappropriated profit

See the notes on page 100 of this Report.

Profit and loss account

Comparison of expenditure and receipts

DM million

Expenditure	1987	1988	Receipts	1987	1988
Interest paid on foreign exchange swap and repurchase transactions with domestic banks	2.2	0.9	Interest received		
			Funds invested abroad	7,442.2	7,827.7
			Lending to domestic banks	2,742.4	3,419.4
			Equalisation claims	81.4	81.4
Interest paid on mobilisation and liquidity paper	164.2	151.6	Securities	352.8	343.1
Other interest paid	9.6	10.0	Cash advances	57.9	56.8
	176.0	162.5	Other interest received	2.8	4.8
				10,679.5	11,733.2
Administrative expenditure					
Staff costs	820.3	838.3	Fees received	25.0	24.1
Other	213.4	217.6	Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	–	1,610.1
Banknote printing	142.4	152.8			
Depreciation	230.4	288.0			
Increases in provisions					
for pensions	222.6	206.7	Other receipts	98.8	117.2
for other purposes	–	–			
Pension payments in respect of the Reichsbank	21.0	19.3			
Write-downs of monetary reserves and other foreign currency positions	8,594.8	–			
Other expenditure	44.9	98.0			
Profit for the year (= unappropriated profit)	337.5	11,501.4			
Total	10,803.3	13,484.6	Total	10,803.3	13,484.6

Staff costs

Staff costs went up against the previous year by DM 18.0 million to DM 838.3 million. This owed something, firstly, to pay rises for the Bank's staff; secondly, there was again a slight increase in the number of the Bank's employees in 1988. The number of staff members rose by 181 to a total of 15,707 (+ 1.2%). About one-third of this increase (63) was accounted for by civil servants undergoing preparatory training and other trainees.

Staff of the Bank

Staff	Beginning of 1988					Beginning of 1989				
	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	960	5,623	6,583	5,903	680	976	5,759	6,735	5,985	750
Other salaried staff	1,664	6,187	7,851	3,606	4,245	1,659	6,206	7,865	3,622	4,243
Wage earners	236	856	1,092	208	884	236	871	1,107	214	893
Total	2,860	12,666	15,526	9,717	5,809	2,871	12,836	15,707	9,821	5,886

1 Including 251 (1988: 135) salaried staff working outside the Bank or released to work for international institutions, 912 (1988: 849) trainees, 687 (1988: 653) part-time salaried staff and 749 (1988: 737) part-time wage earners.

Payments to serving members of the Central Bank Council and the Directorate of the Bank amounted to DM 9,158,709.41 in the year under review. Former members of these bodies and of the Board of Directors and Board of Managers of the Bank deutscher Länder and the Managing Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 8,559,382.26.

Changes in staff regulations

In 1988 the Bank again entered into a number of pay agreements, thereby bringing the legal status of its wage earners and salaried staff into line with the regulations applying to the wage earners and salaried staff of the Federal Government, while paying due regard to the special conditions prevailing at the Bank.

Other

During the financial year 1988 other (non-staff) administrative expenditure increased by DM 4.2 million (+ 2.0%) to DM 217.6 million.

Banknote printing

Expenditure on banknote printing amounted to DM 152.8 million in 1988 against DM 142.4 million in the previous year.

Depreciation and increases in provisions

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

Pension payments in respect of the Reichsbank

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, at DM 19.3 million, continued to decline in the year under review.

Other expenditure

Other expenditure is shown at DM 98.0 million (1987: DM 44.9 million).

Receipts

Interest

	1987	1988
		DM million
Interest received amounted to	10,679.5	11,733.2;
after deduction of interest paid, namely	176.0	162.5,
interest is shown in the profit and loss account at	10,503.5	11,570.7.

At DM 11,733.2 million, the interest received in the year under review was DM 1,053.7 million higher than in 1987. The increase in receipts arising from external transactions, at DM 385.5 million, resulted largely from the higher level of US dollar assets in the first half of 1988. Receipts from lending to domestic banks went up by DM 677.0 million, largely owing to the larger volume of securities repurchase agreements. Other interest income, by contrast, remained virtually unchanged.

The interest paid, at DM 162.5 million, was only slightly lower than in the previous year. DM 151.6 million (1987: DM 164.2 million) was disbursed on Treasury bills and Treasury discount paper of the Federal Government (mobilisation and liquidity paper pursuant to sections 42 and 42a of the Deutsche Bundesbank Act).

Fees

Fees, which accrue mainly in payments and in securities transactions, totalled DM 24.1 million in the year under review (1987: DM 25.0 million).

Receipts from the valuation of the monetary reserves

This item contains the result of the valuation of the monetary reserves and other foreign currency positions, including the profits and losses arising from purchases and sales of foreign currencies. Receipts amounted to DM 1,610.1 million net, mainly because of profits on US dollar sales. The profits arising from the appreciation of the SDR-DM rate since the end of 1987 had no influence on the result, because they were retained as provisions.

Other receipts

The other receipts amounted to DM 117.2 million (1987: DM 98.8 million).

Unappropriated profit	The profit and loss account for 1988 shows a profit for the year of which is entered in the balance sheet as unappropriated profit (net profit).		DM 11,501,352,706.59,
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:		
	to the legal reserves	1,430,500,000.00	
	to the Fund for the Purchase of Equalisation Claims	30,000,000.00	1,460,500,000.00.
	The balance of		10,040,852,706.59
	will be transferred to the Federal Government.		

After this appropriation, the legal reserves will amount to DM 7,197,100,000.00; they will thus come up again to the statutory ceiling of 5% of the amount of banknotes in circulation, which was DM 143,941,663,065.00 at the end of 1988. The other reserves reached the statutory ceiling of DM 290,000,000.00 at the end of 1980.

Frankfurt am Main, April 1989

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

Part D: Report of the Central Bank Council

The annual accounts of the Deutsche Bundesbank for 1988 and the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1988 have been audited by Treuarbeit Aktiengesellschaft Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft of Frankfurt am Main and Dr. Wollert – Dr. Elmendorff KG 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 1988 and the bookkeeping comply with German law and present an accurate picture of the assets, liabilities, financial situation 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 1988 on April 6, 1989 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, 1988.

Since the publication of the Report for the Year 1987 the following changes have taken place in the Central Bank Council and the Directorate of the Deutsche Bundesbank:

Retired

as at the close of June 30, 1988

Helmuth Homp
Vice-President of the Land Central Bank in Schleswig-Holstein,

as at the close of October 31, 1988

Dr. Julia Dingwort-Nusseck
President of the Land Central Bank in Lower Saxony,

as at the close of February 28, 1989

Gerhard Jennemann
Vice-President of the Land Central Bank in the Free and Hanseatic City of Hamburg.

Appointed

with effect from July 1, 1988

Peter Wilhelm Titzhoff
to be Vice-President of the Land Central Bank in Schleswig-Holstein,

with effect from December 1, 1988

Professor Dr. Helmut Hesse
to be President of the Land Central Bank in Lower Saxony,

with effect from March 1, 1989

Hans-Jürgen Siegmund
to be Vice-President of the Land Central Bank in the Free and Hanseatic City of Hamburg.

The Central Bank Council, acting also on behalf of the Directorate and 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 1988. The Council likewise wishes to record its appreciation of the continued excellent collaboration with the staff representative bodies.

Frankfurt am Main, April 1989

Karl Otto Pöhl
President of the Deutsche Bundesbank

Appendix to Part B

Balance sheet of the Deutsche Bundesbank as at December 31, 1988

 Assets

			DM
1 Gold			13,687,518,821.70
2 Reserve position in the International Monetary Fund and special drawing rights			
2.1 Drawing rights within the reserve tranche		5,957,155,548.07	
2.2 Loans under special borrowing arrangements		–	
2.3 Special drawing rights		3,306,768,292.55	9,263,923,840.62
3 Claims on the European Monetary Cooperation Fund in connection with the European Monetary System			
3.1 ECU balances	37,969,381,824.70		
less Difference between the ECU value and the book value of the gold and dollar reserves contributed to the EMCF	16,415,333,580.53	21,554,048,244.17	
3.2 Other claims		–	21,554,048,244.17
4 Balances with foreign banks and money market investments abroad			50,157,612,631.29
5 Foreign notes and coins			25,531,209.–
6 External loans and other external assets			
6.1 Loans in connection with EC medium-term monetary assistance		–	
6.2 Other loans to foreign monetary authorities		–	
6.3 Loans to the World Bank		2,437,383,750.–	2,437,383,750.–
7 Lending to domestic banks			
7.1 Securities bought in open market transactions under repurchase agreements		77,980,186,000.–	
7.2 Domestic bills of exchange		33,485,132,743,72	
7.3 Foreign bills of exchange		22,027,024,349.10	
7.4 Lombard loans		11,243,440,300.–	144,735,783,392.82
8 Cash advances			
8.1 Federal Government		–	
8.2 Equalisation of Burdens Fund		–	
8.3 Länder Governments		1,010,251,750.–	1,010,251,750.–
9 Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			8,683,585,988.93
10 Lending to the Federal Railways and Federal Post Office			
10.1 Cash advances		–	
10.2 Treasury bills and Treasury discount paper		–	–
11 Securities			4,916,179,623.09
12 German coins			713,953,852.44
13 Balances on postal giro accounts			231,819,955.75
14 Land and buildings			2,704,043,767.61
15 Furniture and equipment			190,082,075.–
16 Items in course of settlement			6,081,380,769.96
17 Other assets			2,490,245,338.48
18 Prepayments			41,245,329.15
			268,924,590,340.01

		DM
1 Banknotes in circulation		143,941,663,065.–
2 Deposits of banks		
2.1 Deposits on giro accounts	61,209,345,974.30	
2.2 Other	31,549,401.09	61,240,895,375.39
3 Deposits of public authorities		
3.1 Federal Government	2,718,242,346.56	
3.2 Equalisation of Burdens Fund and ERP Special Fund	107,809,420.17	
3.3 Länder Governments	681,404,233.08	
3.4 Other public depositors	27,275,753.33	3,534,731,753.14
4 Deposits of other domestic depositors		
4.1 Federal Railways	10,431,034.85	
4.2 Federal Post Office (including postal giro and postal savings bank offices)	4,258,983,618.69	
4.3 Other depositors	739,381,656.16	5,008,796,309.70
5 Liabilities arising from mobilisation and liquidity paper sold		4,729,400,000.–
6 Liabilities arising from external transactions		
6.1 Deposits of foreign depositors	23,975,948,479.45	
6.2 Other	44,457,657.27	24,020,406,136.72
7 Counterpart of special drawing rights allocated		2,900,678,270.–
8 Provisions		
8.1 For pensions	2,233,000,000.–	
8.2 For other purposes	2,527,000,000.–	4,760,000,000.–
9 Other liabilities		664,586,184.62
10 Accruals		275,480,538.85
11 Capital		290,000,000.–
12 Reserves		
12.1 Legal reserves	5,766,600,000.–	
12.2 Other reserves	290,000,000.–	6,056,600,000.–
13 Unappropriated profit		11,501,352,706.59
		268,924,590,340.01

Profit and loss account of the Deutsche Bundesbank for the year 1988

Expenditure

			DM
1	Administrative expenditure		
	1.1 Staff costs	838,265,858.57	
	1.2 Other	217,641,780.77	1,055,907,639.34
2	Banknote printing		152,831,980.93
3	Depreciation		
	3.1 of land and buildings	177,776,607.09	
	3.2 of furniture and equipment	110,157,400.91	287,934,008.–
4	Increase in provisions		
	4.1 for pensions	206,727,511.39	
	4.2 for other purposes	–	206,727,511.39
5	Pension payments in respect of the Reichsbank		19,336,318.98
6	Other expenditure		98,008,401.79
7	Profit for the year (= unappropriated profit)		11,501,352,706.59
			13,322,098,567.02

Receipts

		DM
1	Interest	11,570,731,813.71
2	Fees	24,045,328.81
3	Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	1,610,118,224.38
4	Other receipts	117,203,200.12
		13,322,098,567.02

Frankfurt am Main, February 1, 1989

Deutsche Bundesbank
The Directorate

Pöhl Prof. Dr. Schlesinger
Gaddum Prof. Dr. Gleske Prof. Dr. Köhler Dr. Storch Werthmöller

According to the audit which we have carried out in accordance with our mandate, the bookkeeping and the annual accounts comply with German law. While paying due regard to the principles of orderly bookkeeping, the annual accounts present a picture of the assets, liabilities, financial situation and profit or loss which is consistent with the actual state of affairs.

Frankfurt am Main, March 10, 1989

Treuarbeit Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

Dr. Wollert – Dr. Elmendorff KG
Wirtschaftsprüfungsgesellschaft

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