Deutsche Bundesbank Annual Report 1992

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on April 1, 1993

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(Developments from April 2 to October 31, 1992)

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(from November 1, 1992)

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Contents

Charts

Note

The current monetary policy regulations and the Principles Concerning the Capital and Liquidity of Banks are no longer included in the Annual Report, and will be published separately in future. The following publications have already appeared (in German only): Deutsche Bundesbank, Kreditpolitische Regelungen, Frankfurt am Main, April 1993, and Deutsche Bundesbank, Gesetz über das Kreditwesen, 11th edition, Frankfurt am Main, March 1993. They are available to interested parties free of charge. English translations will be appearing shortly.

Abbreviations and symbols

e	Estimated
p	Provisional
pe	Partly estimated
r	Revised
...	Figure available at a later date
.	Figure unknown, not to be published or meaningless
0	Less than 0.5 but more than nil
–	Nil

Discrepancies in the totals are due to rounding.

Foreword
by the President
of the Deutsche Bundesbank

Foreword

In 1992 German monetary policy was exposed to some searching tests, both nationally and internationally. In the second year after unification, the economic integration of the two parts of Germany made further headway, but wage-rate policy and fiscal policy, in particular, were slow to adjust to the reduced scope for income distribution in the economy as a whole. The adjustment of eastern Germany to the competitive conditions of a market economy has not yet made the progress that would have been necessary and, if competitiveness had been less in jeopardy, also possible. The undue demands made in the past two years on Germany's national product are reflected not least in a rate of monetary erosion that is currently exceeding 4 %.

The Bundesbank could not allow such a rate of price rises to become entrenched. It therefore consistently deployed its instruments, as before, with a view to containing the potential for sustained price increases. After monetary expansion far overshot the envisaged mark last year, there are now some indications that the unwavering medium-term-orientated monetary policy stance is bearing fruit. In the long run, however, monetary policy needs the support of all policy areas. Greater discipline and adaptability on the part of the policy makers, the business community and the parties to wage settlements are all the more necessary as the pace of business activity in western Germany slackened perceptibly after the middle of last year and aggregate output tended to decline, as far as the statistics go.

Besides the domestic challenges, the Bundesbank's room for manoeuvre was cramped at times last year by severe external constraints. In the light of some long-standing divergences in price and cost movements, as well as in public finance, and compounded by current problems with respect to business activity and growth, some partner currencies in the European Monetary System (EMS) came under strong pressure in the late summer of 1992. In line with the current regulations, the Bundesbank was obliged to intervene in the foreign exchange market, with support purchases on an unprecedented scale, and this strongly fuelled German monetary expansion. In the long run, adherence to exchange rates in the EMS that had become unrealistic would have meant that the Bundesbank would lose its means of exercising monetary control. In view of the "anchor function" of the Deutsche Mark in that system, however, this would have been detrimental both to price stability in Germany and to the anti-inflationary policy stance of all partner countries. Disequilibria which had accumulated over the years were rectified by exchange rate realignments; that was not a retrograde step on the road to European monetary union, but rather ensured a more sustainable basis for the further course of monetary integration.

The difficult intra-German adjustment problems and the timetable for European monetary union should not, however, obstruct the view of interrelated aspects of the global economy. It is true that Germany and the European Community are having to take action under complex national and regional conditions. At the same time, however, they are integrated in an increasingly interdependent world economy. The pressing issues involved here are capable only of a global solution: the revitalisation of the economies of central and eastern Europe and their integration in the world market; the maintenance of free world trade under the umbrella of the General Agreement on Tariffs and Trade (GATT); and further progress in the economic development of what has become known as the Third World. Industrial countries bear a special responsibility for the performance of these tasks; Germany's role has increased in significance since reunification. Resolute efforts to "keep one's own house in order" are in German eyes the most important contribution that can be made to successful international cooperation between partner countries.

The Bundesbank takes due account of these considerations in its policies. The present "Annual Report 1992" elucidates this fact in detail, and at the same time comments on major national and international monetary policy issues. Simultaneously, the Bank is hereby also presenting its annual accounts for 1992, which have been audited by two firms of auditors and were approved by the Central Bank Council on April 22, 1993. In the discharge of its statutory duties, the Bundesbank has been operating (just as in previous years) in a wide variety of fields: in the provision of cash, in the execution of payments, in foreign exchange dealing, in marketing Federal securities, as well as in the sectors of currency law and national and international banking supervision. On November 1, 1992 a regional restructuring of the Land Central Bank areas came into effect. This marked the end of the provisional arrangements for the new Länder, and completed their integration in the Bundesbank system. A growing number of employees of the Bundesbank are working for international organisations and, in an advisory capacity, in the countries of central and eastern Europe. Acting also on behalf of the Central Bank Council, I should like to take this opportunity of thanking all the staff members of the Bundesbank for the high-quality work they did with such integrity in 1992. Cooperation with the staff representative bodies was likewise once again marked by a spirit of mutual trust.

Frankfurt am Main, April 1993

Prof. Dr Drs h.c. Helmut Schlesinger
President of the Deutsche Bundesbank

The currency
and the economy

I. International economic fundamentals

Difficult global economic environment

The global economic environment in which the German economy operates remained problematical in 1992. Although underlying economic conditions have improved significantly in major industrial countries and in a number of developing countries, particularly in Latin America and east Asia, the onset of an economic recovery in the western industrial countries is being delayed longer than was initially anticipated. Some countries in the former Eastern Bloc succeeded last year in continuing the process of reforms required after the breakdown of the old system, while others are still lacking structures that show promise for the future.

Cyclical weakness in major industrial countries

Last year, overall economic output in the western industrial countries expanded perceptibly more markedly, at 1½%, than in 1991; the self-sustaining upswing on a broad front that had been hoped for in the wake of the strong recovery initially indicated at the beginning of 1992 did not set in, however. Instead, economic growth stagnated again later in the year. In most of the European industrial countries, in particular, cyclical weakness persisted, and even worsened in individual cases. Among the major countries in Europe, France was able in 1992 to achieve a rate of economic growth that was higher than a year before, but expansionary forces in Italy and in other south European economies declined even on average over the year. The recession in the United Kingdom persisted throughout last year, although to a lesser degree. And finally, retarding forces gained the upper hand in both western Germany and Japan, the economies of which had expanded dynamically up to 1991. At some 1½% in 1992, economic growth there came to less than half the high rates of increase registered in the previous year. In western and eastern Germany taken together, however, overall output rose more strongly in 1992 than in the preceding year.

Slowdown after a period of extensive growth

The bout of weakness in most western industrial countries followed a lengthy period of robust growth of a kind most recently recorded in the sixties. In the period from 1983 to 1990, i. e. for eight years, the real gross domestic product of the seven major industrial countries had expanded at an average annual rate of 3½%. Viewed against this background, and measured in terms of the severity of earlier production downturns, the current phase of flagging growth seems rather to be limited in character. This is also suggested by relevant studies by international organisations, although there are significant regional discrepancies. According to the analyses of the Organization for Economic Co-operation and Development (OECD), for instance, the slowdown in business activity in Germany, France, Japan and Italy remained less marked than in earlier periods of downswing right up to the end of the period under review. In the United States, by contrast, the decline in economic activity was in line with the average pattern of past experience. It was only in the United Kingdom and in Canada that the cyclical downturn was protracted and deep-seated, even by historical standards.

Erroneous trends in the past

To a major extent, the clouding-over of the business climate was the consequence of misdirected trends and excesses which economic policy makers in major industrial countries had countered too late, or only hesitantly. In the European Community, in particular, economic growth went hand in hand with a faster erosion of the value of money, which climbed from 3 % in 1987 to ultimately 5 % in 1991. The more persistently the upward movement of prices continued, the more stringent were the stabilisation measures required. The growth processes in the Anglo-Saxon countries, in particular, and in some countries in northern Europe as well as – to an increasing degree – in Japan were distorted in response to earlier excesses. In view of a seemingly inexhaustible dynamism and abundant liquidity, households, enterprises and financial institutions there had built up a considerable volume of debt in the eighties, which proved increasingly to be a heavy and lasting burden. Drastic falls in share prices and losses in the value of real estate undermined confidence in a cumulative process, and thus lastingly curbed the propensity to spend. This trend was exacerbated by the fact that high loan losses sometimes caused the banks to apply stricter yardsticks to their new business, and thus to rein in the expansion of lending to an unusually marked extent.

Prospects for an improvement in the underlying conditions

Notwithstanding the disappointing overall trend in business activity, however, there were also a number of favourable developments. The economy in the United States, in particular, returned to a firmer footing in 1992. Not least on account of the stimuli emanating from there, the prospects for the further development of the world economy are not unfavourable. The real gross domestic product in the United States grew by about 2 % last year, as against a drop of a good 1 % in 1991. At the same time, business activity picked up in Canada. On the basis not only of the developments in North America, but also of similar upward trends in South America and the sustained dynamism in south-east Asia, world trade expanded by some 4 % in real terms in 1992, as against only 2½ % in the year before. Although the growth of international trade in goods has thus not yet resumed the pace attained in the late eighties, the tendencies towards weakness recorded in 1991 appear to have been overcome. Further developments will depend not least on whether latent tendencies towards protectionism are

Key macroeconomic variables in selected industrial countries

Table 1

Country	Real gross domestic product 1991	Real gross domestic product 1992 p	Consumer prices 1 1991	Consumer prices 1 1992 p	Financial balance of the public sector 2 1991	Financial balance of the public sector 2 1992 p	Balance on current account 3 1991	Balance on current account 3 1992 p
	Change from previous year in %				as % of GDP		US$ billion	
Industrial countries	+ 0.3	+ 1.5	+ 4.4	+ 3.2	- 2.9	- 4.0	- 23.5	- 32.5
of which								
European Community	+ 0.7	+ 1.1	+ 4.9	+ 4.4	- 4.6	- 5.3	- 59.5	- 61.0
of which								
France	+ 1.1	+ 1.8	+ 3.1	+ 2.7	- 1.9	- 2.8	- 6.3	+ 2.9
Germany 4	+ 1.0	+ 2.0	+ 3.5	+ 4.0	- 3.2	- 2.8	- 19.6	- 26.0
Italy	+ 1.4	+ 0.9	+ 6.4	+ 5.2	- 10.2	- 10.5	- 21.5	- 17.2
United Kingdom	- 2.1	- 0.6	+ 5.9	+ 3.7	- 2.8	- 6.1	- 11.4	- 20.9
United States	- 1.2	+ 2.1	+ 4.2	+ 3.0	- 3.4	- 4.4	- 3.7	- 62.4
Japan	+ 4.0	+ 1.4	+ 3.3	+ 1.6	+ 3.3	+ 2.0	+ 72.9	+ 117.6
Canada	- 1.7	+ 0.9	+ 5.6	+ 1.5	- 6.1	- 6.8	- 25.5	- 24.2

Sources: EC Commission, IMF and national statistics. — 1 Cost-of-living index. — 2 As defined in the national accounts. — 3 On account of recording deficiencies, the current account deficit of the group of industrial countries is overstated statistically. — 4 Germany as a whole; the growth of west German real GDP amounted to 3.7 % in 1991 and to 1.5 % in 1992. West German consumer prices.

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warded off, and on whether it proves possible at last to bring the GATT negotiations, which have far exceeded the timetable initially set, to a successful conclusion. And finally, an indisputably favourable sign is the fact that, viewed as a whole, inflationary pressures have declined. In Japan and Canada, in particular, the upward movement of prices dropped to below 2 % in 1992. But the pace of price increases also slowed down in most European countries and in the United States. The prerequisites for a world-wide economic revival have thus improved in this respect as well.

No room for fiscal policy manœuvre

Government fiscal policies, by contrast, can hardly be expected to stimulate growth. It has become clear today that the past phase of growth was used only inadequately to reduce structural budget deficits, and thus to create future room for fiscal policy manœuvre. In the year just past, for instance, the public sector deficits in, above all, some of the Anglo-Saxon and Scandinavian countries increased dramatically. In the United States the deficit ratio rose from 3.4 % to 4.4 % of GDP, that in the United Kingdom from 2.8 % to 6.1 %, and that in Sweden from 1.5 % to 7.9 %. To this was added the fact that some countries with persistently high deficit ratios no longer made any progress in the consolidation of their budgets. In many countries public indebtedness reached new record levels not only in absolute terms, but also in terms of current receipts and expenditure (as well as in terms of the domestic product), and the structures of the public budgets are proving to be lasting impediments to growth. In addition, fiscal policy makers in many countries are facing new challenges, such as the forthcoming reforms of the health and social security systems. Another example is the necessary assistance for and support of the reform process in central and eastern Europe. In view of these immense tasks, it is essential that credible steps be taken immediately to place public finance on a sound footing again. The favourable impact this would have on market participants' expectations in respect of future trends in prices, interest rates and exchange rates can hardly be overestimated.

Monetary policy makers on a tightrope

The cloudy overall economic environment has caused monetary policy makers throughout the world to come under the pressure of being expected to give greater consideration than before to the short-term stimulation of business activity. Among the major industrial countries, the United States and Japan, in particular, have advanced far in their easing of the monetary policy reins. At the end of the period under review, the discount rate in Japan amounted to 2½ %, and that in the United States to 3 %. And money market rates were correspondingly low. But long-term interest rates, too, have fallen perceptibly. In view of the burden of the private and public sector debt accumulated in the course of the long period of growth, however, the process of interest rate reductions relatively soon came up against resistance on the capital market. Insofar as monetary policy makers attempt to conceal this by means of a corresponding increase in the liquidity provided, they risk neglecting the needs of a medium-term anti-inflationary stance. In the long run, at any rate, monetary policy cannot serve several goals at one and the same time. This became particularly clear in those countries that had geared their policies to an exchange rate target, but had simultaneously attempted to counter the tendencies towards a weakening of business activity by means of a corresponding relaxation of their monetary policies. Being required to do the splits in this way was simply sure to overtax monetary policy. In the conflict between different economic policy goals, some European countries gave increasing priority to the stimulation of domestic business activity, and abandoned the exchange rate targets they had previously pursued. These countries include the United Kingdom and Italy, both of which withdrew from the exchange rate mechanism of the EMS, as well as Finland, Sweden and Norway, which abandoned the voluntary pegging of their currencies to the ECU.

Marked shifts in exchange rates

In the wake of the changes in the priorities set in economic policy, and in view of both the persistent weakness of growth and the accumulation of undesirable trends, the exchange rates of the major internationally traded currencies changed in 1992, in some cases radically. In this context, it was the weakness of the US dollar, which had persisted virtually since mid-1991, that was initially accentuated further, and the European Monetary System experienced a total of four exchange rate realignments as well as the aforementioned temporary withdrawal of the lira and the pound sterling (see page 46f.). This led to the appreciation of the Deutsche Mark, above all against the other European currencies, and – over major parts of last year – also against the US dollar. The Japanese yen appreciated even more sharply.

"New quality" of the free flow of capital

In connection with the monetary turbulence of autumn last year, attention has repeatedly been drawn to the fact that these developments would hardly have been conceivable without the liberalisation and deregulation of the financial sector in the eighties. The amounts shifted around in those days and weeks were, indeed, of an unprecedented order of magnitude. The interrelationships involved would be misinterpreted, however, if what happened were to be used to discredit the "new quality" of the free flow of capital. The reason for the crisis-like developments is to be found not in this, but rather in the cumulated shortcomings in convergence, which cannot be lastingly concealed in the event of free capital movements. Viewed against the background of what has recently occurred on the exchange markets, the significance of sound fundamentals for the stability of exchange rates cannot be given too much emphasis. As long as far-reaching divergences continue to exist, or as long as different economic policy priorities predominate, it will be impossible, in principle, to dispense with the buffer and compensatory functions of exchange rates.

Price competitiveness and the international current account pattern

The changes in exchange rates that have occurred in the course of 1992 should help reduce the distortions in the international pattern of current accounts again. The strength of the yen, for instance, or the relative weakness of the US dollar, was quite in line with the clearly divergent external positions of the two countries. After the expiry of one-off effects in connection with the Gulf war, the US current account deficit climbed from just under US$ 4 billion in 1991 to a good US$ 62 billion in 1992, while Japan's surplus in that period soared from US$ 73 billion to US$ 118 billion. In the long run, such opposing positions are problematical for the world economy, not least because they encourage latent protectionist endeavours in the deficit countries. In Europe, too, external disequilibria tended to increase in some cases. The United Kingdom's current account deficit, for instance, virtually doubled from US$ 11.5 billion in 1991 to US$ 21 billion in 1992; in view of the deep recession in the United Kingdom, this is a remarkably clear deterioration. The depreciation of the pound sterling which has occurred in the meantime was probably a reflection of the unfavourable trend in foreign trade and payments. Much the same tends to hold true of Italy's persistent deficits on current account. External adjustments to the changes in Germany's supply and demand conditions, by contrast, have largely been completed.

Medium-term orientation of economic policy

The slower pace of business activity in Continental Europe and the persistent growth problems in other regions have revealed the structural weaknesses of the world economy. It has become clear in this context that excesses in the field of private and public sector debt as well as the neglect of adjustments in the past have led to a loss of confidence among consumers and investors, and to problems in the financial sector which cannot be resolved through short-term monetary and fiscal policy action. This clearly underlines just how vital it is to orientate economic policy towards the medium term. "Putting one's own house in order" is the *conditio sine qua non* for flourishing cooperation among the major industrial countries. The best ways of ensuring this are a credible anti-inflationary stance of monetary policy, sound public finance and not least the acceptance by all parties involved of the fact that the leeway for income distribution is limited. All in all, the prospects for 1993 have become more favourable in many respects. The debt situations of both households and enterprises, above all in the Anglo-Saxon countries, are starting to ease perceptibly. Enterprises in Germany's neighbouring countries in Continental Europe have undertaken considerable efforts to reduce costs and increase their competitiveness. There is thus as little reason for immediate stimulating measures as there is, on account of the hopeful signs on the horizon, for cutting back endeavours to adjust.

II. Economic trends in Germany and central bank policy

1. Sluggish business activity in the west, adjustment process in the east

Dampening external and internal influences on economic activity

In 1992 retarding influences from abroad, but also home-grown braking factors, impaired growth and employment in the German economy. In view of the slowdown in export business, which persisted for the third successive year, and the growing labour cost pressure, the economic climate in western Germany clouded over visibly in the course of last year. Nevertheless, the upward movement of prices at the consumer level failed to decline perceptibly. The east German economy made headway on its long road towards adjustment to market economy conditions in 1992, despite unexpectedly pronounced setbacks in trade with the central and east European reforming countries. So far, however, the pace has been determined less by endogenous driving forces than by west German transfer payments, which rose again last year. In spite of the high level of unemployment, the standard of living of the east German population has continued to improve.

Diverging economic trends in western and eastern Germany

Since the middle of 1990, when the monetary union with the then still extant GDR came into force, the east and west German economies have grown together ever more closely, and the reciprocal influences and common features have increased at the same time. Nevertheless, economic trends in the old and the new Länder still show considerable divergences, and many economic policy problems differ so significantly that consistently aggregated analyses (i.e. analyses geared to the respective all-German average) are still impossible. However, the more time has passed since unification, the more difficult it becomes to describe the two parts of Germany separately. Owing to ever-closer integration, it is becoming increasingly difficult to distinguish between the west and the east in the statistics.

Decline in the utilisation of the production potential in the west

In Germany, the real gross domestic product grew by 2 % in 1992; in the new Länder the value added went up by 7 %, as against 1½ % in the old Länder. In western Germany the increase in the gross domestic product was thus smaller than the expansion of overall production potential. Compared with the exceptionally high level of 1991, its utilisation consequently declined. In the manufacturing sector, which was hit hardest by the sluggishness of exports, capacity utilisation decreased most, namely to a level which, around the end of 1992, was considerably below the medium-term average. By contrast, in other sectors of the west German economy, to which the slowdown in the manufacturing sector has increasingly spread, resources were utilised to a greater degree in 1992 than they had been on an average in the preceding years. This applies, inter alia, to the construction industry, although – according to Ifo Institute data on the construction sector – capacity utilisation there did not quite regain the peak figures of the two previous years.

Less favourable situation on the labour market

The sharp wage increases of the past two or three years and the cyclical downturn left an ever-clearer mark on the west German labour market in 1992. Taking the average of last year, the number of persons employed in the old Länder once again

Key economic variables in western Germany

Table 2

Item	Unit	1991	1992	1991 Change from previous year in %	1992 Change from previous year in %
Aggregate demand (real)					
Private consumption	DM billion	1,274.6	1,287.1	+ 3.6	+ 1.0
Fixed capital formation	DM billion	485.0	492.3	+ 6.5	+ 1.5
Machinery and equipment	DM billion	239.6	233.1	+ 9.1	− 2.7
Construction	DM billion	245.4	259.1	+ 4.1	+ 5.6
Domestic expenditure	DM billion	2,148.7	2,182.2	+ 3.1	+ 1.6
Foreign balance 1	DM billion	+ 78.1	+ 64.1	.	.
Exports	DM billion	962.3	994.3	+ 12.7	+ 3.3
Imports	DM billion	884.2	930.2	+ 12.2	+ 5.2
Gross national product at 1985 prices	DM billion	2,226.8	2,246.3	+ 3.6	+ 0.9
Memorandum items					
Orders received (volume)					
by the manufacturing sector	1985=100	122.1	117.8	+ 0.5	− 3.5
by the construction sector	1985=100	137.2	138.7	+ 3.7	+ 1.1
Distribution of income					
Wage and salary income	DM billion	1,422.1	1,506.1	+ 7.9	+ 5.9
do. as a percentage of national income	%	70.8	71.7	.	.
Gross income of producing enterprises	DM billion	431.4	423.9	− 1.1	− 1.8
do. as a percentage of national income	%	21.5	20.2	.	.
National income	DM billion	2,008.8	2,099.7	+ 6.5	+ 4.5
Output					
in the producing sector (excluding construction sector) 2	1985=100	120.2	118.8	+ 2.9	− 1.2
in the construction sector 2	1985=100	127.3	136.4	+ 2.9	+ 7.1
Gross domestic product at 1985 prices	DM billion	2,209.6	2,242.7	+ 3.7	+ 1.5
Employment					
Employed in western Germany	Millions	29.2	29.5	+ 2.6	+ 0.8
Unemployed	Thousands	1,689.4	1,808.3	− 10.3	+ 7.0
do. as a percentage of the total labour force	%	5.7	5.9	.	.
Prices and wages					
Cost-of-living index	1985=100	110.7	115.1	+ 3.5	+ 4.0
Overall construction price level	1985=100	123.9	130.5	+ 6.8	+ 5.3
Index of import prices	1985=100	82.8	80.1	+ 0.4	− 3.3
Gross income per employee (in western Germany)	DM	54,700	57,600	+ 5.8	+ 5.4
Unit labour costs					
in the economy as a whole 3	DM	0.61	0.64	.	.
do. on the 1985 price basis	1985=100	114.2	119.6	+ 4.6	+ 4.7
Productivity 4	1985=100	109.9	110.6	+ 1.1	+ 0.7
do. in absolute figures 5	DM	89,400	90,200	.	.
Overall negotiated wage and salary level (on an hourly basis)	1985=100	130.8	138.5	+ 6.8	+ 5.9

1 Balance of transactions in goods and services with the rest of the world; in contrast to the balance of payments statistics, deliveries to and supplies from eastern Germany (including direct purchases by households in western or eastern Germany) are included in exports or imports. — **2** Results for kinds of activity units. — **3** Index of gross wage and salary income per employee generated in western Germany divided by index of GDP per employed person calculated at 1991 prices. — **4** GDP per employed person at 1985 prices. — **5** Relative to GDP at 1991 prices. — The data from the national accounts and the figures on employed persons are provisional.

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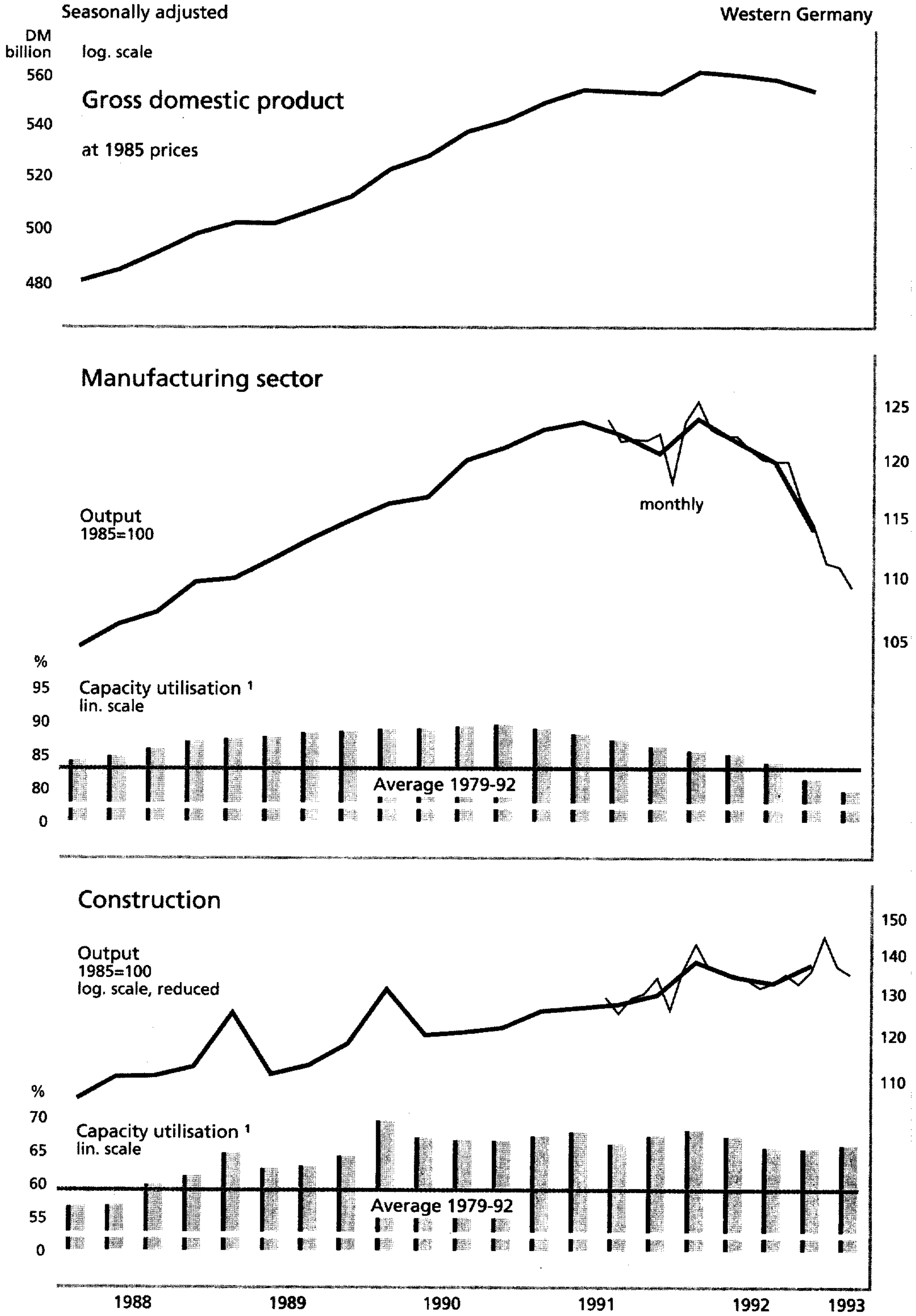
Output

Chart 1



1 Results of the Ifo Business Survey.

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rose by 230,000, or 0.8 %, to the record figure of 29.45 million. Towards the end of 1992, however, seasonally adjusted employment was much lower than at the beginning of the year. This decline persisted after the turn of 1992-3. Manufacturing enterprises had started to reduce their personnel as early as spring 1991. This reduction accelerated last year. In January 1993 465,000, or 6½ %, fewer persons were employed in this sector than in spring 1991. Moreover, short-time working – primarily in the manufacturing sector – grew in significance right up to the end of the period under review. The increase in the number of persons employed in the rest of the economy compensated for the reduction of staff levels in industry to an ever-lesser extent.

Declining demand and growing supply on the labour market

In addition, the decreasing demand for labour caused the number of vacancies registered with the labour exchanges to decline continuously right up to the end of the period under review, after it had reached its highest level since 1974 in spring 1992. On the other hand, the supply of labour grew considerably in 1992, primarily owing to the heavier inflow of foreign manpower. Migration from eastern Germany, by contrast, slackened, and the number of commuters from the new Länder rose less than in 1991. Furthermore, fewer ethnic German resettlers from eastern Europe came to western Germany in 1992 than at the end of the eighties or the beginning of the nineties. Since, as a rule, these persons initially attend language and/or qualification courses, there is a certain time-lag before the aforementioned decline has an impact on the labour market. At all events, the number of resettlers seeking jobs dropped only slightly last year compared with 1991. The greater supply of labour was accompanied – as mentioned – by a decline in manpower demand. Unemployment, which had fallen perceptibly in the three preceding years, consequently increased again in 1992, namely by 120,000 to roughly 1.8 million persons on an annual average, so that the unemployment rate amounted to 5.9 %. By the end of March 1993, the seasonally adjusted number of unemployed had risen to 2.16 million.

Overall economic activity at a high but declining level

Despite the unmistakable cyclical slowdown, overall economic activity on the whole remained at a high level on average in 1992, even if it declined distinctly in the course of the year. One of the main reasons for this was demand from eastern Germany, which increased again in 1992, and – according to the results of the national accounts – accounted for 7½ % of the real gross national product in the old Länder on balance (i.e. after offsetting against west German purchases from the new Länder). This bolstered economic activity not only in western Germany but also in its partner countries since the large supplies to the new Länder triggered additional west German imports. However, the effect of the rise in demand from eastern Germany on the growth of the national product was unable fully to offset the decline in foreign business – unlike the situation in 1991. Although west German sales of goods to other countries in 1992 increased by a seasonally adjusted 1½%, this does not adequately reflect the sluggishness of foreign demand. In real terms, foreign orders fell by 4%. Export deliveries remained at a comparatively high level because the industrial enterprises affected by the slump in foreign demand ran down their order backlogs on a considerable scale – backlogs which, as a whole, reached a level at the end of 1992 that was last seen in summer 1982.

Declining propensity to invest

The sustained drop in demand from abroad was a key reason why west German enterprises' propensity to invest decreased more and more. The dampening influence of sluggish export business was intensified considerably by a domestic factor – the heavy labour cost pressure. In the 1992 pay round management and labour agreed on pay increments averaging 6% on an hourly basis. On an annual average, this resulted in a rise of 4½% in labour costs per unit of real gross domestic product. In view of the fiercer competition on both international and national markets, which resulted, above all, from the economic slowdown in major partner countries, the scope for raising prices was comparatively limited, so that this cost pressure was mostly reflected in narrower profit margins. In view of the muted sales prospects, profit expectations and, in their wake, the propensity to invest deteriorated perceptibly as well. In 1992 the gross fixed capital formation of producing enterprises exceeded the comparable level of the previous year by barely 1½% in value, and undercut it by 1% in volume. Adjusted for working-day variations, domestic orders placed with west German capital goods producers (excluding vehicle manufacturers) in the last quarter of 1992 were as much as 10% down on the year in nominal terms, and 12% lower in real terms (with account having to be taken of the fact that these orders include the demand of west and east German enterprises for capital goods destined for the new Länder).

High level of construction activity

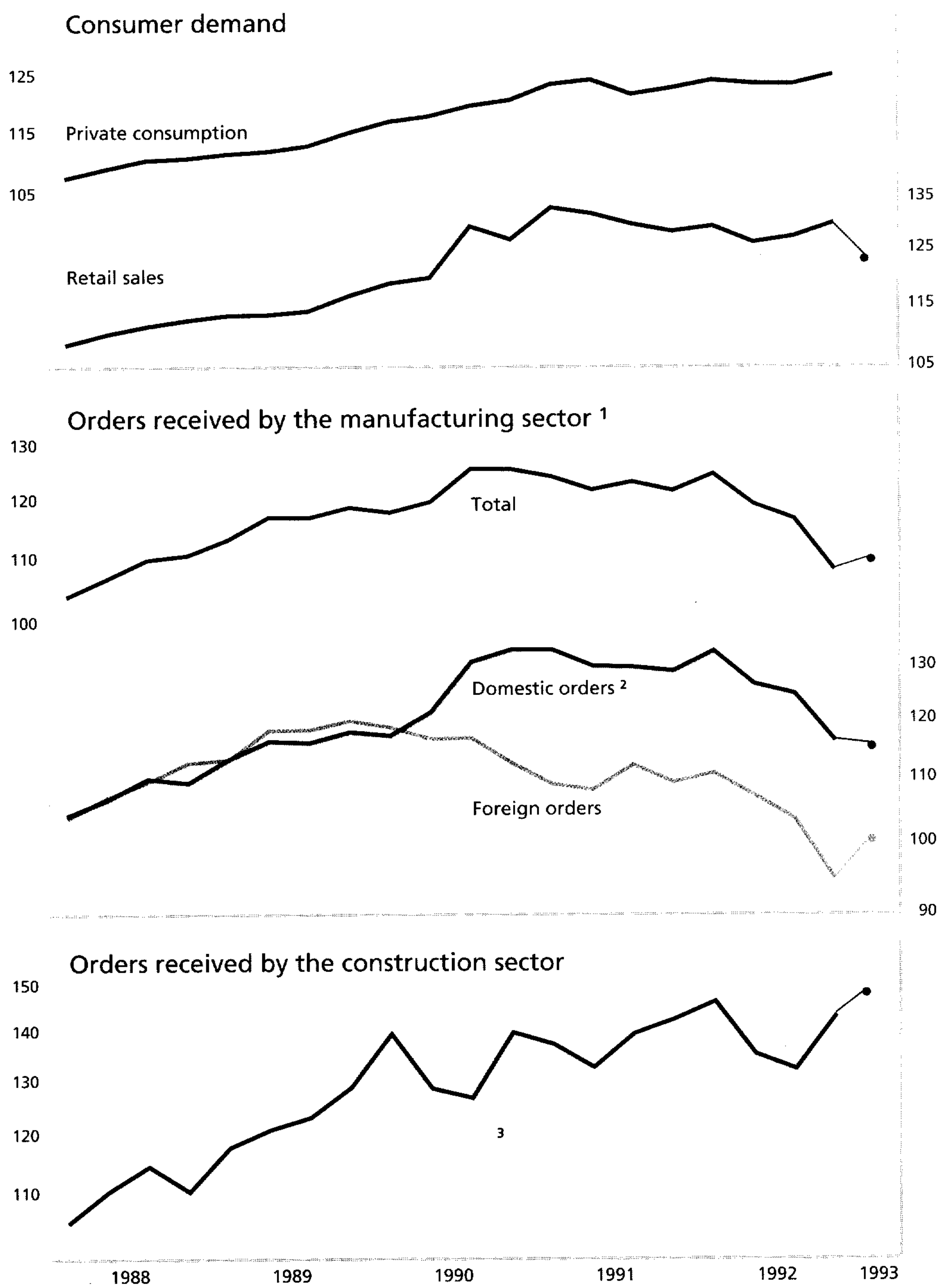
Construction activity was fairly buoyant in 1992. This can be seen from the fact, for instance, that both the forward reach of orders on hand and capacity utilisation remained at a high level, which changed but little against 1991. This also owed something to heavy ordering by public authorities. The main reason, however, was that demand for housing construction once again rose sharply in 1992, namely by 13½% in nominal terms and by 7½% in real terms. This expansion was due primarily to the shortage of housing caused, in particular, by heavy immigration to western Germany, which was reflected in the market in some considerable increases in rents. In addition, the expansion of tax concessions for the construction of owner-occupied homes in autumn 1991 was accompanied by a substantial rise in

Trends in demand

Chart 2

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

Western Germany



1 Excluding food, drink and tobacco industry. — 2 Including orders from eastern Germany. — 3 From October 1990, including orders from the new Länder and Berlin (east) to west German construction enterprises. — ● = January-February 1993; in the construction sector, January 1993.

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demand in this sector, as is suggested by the trend in building permits granted. Altogether, 375,000 dwellings were completed in 1992, which is an increase of about one-fifth against 1991. Building permits were granted for almost 460,000 dwellings, 14½% more than a year earlier. The difference which arose in 1992 between the number of permits issued and the number of dwellings completed – the so-called "overhang", at least the major part of which implies future housing construction work – was thus equivalent to just over one-fifth of overall output last year. It indicates that – as measured by construction capacities – demand in this sector can be expected to remain very buoyant.

Smaller increase in real private consumption

The steep wage increases in 1992 were not accompanied by a correspondingly strong expansion of real private consumption. Firstly, the renewed surge in labour costs was reflected, inter alia, in price increases that reduced the purchasing power of income. Secondly, the high wage increments impaired demand for labour and, to this extent, led to income losses. A stimulus to private consumer demand was imparted, with a short time-lag, by the abolition of the solidarity surcharge in the middle of the year. All in all, households raised their spending on consumption by 5% in value terms, which was a real increase of only 1 % in view of the significant erosion of the value of money. The increase in expenditure on housing was particularly sharp, with steep rises in rents and the enlarged supply of apartments in new buildings having a combined effect. Holiday trips abroad continued to be highly popular among consumers. For the rest, the number of passenger car purchases returned to normal, which automatically implied a decline from the record level of 1991.

Slower growth of disposable income

The growth of income did not quite keep pace with the expansion of expenditure on consumption. Total gross wages and salaries were 6% higher than a year earlier, or 4½% higher after the deduction of taxes and social security contributions. Current government transfers went up considerably more sharply, among other things because of higher payments of unemployment assistance and short-time working benefits. However, since the deterioration of corporate profitability apparently caused the self-employed to exercise restraint in respect of private withdrawals, disposable income nevertheless rose by only 4 % over the year, and thus less than consumer spending. The share of saving in households' income consequently declined somewhat, namely by about ½ percentage point to 14 %.

Sharp increase in private money balances

West German residents were guided by rather diverging considerations in their investment decisions in the course of last year. Initially, it was no doubt mainly interest rate considerations which were to the fore, and savers were guided primarily by the yields at the short end of the financial markets. Financial investment in short-term time accounts in Germany and abroad, for instance, and in liquid savings accounts, which seem to have been increasingly offered on special terms, rose fairly sharply well into the summer. With the decline in interest rates which started in September and the approaching introduction of the flat-rate tax on residents' interest income at the beginning of 1993, preference for liquid assets gained more and more ground and was reflected in a substantial bloating of private cash holdings. In addition, there was a sharp increase in purchases of foreign investment fund units (see page 70f.). In the upshot, the expansion of money balances and investment in foreign securities absorbed just over two-thirds of newly acquired financial assets in 1992, which amounted to some DM 215 billion; this share was twice as high as in 1991.

Persistently sharp upward movement of prices

Although economic activity slowed down more and more in the course of last year, the upward movement of prices did not abate, at least not at the consumer level. At 4 % on an annual average, the rate of inflation (which owed something to the after-effects of the increases in indirect taxes and charges that had come into effect in mid-1991) was higher than at any time since 1982. As the standard rate of value-added tax was raised at the beginning of 1993, the rate of increase in consumer prices in the first three months of this year was distinctly above 4 % again.

Relief from the external flank

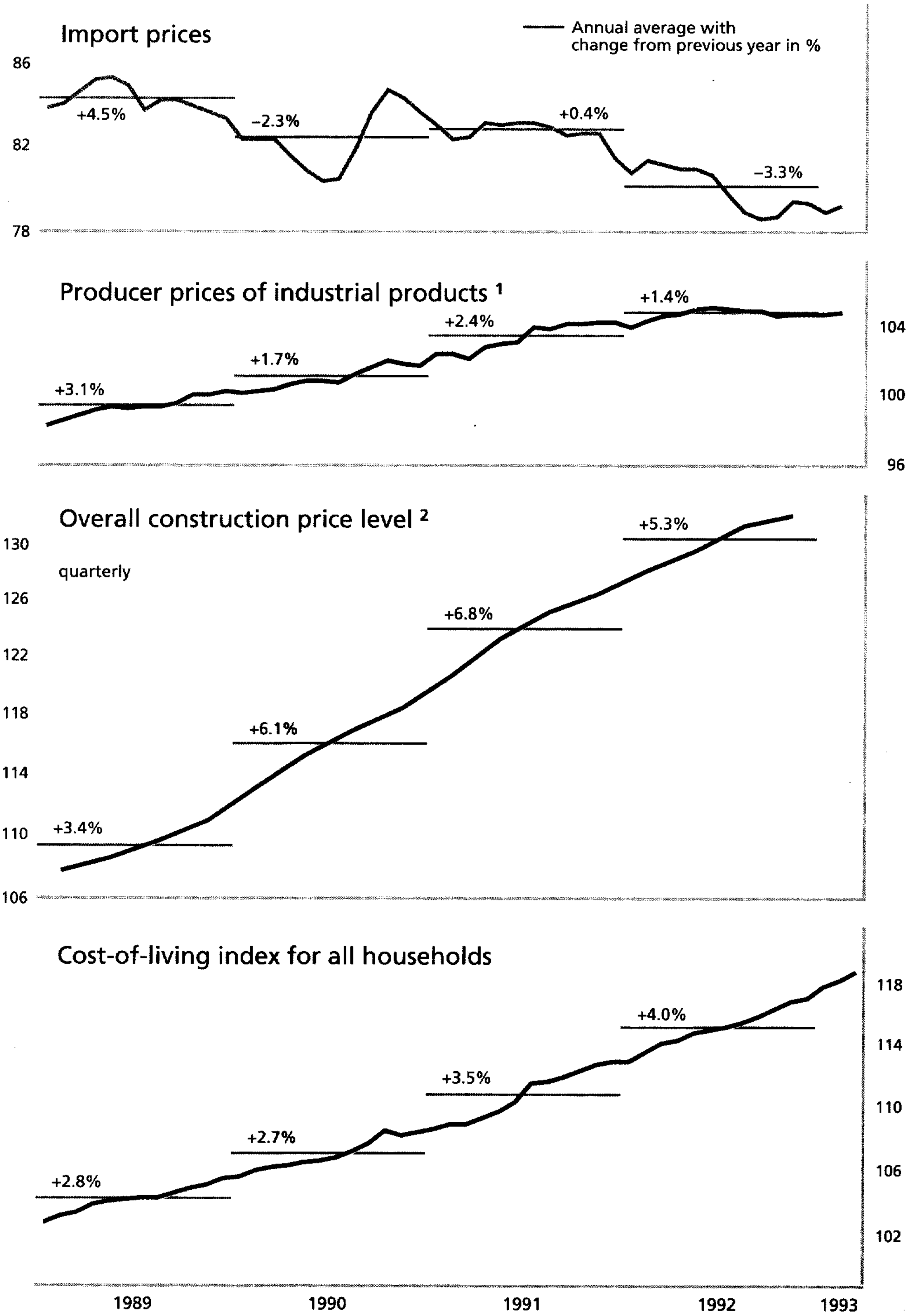
In 1992 there were, all in all, relieving effects on price trends in Germany from the external flank. The dollar quotations for raw materials and sources of energy on international markets were considerably lower than in 1991. In view of the depreciation of the US dollar against the Deutsche Mark, Deutsche Mark prices declined even more sharply. As international economic activity was weak, import prices of other goods dropped as well. In 1992 imports were altogether 3½ % cheaper than a year before; towards the end of 1992 and at the beginning of this year, however, stability imports declined. The external relief provided a certain counterweight to the sharp wage increases, not least in the manufacturing sector. Since competition had become fiercer as a result of the sluggishness of international economic activity, only some of the home-grown cost increases could be passed on in sales prices, so that profit margins narrowed. At the industrial producer stage, the price level rose by only 1½ % last year; in February 1993 the year-on-year rate of increase was merely ½ %. Construction work in western Germany, by contrast, once again rose sharply in price in 1992. On an annual average, the overall construction price level was 5½ % higher than in 1991. The rise was nevertheless smaller than a year earlier, inter alia, no doubt because the pay settlement in the construction industry last year was not quite as high as in the 1991 wage round.

Prices

Chart 3

1985=100, seasonally adjusted, log. scale

Western Germany



1 Domestic sales. — 2 Calculated by the Bundesbank.

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Sharp increases in rents and in the prices of services

At the consumer level, too, the external relief counteracted the upward movement of prices. In spite of the tax increase in the middle of 1991, mineral oil products, for example, were hardly any more expensive in 1992 than a year before. Moreover, the rise in food prices was smaller than in the two preceding years. As regards the overall consumer price level, however, this factor was more than offset by the sharp increase in rents and in the prices of private and public services, which thus responded not least to the new surge in labour costs in 1992.

1993 wage round

The first settlements reached in the 1993 wage round, most of which resulted in pay increases of between 3 % and 4 %, suggest that, compared with the two previous years, a wage policy was being pursued in western Germany which was, on the whole, moderate, a fact which owed much to the deterioration in the overall economic situation, particularly that on the labour market. On the one hand, this improved the prerequisites for a slowdown in the upward movement of consumer prices over time. On the other hand, the prospects for an upswing in western Germany have become better, at least from this angle.

Further improvement of the standard of living in eastern Germany

In eastern Germany the standard of living of the population continued to improve considerably in 1992, particularly as a result of the high west German transfer payments, which rose once again. Aggregate real domestic demand in the new Länder, which comprises not only current consumption but also, with investment, future potential consumption, so to speak, grew by 9 %, or – calculated per capita – by an estimated 10½ %. It thus reached almost two-thirds of west German demand, whereas it had been just over one-half of the west German level in the first six months after the inception of German monetary union. The expansion of output failed to keep pace with this rise in demand, although the real gross domestic product, taken by itself, increased sharply, namely by 7 %. The gap between domestic demand and output, which is "financed" largely by west German transfer payments, thus widened further. In 1992 domestic expenditure on goods was nearly twice as high in real terms as the gross domestic product. In the second half of 1990 it had exceeded output in the new Länder by just under 50 %.

Sharp growth of capital formation

The sharp increase in domestic demand in 1992 was again based on a strong expansion of investment. Gross fixed capital formation rose by 31½ % in value and by 24 % in volume, the expansion being led by investment in construction. All in all, the share of investment in domestic expenditure on goods was for the first time higher than in western Germany. As measured by the requirement of reconstructing large parts of the capital stock, particularly in view of the problems on the labour market, this was not enough, however.

Key economic variables in eastern Germany

Table 3

Item	Unit	1991	1992	2nd hf of 1991	1992
				Change from previous year in %	
Aggregate demand (real)					
Private consumption	DM billion	186.7	196.7	+ 3.7	+ 5.4
Fixed capital formation	DM billion	82.9	102.9	+ 25.1	+ 24.0
Machinery and equipment	DM billion	40.4	45.7	+ 70.0	+ 13.3
Construction	DM billion	42.6	57.2	– 0.7	+ 34.2
Domestic expenditure	DM billion	358.5	390.8	+ 18.4	+ 9.0
Foreign balance [1]	DM billion	– 163.1	– 180.8	.	.
Exports	DM billion	60.4	71.6	– 5.5	+ 18.5
Imports	DM billion	223.5	252.5	+ 43.8	+ 13.0
Gross national product at 1991 prices	DM billion	195.4	209.9	– 7.7	+ 7.4
Memorandum items					
Orders received					
by the manufacturing sector	2nd hf of 1990=100	78.9	73.0	– 20.8	– 7.4
by the construction sector	2nd hf of 1990=100	143.4	210.7	+ 76.5	+ 46.9
Income					
Wage and salary income	DM billion	184.2	222.2	.	+ 20.6
Households' disposable income	DM billion	199.5	248.3	+ 33.4	+ 24.5
of which					
Current transfers received	DM billion	71.8	100.1	.	+ 39.4
Households' saving ratio [2]	%	6.4	13.0	.	.
Output					
in the producing sector (excluding construction sector) [3]	2nd hf of 1990=100	72.0	68.1	– 28.8	– 5.4
in the construction sector [3]	2nd hf of 1990=100	98.9	129.3	+ 5.6	+ 30.7
Gross domestic product at 1991 prices	DM billion	186.2	198.9	– 11.4	+ 6.8
Employment					
Employed in eastern Germany	Millions	7.2	6.3	– 18.7	– 11.7
Unemployed	Thousands	913	1,170	+ 138.0	+ 28.2
do. as a percentage of the dependent labour force	%	10.4	14.8	.	.
Prices and wages					
Cost-of-living index for all employee households	2nd hf of 1990/ 1st hf of 1991=100	108.3	120.4	+ 17.5	+ 11.1
Price index of residential buildings	1989=100	164.3	182.4	+ 15.3	+ 11.0
Gross income per employee (in eastern Germany)	DM	25,600	35,600	+ 56.3	+ 39.0
Unit labour costs in the economy as a whole [4]	DM	0.99	1.13	+ 43.3	+ 14.9
Productivity [5]	DM	25,900	31,400	+ 9.0	+ 21.0

1 Balance of transactions in goods and services with the rest of the world; in contrast to the balance of payments statistics, deliveries to and supplies from western Germany are included in exports or imports. — **2** Saving as % of disposable income. — **3** Results for kinds of activity units. — **4** Index of gross wage and salary income per employee generated in eastern Germany divided by index of GDP per employed person calculated at 1991 prices. — **5** GDP per employed person at 1991 prices. — The data from the national accounts and the figures on employed persons are provisional.

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Undesirable trends in wage policy

The relatively high share of consumption in total domestic expenditure on goods probably owes something to the trend in wages, which – from the supply side – still stands in the way of greater capital formation, as well as many other obstacles. Actual earnings per employee in eastern Germany increased by an average of 39 % in 1992, and thus reached 62 % of the west German level (as against only 34½ % in the second half of 1990). Measured in terms of productivity advances, east German wages are being brought into line with west German levels too rapidly – with corresponding consequences for enterprises' profitability, and thus for existing and essential new jobs. Despite a sharp increase, the east German real gross domestic product per employed person came to only a good one-third of the west German level last year. In macroeconomic terms, east German unit labour costs were therefore about three-quarters higher than in the old Länder.

Gradual dismantling of investment barriers

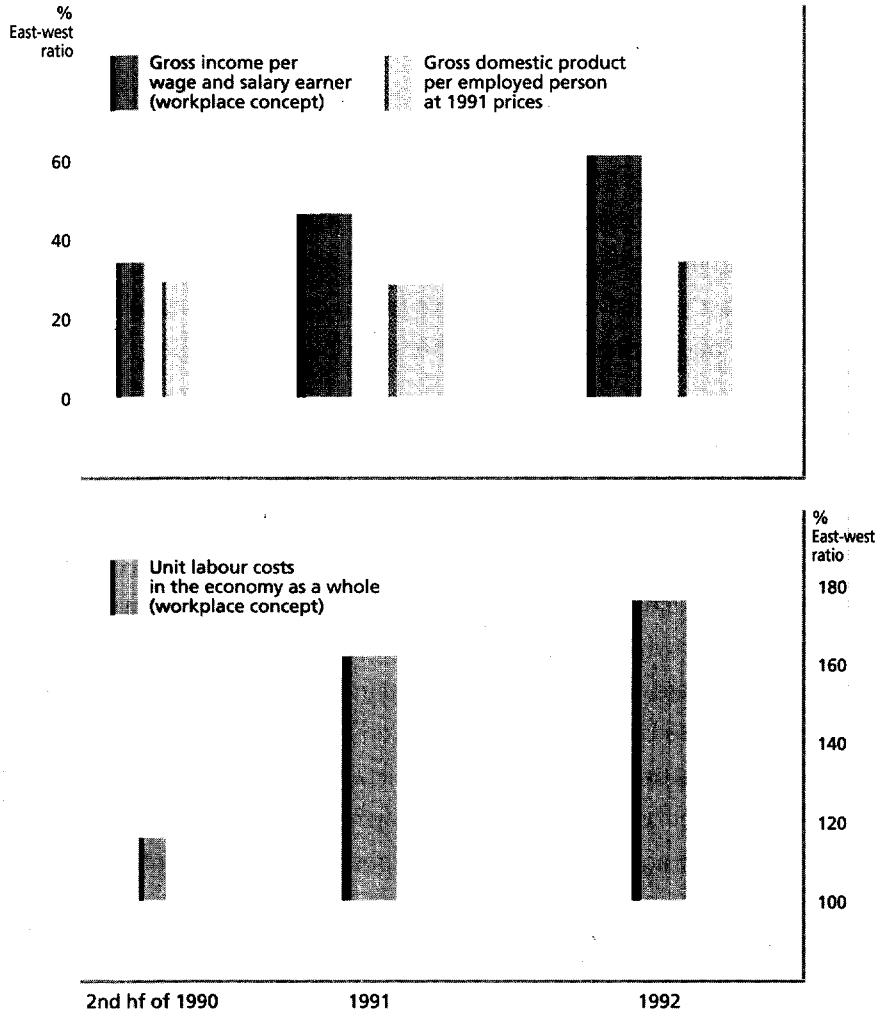
Disregarding the trend in wages, the conditions for a gradual narrowing of the gap between domestic demand and output, and for a self-sustaining upswing coming under way as a result of an increase in east German output, improved in 1992. On the demand side, this improvement owed something to the fact that east German residents are apparently again resorting more strongly to east German products, which have meanwhile become increasingly competitive vis-à-vis products originating elsewhere. On the supply side, the underlying conditions became more favourable, inter alia because the reconstruction of the public infrastructure was pushed ahead, because the efficiency of public administration was improved, and because investment barriers relating to the ownership issue were dismantled. In 1992 the Treuhand agency made great progress in privatising enterprises. All in all, some 7,000 out of 11,800 enterprises had been privatised or returned to former private or municipal owners by the end of last year, and 2,200 were in the course of liquidation.

Collapse of traditional export markets

Despite the progress made in the east German economy towards increased national and international competitiveness, the remaining adjustment needs are still considerable. This applies primarily to the manufacturing sector, where pressure to adjust increased very substantially in 1992 because the traditional sales markets in central and eastern Europe either collapsed completely or had only limited absorptive capacity, inter alia as a result of the shortage of foreign exchange in the reforming countries there. Foreign demand for east German industrial products, which is fuelled mainly by the export orders of these countries, dropped by almost two-fifths in 1992. Although domestic orders increased fairly sharply, this did not offset the losses in foreign business, so that total orders declined by 7½ %. In line with this trend in demand, manufacturing output was

Comparison of wages, productivity and labour costs in eastern and western Germany

Chart 4



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cut by 1½%. The problem of finding sales opportunities on other markets as soon as possible to compensate for losses in business with the reforming states, first signs of which had become visible as early as 1991, was thus exacerbated dramatically for east German firms. The persistent economic weakness in most western industrial countries, and not least the perceptible downturn in economic activity in western Germany, are impairing the success of such efforts considerably.

Sharp expansion in the services sector and the construction industry

In contrast to the manufacturing sector, output in the other sectors of the east German economy expanded sharply. This applies to large parts of the services sector and particularly to construction. In 1992 demand for construction work rose steeply again, namely by a nominal 47 %, as measured by the orders received by the construction industry. In the course of last year the pattern of demand for construction work changed to the extent that housing construction orders, many of which were apparently placed for the renovation and rehabilitation of existing dwellings, gained more and more in significance. Construction output last year was 30½ % higher than in 1991; the finishing trades, too, are likely to have raised their output perceptibly.

Further decline in employment

Irrespective of the marked economic growth, employment continued to decline in 1992. At 6.3 million, the number of persons employed in eastern Germany was 840,000, or 11½ %, lower than a year earlier. Compared with 1989, it fell by about 3 million, or just over one-third. The hopes still entertained in 1990, to the effect that the labour market problems to be expected, and particularly the reduction of overstaffing in the industrial sector, would largely be resolved through moves on the part of many members of the work-force over to the comparatively underdeveloped private services sector, were realised only in part. A major factor in this context is probably that the surging wage increments have accelerated the reduction of employment in industry in many cases, and have considerably hampered the creation of profitable alternative jobs in the particularly labour-intensive services sector. Compared with the preceding year, the number of unemployed consequently rose by roughly 260,000 to an average of almost 1.2 million in 1992; that represented an unemployment rate of nearly 15 %. With the phasing-out of the special arrangements for short-time workers towards the end of 1991, the number of persons working short time fell sharply, namely by 1.25 million to 370,000 on average in 1992. Thanks mainly to the increased use of labour market policy measures, however, the rise in unemployment was much lower than the reduction in employment. 490,000 persons attended vocational further training courses, 390,000 participated in job creation schemes, and 515,000 received transitional benefits for early retirement. All in all, 1.4 million persons were thus covered by labour market policy measures, the previous year's level being exceeded by 750,000. Moreover, some relief was afforded to the east German labour market by the fact that many members of the labour force found jobs in western Germany – either as commuters (whose number increased by an estimated 100,000 to an average of 420,000 in 1992) or after moving to the old Länder, although this process probably slowed down in the course of last year. And finally, a considerable number of previously employed women seem to have left the work-force in view of the unfavourable labour market situation.

Price increases as a result of the adjustment of prices to market conditions

In 1992 price trends in eastern Germany, above all at the consumer level, were again strongly characterised by the fact that prices were adjusting to market conditions. In many fields this change in relative prices has largely been completed. The price movements of industrial products experienced by consumers in eastern Germany, for example, were fairly similar to those in western Germany. The situation is different in the case of rents, which still do not nearly cover the costs of housing in the new Länder. A first step towards the adjustment of rents in October 1991 contributed a great deal to the severity of the increase in the cost-of-living index in eastern Germany, of just over 11 % on average in 1992. Excluding rents, the rate of price increases was only half as high. For many east German households in the lower income brackets, the burden associated with the rent adjustment was offset, partly or completely, by the government's granting of housing allowances. Where this was the case, the above-mentioned increase in the consumer price index overstates the burden on income. This may even be true in other respects. The index is still based on consumption patterns in the second half of 1990 and the first half of 1991. In the meantime, these patterns have changed considerably, presumably in such a way that an appropriate adjustment of consumer spending caused the actual price increases to be smaller than the rise in the index, even if account is taken of the fact that the share of rents in the consumer price index is still relatively low. Such an overstatement is suggested by the fact, for example, that the so-called deflator of private consumption, which is determined in the context of the national accounts and which takes due account of changes in what consumers buy, rose by just under 10 % in 1992, and thus less than the consumer price index.

Home-grown inflationary pressures

The upward movement of prices in eastern Germany is largely home-grown; it is due not least to the surging wage increments, which were reflected in the increases in the prices of services, and most clearly in the sharp rises in construction prices. From the third quarter of 1990 (the first period for which data are available) to the last quarter of 1992, the prices of construction work on residential buildings increased by roughly one-third, on industrial buildings by just over one-quarter and of work on road construction by roughly one-tenth. A large proportion of the public construction incentives was "lost" through these price rises.

Increase in promotional schemes problematical

Further economic developments in eastern Germany depend not just on the world-wide and, particularly, the west German business situation, but mainly on the progress made in creating a sustainable economic basis for profitable investment. This requires improvements in the infrastructure as well as a better conformity of the trends in wages and productivity, which is ultimately also likely to contribute to a reduction in the high unemployment level. At the same time, enterprises are called upon to open up new markets with new products. In the long run, sales problems cannot be concealed by maintenance subsidies. Other countries' experience of considerable regional discrepancies shows, firstly, that the government is overtaxed by the resulting financial burden and, secondly, that it will hardly be possible by industrial policy means to set up the necessary modern and competitive industrial structure. All that often happens is the prolongation of the death-throes of enterprises which are not viable under market conditions. There are numerous and necessary incentives for capital formation in eastern Germany. A further sharp expansion of the manifold promotional schemes is hardly likely to increase the propensity to invest in the new Länder significantly, quite apart from the fact that this would substantially increase the risk of misdirected investment and – owing to the "exploitation" effects – the burden on public budgets.

2. Public finance under persistent strong pressure

Sharp rise in the expenditure of the central, regional and local authorities

Last year public sector expenditure once again rose sharply, with the result that, all in all, the budgetary situation (which showed a massive deficit after German unification) failed to improve, in spite of the increases in taxes and social security contributions. In 1992 the expenditure of the central, regional and local authorities (including the "German Unity" Fund, the ERP Special Fund and the Debt-Processing Fund) grew by 9½%. This owed something to requirements which had increased in the wake of German unification. For example, spending by the new Länder went up by over one-tenth, and that by east German local authorities by almost one-quarter. But expenditure in the old Länder continued to rise quite strongly, too. This shows that the necessary adjustment of requirements to the fundamentally changed situation (owing to unification) has made little progress so far. This was particularly manifest in the case of the old Länder and their local authorities, the expenditure of which in 1992 exceeded the previous year's level by 6% and 9%, respectively. This was mainly due to the expansion of personnel expenditure, and social expenditure in particular, but most of the other expenditure items likewise rose. The expenditure of the Federal Government was 6½% higher than a year before, largely because of higher transfers to eastern Germany and increasing interest burdens arising from debt incurred in the course of unification. Other important factors were additional benefits granted in the context of the equalisation of burdens for families. On the other hand, the special burdens arising from the contribution made in 1991 towards the cost of the Gulf war were no longer felt.

Public sector finance *

Table 4

Item	1990 p Old Länder	1990 [1] Eastern Germany	1991 pe Whole of Germany	1992 pe Whole of Germany	1992 pe Whole of Germany
	DM billion				Change from previous year in %
Central, regional and local authorities					
Expenditure					
Personnel expenditure	236.1		287	313	+ 9
Other operating expenditure	118.5		142	152	+ 7
Transfers [2]	214.9		294	302.5	+ 3
Interest paid	64.7		77	101	+ 30.5
Fixed capital expenditure	66.7		88.5	100	+ 12.5
Financial aid [3]	47.9		70.5	81	+ 15
Total expenditure [4]	749.4	72.1	961	1,051	+ 9.5
of which					
Federal Government	311.4	72.1	405.5	431	+ 6.5
West German Länder Governments	299.6		[7] 328	[7] 348	+ 6
East German Länder Governments			77	87	+ 13
West German local authorities	209.9	.	227.5	247.5	+ 9
East German local authorities			43.5	53.5	+ 23
EC [5]	22.5		33	35.5	+ 8
Receipts					
Tax revenue	549.7	17.4	662	731.5	+ 10.5
Other receipts	154.4	10.5	181	216.5	+ 19.5
Total receipts [4]	703.1	27.9	838.5	945	+ 12.5
of which					
Federal Government [6]	290.5	47.9	353.5	399.5	+ 13
West German Länder Governments	280.2		[7] 309	[7] 330.5	+ 7
East German Länder Governments			66	72.5	+ 10
West German local authorities	205.8		222	239.5	+ 8
East German local authorities			45	48	+ 7
EC	22.5		33	35.5	+ 8
Surplus (+) or deficit (–)	– 46.3	– 44.2	– 122.5	– 106	
of which					
Federal Government	– 20.9	– 24.2	– 52	– 32	
West German Länder Governments	– 19.4		[7] – 19	[7] – 17.5	
East German Länder Governments			– 11	– 14	
West German local authorities	– 4.2		– 5.5	– 8	
East German local authorities			+ 1.5	– 5.5	
"German Unity" Fund		– 20.0	– 30.5	– 22.5	
Debt-Processing Fund			+ 0.5	+ 0.5	
ERP Special Fund	– 2.2		– 6.5	– 6.5	
Social security funds					
Expenditure	426.4		545.5	624.5	+ 14.5
Receipts	442.7		558.5	617.5	+ 10.5
Surplus (+) or deficit (–)	+ 16.3		+ 13	– 7	
Public sector, total					
Expenditure	1,124.4		1,436.5	1,597	+ 11
Receipts	1,094.4		1,327	1,484	+ 12
Deficit (–)	– 29.9		– 109.5	– 113	

* 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** Section B of the Federal budget and "German Unity" Fund; only second half of 1990. — **2** Mainly social expenditure and current grants to the enterprise sector. — **3** Expenditure on investment grants and loans to third parties, plus the acquisition of participating interests. — **4** Including differences in clearing operations. – **5** EC expenditure financed out of EC revenue in Germany. — **6** The Bundesbank profit transfer is included in full in this figure as Federal Government revenue. — **7** Including the whole of Berlin.

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Strong expansion of social security spending

In the field of social security, the Federal Labour Office incurred heavy additional expenditure as a result of job-creation measures and vocational training measures in eastern Germany. Moreover, additional cyclical burdens arose from the increase in unemployment in the old Länder. The expenditure of the statutory pension insurance funds in eastern Germany also soared. On the one hand, this owed something to the very strong wage increases, which, in accordance with the adjustment procedure, were reflected in the level of pensions. On the other hand, the introduction of west German pension legislation in the new Länder at the beginning of 1992 gave rise to considerable additional benefits – although this did not affect the financial situation in full last year. In contrast to that, financial trends in the statutory health insurance funds were significantly affected by exceptionally strong increases in expenditure in western Germany. If one includes the social security funds, public sector expenditure rose by 11 % in 1992; the growth rate of public expenditure thus almost matched that of revenue.

Substantial additional revenue

In 1992 the revenue of the central, regional and local authorities was 12½ % above the previous year's level. Tax revenue alone grew by 10½ %. In part this was attributable to the fact that it was now a full year since the excise tax increases had come into force in mid-1991. The solidarity surcharge on income tax which had been introduced at the same time expired in mid-1992. All in all, tax revenue exceeded the comparable estimates of the end of 1991, on which budgetary planning was largely based, by DM 13.5 billion; this above all reflected the relatively high wage increases and the strong inflationary pressure in the old Länder. Among the other types of revenue, the higher profit transfer by the Bundesbank to the Federal Government was an important factor. In the field of social security, the increase in the contribution rate introduced at the beginning of April 1991 in order to finance the expenditure of the Federal Labour Office also made itself felt compared with the previous year. In addition, the contributions to the statutory health insurance funds had to be increased in the course of 1992 in response to the mushrooming expenditure.

Rising transfers from western to eastern Germany

In the field of public sector finance, transfers from western to eastern Germany once again rose considerably in 1992. On balance, i.e. net of the revenue of the Federal Government in eastern Germany, they came to almost DM 130 billion, compared with about DM 110 billion a year before. (This is not counting interest expenditure on debt due to unification or interest-subsidised loans, since only the funds spent on interest subsidies in the year concerned are regarded as transfers.) In this context, the transfers effected in the context of social security rose strongly, thus further increasing the proportion of funds spent for consumption purposes.

Large public sector deficit

Altogether, the public sector deficit, at almost DM 115 billion, was slightly larger than in 1991; relative to GNP, it remained approximately the same (just under 4 %). The position of the social security funds deteriorated dramatically. After having shown a surplus of DM 13 billion in 1991, they now ran a deficit of about DM 7 billion, which was financed by drawing on previously accumulated reserves. By contrast, the deficit of the central, regional and local authorities decreased in 1992. According to the information now available, it amounted to about DM 106 billion, compared with DM 123 billion a year before. However, the budgetary situation did not improve everywhere. For example, the deficit actually expanded further in the new Länder and their local authorities. On a per-capita basis, it was approximately three times as high as in the old Länder and their local authorities.

High level of net borrowing

In 1992 net borrowing in the market by the central, regional and local authorities amounted to DM 103 billion (after having reached DM 107 billion in 1991).[1] It did not quite equal the volume of the deficit, in particular since the Federal Government withdrew the balances it had held with the Bundesbank at the end of 1991. Admittedly, the credit markets were drawn upon not only by the central, regional and local authorities but, to an increasing extent, also by the other public agencies. In 1992 the Federal Railways, the Federal Post Office and the Treuhand privatisation agency, taken together, raised loans amounting to DM 59 billion (a year before, loans had come to DM 37.5 billion). Moreover, the large number of programmes for granting interest-subsidised loans, in particular for the restructuring of eastern Germany, continued to impose heavy demands on the credit markets. Only the lesser part of these loans is included in the budget volume of the central, regional and local authorities.

Public finance relative to 1989

The severity of the pressures affecting public finance is brought out clearly by a comparison with 1989, the last year prior to German unification. In 1992 government expenditure (in the budgetary definition) was equivalent to some 53 % of all-German nominal GNP, compared with about 47 % in the old Länder in 1989. In the same period, the government levy ratio (taxes and social security contributions taken together) rose from 39½ % to 41½ % of GNP, thus reaching the highest level since the Federal Republic of Germany came into existence. The

1 In addition, the level of debt increased on account of the obligations incurred by the Debt-Processing Fund, which had grown as a result of the allocation of equalisation claims.

deficit ratio expanded from ½% to almost 4%, as mentioned above.[1] Last year public sector borrowing came to about 40% and – if the Federal Railways, the Federal Post Office and the Treuhand agency are included – to as much as about 60% of domestic net saving. The level-of-debt ratio of the central, regional and local authorities rose from 41½% in 1989 to 44½% of GNP, although it must be borne in mind that the liabilities of the Debt-Processing Fund have not yet been quantified in full and that the debt of the Treuhand agency which will be assumed by the Federal Government has not yet been included at all. In absolute terms, at the end of 1992 all-German public sector debt (excluding the debt of the Federal Railways, the Federal Post Office and the Treuhand agency) totalled about DM 1,345 billion, after having reached some DM 930 billion in the old Länder at the end of 1989.

The budgets for 1993

Budgeting for 1993 was significantly affected by the necessity of containing the expansion of expenditure, and thus of aiming at a consolidation over the medium term. However, as a result of the economic slowdown, the public authorities are at present confronted with losses of revenue and additional expenditure. Toleration of these budgetary burdens can only be justified on condition that the fiscal policy makers definitely set a course in the direction of consolidation over the medium term. Reduction of the deficits is a major prerequisite of smooth and sustained economic growth in Germany.

Lower rise in expenditure

According to the budgets of the central, regional and local authorities, the growth rate of expenditure in the current year will slow down to just over 4%. At the beginning of March a draft supplementary budget for the Federal Government was submitted which provides, in particular, for funds to offset a cyclical deficit of the Federal Labour Office and for an investment lump-sum to be paid to the east German local authorities; these funds are partly to be generated by cutting expenditure. Overall, inclusive of the draft supplementary budget, an increase of 3% in Federal expenditure compared with 1992 is planned. If one includes the rise in Federal spending on job-creation measures and on the "German Unity" Fund agreed upon in mid-March, the growth rate amounts to just over 4%. On an average, the budgets of the Länder Governments imply an increase in expenditure of 4½% in the west and just under 5% in the east. On the strength of a

1 The figures of the national accounts differ slightly from those shown in the financial statistics. In the former definition, on which the deficit criterion of Maastricht is based, the government levy ratio came to 43½% in 1992, and the deficit ratio to just under 3% of the gross domestic product.

Indebtedness of the central, regional and local authorities

Table 5

DM billion

Item	1991	1992 pe	1991	1992 pe
	Level at end of year		Change from previous year	
Borrowers' note loans	549.3	559	+ 32.3	+ 9.5
Securities	602.4	695	+ 83.9	+ 92.5
Other debt	22.1	92	+ 4.2	+ 70
Total indebtedness	1,173.9	1,346	3 + 120.4	3 + 172
of which				
Federal Government	4 586.5	611	4 + 44.3	+ 24.5
West German Länder Governments	347.4	367.5	+ 18.6	+ 20
East German Länder Governments	4.9	19.5	+ 4.9	+ 14.5
West German local authorities 1	132.1	144	+ 6.5	+ 12
East German local authorities	8.6	13	+ 8.6	+ 4.5
"German Unity" Fund	50.5	74.5	+ 30.7	+ 24
Debt-Processing Fund	27.5	5 92	− 0.2	5 + 64.5
ERP Special Fund	16.4	24.5	+ 6.9	+ 8
Memorandum items				
Treuhand agency 2	39.4	107	+ 25.3	+ 67.5
Federal Railways-East German Railways	6 43.1	56.5	6 − 5.3	+ 13.5
Federal Post Office	81.3	96.5	+ 10.3	+ 15.5

1 Including municipal special-purpose associations. — 2 Including assumption of old loans and liabilities arising from equalisation claims of enterprises. — 3 The figure for net borrowing given in the text on page 36 is lower than the increase in indebtedness, which also includes the assumption of old debt. — 4 Including bonds taken over from the Federal Railways in the amount of DM 12.6 billion. — 5 Including a provisional amount of liabilities to the Currency Conversion Equalisation Fund to the value of DM 65 billion. — 6 Excluding bonds in the amount of DM 12.6 billion taken over by the Federal Government.

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survey, the local authority central associations expect municipal spending to go up by 4½ % in the old Länder and by almost 10 % in the new Länder.

More sluggish growth of revenue

Admittedly, the revenue of the central, regional and local authorities will likewise grow far more sluggishly than last year. The official tax estimate of November 1992 expected tax revenue to rise by 4.7 % in 1993. In this context, expected additional revenue from the increase in the standard rate of value-added tax and from the Flat-Rate Tax Act is being accompanied by the lapsing of the solidarity surcharge and revenue losses due to relief measures for enterprises in the field of property tax and trade tax, as approved at the beginning of 1992. The losses attributable to the slowdown in business activity – as compared with the previous estimate of May 1992 – were put at DM 12.5 billion at that time. In the meantime, further losses appear likely; for the Federal Government alone, they have been estimated at DM 5 billion in the draft supplementary budget.

Social security funds

In the field of social security, the Act on the Structure of the Health Sector passed at the end of 1992 is intended to achieve substantial economies. Even so, many health insurance institutions increased their contribution rates once again at the beginning of 1993. The pension insurance funds are expecting a further steep rise in their spending, particularly in eastern Germany. The Federal Labour Office will be affected, on the one hand, by the retrenchments decided on last autumn and, on the other, by additional expenditure owing to the economic slowdown and the increase in the funds originally earmarked for job-creation measures.

Further increase in the public sector deficit

All in all, it is to be expected that in 1993 the deficit of the central, regional and local authorities will exceed that recorded in 1992 quite considerably. Particularly in the case of the Federal Government, the budgetary situation will deteriorate. The deficit of the social security funds will probably increase further, too. An improvement in the financial situation of the health insurance funds will be accompanied by the fact that the pension insurance funds, which in 1992 still showed a surplus, will now incur a considerable deficit that will entail the dissolution of reserves. In addition, the credit requirements of the other public agencies – the Federal Railways, the Federal Post Office and the Treuhand agency – will remain persistently high.

Federal Consolidation Programme

At the end of January, the coalition parties submitted a Federal Consolidation Programme which covered all levels of government and subsidiary budgets and even contained suggestions regarding the assumption of the debts "inherited" from the former GDR, as well as regarding the necessary reform of the revenue-sharing arrangements. In mid-March, discussions took place between the Federal Chancellor, the Heads of the Länder Governments and the leaders of the major political parties for the purpose of agreeing on a solution to the politically controversial issues. The agreements reached in the context of what is known as the "solidarity pact" put an end to the uncertainty that had arisen with respect to the fiscal policy stance, laid down solid foundations for further plans and opened up prospects of a reduction in the public sector deficit over the medium term. However, the package of consolidation measures – some of which still have to be approved by Parliament – attaches less importance to expenditure cuts than to revenue improvements by means of tax increases. A solidarity surcharge is to be levied again from 1995 onwards. It is to amount to 7½ % of the income tax and corporation tax liability (including a social component); for 1995 the additional revenue is estimated to amount to DM 28 billion. Moreover, insurance tax is to be increased in two stages – in mid-1993 and at the beginning of 1995; in 1995 an increase in the property tax rate for private property is planned. In the aggregate, these tax increases and some other tax measures are expected to generate additional revenue amounting to DM 35 billion in 1995. With regard to the prospects for the overall burden of taxes and social security contributions, it also has to be borne in mind that the financing of the reform of the Federal Railways planned for 1994 will entail additional levies. For this purpose, a further increase in mineral oil tax is envisaged (and the introduction of a motorway toll is also under discussion). Moreover, at the beginning of next year the contribution rate to the statutory pension insurance funds will have to be increased in order to fill the financial gap which has emerged in this sector of social security after the reserves had dwindled to their statutory floor. All in all, therefore, the government levy ratio could rise by another 2 percentage points of GNP over the medium term. However, how much progress towards budgetary consolidation can ultimately be made in the years to come will also depend to a high degree on overall economic trends. The planned increases in levies will certainly not improve the growth prospects of the German economy. Given the necessity of strengthening investment activity, it will now be even more important to ensure that enterprises are not additionally overburdened by labour costs, considering that they are also being hit by the rises in taxes and other levies. For the rest, a substantial reduction in the public sector deficit presupposes strict expenditure restraint over the next few years – a requirement which applies also to those central, regional and local authorities which will have to assume relatively low additional burdens in the context of the reorganisation of intra-German financial relations.

3. External economic burdens

Persistent current account deficit

The external economic burdens to which the German economy was exposed last year were manifold. By the time the adjustment process which had been necessary to meet the rising demand from eastern Germany following unification had more or less tailed off towards the end of 1991, and production capacity was again free to enable German enterprises to supply their traditional export markets, the restraining influences of the continuing weakness in growth abroad became discernible on a broad front. Furthermore, the strength of the Deutsche Mark in the foreign exchange markets towards the end of the year adversely affected the competitiveness of German exporters. However, as a result of the significant improvement in the terms of trade, which was accompanied by the appreciation of the Deutsche Mark against the US dollar, there was a slight increase in the foreign trade surplus. At the same time, there were sizeable losses in services and another large deficit on transfer payments. Consequently, there was little change overall in Germany's current account deficit in 1992. At DM 40 billion, or just over 1 % of the all-German gross national product, it was little higher than in the previous year.

Sluggish export growth

The sustained sluggishness of growth in Germany's partner countries proved to be the major obstacle to a revival of exports throughout 1992. In terms of value, exports last year were hardly any higher than in 1991. Although they increased a little (by 1½ %) in real terms, this was less than the growth (of 4 %) in world trade. This is partly due to the regional distribution of world trade growth. In 1992 it was mainly non-European regions which provided the stimulus to growth, and these, such as the Asian countries and those of North and South America, are of comparatively little importance for German exporters. Another contributory factor was that German exports focus strongly on capital goods, which are sensitive to cyclical changes. The weakness in exports was possibly also due to factors affecting price competitiveness, as the Deutsche Mark had appreciated strongly against the dollar up to the middle of the year. Towards the end of the period under review German exporters experienced intensified competition, especially within Europe, after the Deutsche Mark had significantly appreciated against the other EC currencies in the second half of 1992. In some cases exporters absorbed these additional costs in their profit margins. Finally, exports were also adversely affected last year by the sales difficulties experienced by east German enterprises in their traditional central and east European markets. Their share of total German exports amounted to only 2 % on an annual average; that is somewhat less than in 1991.

Imports at a high level

Following the adjustment of imports to meet the rapidly rising demand associated with German unification, imports again grew by 2 % in real terms in 1992. At the same time import prices declined on a wide front and to such an extent that, not least as a result of the appreciation of the Deutsche Mark, the overall import bill was somewhat lower despite the greater import volume. The principal beneficiaries of the continuing high absorptive capacity of the German market were suppliers in the European Community and other European industrial countries as well as those in the United States. The central and east European reforming countries also increased their exports to Germany.

Larger deficit on services account

Service transactions put a considerable strain on Germany's current account last year. Including the freight and insurance costs of imports, the deficit rose to DM 40 billion in 1992, compared with only DM 15 billion in 1991. The main factor here was the trend in investment income, the surplus on which fell by DM 13 billion to DM 17 billion in 1992. To a certain extent this is the outcome of the current account deficits in 1991 and 1992, which were accompanied by a corresponding reduction in Germany's external assets. Furthermore, net income was reduced by the fact that the average rate of interest on German external assets, which are

Major items of the balance of payments *

Table 6

DM billion, surplus or net capital imports: +

Item	1989	1990	1991	1992
I. Current account				
1. Foreign trade				
Exports (f.o.b.) 1	641.0	662.0	665.8	670.6
Imports (f.o.b.) 1	493.4	543.5	627.7	622.3
Balance	+ 147.6	+ 118.6	+ 38.1	+ 48.3
2. Supplementary trade items and merchanting trade 2	− 1.3	− 0.6	+ 2.6	+ 1.2
Balance of trade	+ 146.4	+ 117.9	+ 40.7	+ 49.5
3. Services (net)	− 4.6	− 4.9	− 14.6	− 39.8
of which				
Investment income (net)	+ 22.2	+ 27.5	+ 29.9	+ 17.0
Foreign travel (net)	− 28.4	− 30.5	− 34.0	− 40.4
4. Transfer payments (net)	− 33.7	− 36.7	− 59.2	− 49.9
of which				
Net contributions to the EC budget	− 13.4	− 11.6	− 19.1	− 22.0
Other official payments to non-residents (net)	− 9.7	− 13.8	− 28.6	− 16.0
Balance on current account	+ 108.1	+ 76.4	− 33.1	− 40.3
II. Capital account				
1. Long-term capital transactions				
(a) German investment abroad (increase: −)	− 95.0	− 107.2	− 94.3	− 113.7
of which				
Direct investment	− 27.4	− 37.4	− 37.1	− 28.1
Foreign securities	− 50.2	− 23.4	− 26.5	− 68.0
Lending to non-residents	− 14.2	− 43.1	− 26.2	− 13.2
(b) Foreign investment in Germany (increase: +)	+ 72.8	+ 41.2	+ 69.0	+ 160.3
of which				
Direct investment	+ 13.4	+ 3.8	+ 6.2	+ 6.0
Domestic securities and official domestic borrowers' notes	+ 40.1	+ 15.7	+ 62.8	+ 126.9
Securities	+ 45.2	+ 17.3	+ 63.9	+ 130.0
Borrowers' notes	− 5.1	− 1.6	− 1.2	− 3.1
Lending to residents 3	+ 19.4	+ 22.1	+ 0.1	+ 27.7
Balance of long-term capital transactions	− 22.2	− 65.9	− 25.4	+ 46.6
2. Short-term capital transactions				
(a) Credit institutions	− 56.7	+ 0.6	+ 39.8	+ 64.2
(b) Enterprises and individuals	− 51.6	− 19.3	+ 7.5	+ 3.3
(c) Official	− 4.6	− 5.0	− 3.8	− 7.3
Balance of short-term capital transactions	− 112.9	− 23.7	+ 43.4	+ 60.2
Balance on capital account	− 135.1	− 89.7	+ 18.0	+ 106.8
III. Balance of unclassifiable transactions (balancing item)	+ 8.0	+ 24.3	+ 15.4	+ 2.2
IV. Balancing item in respect of the Bundesbank's external position 4	− 2.6	− 5.1	+ 0.5	− 6.3
V. Change in the Bundesbank's net external assets 5 (increase: +)	− 21.6	+ 5.9	+ 0.8	+ 62.4

* From July 1990 including the external transactions of the former GDR. — **1** Special trade. — **2** Mainly warehouse transactions for account of residents and deduction of goods returned and of processing. — **3** Excluding official domestic borrowers' notes. — **4** Counterpart of changes in the Bundesbank's external position which are not caused by external current and capital transactions: changes in the Deutsche Mark value of the Bundesbank's assets and liabilities denominated in foreign currencies owing to the revaluation at the end of the year and differences between the transaction values and the changes in the external position of the Bundesbank shown at balance sheet rates. — **5** Valued at balance sheet rates.

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mostly denominated in US dollars and other foreign currencies, declined relative to that on external liabilities, which are mainly denominated in Deutsche Mark. This is not only a reflection of the greater differential between Deutsche Mark and dollar interest rates on average during 1992; the depreciation of the dollar up to the autumn of 1992 also depressed the Deutsche Mark value of investment income. It must likewise be remembered that one consequence of the tax-related transactions to reroute capital in the second half of 1992 was a general tendency to underrecord investment income. In addition, the outcome of the services account was impaired by a further rise in expenditure on foreign travel. The deficit increased by DM 6.5 billion to DM 40.5 billion last year. No doubt higher expenditure by travellers from the new Länder was just as responsible for this as the appreciation of the Deutsche Mark.

Large transfer payments

Following the rapid rise in unilateral transfers abroad in 1991 as a result of the contributions towards financing the Gulf war, the large deficit in this sector of the current account declined by DM 9 billion in 1992 to just under DM 50 billion. If the "one-off" payments in connection with the Gulf war are disregarded, the deficit on transfer payments increased further in 1992. Germany's unilateral payments to non-residents in 1992 were, after all, equivalent to more than 1½% of the all-German national product. Net contributions to the EC budget, at DM 22 billion, accounted for the largest portion of this. However, there were other significant contributory factors: the remittances by foreign workers living in Germany to their home countries (DM 7 billion), pensions and other maintenance payments to non-residents or to Germans living abroad (DM 9 billion), payments made under official development assistance (DM 3 billion) and the payments to the CIS under the agreement concluded with the former Soviet Union on the withdrawal of Soviet troops from eastern Germany (almost DM 3 billion).

Capital transactions marked by monetary unrest

There were some extremely significant shifts of emphasis in the financial operations between Germany and the rest of the world in 1992, and these posed particular challenges to German monetary policy makers at times. In view of the uncertainties surrounding the future development of the process of monetary integration in Europe, which spread in the market in the early summer following the Danish referendum on the Maastricht Treaty, and the fundamental discrepancies between the countries participating in the exchange rate mechanism, which had been building up since the previous realignment in the European Monetary System (EMS) in 1987, the currency preferences of international investors shifted significantly in favour of the Deutsche Mark in 1992. As a result, extensive amounts of foreign capital flowed on to the German market; these funds far exceeded the deficit on current account at that time and led to a sharp rise in the monetary reserves of the Bundesbank.

Large long-term capital imports

Last year's balance of payments shows net capital inflows of DM 47 billion in long-term capital transactions alone, whereas in each of the previous five years there had been net capital outflows in this sector. At the same time there was an unusually sharp increase in the gross flows responsible for this. At DM 160 billion, for example, foreign investment in Germany reached an unprecedented level. Securities investment, almost two-thirds of which was in public bonds, accounted for by far the largest part of this sum (DM 130 billion). There was also an exceptionally heavy demand for German bank bonds in 1992, but this was mainly related to purchases by Luxembourg investment funds, which in this way returned a large proportion of the capital inflows they had received from German investors to the German capital market. To that extent, the sharp rise in securities purchases overstates the real exposure of non-residents.[1]

"Rerouting" of German investible capital through Luxembourg investment funds

Purchases of Luxembourg investment fund units (DM 59 billion), which enjoyed increasing popularity among German investors last year in view of the flat-rate tax on residents' interest income that came into force at the beginning of 1993, accounted for about one-half of German investment abroad (DM 114 billion). Only DM 9 billion was exported overall in 1992 as a result of other purchases of foreign securities (excluding participating interests). These mainly involved foreign Deutsche Mark bonds, which were issued in greater amounts, given the heavy demand for Deutsche Mark assets since the autumn of 1992, and for the most part were taken up by the banks unless the latter placed them abroad. On the other hand, there was generally little interest on the German market in foreign-issued foreign currency bonds.

Less direct investment and fewer bank loans

The remaining German capital investment abroad – especially direct investment and long-term loans – was appreciably lower in 1992 than in 1991. Direct investment by German enterprises and financial institutions fell by one-quarter to DM 28 billion as a result of the cyclical weakness in major industrial countries and the abolition of tax advantages for capital investment in Ireland. Furthermore, the cyclical weakness in international lending meant that the banks granted significantly fewer loans to non-residents than they had done in 1991.

1 Much the same is true of the investment by residents in the German market, which was (re)routed through foreign banks in the form of cash transactions and which cannot be recorded in the statistics.

Changes in the net external position of the Bundesbank *

Table 7

DM billion; increase in foreign exchange: +

Period		Net external position, total	Operations in the foreign exchange market 1: Total	Deutsche Mark/ dollar market	EMS intervention and debt settlement 2	Other transactions: Total	Dollar interest income and dollar receipts from US troops	Official (net)	Other foreign exchange movements (net)
1992	Jan.	+ 1.6	–	–	–	+ 1.6	+ 1.2	- 1.0	+ 1.3
	Feb.	+ 1.1	–	–	–	+ 1.1	+ 2.0	- 0.9	+ 0.0
	Mar.	+ 2.5	–	–	–	+ 2.5	+ 1.1	- 0.7	+ 2.2
	Apr.	+ 1.1	–	–	–	+ 1.1	+ 1.7	- 0.5	- 0.1
	May	+ 1.9	–	–	–	+ 1.9	+ 2.2	- 0.8	+ 0.5
	June	+ 2.0	–	–	–	+ 2.0	+ 1.1	- 0.7	+ 1.7
	July	+ 1.3	+ 0.1	+ 0.1	–	+ 1.2	+ 1.4	- 1.3	+ 1.1
	Aug.	+ 3.2	+ 1.0	+ 1.0	–	+ 2.2	+ 1.8	- 0.5	+ 0.8
	Sep.	+ 82.5	+ 82.6	–	+ 82.6	- 0.0	+ 0.9	- 0.7	- 0.3
	Oct.	- 38.0	- 33.7	–	- 33.7	- 4.3	+ 1.3	- 0.6	- 4.9
	Nov.	- 1.0	- 0.8	–	- 0.8	- 0.3	+ 2.2	- 1.1	- 1.4
	Dec.	+ 10.5	+ 11.3	–	+ 11.3	- 0.8	+ 1.5	- 1.1	- 1.1
	Total	+ 68.7	+ 60.5	+ 1.2	+ 59.4	+ 8.2	+ 18.3	- 9.8	- 0.3
1993	Jan.	- 11.4	- 11.0	–	- 11.0	- 0.4	+ 1.0	- 0.8	- 0.6
	Feb.	- 12.3	- 4.4	–	- 4.4	- 7.9	+ 1.8	- 0.8	- 8.9
	Mar.	- 12.8	- 6.0	–	- 6.0	- 6.8	+ 1.1	- 0.8	- 7.2

* Transactions recorded according to the date of entry. Excluding external transactions in Bundesbank Treasury discount paper (liquidity paper), which was first issued in March 1993. — **1** Including operations by other central banks, where they affect the external position of the Bundesbank. — **2** Debt settlement: Deutsche Mark repayments to the Bundesbank by EMS partners.

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Heavy imports of funds by banks

In short-term capital transactions, too, there were extensive inflows of funds in 1992, some of which were of a speculative nature. In particular, banks recorded net inflows of DM 64 billion. On the other hand, the short-term financial operations of non-banks with the rest of the world were less influenced by the currency turbulence of last autumn. However, special factors did lead to major movements in financial and trade credits. As a result, domestic enterprises and individuals built up their balances with foreign banks by DM 36 billion. These were mainly Deutsche Mark balances, and the prime motivation was apparently the avoidance of the flat-rate tax on residents' interest income which came into effect at the beginning of 1993. In addition, the abolition of German bill tax from January 1, 1992 led to a sharp decline in the claims arising from foreign bills of exchange (which are recorded under trade credits) because these became less attractive in comparison with other sources of finance since domestic bills were now on the same fiscal footing.

Record inflows of foreign exchange

The net external assets of the Bundesbank – calculated at transaction values – increased by a record DM 69 billion in 1992 as a result of the currency turmoil within the EMS. At the height of the turbulence on the foreign exchange markets – in September 1992 – foreign exchange worth no less than DM 92 billion (gross) flowed to the Bundesbank through its own support purchases and through its financing of intervention by other central banks in favour of the Italian lira, the pound sterling and the French franc. Although its EMS partners were able to run down their intervention liabilities considerably by repaying Deutsche Mark as early as September and October, there were renewed exchange rate tensions in December, and foreign exchange again flowed to the Bundesbank. Consequently, foreign exchange receipts of almost DM 60 billion through EMS intervention remained with the Bundesbank up to the end of the year. All the other external transactions of the Bundesbank led to net inflows of DM 9.5 billion in foreign exchange, which were essentially the result of interest income from monetary reserves and of the exchange of dollars by US troops stationed in Germany. At the beginning of 1993 EMS partners made further Deutsche Mark repayments. In addition, the Bundesbank put dollars on to the market in order to reduce its relatively high dollar holdings. The net external assets had therefore fallen by DM 36.5 billion by the end of March. Nevertheless, at the time this Report went to press they were DM 24 billion higher than at the same date last year.

Valuation losses

During the usual revaluation of the external position at the end of the year the balance sheet rate of the dollar was reduced from DM 1.4500 to DM 1.3870 – its last year's low; the ECU balances were also valued at last year's lowest rate (DM 1.94688, compared with DM 2.02412). The consequent book losses were reflected in the balance of payments, along with the other exchange rate losses, in the balancing item in respect of the Bundesbank's external position (DM 6.5 billion in total).

Exchange rate movements within the EMS

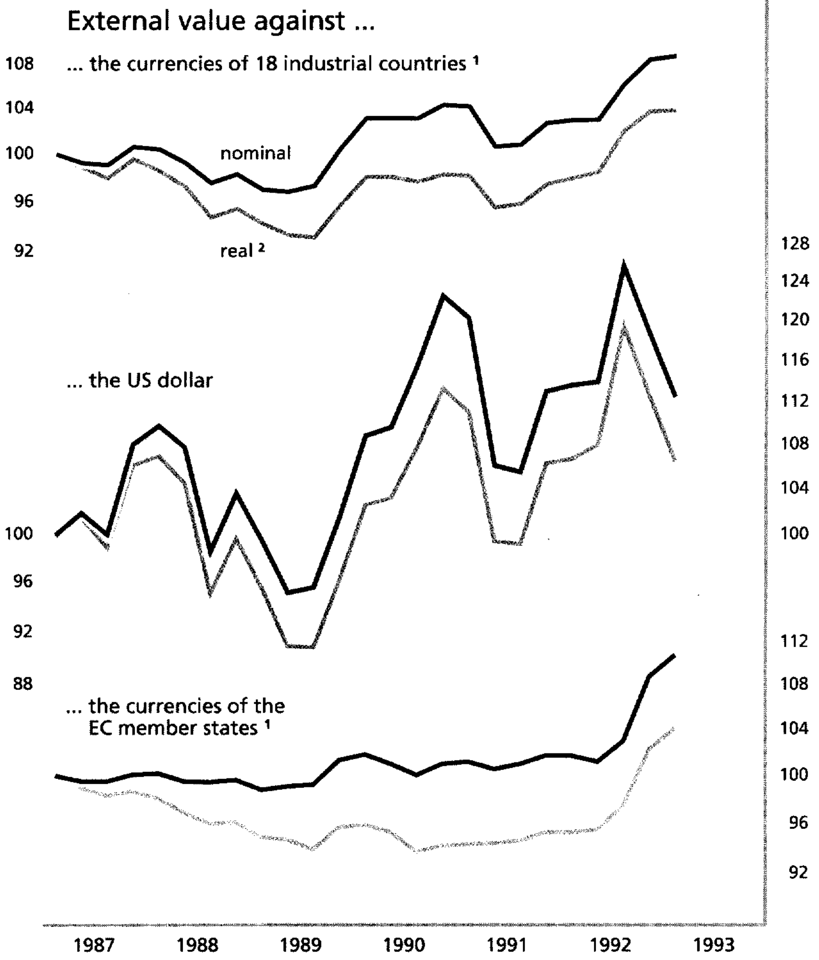
During the five years since the previous comprehensive realignment within the EMS at the beginning of 1987, significant divergences, mainly in price movements, had arisen between the various European currencies owing to the "illusion"of fixed exchange rates that was widespread in the markets. These divergences had not been accompanied for some time by the relevant adjustment constraints. In the wake of the currency turbulence in the autumn of 1992, however, a number of exchange rate measures were taken which amounted to an actual appreciation of the Deutsche Mark against the currencies concerned.[1] Firstly, the Italian lira and

1 See also section III.1, "The crisis within the EMS and its lessons", page 77 ff.

External value of the Deutsche Mark

Chart 5

1st qtr of 1987 = 100, log. scale



1 Weighted external value. — 2 External value after adjustment for the differing macroeconomic price movements (as measured by the prices of total sales).

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the pound sterling left the exchange rate mechanism for an unspecified period and subsequently sustained a significant depreciation against the other EC currencies; secondly, the central rates of various EMS currencies (the peseta, escudo and Irish pound) were lowered in several stages. As a result of these exchange rate movements the Deutsche Mark was quoted 9 % higher than a year earlier on average during the first quarter of 1993 against the other EC currencies. Compared with the period immediately after the realignment at the beginning of 1987, the Deutsche Mark therefore appreciated by a nominal 11 % against the other EC currencies. However, in real terms (that is to say, after taking account of the differing rates of inflation) the appreciation of the Deutsche Mark amounted to only 4 %.

Record of domestic and external monetary policy measures

February 7, 1992

The Treaty on European Union in its final form is signed by the ministers of foreign affairs and finance of the EC governments in Maastricht.

April 2, 1992

The Central Bank Council approves the annual accounts for the financial year 1991; DM 14.5 billion of the net profit is paid over to the Federal Government.

April 6, 1992

Portugal joins the exchange rate mechanism of the EMS. The margins of fluctuation for the escudo in the EMS are set at ± 6 %.

July 16, 1992

The Central Bank Council reviews and reaffirms the monetary target for 1992, which provides for a 3½ % to 5½ % expansion of the money stock M3 between the fourth quarter of 1991 and the fourth quarter of 1992. At the same time, the discount rate is raised from 8 % to 8¾ % with effect from July 17, primarily in order to mitigate the risks to stability inherent in the very strong monetary growth and to strengthen confidence in the maintenance of the stability of the Deutsche Mark, even under the more difficult conditions obtaining in united Germany.

September 8, 1992

Finland abandons the unilateral pegging of the Finnish markka to the European Currency Unit (ECU).

September 14, 1992

Following massive support purchases, the Italian lira is devalued by about 7 % in the EMS. In connection with these developments, which have changed the underlying monetary policy conditions, the Central Bank Council lowers the discount rate from 8¾ % to 8¼ % and the lombard rate from 9¾ % to 9½ % with effect from September 15.

September 17, 1992

Owing to persistent currency turmoil in the EMS, the participation of the Italian lira and the pound sterling in the exchange rate mechanism is suspended until further notice at the request of the respective countries. At the same time, the Spanish peseta is devalued by 5 % against the other EMS currencies.

September 23, 1992

Against the background of speculation on a devaluation of the French franc, the governments and central banks of France and Germany publish a joint statement reaffirming that the ruling central rates of their currencies accurately reflect their countries' economic situations and that no change in those central rates is warranted.

October 2, 1992

In the light of the huge foreign exchange inflows in the wake of the turmoil in the EMS, the Bundesbank decides generally to offer, until further notice, securities repurchase agreements with maturities of two weeks (instead of one month or two months). This cut in maturity enables it to respond flexibly to short-term changes in bank liquidity.
East German credit institutions' refinancing quotas are transformed into normal rediscount quotas from November 2, 1992 and calculated according

to the same criteria as apply to west German banks. Lombard loans against promissory notes are granted only until the end of 1992, at the latest.

November 1, 1992
The Fourth Act Amending the Deutsche Bundesbank Act comes into force. Its main concern is the restructuring of the Bundesbank, whereby the new Länder are included in the new multi-Länder system of Land Central Banks.

November 19, 1992
Sweden abandons the unilateral pegging of the Swedish krona to the ECU.

November 23, 1992
The Spanish peseta and the Portuguese escudo are devalued by 6 % in the EMS.

December 2, 1992
The Deutsche Bundestag ratifies the Treaty on European Union.

December 10, 1992
The Bundesbank announces the monetary target for 1993. It provides that the Bundesbank will continue to conduct its monetary policy in 1993 in such a way as to ensure that the persistent threats to monetary stability are strictly contained and, at the same time, that the monetary conditions for durable economic growth remain in place. To this end, the Bank regards it as appropriate for the money stock M3 to expand by 4½ % to 6½ % between the fourth quarter of 1992 and the fourth quarter of 1993.
The Central Bank Council decides to offer securities repurchase agreements with maturities of two weeks and one month – instead of generally offering only two-week maturities, as since October 1992.

December 10, 1992
Norway abandons the unilateral pegging of the Norwegian krone to the ECU.

January 1, 1993
The Fourth Act Amending the Banking Act and the amendment of the "Principles Concerning the Capital and Liquidity of Credit Institutions" come into force; these measures translate into German law the EC Council Directives on banking coordination, on the own funds of credit institutions and on a solvency ratio for credit institutions.

January 5, 1993
The governments and central banks of the French Republic and the Federal Republic of Germany reaffirm the joint statement of September 23, 1992 and emphasise once again that the ruling central rates of the two currencies are fully consistent with the economic fundamentals.

February 1, 1993
The Irish pound is devalued by 10% in the EMS.

February 4, 1993
The Central Bank Council decides that the Bundesbank will sell by tender in the open market in March up to DM 25 billion of liquidity paper in the form of Treasury discount paper (pursuant to section 42 of the Deutsche Bundesbank Act) in three tranches with maturities of three, six and nine months. The minimum reserve ratios for time liabilities and savings deposits are uniformly reduced to 2 % (from 4.95 % and 4.15 %, respectively) with effect from March 1. In this context, the lombard rate is lowered from 9½ % to 9 % and the discount rate from 8¼ % to 8 % with effect from February 5. These measures are designed to enlarge the Bundesbank's arsenal of liquidity policy instruments and to take due account of the keener competition between European financial centres.

March 18, 1993
The Central Bank Council lowers the discount rate from 8 % to 7½ % with effect from March 19.
By taking this measure, the Bank continues its policy of gradual interest rate reduction.

April 22, 1993
The Central Bank Council lowers the discount rate from 7½ % to 7¼ % and the lombard rate from 9 % to 8½ % with effect from April 23.
At the same time it approves the annual accounts for the financial year 1992; DM 13.1 billion of the net profit is paid over to the Federal Government.

Record of general economic and fiscal policy measures

April 3, 1992
The Federal Cabinet approves the draft Act on Turnover Tax in the Single European Market, which translates the respective EC Council Directive into national law and provides for the abolition of some minor taxes.

May 13, 1992
The Federal Cabinet approves the draft supplementary budget for 1992. Receipts are increased by DM 8 billion to DM 383.5 billion, and expenditure is augmented by DM 3 billion to DM 425 billion. The deficit accordingly diminishes by DM 5 billion to DM 41.5 billion. At the same time, medium-term benchmark figures for fiscal policy are adopted which provide for the rise in Federal expenditure being limited to an average of 2½ % up to 1996, and for the deficit being reduced to DM 25 billion in 1995.

June 3, 1992
In the light of the requirements to be expected in the future, the Financial Planning Council regards it as being indispensable to pursue a policy of strict consolidation at all budgetary levels and to reduce the financial deficit to 2 % of the gross national product by 1996. To this end, the Federal Government, the governments of the old Länder and their local authorities are to restrict the growth of expenditure to an average of 3 %.

July 1, 1992
The Federal Cabinet approves the draft Federal budget for 1993, involving an expenditure volume of DM 435.5 billion and a deficit of DM 39 billion, and a medium-term financial plan covering the years 1992 to 1996. The rise in expenditure is to be limited to an average of 2.3 % in the years from 1992 to 1996, and the deficit is to be reduced to DM 23 billion by 1996.

September 25, 1992
The Bundesrat approves the Act on the Tax on Interest Income in the compromise wording agreed in the Mediation Committee. The flat-rate tax to be levied from the beginning of 1993 is set at the rate of 30 % (or 35 % in the case of counter transactions), the saver's tax allowance is increased tenfold (to DM 6,000 for single persons and DM 12,000 for married couples).

November 19, 1992
According to its Annual Report for 1993, the German Council of Economic Experts expects the real gross national product in western Germany to stagnate and aggregate output in the new Länder to increase by 6½ %. Inflationary pressures will probably slacken only slightly in western Germany and remain strong in eastern Germany, particularly because rents are being brought into line with costs.

November 27, 1992
The Bundestag approves the 1993 Federal budget, involving an expenditure volume of DM 435.5 billion and a deficit of DM 44 billion, which exceeds the amount envisaged in the draft by DM 5 billion, mainly because of losses of tax revenue due to the slowdown in business activity.

December 9, 1992
The Federal Cabinet approves a Location Protection Bill as the second stage of the corporation tax reform; it provides, inter alia, for the

lowering of the top rate of income tax on industrial earnings and of the corporation tax rate for retained profits to 44 %; on the other hand, existing depreciation allowances are to be curtailed in order to ensure that financing does not affect revenue.

January 1, 1993

Various fiscal policy measures come into force: parts of the 1992 Tax Amendment Act (value-added tax increase and relief measures for trade tax and corporate property tax); Act on Excise Taxes in the Single European Market (prolongation of and increase in the investment grant in the new Länder); Act on Turnover Tax in the Single European Market; Act on Tax on Interest Income; Act on the Health Insurance System (cuts in the benefits provided by the statutory health insurance funds); tenth amendment of the Work Promotion Act (reduction of vocational assistance measures); transitional arrangement in connection with a ruling of the Federal Constitutional Court dated September 25, 1992 in respect of the exemption from wage tax of the subsistence level in the case of low-income groups.

January 20, 1993

The coalition parties submit the benchmark figures of a supplementary Federal budget for 1993, which provide for a DM 8 billion rise in the deficit to a total of DM 52 billion, mainly owing to reduced receipts and increased expenditure because of the economic slowdown. At the same time, a Federal Consolidation Programme is presented which, by means of a package of cuts in benefits and rises in taxes and social security contributions, aims to reduce the deficit of the central, regional and local authorities to DM 75 billion in 1996, and simultaneously makes proposals for the reform of the financial situation of the individual levels of government (which will be necessary from 1995) as well as for the distribution of the unwelcome legacy of the former GDR's debt.

February 11, 1993

In its 1993 Annual Economic Report, the Federal Government assumes that the real gross domestic product in the old Länder will decrease by up to 1 % and that that in the new Länder will grow by between 5 % and 7 %; in the Federal Republic as a whole, this implies a stagnation of aggregate output compared with 1992.

March 13, 1993

The Federal and Länder Governments and the leaders of the major political parties agree on a consolidation programme, on an increase in the "German Unity" fund and on a restructuring of the financial situation of the individual levels of government from 1995. Besides other tax increases and some spending cuts, the centrepiece of the consolidation measures is the introduction of a 7.5 % solidarity surcharge from 1995. The financial situation of the new Länder will be put on a new footing which is viable over the long term, with the Federal Government assuming the major part of the burdens on the other levels of government associated with this measure.

Overall, limited appreciation effect

Since last autumn the Deutsche Mark has lost considerable ground against the US dollar. It is true that the dollar was at a historic low at the beginning of September as a result of the very low interest rates and somewhat pessimistic economic prospects in the United States, but a steady recovery of its exchange rate set in towards the end of the year, when the Bundesbank relaxed its interest rate policy against the background of the Deutsche Mark's appreciation trend and when the economic outlook in the United States improved. Taking the average of the first quarter of 1993, the dollar was recently quoted at roughly the same level as during the same period last year. Compared with the yen, the Deutsche Mark fell distinctly in value over the same period. On a weighted average against the currencies of 18 industrial countries its year-on-year appreciation was just under 6 % in nominal terms. As prices in Germany rose to approximately the same extent as the average in the other industrial countries, this was tantamount to a real appreciation. Although the overall effect of this appreciation was limited, German exporters incurred significant price disadvantages in relation to their competitors in a number of other European countries – an effect which, at a time of cyclical weakness, can have a stronger impact than usual on overall economic activity, even though domestic inflation is checked in turn.

4. Monetary policy under the impact of the need to fight inflation and of exchange rate unrest

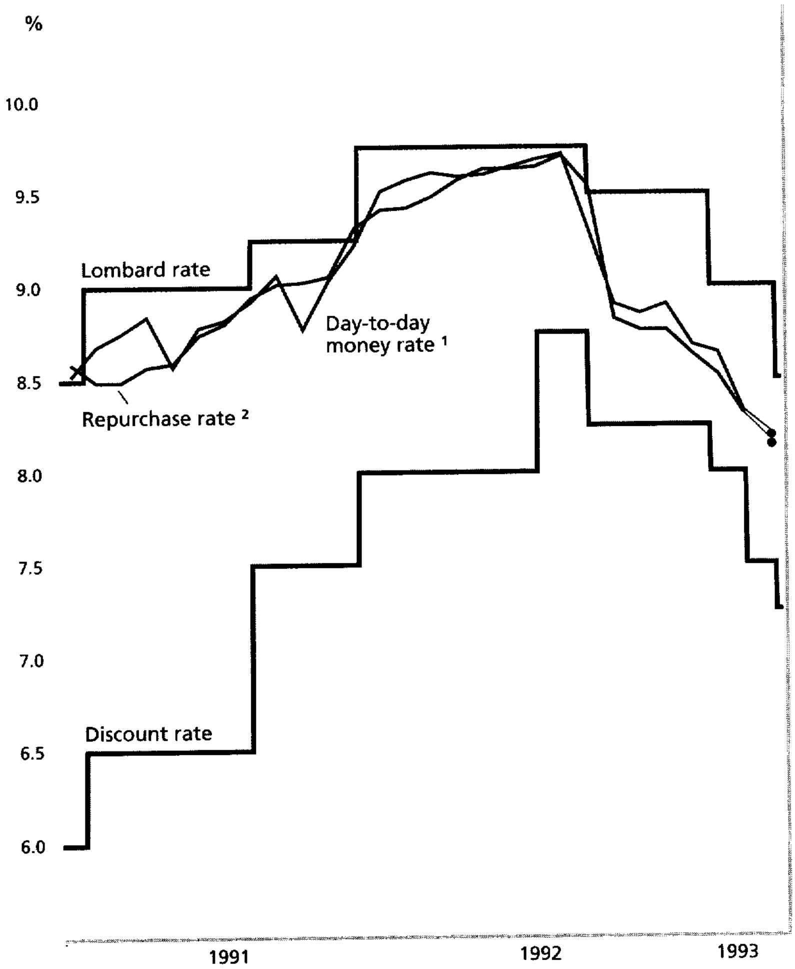
(a) Restrictive stance of interest rate policy initially continued, but significantly relaxed later on

Difficult monetary policy setting

Owing to the problems associated with reunification, in 1992 the Bundesbank continued to be faced with an overall economic setting which differed from that in which most other central banks were operating. Although economic activity slowed down markedly in western Germany, too, in the course of the year, as described in the previous sections, strong domestic cost and price pressures persisted and the further outlook for prices remained bleak. Monetary growth, which had accelerated in mid-1991, from the beginning of 1992 exceeded the rate which would have been consistent with the Bundesbank's monetary target and the medium-term requirements of monetary stability. The money stock was bloated further by speculative inflows of funds from abroad in the wake of the turmoil in Monetary System in the autumn of 1992. Against this backdrop, the Bundesbank continued its monetary policy stance, which was geared to safeguarding monetary stability. Past experience has shown that in the long run monetary

Bundesbank interest rates
and day-to-day money rate

Chart 6



1 Monthly averages. — 2 Average rate during month applied to securities repurchase agreements with one-month or, from October 1992, with two-week maturities; uniform allotment rate (fixed-rate tender) or weighted allotment rate ("US-style" variable-rate tender). — ● = Latest position: April 1 to 22, 1993.

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policy contributes most effectively to economic growth if it ensures stable underlying monetary conditions. The particular circumstances of German unification do not invalidate this fact. Nor can the proposed European Monetary Union be used as an argument for lowering the priority of monetary stability, most certainly not in the country of the anchor currency. Otherwise, there would be a risk of the stability bias in the EMS as a whole being undermined and of further European monetary integration being hampered.

Tight monetary conditions until after mid-year

In implementing its counter-inflationary policy the Bundesbank adopted a pragmatic approach and, as usual, took due account not only of the money stock but also of overall domestic and external conditions. In the first half of 1992, for example, despite the persistent overshooting of the monetary target, it kept the discount and lombard rates, which had been raised to 8% and 9¾%, respectively, in December 1991, unchanged. During this period only the allotment rates applied to securities repurchase agreements and money market rates tightened somewhat against the background of the inflationary risks, which were emerging more clearly. It was not until July that the Bundesbank raised the discount rate from 8% to 8¾%, when reviewing the 1992 monetary target. This tightening of interest rate policy was necessary so as to reduce the risks to stability posed by the "overshooting" monetary growth and not to jeopardise the credibility of monetary policy. On the other hand, the Bundesbank deliberately refrained from also raising the lombard rate and hence money market rates, in order to keep the impact on international interest rate and exchange rate patterns as small as possible. Moreover, it indicated that it was going to tolerate the overshooting of the monetary target and would not further tighten its monetary policy stance.

Scope for interest rate cuts in the wake of the Deutsche Mark appreciation

A new situation arose for the monetary policy makers as a result of the currency unrest in the EMS in the autumn of 1992. The associated appreciation of the Deutsche Mark tended to ease the upward pressure on prices and enabled the Bundesbank gradually to lower interest rates without this implying a basic change in the stance of monetary policy. With effect from September 15, 1992 the discount and lombard rates were reduced from 8¾% to 8¼% and from 9¾% to 9½%, respectively; moreover, in the ensuing period the Bundesbank concluded its securities repurchase agreements, which have a major impact on the money market, at interest rates that were lowered in several steps. In February 1993 the discount and lombard rates were cut to 8% and 9%, respectively, as part of a restructuring of the arsenal of liquidity policy instruments. In mid-March the discount rate was reduced further to 7½%, and , with effect from April 23, 1993, to 7¼%. Securities repurchase rates and hence also the day-to-day money rate were about 1½ percentage points lower in the first three weeks of April than in the autumn of 1992. Time deposit rates in the money markets dropped even more steeply – by up to 3 percentage points – during that period, and yields in the capital market also declined sharply (see page 65f.). Scope for interest rate cuts was provided to the Bundesbank – quite apart from the price-curbing effects of the Deutsche Mark appreciation – mainly by the fact that monetary expansion slowed down noticeably around the turn of 1992-3, partly in response to the previous excessive growth due to external factors. There were also indications that initial progress towards fighting inflation was being made in the fields of wage and fiscal policy. The Bundesbank cautiously explored the scope for lowering interest rates, so as to avoid the risk of a loss of confidence in the Deutsche Mark or a setback in the capital market or in the movement of the exchange rate. Eventually, this strategy was successful and also helped ease tensions in the European Monetary System.

Liquidity policy disruptions on account of EMS turbulence

The turbulence in the EMS last autumn strongly inflated not only the money stock, but also above all bank liquidity, so that the Bundesbank's ongoing money market management was faced with exceptional challenges.[1] Support buying of EMS currencies (or the funding thereof) generated inflows of foreign exchange to the Bundesbank and hence inflows of liquid funds to domestic credit institutions to the record amount of over DM 92 billion in September. This was equivalent to virtually a doubling of the Bundesbank's monetary reserves and several times the amount of the banks' central bank money requirements over the year as a whole. The Bundesbank responded to the sudden massive increase in liquidity by cutting and eventually skipping securities repurchase agreements, and by mopping up large amounts of liquidity through very short-term assistance measures in the money market in the form of foreign exchange repurchase agreements and Treasury bill sales. When the situation in the exchange market had stabilised somewhat and (liquidity-absorbing) repayments of "intervention claims" that had been building up before started to come in, it was able to resume regular securities repurchase agreements in October.

Securities repurchase agreements with enhanced flexibility

At the same time, the Bundesbank further enhanced the flexibility of that open market policy instrument by generally shortening its maturity (from one month and two months, respectively), initially to two weeks. When the liquidity situation had more or less returned to normal, it also offered securities repurchase agreements with somewhat longer maturities (of one month) again from the beginning of January 1993, so that the maturity range of the transactions was halved on balance compared with the period before the currency unrest. Since December 1992 bids for variable-rate tenders may be expressed in 0.01 percentage points (instead of the previous 0.05 percentage points); this enables credit institutions to differentiate their bids more effectively.

1 See also Deutsche Bundesbank, "The impact of external transactions on bank liquidity, the money stock and bank lending", Monthly Report, January 1993, page 19.

Monetary developments *

Table 8

Change during year 1

Item	1989	1990	1991	1992
	DM billion			
I. 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: –)	– 9.4	– 29.6	– 20.2	– 38.7
Foreign exchange movements (excluding foreign exchange swaps)	– 20.0	+ 9.9	+ 1.1	+ 63.6
Cash transactions of the central and regional authorities (including shifts of Federal balances under section 17 of the Deutsche Bundesbank Act)	– 2.2	– 16.2	+ 9.7	+ 10.9
Transfer of the Bundesbank's profit to the Federal Government	+ 10.0	+ 10.0	+ 8.3	+ 14.5
Other factors	– 11.4	– 15.0	– 19.0	– 19.1
Total 1	– 32.9	– 40.8	– 20.1	+ 31.1
2. Liquidity policy measures:				
Change in minimum reserves 4	– 0.1	– 0.2	– 0.1	– 0.9
Change in refinancing facilities	+ 7.5	+ 25.2	– 7.6	– 15.5
Open market operations in the bond market and with non-banks	– 0.4	– 0.3	+ 1.5	+ 3.3
Securities repurchase agreements	+ 26.7	+ 13.3	+ 29.8	– 16.0
Other assistance measures in the money market 5	+ 0.2	+ 1.0	+ 0.8	– 2.6
Total 2	+ 33.9	+ 39.0	+ 24.3	– 31.7
3. Remaining deficit (–) or surplus (+) (1 plus 2)	+ 1.0	– 1.8	+ 4.2	– 0.6
met or absorbed by:				
Recourse to unused refinancing facilities (reduction: +)	– 0.5	– 0.5	– 2.0	+ 2.0
Changes in lombard loans (increase: +)	– 0.6	+ 2.3	– 2.3	– 1.4
	%			
II. Key monetary indicators				
Money stock M3 6	+ 4.5	+ 5.6	+ 6.1	+ 8.4
Money stock M3 extended 7	+ 8.4	+ 7.8	+ 7.2	+ 9.6
Lending by the banking system to domestic non-banks	+ 5.8	+ 7.4	+ 9.9	+ 9.4
	DM billion			
III. The money stock and its counterparts				
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 66.3	+ 66.9	+ 95.7	+ 117.1
Counterparts in the balance sheet				
1. Volume of credit 8	+ 135.8	+ 223.1	+ 286.1	+ 299.8
of which				
Lending by credit institutions to domestic non-banks	+ 136.3	+ 223.3	+ 286.0	+ 294.2
– to enterprises and individuals 9	+ 129.3	+ 181.7	+ 259.3	+ 247.9
– to public authorities	+ 7.0	+ 41.6	+ 26.7	+ 46.3
2. Net external assets 10	+ 36.3	+ 48.4	– 7.4	– 40.8
3. Monetary capital	+ 110.3	+ 161.3	+ 154.4	+ 101.5
of which				
Savings deposits at agreed notice and bank savings bonds	+ 6.4	+ 37.4	+ 10.3	+ 12.8
Time deposits for four years and over	+ 38.7	+ 33.1	+ 32.1	+ 26.5
Bank bonds outstanding 11	+ 48.6	+ 76.9	+ 92.1	+ 40.4
4. Central bank deposits of public authorities	+ 3.3	+ 12.3	– 6.4	– 12.3
5. Other factors	– 7.9	+ 31.1	+ 35.1	+ 52.6

* New territorial definition of the Federal Republic of Germany for items I and III from July 1990, for item II from 1991. — **1** Unless otherwise indicated, based on end-of-month figures. — **2** Based on daily averages of the last month of the period. — **3** Currency in circulation (excluding credit institutions' holdings of domestic notes and coins, which are deductible from the required minimum reserves) and required reserves on credit institutions' domestic liabilities at current reserve ratios; but excluding changes in the required reserves due to changes in the reserve ratios. — **4** Including changes in minimum reserves due to growth in reserve-carrying external liabilities. — **5** Short-term sales of Treasury bills, foreign exchange swaps and foreign exchange repurchase agreements, quick tenders and shifts of Federal balances under section 17 of the Deutsche Bundesbank Act. — **6** Currency in circulation plus sight deposits, time deposits for less than four years and savings deposits at statutory notice held at domestic credit institutions, computed as a monthly average. — **7** Money stock M3 extended to include Euro-deposits and short-term bank bonds held by domestic non-banks. — **8** Credit institutions and the Bundesbank; including lending against securities. — **9** Including housing loans. — **10** Credit institutions and the Bundesbank. — **11** Excluding banks' portfolios.

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Despite the upsurge in liquidity caused by inflows of foreign exchange, the relative "predominance" of securities repurchase agreements in credit institutions' borrowing from the central bank was maintained. The main reason for this was that, owing to the rapid pace of monetary growth, the banks' needs of central bank money to feed currency in circulation and meet their minimum reserve requirements went up by DM 39 billion, and thus about twice as fast as would have been consistent with the monetary target for 1992. Another significant factor was that the Bundesbank cut the banks' refinancing facilities in several steps (by a total of DM 15.5 billion). Almost all of this cut was in east German institutions' refinancing quotas (of initially DM 25 billion), which had been granted to them in the context of German monetary union to give them greatly simplified access to central bank credit. These quotas were completely cancelled for banks winding up or refocusing operations, and converted into normal rediscount quotas for fully operational banks at the beginning of November 1992. At the end of last year the east German special arrangements for lombard borrowing, backed by a pledge of bank promissory notes, also expired.

Modification of liquidity policy instruments

At its meeting on February 4, 1993, the Central Bank Council approved a far-reaching modification of the instruments of liquidity policy. At the centre of this modification was a broadening of the basis for open market policy operations – taking advantage of the extended scope provided by the amended section 42 of the Deutsche Bundesbank Act – through the issue of liquidity paper totalling DM 25 billion in the open market in March. The liquidity paper, which was offered by tender in three tranches with maturities of three, six and nine months, is Treasury discount paper of the Federal Republic of Germany in legal terms, but in economic terms the issues are those of the Bundesbank.[1] The extended range of market policy instruments is in line with international monetary policy practice. If appropriate, the paper will enable funds to be siphoned off from banks and non-banks direct and thus, in particular, enable heavy inflows of funds in the wake of currency turmoil to be sterilised. As the Bundesbank reserves the right to buy the liquidity paper in the open market, the new instrument can also be employed for creating liquidity. The issue of open market paper for the purpose of absorbing liquidity at the same time enabled the Bundesbank to lower the credit institutions' minimum reserve requirements substantially (by some DM 33 billion). With effect from March 1, 1993, the reserve ratios for time liabilities and savings

1 For details of the terms of the tenders, see Deutsche Bundesbank, Monthly Report, February 1993, page 15, and the relevant press releases of the Deutsche Bundesbank, of February 15 and March 8, 1993.

deposits were reduced from 4.95 % and 4.15 %, respectively, to a uniform 2 %. This measure is designed to strengthen the competitiveness of the domestic financial markets; the lowering of the minimum reserve ratio reduces market operators' interest in evasive action. It does not imply any change in the Bundesbank's basic attitude towards the minimum reserve instrument.

(b) 1992 monetary target overshot by a wide margin

Monetary target for 1992 ambitiously formulated

At the end of 1991 the Bundesbank adopted a monetary target for united Germany for the second time. It provided for the money stock M3 growing by 3 ½ % to 5 ½ % between the fourth quarter of 1991 and the fourth quarter of 1992. This corridor was somewhat wider than the 1991 target range, which had been lowered to 3 % to 5 % in mid-1991. Nevertheless, the target set for 1992 was fairly ambitious. Monetary growth had gathered pace after the portfolio adjustments in eastern Germany had tailed off, and as early as the end of 1991 it was much faster than would have been consistent with the Bundesbank's monetary target. Moreover, the Bundesbank based the derivation of the target for 1992 on an unchanged medium-term price norm of 2 %; this was far less than the rate of price increases that was in prospect for 1992 at that time. The Bundesbank in this way sought to counteract inflationary expectations and emphasise its resolve to return to a path of monetary stability as soon as possible, even in the face of the more difficult conditions that resulted from unification.

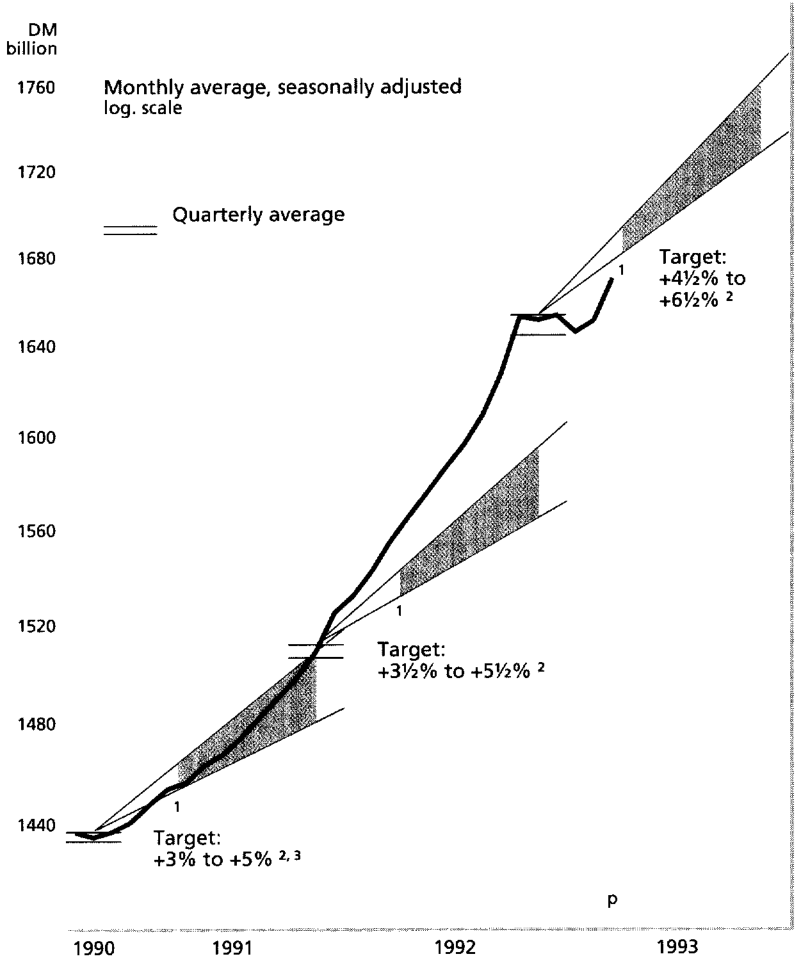
Monetary growth above the target range

In fact, monetary growth remained buoyant until about the end of 1992, even though the Bundesbank raised its interest rates once more at the end of 1991 (and the discount rate in July 1992). The money stock M3 expanded at a trend rate of some 8 ½ % until well into the summer. The Bundesbank's interest rate policy measures were insufficient to bring monetary growth closer to the target corridor. This was due not only to the relatively low interest rate sensitivity of the broadly defined monetary aggregate – especially in the short run – but also to the fact that the higher money market rates failed to spark off a rise in longer-term interest rates, too, last year. Capital market rates, on the contrary, dropped markedly already around the turn of 1991-2 (not least under the impact of international interest rate and exchange rate movements), and declined further from the autumn of 1992. This was why non-banks' demand for money and credit was comparatively little moderated, despite the relatively high level of short-term interest rates. Moreover, the effect of interest rate policy action on bank lending was mitigated by very extensive interest rate subsidies, in particular in eastern Germany. Finally, it should be borne in mind that, in the light of the sharp rise in

Growth of the money stock M3 *

Chart 7

Target and movement to date



* Average of five bank-week return days; end-of-month levels included with a weight of 50 %. — 1 The target corridor has not been shaded until March because M3 is normally subject to major random fluctuations around the turn of the year. — 2 Between the 4th quarter of the preceding year and the 4th quarter of the current year. — 3 In line with the adjustment of the monetary target in July 1991.

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prices and the associated high nominal rate of economic growth (of about 7 %), monetary expansion was to be expected to be comparatively vigorous, since the trend growth of the money stock is faster than that of GNP.

Accelerated monetary growth in the wake of the EMS turbulence

In the autumn of 1992 monetary expansion accelerated further, even though economic activity slowed down markedly. The acceleration was fuelled by heavy inflows of funds from abroad during the currency turmoil in the EMS. They led to an exceptionally sharp upsurge in the money stock in September and October, causing it to deviate further from the target path; in October the money stock M3 exceeded its level in the fourth quarter of 1991 by an annual rate of 10.3 %. In the wake of the subsequent swing in external payment flows, a corrective movement set in towards the end of the year, but it did not result in a rapid reduction in the excess liquidity. This is consistent with past experience, according to which an inflation of liquidity caused by speculative inflows of funds from abroad will be reversed only gradually, if at all. In the fourth quarter of 1992 the money stock M3 was eventually 9.4 % up on the year. The Bundesbank's monetary target was thus overshot by a wider margin than at any time in the eighteen years of publicly announced monetary targets.

Monetary relationships not affected by special factors

Besides the factors mentioned above, this substantial overshooting of the target owed something to other influences, such as the introduction of a tax on interest income at the beginning of the current year. It triggered major shifts of financial assets abroad, particularly towards the end of 1992, and large-scale hoarding of banknotes. The sharp rise in currency in circulation – of 16 % during 1992 as a whole, with a rapid increase in the share of large denominations – had comparatively little impact on the growth of the money stock M3, however, since currency in circulation accounts for only a good 11 % thereof. The growth of short-term time deposits was temporarily likewise fostered by the inverse slope of the yield curve and by increased uncertainty about the future movement of interest rates in the capital market. They prompted investors temporarily to lodge funds intended for long-term investment in time deposit accounts. But most of the steep rise in short and medium-term time deposits was attributable to shifts within M3, i.e. switching out of sight and saving deposits (as usual in periods of high money market rates). Towards the end of the year, incidentally, time deposits were run down markedly. Their trend thus did not distort the money stock to any major extent or permanently. Much the same is true of money balances held in eastern Germany. Here, reconstruction and adjustment to west German price structures are apparently being accompanied by a comparatively large demand for money, which can no longer be satisfied in full from the ample "initial provision of currency" in the wake of the currency conversion. The money stock therefore seems to have grown more rapidly in the new Länder than in the old ones. Given the low weight of the east German economy, this will have but a minor impact on all-German monetary growth.

Overall, special factors only temporarily had an adverse effect on the performance of the indicator function of the money stock M3, but did not basically call it into question. This is also apparent from the fact that the money stock in all other statistical definitions grew even more rapidly than the money stock M3 last year.

The strength of monetary expansion therefore had to be taken seriously as a reflection of persistent inflationary risks, especially as there are no indications that temporary distortions of monetary growth imply that its long-term link with prices is bound to be disturbed as well.

Continuation of the medium-term orientation of monetary policy

The Bundesbank also set a target for the expansion of the money stock M3 in 1993. It thus signalled that it was continuing its anti-inflationary policy and the medium-term orientation of monetary targeting. According to the new target, the Bank considers it appropriate if the money stock M3 grows by 4½% to 6½% between the fourth quarter of 1992 and the fourth quarter of 1993. The price norm on which the derivation of the target was based remained unchanged at 2%. The slight raising of the target corridor compared with the previous year results firstly from the marginally higher benchmark figure for real potential growth in Germany (of 3%, compared with 2¾% in 1992), with all of the increase being ascribable to the improved underlying conditions in the east German economy. Secondly, an increment of 1 percentage point (instead of the previous ½ percentage point) has been added to nominal potential growth when deriving the target. This increase takes account both of the long-term slowdown in the "velocity of circulation of money" and of the administrative price rise, especially in eastern Germany. In translating these benchmark figures into the desirable rate of monetary expansion over 1993 as a whole, the Bundesbank also took account of the fact that the money supply was very ample in the fourth quarter of 1992. The 1993 monetary target calls for the money stock growing markedly less in the current year than it did last year.

Start to the period covered by the 1993 monetary target distorted

Monetary growth around the turn of the year was in fact subdued owing to a reversal of special factors. Domestic non-banks' external payments generated sizeable outflows of funds from the fourth quarter of 1992, and currency in circulation has also been declining sharply since January 1993. In February and March, however, the money stock increased strongly again. If the last six months are combined so as largely to eliminate the distorting effects of special factors, the money stock M3 has expanded at an annual rate of 5½% during this period. Its year-on-year growth came to 7½% in March 1993. These trend rates indicate, for one thing, a slight slackening of the pace of monetary growth and, for another, a persistently ample supply of liquidity.

(c) Determinants of monetary growth

Continued buoyancy of lending to the private sector

In 1992 monetary growth was again mainly fuelled by bank lending to the private sector. Bank lending to enterprises and individuals went up by DM 248 billion, or 10%, in 1992 and thus almost as rapidly as in 1991 – the first year after German unification, when its growth had accelerated sharply (to 11 ½%) – and faster than in the eighties. Specifically, credit expansion became more mixed last year. In short-term lending, the peak was passed. In the course of the year there were indications of an increasing normalisation, which was obscured in the autumn by the shifts between borrowing at home and abroad sparked off by the exchange rate turbulence. Over the year as a whole, short-term lending went up by a mere 3% (or DM 18 billion). The growth of longer-term direct lending, by contrast, remained vigorous virtually throughout the year. Such lending expanded by 11 % (or DM 205 billion), and thus even more strongly than a year before. Bank lending against securities (and thus likewise at longer term) to public and private enterprises also grew more rapidly, at DM 25 billion. The main reason for this divergent trend was that enterprises' demand for short-term operating credit declined in view of the slowdown in economic activity. In contrast to this, demand for investment credit remained brisk in connection with reconstruction in eastern Germany. Overall, some 30% of bank lending to enterprises and individuals is likely to have gone to the new Länder, directly or indirectly. Increased needs of funds for housing construction also fostered the growth of long-term lending. Housing loans rose by 8 ½% in 1992. Consumer credit, which likewise for the most part falls into the medium and long-term maturity ranges, mounted by 9 ½%.

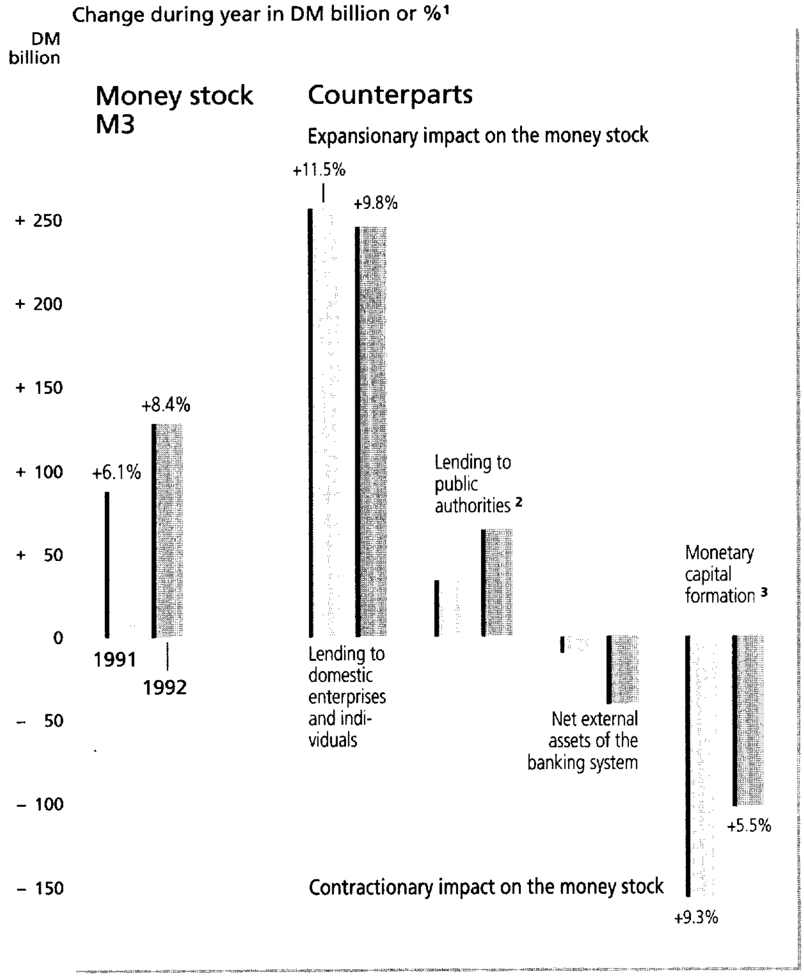
Interest rate policy no obstacle to investment in eastern Germany

One factor contributing to the predilection for longer-term lending was the interest rate pattern, which made a consolidation of short-term debt appear advisable. Between the end of 1991 and the summer of 1992, short-term bank lending rates rose by over 1 percentage point in line with the Bundesbank's rates. Most long-term fixed-rate loans, by contrast, cost less than a year before. From the autumn, short-term interest rates also declined, it is true, but the fall in long-term rates was even steeper. At the end of 1992 short-term credit cost ½ to ⅔ percentage point more than at the end of 1991, while long-term fixed-rate loans (at just over 8 ½%) were 1 to 1 ¼ percentage points cheaper, depending on the period for which interest rates were locked in. This was the lowest level since 1989, when inflation rates had been much lower. In view of the great variety of interest rate subsidies available in eastern Germany (their significance tended to increase further, if anything, last year), the effective interest rate burden on investors is to be rated even

The money stock and its principal counterparts

Chart 8

Change during year in DM billion or %[1]



1 Money stock M3 on a monthly average basis, counterparts latest position. — 2 Less public sector deposits at the Bundesbank. — 3 Monetary capital formation of domestic non-banks at domestic credit institutions.

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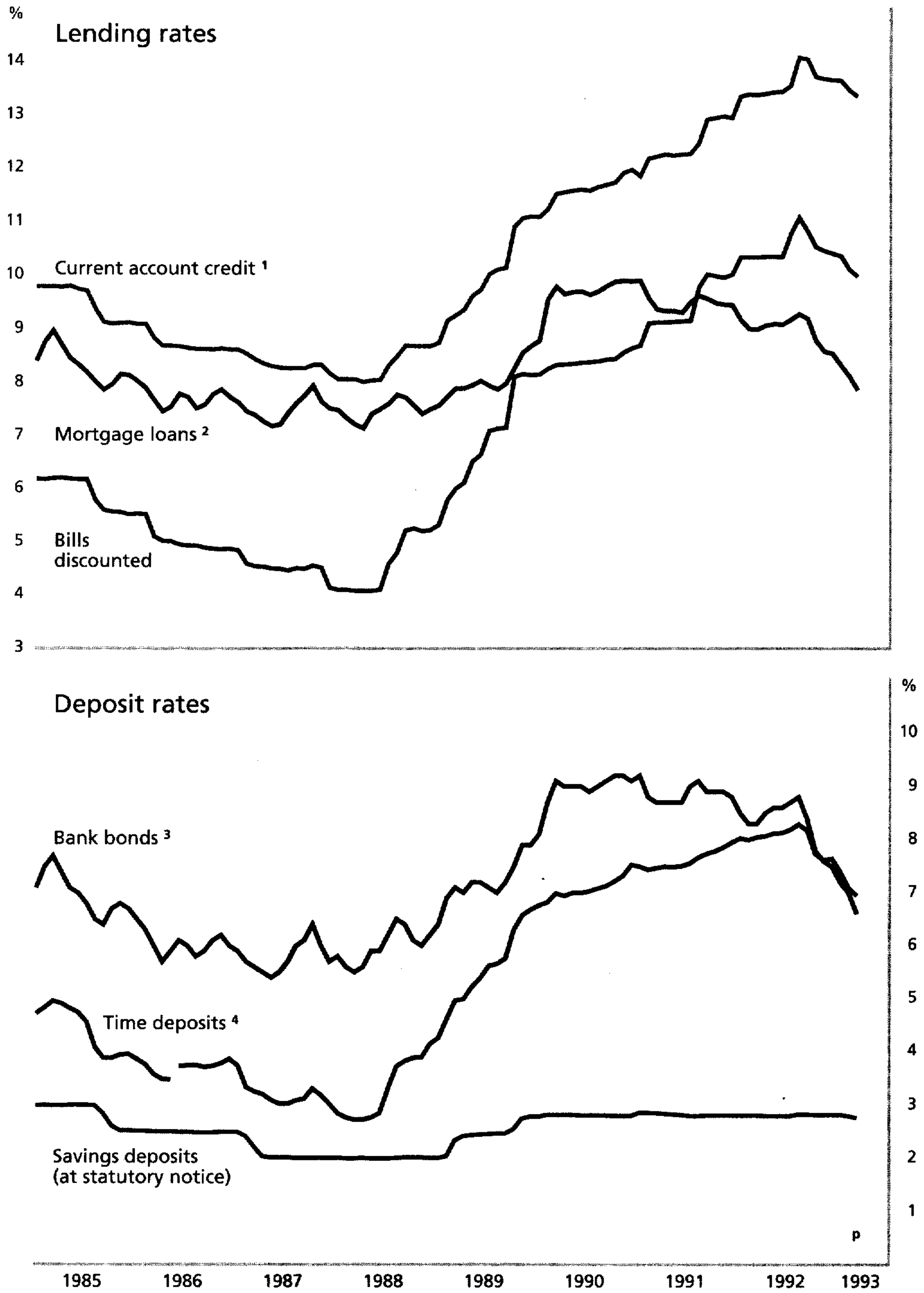
lower there. The Bundesbank's interest rate policy has thus not impeded the trend of investment or, in particular, of reconstruction in eastern Germany.

Expansionary impact of public sector borrowing

In 1992 monetary expansion was fostered not only by lending to the private sector, but also by public sector cash transactions, notably in the fourth quarter, when public sector budget deficits widened. Lending by the banking system to the public sector, at DM 52 billion, increased almost twice as fast as in 1991. In addition, the public authorities ran down their deposits with the Bundesbank, which are not counted towards the money stock, sharply (by DM 12 billion).

Movements in selected bank interest rates *

Chart 9



* Since January 1991, including the rates in the new Länder. — 1 Under DM 1 million. — 2 Average effective rate for fixed-rate mortgage loans secured by residential real estate with interest locked in for 10 years. — 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.

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Overall, net outflows of funds, but heavy inflows during the EMS turmoil

Domestic non-banks' external payments on balance generated outflows of funds last year. The net external assets of the banking system, a fall in which mirrors this fact, went down by DM 41 billion. However, this net amount for the year masks sharply contrasting effects of external payments on the growth of money and credit during the year. While there were net outflows in the first half of the year, in line with the deficit on current account, September saw exceptionally heavy inflows of funds in the wake of the currency turbulence. As mentioned, these inflows temporarily caused the money stock to soar and domestic demand for credit to slacken. Thereafter the outflows of funds abroad resumed.

Increasingly sluggish monetary capital formation

Monetary capital formation at domestic banks was very sluggish last year. At a bare DM 102 billion, which is equivalent to a four-quarter growth of 5 ½%, it provided only a minor counterweight on balance to the expansionary impact of the banks' lending business – in sharp contrast to 1991, when DM 154 billion of long-term funds accrued. In addition to lower interest rates and temporary uncertainty about the further movement of interest rates in the capital market, it was above all investors' evasive action in response to the changes in interest income taxation that appeared likely for 1993 after mid-year which contributed to the restraint shown in the longer-term placement of funds at domestic credit institutions. Instead, the acquisition of longer-term financial assets was increasingly shifted to the financial centre Luxembourg (see page 70). In the monetary analysis this is reflected in a fall in the net external assets of the banking system. To the extent that the funds were recycled from abroad into long-term assets held at domestic banks, domestic capital formation is shown at too low a figure in the statistics. Direct sales of bank bonds to residents, in particular, amounted to only DM 40 billion, compared with DM 92 billion in 1991. But the amount of funds accruing on longer-term time deposit accounts (DM 27 billion) and from sales of bank savings bonds (DM 4 billion) was also comparatively low. On the other hand, the increase in savings deposits at agreed notice (DM 9 billion) and in the banks' capital (DM 22 billion) outstripped that of the previous year.

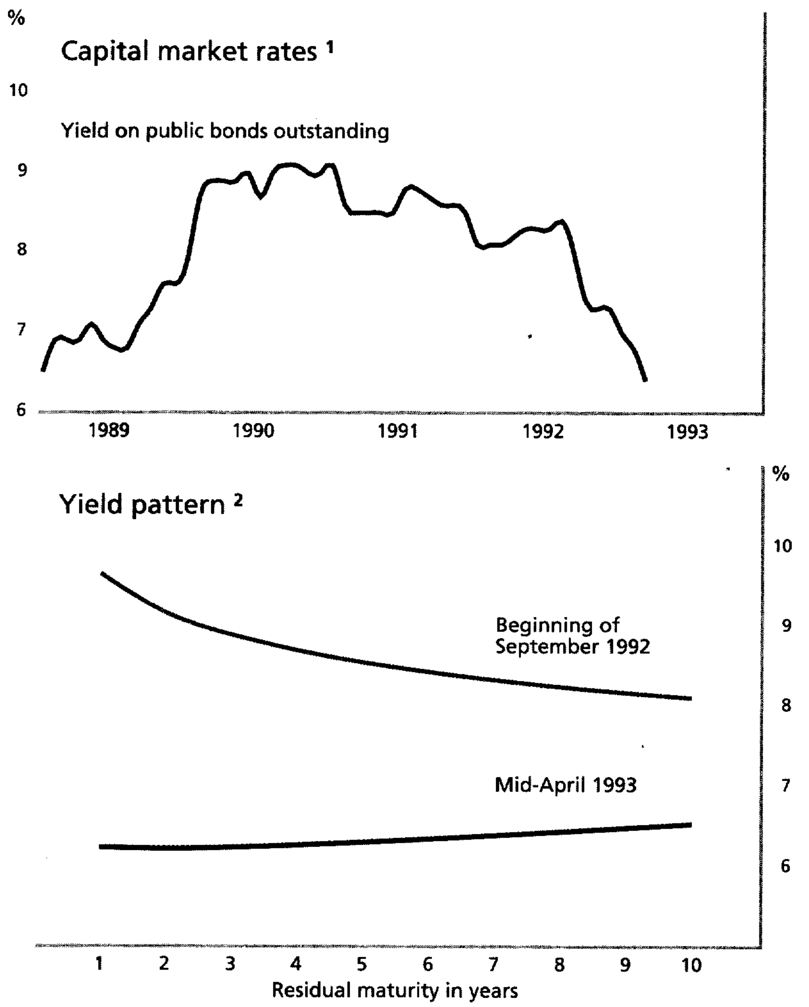
5. Sharp decline in capital market rates

(a) Buoyant bond market

Capital market rates on the descent

Last year the German bond market managed to cope with a sustained high level of credit demand at sharply declining interest rates, and thus impressively demonstrated its efficiency under difficult domestic conditions. The descent from

Interest rate movements in the bond market Chart 10



1 Monthly averages. — 2 Estimated figures for listed Federal securities with a residual maturity of not less than one year, adjusted for coupon effects.

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the yield peak which had been reached (at just under 9¼%) in September 1990 accelerated markedly in 1992, after a temporary firming of interest rates, and continued well into 1993. In mid-April the yield on public bonds outstanding, at just under 6½%, was lower than at any time since the beginning of 1989. At the same time the real rate of interest, calculated as the inflation-adjusted yield on bonds outstanding, at about 2½%, reached its lowest level for more than twelve years. In the second half of the year, strong pressure to reduce interest rates was exerted, in particular, by declines in global capital market yields and massive inflows of funds from abroad. The Bundesbank evidently succeeded in maintaining confidence in the longer-term stability of the Deutsche Mark. This underlines the fact that a credible anti-inflationary stance of monetary policy is the most important contribution that a central bank can make to a prospering capital market, and thus ultimately to a long-term interest rate level that encourages investment. In the course of the downward trend in interest rates in the German capital market the yield curve, which was previously distinctly inverse, flattened out progressively at a markedly lower level, and finally started to rise slightly. The gradual "normalisation" of the interest rate pattern, starting from the short end of the market, may be rated a confirmation of the Bundesbank's policy of lowering interest rates cautiously, because the sustained decline in yields in all maturity categories suggests that there was no increase in the inflation and risk premiums included in long-term capital market rates.

Decline in interest rates improves investment conditions

The sharp decline in capital market yields was accompanied by a marked reduction in the cost of procuring outside funds for German enterprises. In Germany longer-term bank loans predominate, accounting for more than 80 % of the total; the rates of interest on them are generally closely linked to bond market rates via the refinancing terms. The situation in Germany therefore differs from that in other countries, in which corporate financing on money-market-related terms plays a considerably greater role. In addition to the impact on short-term interest rates, German monetary policy makers have to pay due regard to the more indirect influence on movements in long-term interest rates, which are in the main determined by inflation expectations. Any attempt to achieve a lower overall level of interest rates through a relaxation of monetary policy that is inappropriate in terms of anti-inflation policy involves the risk of higher inflation expectations and thus rising capital market rates; moreover, in this connection the propensity to invest funds at long term, which has hitherto been very pronounced in Germany and economically is highly desirable, might slacken in the longer run. In addition, there is a danger of the Deutsche Mark being weakened in its function as the principal international investment currency (after the US dollar), and of foreign investors, who had accumulated Deutsche Mark assets totalling about DM 1 trillion by the end of 1992, turning their backs on the Deutsche Mark and thus triggering interest rate increases.

New issue record in the bond market

The impressive performance of the German bond market is reflected both in its absorptiveness and in the development of turnover in the primary and derivative markets alike. Compared with 1991, the amount raised increased by just under one-quarter to more than DM 300 billion; overall, it accrued almost entirely to domestic issuers. In addition, DM 49.5 billion of floating-rate notes of the Currency

Conversion Equalisation Fund were issued in exchange – and thus without direct recourse to the market – for non-fungible equalisation claims which came into being at east German credit institutions on the occasion of the currency conversion. Altogether, the bond market, with net sales amounting to DM 350 billion, held its ground in the context of macroeconomic financial flows. In 1992 bonds accounted for one-third of longer-term borrowing by the domestic non-financial sectors. The degree of maturity now reached by the German bond market is mirrored in the fact that internationally customary derivative instruments and markets are now well established, and that great use is being made of them. For instance, the total number of futures and options contracts on fixed interest Deutsche Mark paper traded on the German Financial Futures and Options Exchange (DTB) in 1992 rose to about 7.5 million; this was almost three times as many as a year before.

Heavy recourse to the bond market by the public sector

The driving force behind issuing activity in 1992 was the public sector. By issuing its own securities in the bond market (excluding bonds of the Currency Conversion Equalisation Fund), it raised DM 128 billion, and thus 50% more than in 1991. Moreover, there was indirect recourse in the shape of bank lending refinanced in the bond market, which likewise increased sharply in 1992. In the first half of the year it was mainly the special funds of the Federal Government that issued bonds of their own, while the Federal Government held back owing to its favourable cash position. The ERP Special Fund and the Treuhand agency for the first time figured as issuers in the German bond market. Altogether, the Federal Government, its special funds (excluding the Currency Conversion Equalisation Fund) and the Treuhand agency drew on the bond market to the extent of almost DM 100 billion. Listed Federal securities were sold on a large scale (DM 65 billion gross) in the context of market-smoothing operations. In addition to the traditional objective of creating favourable placement conditions for issuers (through the settlement of balances), assisting the liquidity of the secondary market has meanwhile, in the light of the considerably increased transaction volume, become a more important motive for market-smoothing operations. It has therefore developed into a significant service rendered by the Bundesbank as part of its activities as the fiscal agent of the public sector, and at the same time a major issuing channel.

"Traditional" bank bonds in the ascendant

In 1992 issues of bank bonds also served to a substantial extent to meet public sector financial needs. Net sales of communal bonds, which are issued to fund lending to the public sector, at DM 55.5 billion, more than doubled compared with 1991. In the case of mortgage loans (DM 12 billion) there was likewise a marked upturn; they seem to have profited from the fact that both housing loans

Sales and purchases of bonds *

Table 9

DM billion

Period		Sales Total	Domestic bonds 1 Total	of which Bank bonds	of which Public bonds	Foreign bonds 2 Total	of which Investment fund units	Memo item Balance of transactions with non-residents 3
1985		103.4	76.1	33.0	42.7	27.4	- 0.1	+ 4.1
1990		244.3	220.3	136.8	83.6	24.0	- 1.1	- 3.7
1991		243.8	219.3	131.7	87.0	24.4	12.1	+ 35.8
1992		350.2	284.1	106.9	177.4	66.1	57.6	+ 67.0
	1st qtr	81.6	65.2	34.6	30.6	16.4	7.5	- 7.1
	2nd qtr	57.5	41.9	16.5	25.6	15.6	7.6	- 11.7
	3rd qtr	84.7	79.2	32.4	46.8	5.5	14.8	+ 53.1
	4th qtr	126.4	97.7	23.4	74.4	28.6	27.7	+ 32.7

Period		Purchases Total	Residents Total	Banks (incl. the Bundesbank) 4	Non-banks 5 Total	Non-banks 5 Domestic bonds	Non-banks 5 Foreign bonds	Non-residents 2
1985		103.4	72.0	32.5	39.4	15.9	23.6	31.5
1990		244.3	224.0	89.4	134.6	122.6	12.1	20.3
1991		243.8	183.5	43.0	140.5	127.2	13.3	60.3
1992		350.2	217.1	131.9	85.2	37.0	48.1	133.1
	1st qtr	81.6	72.2	22.7	49.6	38.6	11.0	9.3
	2nd qtr	57.5	53.7	26.4	27.3	18.8	8.5	3.9
	3rd qtr	84.7	26.1	17.2	8.9	3.6	5.3	58.6
	4th qtr	126.4	65.0	65.6	- 0.6	- 24.0	23.4	61.4

* Including foreign investment fund units, which are incorporated in foreign bonds. From July 1990 including eastern Germany. — **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; statistically adjusted.— **5** Residual.

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with interest rates locked in for longer periods and rescheduling operations became more attractive. In contrast, sales of "other", typically medium-term, bank bonds declined sharply; this reflects, on the one hand, the slackening credit demand of industrial enterprises and, on the other, the greater orientation towards long-term financing. Bonds of specialised credit institutions were also sold to a much smaller extent than in previous years, when they increased in significance in connection with the consolidation of the east German banking system. In addition to the "traditional" securitisation of credit relations in the form of capital market paper, the issuing of money market paper continued to increase in 1992. The market for Deutsche Mark commercial paper is in the forefront here; its volume (with agreed programmes of domestic issuers amounting to DM 35 billion) doubled compared with 1991, as did recourse to these facilities (DM 16 billion). So far, foreign issuers have made little use of the option of direct recourse to the domestic commercial paper market, which option has existed since August 1, 1992. After the issue of new-style liquidity paper by the Bundesbank in March 1993, the issuing of short-dated paper will probably become more attractive to credit institutions, too, as has been suggested by initial issues.

Foreign Deutsche Mark bonds much in demand

In 1992 the market for Deutsche Mark bonds became more attractive again to foreign issuers since many investors pulled out of high-yielding foreign currency bonds and ECU securities. The amount raised in 1992, at DM 34 billion, was almost twice as high as in the previous year. Large-volume bonds, which some governments issued to build up their Deutsche Mark reserves (which had dwindled significantly in the course of the EMS crisis), accounted for a sizeable proportion of this sum.

Heavy demand for foreign investment fund units

The investment operations of the individual groups of investors in the domestic bond market in 1992 are inadequately described by the available statistics, owing to special factors. While domestic credit institutions' and foreign investors' propensity to invest is overstated, domestic non-banks' interest in German bonds is understated (the statistics showing purchases totalling DM 37 billion). Firstly, this is mainly because bonds of the Currency Conversion Equalisation Fund were handed out to east German banks and, though included to the amount of DM 48.5 billion in domestic credit institutions' bond purchases (totalling DM 132 billion), did not involve any additional commitments in the bond market. As is quite usual in periods of falling capital market rates, domestic credit institutions' "genuine" bond purchases likewise ran at a high level (DM 83 billion). Secondly, last year domestic non-banks effected heavy "indirect" bond purchases via non-residents, which purchases were recorded in the statistics as bond-buying by non-residents. Since mid-1992, in particular, private investors have been shifting substantial sums abroad. Purchases of foreign investment fund units by residents, to the record amount of DM 57.5 billion, played a major role in this. In addition, domestic securities safe custody accounts and funds intended for the purchase of securities have been transferred to banks abroad. It was primarily the subsidiaries of German banks domiciled in Luxembourg and their investment companies that profited from this. The predominant motive for these transactions was no doubt to get interest payments to accrue abroad and thus to avoid the flat-rate tax on interest income levied in Germany from January 1, 1993. But the basic preference of private investors for Deutsche Mark securities was not affected by this tax avoidance gambit, because a large part of the funds shifted abroad flowed back again to the German capital market through investment purchases by the respective investment funds and banks, and to this extent did not constitute any burden on long-term interest rates or the exchange rate of the Deutsche Mark.

Deutsche Mark bond market and turmoil in the EMS

Besides the "recycling" of domestic funds earmarked for investment, another major reason for foreign investors' heavy purchases in the German capital market was the turmoil in the foreign exchange markets in autumn 1992. Uncertainty about the course of the European integration process, and doubts as to whether the headway made so far with respect to convergence would be sufficient, made the avoidance of exchange rate risks within the EMS a key criterion of the investment behaviour of internationally operating investors. Confidence in the Deutsche Mark as the anchor currency of the EMS, as well as speculative motives, led to massive purchases of Deutsche Mark bonds by foreign investors in the second half of 1992. In 1992 as a whole, DM 133 billion net flowed into the German bond market from abroad.

(b) Disappointment in the share market

Cyclical low in share prices

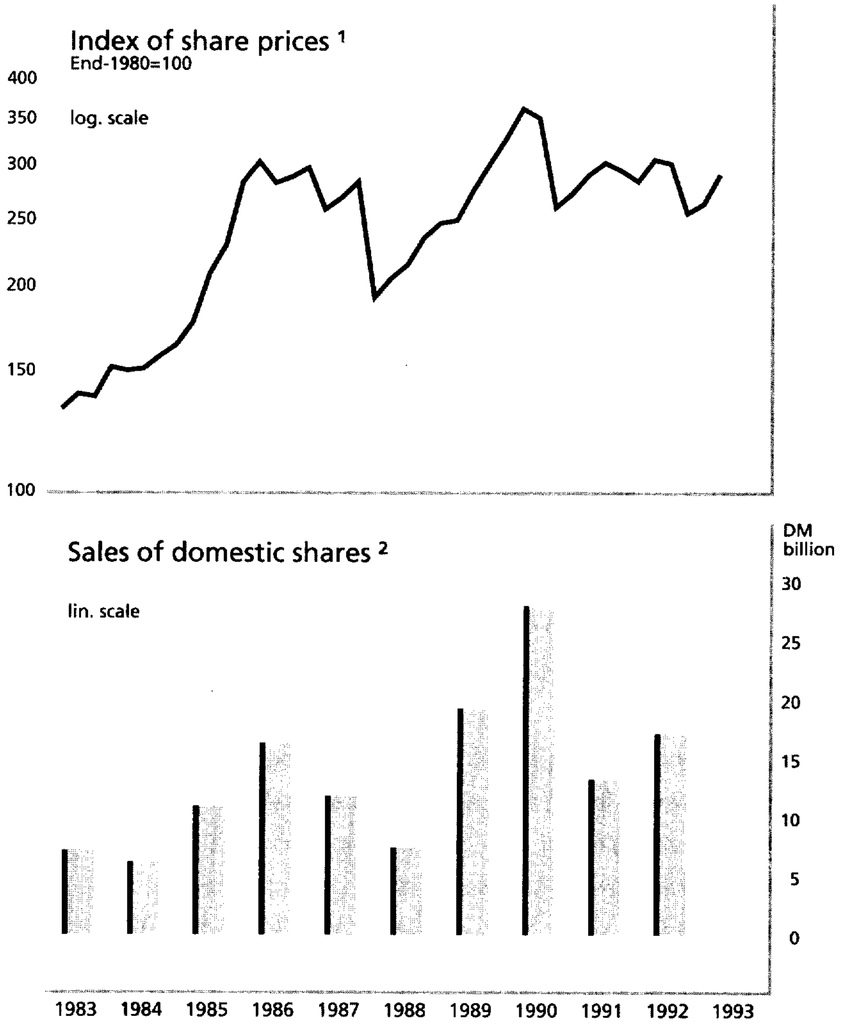
1992 as a whole was disappointing for the German share market. After share prices had risen quite fast at the beginning of the year, they declined sharply from the early summer in view of the clouded economic climate, and in October they reached their lowest level since March 1989. Under the impact of the nosedive in capital market rates, prices then recovered; at the end of 1992 they were on average 7 % lower than at the beginning of the year; in mid-April 1993 prices were 10 % higher than at the beginning of that year. The upswing that started in the late autumn of 1992 highlights the cyclical character of the decline in prices in the German share market. By contrast, at the end of the eighties a number of countries experienced a dramatic rise in the prices of shares and other assets, not least as a consequence of a plentiful liquidity supply and some shock-like steps towards deregulation. Hence the price falls which are now to be seen there often reflect not only a cyclical slowdown but also a need for structural adjustments, which in some countries has narrowed the anti-inflationary room for manoeuvre of monetary policy.

Subdued issuing activity

In 1992 issuing activity in the German share market, at DM 17 billion, remained on a fairly modest scale. Moreover, it was dominated by capital increases by major enterprises, including banks, which enlarged their capital in order to meet

Conditions in the share market

Chart 11



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

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new statutory capital standards. In 1992 only eight companies were newly listed on the stock exchange, and thus less than half as many as in 1991. As uncertainty about economic trends increases, the procurement of risk capital through the stock exchange (which is expensive anyway because of the lower share price level) is often not very attractive, particularly to smaller and frequently little-diversified enterprises.

Foreign investors pull out

The sluggish trend in the German share market in 1992 also owes something to the fact that foreign investors sold German equities on a significant scale. From foreign large-scale investors' point of view, purchases of Deutsche Mark bonds often presented a better prospect of short-run returns than German shares, which were affected by the uncertainties surrounding economic activity. Non-residents sold German equities amounting to over DM 5.5 billion (net), while residents increased their holdings of domestic and foreign shares (excluding foreign investment fund units) by DM 37.5 billion. In the longer run, with respect to the attractiveness of the German share market, structural improvements of the stock market would seem to be of fundamental significance, especially to the important group of foreign investors.

Major decisions on stock market reform still pending

In 1992 as a whole the restructuring of the underlying institutional conditions of the German financial system lost some of its momentum, after years of rapid structural change. Until the beginning of 1993, it is true, further steps were taken towards more efficient stock market organisation and securities trading supervison, in the shape of the establishment of the *"Deutsche Börse AG"* (German Stock Exchange Company) and the decision of the Council of Ministers Responsible for Stock Exchanges on the future structure of securities trading supervision, which decision provides, inter alia, for the establishment of a Federal Securities Trading Supervisory Office. But after this agreement in principle on the structure, the major decisions to fill in the contents, on the way to a system of financial market supervision which satisfies international requirements, are still outstanding. The key issues here are the powers of the stock market supervisors to intervene and to gather information, which ultimately constitute the operating basis for punishing insider offences and for exchanging information at an international level. It is essential in this context to find and quickly implement solutions which on the one hand are practicable and on the other are effective and sufficiently transparent to ensure investors' confidence in the viability of financial market supervision.

(c) Current trends in the banking sector

Market share of big banks recedes

In lending business with domestic non-banks, the market shares of the individual categories of banks shifted rather significantly last year. This was mainly because of the divergence in the trends of short and longer-term lending to trade and industry, which affected the individual categories of banks in different ways, depending on the traditional focal points of their business. The strong growth of lending to the public sector benefited banks which engage more in long-term securitised and unsecuritised lending. Among the major categories of banks, credit cooperatives (+ 14.2 %), savings banks (+ 10.2 %) and mortgage banks (+ 10.8 %) were able to increase their lending to domestic non-banks more than credit institutions as a whole (+ 9.3 %). Owing to their close involvement in reconstruction financing in eastern Germany, banks with special functions likewise ran markedly above the sectoral average (+ 15 %). By contrast, commercial banks lost ground. After the above-average growth rates of previous years, big banks, in particular, increased their lending business only slightly (+ 4.2 %). The decisive factor here was, first and foremost, the decline in the demand of trade and industry for short-term operating loans.

Satisfactory course of profitability

According to the available data, the profitability trend in the banking industry in the financial year 1992 is once again likely to be satisfactory. The favourable picture presented by ordinary business, which is marked by a relatively stable interest figure and by somewhat higher net commissions received, is slightly marred, however, by the trend in administrative expenses and "extraordinary" business. Administrative expenses continue to be affected by the establishment of branches in eastern Germany (which is not yet quite completed), and probably also by preparations for the flat-rate tax on interest income, which has been in effect since January 1993. Owing to the slowdown in economic activity, a need for somewhat higher provisions in domestic lending is to be expected in "extraordinary" business.

Progressive adjustment of east German credit institutions

Last year east German credit institutions made further headway in the restructuring process. The average size and balance sheet structure of savings banks and credit cooperatives continued to move into line with west German standards. The number of savings banks declined by seven to 181, that of credit cooperatives, with their lower balance sheet totals, decreased by 57 to 235 (owing to numerous mergers). Savings banks and credit cooperatives in the new Länder stepped up their lending to non-banks by just under one-half and one-third, respectively. Even so, they continued to report a pronounced excess of liabilities. In terms of market shares in eastern Germany, savings banks' lending accounts for about 40 %, and, in borrowing and deposit business, for just under 60 %, and credit cooperatives for about 15 % and 17 %, respectively. The profitability of east German credit institutions is marked by relatively high net interest received (and thus by a favourable operating result), but also by large loan loss provisions. Profitability deteriorated slightly because refinancing became more costly on account of the decline in low-interest-bearing savings deposits and sight deposits and because interest income from equalisation claims diminished with the fall in money market rates. The cost of money increased for east German credit institutions to the extent that the Bundesbank reduced its low-interest refinancing quotas, which had amounted to DM 18 billion at the end of 1991, to DM 2.3 billion in November 1992 (and transformed them into standard rediscount quotas).

(d) Longer-term trends in the overall acquisition of financial assets and its financing

Universal banks at the centre of the German financing cycle

In Germany, credit institutions operating mainly as "universal" banks and focusing their operations on classical deposit and lending business are traditionally at the centre of the overall financing cycle. At the end of 1992 they accounted for about four-fifths of the financial assets of all domestic financial institutions. The share of bank deposits in the total financial assets of the domestic non-financial sectors has declined continuously since the beginning of the seventies; at the end of 1992 it came to 42 %, compared with 56 % in 1970. However, credit institutions have responded flexibly to this gradual change in the structure of private financial asset acquisition. They have extended the range of their own products and increasingly offered bank savings bonds and bank bonds carrying attractive interest rates to refinance their lending; the amount of these bank securities outstanding has more than octupled in the last 20 years, and their share in the volume of business of credit institutions has risen during the same period from 16 % to 23 ½ %. Furthermore, many credit institutions have considerably extended their business base by building up general finance conglomerates, thus strengthening their position as intermediaries in the overall financing and financial asset acquisition process. By contrast, the direct securitisation of credit relations between non-banks, e.g. in the form of commercial paper, and thus the trend apparent in many countries towards increasing "disintermediation", has been of only minor significance so far in Germany. For the German economy (which is predominantly structured in small and medium-sized units in many sectors), the bank loan continues to be the main traditional instrument for procuring outside funds. Since the beginning of the seventies, the share of bank loans in the outside funds taken up in the market by producing enterprises has been just under 85 %, and for the domestic non-financial sectors as a whole it has been almost 75 %.

Far-reaching structural changes in the financial markets

In the past few years, the appearance and mode of operation of the financial markets have changed profoundly in many countries. In the German financial system, too, as already mentioned, structural changes are under way which have to be taken into consideration by a systematically operating and forward-looking financial market policy. In contrast to the experience gained in some other countries, structural changes in the German financial sector tend to take place gradually. It has proved to be an advantage in this context that far-reaching deregulation measures in the banking industry and freedom in cross-border money and capital transactions were achieved in Germany at an early date, and in a comprehensive manner. The capacity of the German universal banking system efficiently to pro-

Trends in overall asset acquisition and its financing *

Table 10

Item	1970	1980	1992 pe	1970	1980	1992 pe
	DM billion 1			Percentage of total 1		
Financial assets of the domestic non-financial sectors						
Funds placed with banks 2	502	1,238	2,377	56	52	42
Funds placed with building and loan associations and insurance enterprises	1 131	385	938	15	16	17
Securities 3	133	360	1,189	15	15	21
Other assets	131	386	1,099	15	16	20
Total	896	2,369	5,602	100	100	100
Funds borrowed by domestic producing enterprises 4						
Bank advances	249	596	1,262	81	83	84
of which: short-term	105	230	439	34	32	29
Bonds	24	32	90	8	4	6
Other borrowed funds 5	35	92	157	11	13	10
Total	308	721	1,510	100	100	100

* Western Germany. — 1 End-of-year levels. — 2 Including bank savings bonds. — 3 Including bank bonds; shares valued at issue prices. — 4 Funds borrowed in the market. — 5 Loans granted by building and loan associations and insurance companies, and liabilities to credit institutions abroad.

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vide a wide range of financial services without recourse to spectacular financial innovations and the consistent anti-inflationary stance of monetary policy have probably helped to ensure that the German financial system has so far been spared any crisis-like disruptions.

Risks posed by the process of financial change

The rather gradual process of structural change in the German financial system and the comparatively enduring German universal banking system (thanks to its wide spreading of risks and relatively stable profitability) have so far made it easier to cope flexibly and fairly unobtrusively with the many and varied challenges which have arisen as a consequence of the globalisation of the financial markets and the internationalisation of financial services. Nevertheless, there are signs of trends whose relevance to banking supervision and monetary policy must not be underestimated. The volume of banks' off-balance-sheet operations has sky-rocketed in the last few years, thus not only complicating the assessment of individual banks' risk positions but also posing greater risks to the stability of the financial sector as a whole. These operations, which have been subject to reporting requirements in Germany since 1986, as part of the banking statistics and of the reports for banking supervision purposes, and which have been limited in quantity since October 1990 by the need for capital backing, were equivalent on average at the end of 1992 (in volume terms) to 83 % of the on-balance-sheet operations, compared with 56% at the end of 1989 and 29% at the end of 1986. Regulations on a sound equity capital base and on adequate reporting requirements for institutions providing financial services should therefore be at the centre of coordinated efforts, on a national and international basis, to enhance financial systems' ability to withstand crises. Moreover, due consideration must be given to the virtually incalculable systemic risks posed by the (sometimes rather opaque) business and participatory structures of internationally operating financial conglomerates, and by the collision of different legal systems and payment techniques in strongly expanding international financial service operations. If this is successfully accomplished, the monetary policy makers' scope for pursuing anti-inflationary policies will be preserved; in some countries it has been significantly reduced by the greater fragility and "shortness of breath" of the financial system.

III. International monetary policy cooperation

1. The crisis within the EMS and its lessons

Sustainable basis for the further process of integration

The period of relative calm within the EMS that had lasted for more than five years after the last realignment in early 1987 came to an end in mid-1992. Since then the system has gone through a number of crises that were still continuing at the beginning of the current year. After the period that was practically free of tensions and the further development this favoured in the direction of a monetary union based on the treaty on political union concluded in Maastricht (with a single currency and an independent system of central banks as its core element), the Community now faces the task of stabilising exchange rate expectations on the sustainable basis that now exists. The fact that success in this direction had not been achieved to a sufficient extent by the summer of 1992 can probably be put down to the circumstance that up to the present it has been possible to safeguard monetary integration only incompletely through corresponding progress in bringing about the necessary basic prerequisites in the economic field.

Progress in convergence in the EC

Table 11

Country	Change in consumer prices from previous year in %		Financial balance of the public sector as % of GDP 1		Gross indebtedness of the public sector as % of GDP 1		Yield on long-term public bonds in %	
	Annual average 1987–92	1992	Annual average 1987–92	1992	Annual average 1987–92	1992	Annual average 1987–92	1992
Belgium	2.5	2.4	– 6.7	– 6.7	130.2	132.2	8.7	8.6
Denmark	3.4	2.1	– 0.5	– 2.3	68.6	74.0	10.0	9.0
France	3.1	2.7	– 1.8	– 2.8	47.8	50.1	9.1	8.6
Germany	2.4 2	4.0 2	– 2.0	– 2.8	43.6	44.9	7.5	7.9
Greece	16.5	15.9	– 15.1	– 13.4	90.6	106.7	21.1 3	21.5 3
Ireland	3.1	3.1	– 3.8	– 2.5	108.1	99.0	9.7	9.1
Italy	5.7	5.2	– 10.5	– 10.5	97.5	106.8	11.3 4	11.9 4
Luxembourg	2.4	3.2	2.4	– 0.4	8.3	6.8	7.9	7.9
Netherlands	1.9	3.7	– 4.4	– 3.5	78.4	79.8	7.8	8.3
Portugal	10.8	9.0	– 5.5	– 5.6	70.6	66.2	14.2	12.2
Spain	5.9	5.9	– 3.8	– 4.6	45.2	47.4	13.0	12.2
United Kingdom	6.0	3.7	– 1.6	– 6.1	45.9	45.9	10.1	9.1

Sources: EC Commission and national statistics. — **1** In the definition of the national accounts. — **2** Old Länder. — **3** Twelve-month Treasury bills. — **4** Less withholding tax.

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Considerable progress in achieving convergence in the past

In this context the fact deserves to be recognised that some member countries have made quite considerable progress in their endeavours to achieve greater economic convergence. After an initial period marked by frequent realignments, the internal cohesion of the EMS became stronger from the mid-eighties onwards and led to the crystallisation of a "hard core" to the extent that individual member countries succeeded in reducing their rates of inflation and also seemed to fulfil more effectively other conditions for participating in a system of fixed but adjustable exchange rates. This was made easier for various countries by the fact that linking their currencies firmly to the "hard core" of the EMS, with the Deutsche Mark as the generally accepted anchor currency, provided the best prospect of attaining within a reasonable period of time the desirable degree of price stability that is necessary for participation in the exchange rate mechanism on a lasting basis. A number of neighbouring countries in northern Europe which do not belong to the Community but which are endeavouring to become members in the near future likewise hoped to gain advantages of this kind by linking their currencies, initially on a unilateral basis, to the exchange rate mechanism of the EMS. An additional outward sign of the attractiveness of the EMS in the period of relative calm was the inclusion of the peseta, the pound sterling and the escudo in the exchange rate mechanism, while the renunciation by Italy of the special status of the lira, with its wider margins of fluctuation of ±6% (which were intended to be temporary but were maintained for a long period of time), signalled growing endeavours to bring about greater exchange rate stability. This, however, also constitutes the list of participating currencies which – along with the Irish pound – either had to be strongly devalued or were withdrawn from the exchange rate mechanism for the time being in the wake of the latest crisis within the EMS.

Greater attention paid to existing shortcomings in convergence

The fact that success had not been achieved to a sufficient extent in consolidating the domestic economy became clear around the middle of 1992 after the rejection of the Maastricht Treaty through the referendum in Denmark. The expectation of a smooth transition from the parities that currently apply in the EMS to a monetary union (which was by no means fully justified either by actual developments or by the applicable rules) was suddenly called in question once again by the financial and foreign exchange markets. The price and cost differentials that had evolved since 1987 made exchange rate corrections all the more probable in the eyes of market participants as the losses in competitiveness on the part of individual countries owing to the real appreciation of their currencies became more apparent in the light of the increasing sluggishness of economic activity both within the Community and outside it. This was compounded by growing doubts about the willingness of some countries to continue to persevere with the strict stance of monetary policy needed to defend existing parities in a less favourable economic environment.

Huge demand for Deutsche Mark assets after the "rediscovery" of the exchange rate risk

The upshot was a reorientation on the part of investors that operate internationally – led by institutional investors, who have greatly increased in importance on the financial markets in recent years. Whereas investors previously seized interest rate advantages without hedging the associated exchange rate risks, upon the "rediscovery" of exchange rate risks DM-denominated assets were suddenly in demand on a huge scale, be it through switching out of investment in weak currencies, be it through exchange risk cover operations or speculative transactions. Tension was additionally triggered by the simultaneous interest-rate-induced fall in the US dollar rate. In the light of the need to counter the pressure on exchange rates emanating from the markets also by increasing interest rates, in order to give extra impact to the interventions of the central banks in the foreign exchange markets, several member countries saw themselves confronted with a dilemma that the United Kingdom and Italy escaped by temporarily withdrawing from the exchange rate mechanism. Both of these countries took advantage of the scope for monetary policy action they gained in this way to lower their central bank

Economic activity and the current accounts of the EC countries Table 12

	Change in real GDP from previous year in %		Unemployment as % of the civilian labour force 1		Current account balance as % of GDP	
	Annual average 1987–92	1992	Annual average 1987–92	1992	Annual average 1987–92	1992
Belgium	2.8	1.0	8.9	8.2	1.5	1.8
Denmark	1.0	1.0	7.7	9.5	- 0.2	3.0
France	2.6	1.8	9.7	10.1	- 0.4	0.1
Germany	3.2 2	2.0 2	5.8 2	7.5 2	2.3 3	- 1.3
Greece	1.7	1.5	7.5	7.7	- 4.1	- 3.3
Ireland	5.0	2.9	16.6	17.8	2.9	6.7
Italy	2.4	0.9	10.3	10.2	- 1.2	- 1.9
Luxembourg	4.0	2.2	1.9	1.9	29.5	19.9
Netherlands	2.6	1.3	8.2	6.7	3.3	3.9
Portugal	3.7	1.7	5.2	4.8	- 2.2	- 0.2
Spain	3.8	1.2	17.9	18.0	- 2.5	- 3.7
United Kingdom	1.4	- 0.6	8.8	10.8	- 3.4	- 2.1

Sources: EC Commission and national statistics. — 1 Determined on the basis of the standardised EC procedure. — 2 From 1992 Germany as a whole. — 3 From mid-1990 Germany as a whole.

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interest rates and consequently bring domestic monetary conditions more into line with their respective economic situations. Other participating countries confined themselves to bringing the exchange rate of their currencies more into keeping with international price and cost relationships by allowing them to depreciate.

Indications of potential tensions ignored

Although the sudden appearance of doubts about the political implementation of the Maastricht Treaty was the most important factor that triggered the worst crisis in the EMS since the inception of the system, the real reasons have to be sought elsewhere. Chief among them is the failure to undertake corrections of exchange rates in good time in the light of persistent and hence cumulative divergences in the development of costs and prices, public sector budgets and external balances. After realignments in earlier years had almost always been triggered by tensions on the foreign exchange markets, the emerging divergences in a period of relative calm would have called for a heightened sense of awareness of the build-up of potential dangers on the part of the monetary authorities. Corresponding indications, such as had been expressed by the Bundesbank, for instance, on various occasions,[1] did not meet with any response, however, on the part of the authorities that are responsible for setting exchange rates in the countries concerned. From the point of view of individual countries, the factors arguing against exchange rate adjustments were, on the one hand, the concern that they might once again endanger the insufficiently established credibility of their anti-inflation policy by depreciating and, on the other hand, the determination of the Community to bring the process of political, economic and monetary union to a successful conclusion rapidly and without any delays.

Overrated importance of Germany's policy mix

The economic conseqences of German unification and, in particular, the resultant German policy mix are also repeatedly made responsible for the crisis in the EMS, particularly as regards its extent and the difficulties in bringing it under control. In reality, in the initial stage the surge in demand emanating from eastern Germany buttressed economic activity in Germany's partner countries in Europe – as well as in third countries – and thus more or less offset the dampening effect of the rise in interest rates in Germany that was triggered by changes in market expectations. This has been explicitly acknowledged on many occasions. However, as time passed, the relatively high interest rates that were inevitable in Germany in order to contain the tendencies for inflation to accelerate were increasingly felt to be troublesome by a number of countries. This was clearly reflected in demands from other countries directed at the Bundesbank to reduce its interest rates. However, putting strong emphasis on German unification as the cause of the crisis in the EMS is unjustified, if only because the continuation of the development that had been observed beforehand and occasionally deplored (not only within the Community) – namely comparatively low rates of inflation, exceptionally small budget deficits and large external surpluses on the part of western Germany – would have signalled a need to adjust exchange rates sooner or later. A persistently more favourable development of prices and costs than in some partner countries would have further strengthened Germany's competitive position and the

1 The Bundesbank adopted the following viewpoint in its Report for the Year 1990, for example (page 66): "To the extent that the stability of exchange rates or even the pronounced strength of a number of partner currencies that do not belong to the "hard core" of the EMS can be explained essentially by inflation-induced higher rates of interest, it can basically be justified only if it is consolidated by a domestic economic policy that is durably geared to stability. If success is not achieved in coping with the structural causes of inflation within a reasonable period of time, it will probably become increasingly difficult over the long term to avoid having recourse to exchange rate adjustments. ... This explains why an exchange rate arrangement that is not based on durable progress in the direction of convergence will remain under the threat of tensions. For this reason, changes in central rates within the EMS should not be excluded in principle during the transitional stages towards bringing about economic and monetary union."

tendency to register surpluses on current account. Particularly in a deteriorating global economic environment, Germany's partners as well as Germany itself would in the end have felt this to be burdensome. Judging by past experience, the foreign exchange markets would have perceived this sooner or later and pushed for a general adjustment of exchange rates.

"Home-grown" reasons for high long-term interest rates abroad

Moreover, attention must be drawn to the fact that, after a temporary rise, long-term interest rates in Germany, which are largely determined by inflation expectations on the markets, have meanwhile returned to a level that cannot by any means be considered to be high by historical standards, either in nominal or in real terms. Short-term interest rates in Germany have also fallen considerably since September 1992. The reasons why a number of partner counries continue to be burdened by distinctly higher market rates of interest have to be sought in the countries concerned themselves. In individual cases these countries have experienced a greater deterioration in their policy mix within a relatively short period of time than was the case in Germany owing to the special burdens imposed by unification.

No stabilisation of exchange rates at the expense of price stability

Besides the above-mentioned, often hotly disputed causes of the crises, however, special importance attaches to a development that meanwhile constitutes a new challenge to the cohesion of a fixed rate system, namely the size and mode of operation of the liberalised financial and foreign exchange markets. The latest currency crisis illustrated at a single stroke the extent to which international movements of money and capital can meanwhile put pressure on individual currencies, even within the EMS, and what effects this can have on banks, liquidity and the money stock in the target country of such movements. Attention has frequently been drawn to the implications for a fixed rate system of any transition to money and capital transactions that are free of controls and of the crystallisation of sophisticated financial and foreign exchange markets. The conclusion has often been drawn that under such conditions individual countries no longer have any real scope for a monetary policy that is geared to national requirements, and that therefore national monetary policies must be replaced by a common or at least a very closely coordinated monetary policy. Against this it can be held, of course, that shifts in money and capital between individual EMS currencies are not the real cause of tensions in exchange rates but rather a symptom of accumulated and current divergences in economic developments and economic policy. To this extent, the freedom of capital transactions is not a new "source of disturbance" for exchange rate developments, but rather constitutes a catalyst of necessary adjustments relating to the whole range of economic, fiscal and wage policies.

Gearing monetary policy to the need to stabilise exchange rates must neither operate to the detriment of adjustment constraints nor be at the expense of price stability, the durable safeguarding of which is generally recognised in every participating country as the indispensable prerequisite of exchange rate stability.[1]

Anti-inflation policy jeopardised by unlimited financing of interventions

The unrest in the EMS in recent months makes it clear that exchange rate expectations cannot be controlled in the long run contrary to the fundamentals by intervening in the market. Neither "unlimited" interventions nor special intervention tactics, and neither monetary policy reactions perceived to have a short-term effect nor public statements will ultimately be successful if a lack of convergence has arisen on a broad front and the markets draw their conclusions from this. In this context greater account should in future be taken of the fact that interventions in the foreign exchange market must not have a serious adverse effect on the monetary policy of the countries whose currency is in demand on the markets. For this reason, from Germany's point of view the current mutual obligation to finance compulsory interventions in unlimited amounts needs to be reviewed with respect to its application in practice. Although a pledge to provide unlimited financing is part of the logic of a fixed rate system that envisages the obligation of central banks to buy and sell without limitation at publicised minimum and maximum rates, this obligation leaves market participants in doubt as to what resources the central banks are willing to spend in specific circumstances to defend existing exchange rates. For many participants this at the same time constitutes the basis of credibility of the EMS. However, this credibility is bound to prove to be illusory if, in the event of excessive interventions, the ability of individual debtor central banks to repay on time the credits they have taken up is called into question and if the difficulties of the creditor central banks in tolerating the expansionary monetary effects of financing interventions in unlimited amounts become evident.

Exchange rate tensions cannot be warded off through a "symmetrical" interest rate policy

Moreover, persistent exchange rate tensions could not be warded off by hard currency countries accepting demands for a "symmetrical" interest rate policy if, by doing so, they would ultimately undermine the intrinsic value of their own currency. What is needed instead is to ensure convergence between the

1 Article 3 of the Council Decision of March 12, 1990 on cooperation between the central banks of the Member States of the European Economic Community gives the Committee of central banks of the Member States the task of "promoting the coordination of the monetary policies of the Member States with the aim of achieving price stability as a necessary condition for the proper functioning of the European Monetary System and the realization of its objective of monetary stability."

endeavours to bring about stability as well as success in achieving stability and an orientation towards the optimum outcome over the longer term. Differing rates of inflation and the imbalances ultimately responsible for them therefore require asymmetrical defensive reactions in the event of exchange rate tensions. Moreover, the fact that Germany's monetary policy is consistently geared to stability is also in Europe's enlightened self-interest. In this context, the Deutsche Mark fulfils a key currency function that has gradually accrued to it and which – so long as Germany's monetary policy does not place its credibility in terms of anti-inflation policy at risk – cannot easily be assumed by any other currency within the EMS. The anchor role played by the Deutsche Mark is the outcome of confidence in Germany's monetary policy that has been acquired over a period of several decades. If there were any weakening of the stability of the Deutsche Mark, there would be no gainsaying the danger of the pace of inflation generally increasing in Europe. This would not be the right ground on which to base a monetary union. Thus, the expectation placed in the EMS that the threshold to a monetary union could be reached with this fixed rate system can only be fulfilled if due account is taken of the need to achieve convergence with tenacity and success. To the extent that this is not yet assured, timely and appropriate realignments will remain necessary in order to protect both individual countries and the system as a whole from "permanent damage". This need was explicitly confirmed in the Basle/Nyborg agreement of 1987.

Denomination of intervention loans in ECUs problematical

In the light of the magnitude of the interventions involved, the Bundesbank has also called for a discussion of the denomination in ECUs of the intervention balances booked by the European Monetary Cooperation Fund, as laid down in the EMS Agreement. This leads to heavy losses on the part of the creditor central banks if exchange rates are ultimately changed despite everything, after interventions have been undertaken on a huge scale. This problem is compounded by the fact that currencies which have temporarily withdrawn from the exchange rate mechanism influence the ECU countervalue of cumulative debtor and creditor balances in line with their weight in the ECU basket. At present, the currencies not participating in the exchange rate mechanism have a share of over one-fifth in the ECU basket. If the market value of the ECU falls between the time when the claims from interventions arise and the point in time when they are redeemed, the creditor central bank suffers corresponding losses, which in the case of Germany are ultimately borne by the Federal Government. Such an outcome can be accepted only with difficulty over the long term.

Convergence as the basis for EMU

The crisis in the EMS provides cogent confirmation of the fact that only countries that have made great progress on the road towards convergence can participate fully in a monetary union from the very beginning. Otherwise the economic divergences that up to now have made themselves felt in the form of tensions on the foreign exchange markets and exchange rate realignments would give rise to serious regional and sectoral imbalances that could endanger the viability of the economic and monetary union (EMU). This would ultimately also make the anti-inflationary task of the common system of central banks more difficult, if not impossible, to perform. The ground would thus be cut from under the feet of monetary union retroactively. This is why the convergence criteria laid down in the Maastricht Treaty, which define the basic prerequisites for participation in the envisaged monetary union, must serve even today as the guideline for action in the economic field on the part of individual countries. On no account must they be softened, particularly since they are not overly demanding in individual respects in any case. Moreover, the prospect of a European monetary union demands not only the establishment and safeguarding of its economic prerequisites. It also requires the thorough preparation of the way in which the future common central bank system is to function, and not least agreement on a convincing monetary policy strategy.

2. Ideas concerning a monetary policy strategy for Europe

Need for a convincing monetary policy strategy

Under the Maastricht Treaty, the European System of Central Banks (ESCB) will be responsible for monetary policy in the participating countries from the third stage of economic and monetary union onwards. The ESCB is committed to safeguarding monetary stability. In order to be in a position to achieve this objective, institutional arrangements that are appropriate all in all have been laid down in the Treaty. Similar to the Bundesbank, the ESCB will be independent of national governments as well as of Community institutions in deploying its instruments. It will therefore be solely responsible for the formulation of an appropriate strategy for a policy geared to stability. What the details of such a policy will look like depends, inter alia, on the concrete conditions with which the ESCB is confronted at the beginning of stage three, which cannot be foreseen yet. However, there are a number of basic demands on a monetary policy strategy that should be met in order to fulfil the mandate to ensure price stability. This concept will also determine the interrelationship between the central body, the European Central Bank (ECB), and the subordinated national central banks, on which interrelationship decisions will have to be taken in good time in the years ahead if success is to be achieved in bringing about a smooth transition to the final stage of economic and monetary union. Thus, with the selection of the strategy, a certain preliminary decision will be taken regarding the future arsenal of monetary policy instruments, as well as the way in which monetary policy is organised in Europe.

Monetary targeting geared to the medium term particularly suitable for Europe

Between the individual measures and the basic objective of monetary policy, namely ensuring monetary stability, there lies a long and complex transmission mechanism that cannot be traced in its entirety and in all its details. In addition, the movement of prices is influenced over the shorter term by a number of non-monetary factors. It is therefore not advisable for a central bank to take decisions only in the light of current price movements. Moreover, other economic agents could hardly refer to the individual decisions taken by the central bank to verify whether it is pursuing a policy that is in line with the objective of ensuring monetary stability, although this is important if it is to be credible. For this reason, a two-stage strategy seems to be most appropriate that has an intermediate target which is simple to observe and which makes it easier to form an opinion on monetary policy. From our limited knowledge of the process whereby monetary policy is transmitted it also follows that monetary policy should primarily be geared to the medium term, in order to avoid procyclical swings. Since the stability of the price level depends in the medium run on the appropriate growth of money balances in an economy, a policy that allows the money stock to expand in line with the growth potential of the economy – adjusted as necessary for long-term tendencies of the velocity of circulation of money to change – is particularly suitable for achieving the goal of price stability agreed upon in the Treaty. The policy of the Bundesbank has been based on considerations and experiences of this kind for almost 20 years. In principle, for the ESCB, with its large currency area, a monetary policy geared to these principles would appear to be even more appropriate than for a national central bank. The reason for this is that, in a future European economic and monetary union, external influences that are of great significance for the individual economies of Europe today will tend to play a subordinate role. Fluctuations in exchange rates, in particular, will have less economic impact on Europe as a whole than on the national states of today. Moreover, under the Maastricht Treaty no arrangements may apply in exchange rate policy vis-à-vis non-Community countries that collide with the commitment to ensure monetary stability. This calls for floating exchange rates vis-à-vis the outside world, with the result that the central bank will not be hindered in pursuing a target for monetary growth by intervention obligations in the foreign exchange markets.

Clear strategy to strengthen credibility

Given the special situation in which the ESCB will find itself at the beginning of the third stage, a strategy of monetary targeting has a number of substantial advantages. Although at the start of the final stage the new monetary institute will be able to base its actions on a clear mandate to defend the value of money, it will not yet be able to point to any successes of its own as regards monetary stability or its credibility on the markets. A clearly defined strategy that can be verified, like the medium-term monetary targeting approach, can help quickly to create confidence in its anti-inflation policy, particularly since in doing so the time-tested approach of the Bundesbank would be adopted, with the result that the chances of its credibility being transferred to the ESCB would improve. A monetary targeting strategy is also appropriate in the light of the distribution of economic policy roles in Europe. By means of monetary targets, a central bank sets the monetary framework for the other agents operating in an economy. This makes it easier to allocate responsibilities. This will be particularly important in Europe since, although there will be a uniform monetary policy from stage three onwards, decisions in other fields – such as fiscal policy and wage policy – will continue to be taken primarily on a decentralised basis, and there are not yet any signs of agreement on the envisaged political union. To this extent, ideas that amount in significant measure to solutions being sought between the field of monetary policy and other areas of policy through negotiations and coordination are not practicable. Finally, monetary targets can facilitate decision-making in the Council of the ESCB because they make the connection between the deployment of its instruments and the final objectives visible and reconstructable. In the light of the federative nature of this decision-making body, whose members will be characterised by differing experiences and ideas, this aspect should not be disregarded.

Manageability of a European money stock

First of all, a strategy of monetary targeting makes it necessary to manage the money stock in a foreseeable manner. Although it is not essential to keep the money stock on the desired path all the time even over the very short term, the ESCB ought to be in a position to influence a suitable monetary aggregate over the medium term in the desired direction with the instruments envisaged in its statute. Even though a precise statistical definition of a European monetary aggregate cannot be given at present, there is a good deal of evidence that the money stock will be manageable in this sense. For instance, potential obstacles to efficient monetary management, such as the obligation to grant credit to the state or to stabilise a given exchange rate, have largely been eliminated by the future central bank act. Monetary targets like the ones the Bundesbank sets every year should therefore likewise be implementable at the European level.

Stability of the demand for money

Secondly, an approach that is geared to the money stock calls for a stable relationship between the chosen intermediate target and expenditure growth or price movements within the currency area. How well this requirement will be met in stage three is ultimately an empirical question. Although this question cannot be answered conclusively yet, existing studies on the stability of the demand for money in Europe display quite satisfactory results, which are often even more favourable than is the case with individual countries. Owing to the progressive integration of the markets, the results will tend to become even better in the future. Financial innovations that have led to disruptions in the demand for money in a number of EC member states in the past will then probably no longer play any particular role. They were not infrequently the consequence of an anti-inflation policy that was pursued with too little consistency, or of monetary management methods which were not in line with the way the market operates, and which provoked attempts at circumvention. These influences will cease to operate once the ESCB meets its obligation to ensure price stability and renounces administrative regulations in implementing monetary policy.

No genuine alternatives

Even though risks cannot be ruled out with respect to monetary targeting that is geared to the medium term, it is not least the lack of convincing alternatives that argues in favour of such an approach. A policy which sets itself exchange rate targets instead is probably out of the question in any case for Europe, owing to the size of the economic area. Taking all things together, gearing monetary policy to interest rates has failed to be successful in the past. Long-term interest rates, which are undoubtedly of great importance for the development of the economy, cannot be adequately managed by monetary policy. By contrast, money market rates belong more to the operational area than to the level of the intermediate target. In any case, by fixing interest rates the central bank would risk losing control of monetary growth and exerting a procyclical and hence destabilising influence on economic developments. Any attempt to use the nominal national product as the intermediate target also appears to be rather unpromising. This approach has not yet been tried out in practice. The main argument against using it is that the development of the national product is not primarily in the hands of the central bank, so that responsibilities would be blurred and no verification criteria would exist. This would be accompanied by the danger of excessive demands being placed on the central bank and its credibility suffering because, in the final analysis, it would in fact be held responsible both for real economic growth and for price movements.

Arsenal of instruments for a medium-term monetary targeting strategy

The instruments at the disposal of the ESCB should be designed in such a way that the money stock can indeed be controlled over the medium term by deploying them. At the same time, they need to comply with the principles of simplicity and competitive neutrality. Moreover, the possible combination of centralised and decentralised elements must not conflict with the efficacy of monetary policy. In stage three, where the exchange rates of the currencies of the participating countries are irrevocably fixed or where there is just one currency, there can only be a single monetary policy. Central bank money must therefore be provided everywhere on the same conditions. This requires uniform money market rates throughout the currency area. The regulations pertaining to the maintenance of central bank balances by commercial banks also need to be placed on a largely uniform footing. If differences were to exist from country to country in this respect, business opportunities would not be evenly distributed; this would involve the danger of competition between national central banks that might be at the expense of the soundness and appropriate orientation of monetary policy in general. Standard approaches that go beyond uniform money market rates will therefore be unavoidable for monetary policy in Europe.

Taking account of elements of subsidiarity

On the other hand, the need for a uniform monetary policy does not preclude decentralised elements in implementing the jointly formulated monetary policy. In this context, due account has to be taken of the fact that the financial markets have their own history in the individual countries and that differences will continue to exist at the beginning of the final stage with respect to a number of practices. In addition to this, the interaction between the individual national central banks and the credit institutions in their regions already runs along established lines in many respects. In keeping with the principle of subsidiarity, advantage should be taken of this fact. The more clearly the instruments are defined, the fewer will be the problems to which this will give rise. Scope for decentralised regulations is likely to exist with respect to a number of technical aspects relating to the provision of central bank money, such as, for example, defining the pledges and collateral for central bank credit.

Open market policy in the forefront

It is obvious that open market policy, i.e. the auctioning of central bank money under market conditions, constitutes the focal point of providing central bank money. This approach largely obviates the need for administrative regulations that can be interpreted in different ways, and is one that is practised in many member states of the Community. In this way, adjustment problems are kept to a minimum. Moreover, by this approach it is perfectly possible to integrate federative elements, as is illustrated by the example of Germany, where regular open market operations are cleared and settled via the Land Central Banks. A wide range of authorised securities that can be bought or sold in the context of such transactions would ensure banks equal opportunities as regards access to the market. Open market policy should therefore not be conducted with public securities only. Not least in terms of the credibility of the central bank, equal treatment for private securities should be demanded. One should consider including short and long-term securities from the non-bank sector (such as trade bills) which are based on real economic transactions and which have been checked as regards the standing of the borrowers. To solve the problem of different degrees of credit-worthiness, a problem which nevertheless remains, the instrument of securities repurchase agreements would, incidentally, be a suitable tool, because in this case the residual risk borne by central banks is very slight.

Major role for minimum reserve policy

The main advantage of open market policy is that the initiative to provide central bank money and the associated conditions are in the hands of the central bank, to a greater extent than in the case of other instruments. Admittedly, open market policy needs to be complemented by the demand side of the equation, i. e. a demand for central bank money has to exist. In this context, it is necessary, on the one hand, for this demand to be foreseeable to a sufficient extent, and it would be useful if a stable relationship were to exist with respect to the intermediate target, especially because this would document the particular responsibility of the central bank, with its offer of central bank money, for monetary developments in general. On the other hand, demand for central bank money should be sufficiently flexible. This could ensure that short-term, reversible disturbances on the market for central bank money are cushioned without excessive swings in money market rates arising or without the central bank being forced constantly to undertake fine-tuning measures that involve the danger of signals of scarcity which are also relevant to monetary policy being overlooked. A minimum reserve requirement under which prescribed balances with the central bank have to be held not on a daily basis but on average over a given reserve period can render good services in this context. However, it must be ensured at the same time that such regulations do not lead to distortions in competition that provoke attempts to circumvent them and thus give rise to disturbances in basic monetary relationships. Despite all the flexibility applied in maintaining minimum reserves, a special credit facility will probably have to be made available as a safety valve to meet a sudden, unforeseen need for central bank money. Germany's lombard loan facility, with its interest rate that is above market rates, could provide some ideas regarding the technical design of such an instrument.

3. Continuing challenges posed to the international community by the difficult problems of the reforming countries

International help for self-help needed

The countries of central and eastern Europe, including the successor states to the Soviet Union, are faced with the unprecedented task of helping to implement the principles of democracy and a free market economy after the historic failure of the socialist political and economic system, and of accomplishing this basic change in the economy and society in practice. These structural changes are accompanied by serious economic and social problems of transition. After the old "system" had collapsed, practically all the fundamental prerequisites enabling the forces of a free market economy to develop were initially lacking. Creating them step by step requires not least the restoration and development of the monetary system. Without a minimum of monetary stability and without a banking and financial system that operates along the lines of a free market economy, all other reforms would remain imperfect. Since the international community would also be seriously disrupted by setbacks in the process of reform, it is called upon in its own interests to help the reforming countries. It cannot, however, relieve these nations of comprehensive and sustained efforts of their own. Instead, the task of the international community is to help those countries to help themselves. In the initial stages the emphasis should be placed on providing technical advice, fostering training and adopting measures to ease the hardship of the population. Only to the extent that progress is achieved in the process of reform can a greater role also be played by official capital assistance and temporary balance of payments credits. The recipients, too, must see to it themselves, in the interests of their long-term creditworthiness, that the financial assistance is not poured into a "bottomless pit".

Process of transformation made more difficult through shortcomings in anti-inflation policy

The paralysing effect that a shattered monetary system exerts on the process of transformation became particularly evident in Russia and other successor states to the Soviet Union in 1992. The decontrol of prices, which was, in principle, correct and which took effect at the beginning of 1992 in the Commonwealth of Independent States (CIS), occurred against the background of supply structures that had hardly any flexibility. This is all the more reason why the imbalanced process of reform should have been accompanied by a policy closely geared to stability. Instead of this, the financing difficulties of enterprises and the government were accommodated by generous central bank credits – with the result that inflation erupted at an explosive pace (in 1992 the level of prices in Russia rose more than twentyfold against the previous year). The current virtual standstill of the reform process in Russia and in other states that have become independent is closely connected with this development. Galloping inflation not only paralysed the driving forces of the economy, but also gave rise to social dynamite that is endangering the change in the political system. What is more, the external consequences proved to be very serious. The flight of capital encouraged by constantly falling exchange rates led to severe cuts in imports of urgently needed capital and consumer goods and made repeated concessions on the part of the industrial countries necessary with respect to the debt service payments of the CIS member states. All this was also bound to be reflected in great restraint as regards direct investment by foreign enterprises.

Visible progress towards reforms by the central European countries

By contrast, the central European reforming countries – especially Poland, the former CSFR and Hungary – endeavoured to take due account of anti-inflationary requirements and made visible progress in the process of transformation. Although here, too, the liberalisation of the economy initially gave rise to open inflation, success was finally achieved in containing price movements again (prices nevertheless still increased by 45 %, 12 % and 22 %, respectively, on average in 1992). The countries of central Europe were also able to combat inflation better because influences fostering competition were exerted by the rapid privatisation of smaller enterprises and the development of a legal system geared to a free market economy. The upshot was that in the meantime the Czech Republic and Hungary, in particular, are benefiting from sizeable inflows of foreign capital. However, in the monetary field further serious efforts are still needed, not only in combating inflation but also in reforming the financial system. This includes eliminating bad debt from the balance sheets of the banks and gearing lending business consistently to profitability considerations.

Rapid implementation of a "critical mass" of reform measures necessary

For the process of transformation to be successful, it is important in addition to map out a realistic overall strategy. Shock therapy has the advantage over a gradualist approach that the initial elan in the reforming countries can be better exploited. The inevitable social hardship associated with the change in the system may then be understood better and perhaps borne more successfully. Besides, a thoroughgoing change can afford improved protection against the danger of a political U-turn. However, in the light of the fact that the necessary prerequisites for a smoothly functioning free market economy – they include, in particular, private ownership, the reliability provided by a democratic legal system and social safeguards – are often largely lacking, stretching out the process of transformation over varying periods of time, in line with the conditions prevailing in the individual countries, seems to be unavoidable. But in doing so, the danger must be avoided of the process of change losing its momentum or even coming to a complete halt. A purposeful policy must therefore be directed towards taking the interdependence of all the steps of reform into account and implementing a "critical mass" of the most urgent transformation measures as rapidly as possible. A number of calls for a gradualist approach do not take adequate account of this requirement, and in some cases seem to be based on an insufficient willingness to carry out reforms.

Key role of the IMF

The International Monetary Fund (IMF) is meanwhile playing a key role in the context of international assistance for the reforming countries, now that practically all of them have become members of the IMF and the World Bank (only Tadjikistan has not yet legally ratified its membership). The Fund is primarily developing programmes to bring about macroeconomic stabilisation. In addition, together with the World Bank and other international organisations, it is providing technical administrative assistance in many fields. It is being given strong support in this process by the central banks and supervisory authorities of the industrial countries in reforming the central bank system and developing banking supervision.

Large number of loan agreements with reforming countries

The stabilisation programmes of the IMF are based on loan agreements already made or still to be negotiated with the reforming countries. They make balance of payments assistance available on the condition that certain reform goals are aimed at and gradually attained. After loan agreements of this nature had initially been concluded in 1991 with various countries in central and south-eastern Europe, agreements followed in 1992 with Russia (on drawing its first credit tranche) as well as with the three Baltic countries. As a result, of a total volume of new loans granted by the IMF in 1992 amounting to US$ 7.5 billion, a sum of US$ 1.7 billion went to the countries undergoing reform.

International programme of assistance for Russia only partly in place

The IMF was also involved when the Group of Seven announced a programme of assistance for Russia totalling US$ 24 billion in spring 1992, only part of which has been put in place up to the present, however. The aim was for this amount to be raised on a broad international front. About US$ 4.5 billion was to be contributed by the IMF from its own resources together with the World Bank and the European Bank for Reconstruction and Development (EBRD). Bilateral loans from the industrial countries totalling US$ 11 billion were envisaged. A further amount of approximately US$ 2.5 billion was to be accounted for by rescheduling debts, which in turn was partly made dependent on successful negotiations with the IMF. Moreover, a rouble stabilisation fund totalling US$ 6 billion was to be established, to be financed via the General Arrangements to Borrow (GAB) of the IMF, with disbursements being tied to the implementation of appropriate adjustment measures. The reasons for the delay that has occurred in putting this overall package into practice are to be sought, above all, in the domestic disagreements in Russia regarding the course to be followed in economic policy and the resultant lack of reforms and adjustment measures. The international community as well as Russia and the other reforming countries need to draw conclusions from this. Both sides have to gear their policies even more strongly to the necessary conditionality of financial assistance. For Russia, this means giving absolute priority to fighting hyperinflation, which is making it virtually impossible to solve other key problems.

Support of the process of reform by the World Bank and EBRD

The World Bank was active in the countries of central and south-eastern Europe even before the general political change took place, depending on when the individual countries became members. For example, at the end of the 1992 fiscal year the loan commitments to Hungary totalled US$ 2.9 billion, to the former Yugoslavia US$ 2.8 billion, and to Poland US$ 2.6 billion. Whereas the lending operations of the Bank in a socialist environment largely had to be tied to projects, the loans now focus on supporting the process of privatisation and fostering the restructuring of specific sectors of the economy. Russia also received financial assistance from the World Bank in 1992, for the first time. It served to finance imports intended to help stabilise the level of output in agriculture and coal-mining and to make the transport and health systems more efficient. The European Bank for Reconstruction and Development established in 1991 has also already provided the reforming countries with technical and financial assistance, most of which, under the Bank's statutes, is to foster the development of the private sector. By the end of 1992 loans and participating interests totalling ECU 1.7 billion (US$ 2.1 billion) in the ratio of 90:10 had been committed. This was backed by considerable financial commitments on the part of other investors. In addition to this, the reforming countries have likewise been given primarily humanitarian assistance by the European Community.

IMF and World Bank largely equipped for growing demands

Owing to the admission to the IMF and World Bank of the successor states to the Soviet Union, there has been a strong rise in the number of members that are in extreme economic difficulties, with the result that soaring demands on both institutions for finance are to be expected in the years ahead. The IMF and World Bank have in the meantime largely equipped themselves for these tasks. A 50 % increase in quotas in the IMF entered into force in November 1992. This provided the Fund with considerably greater scope to extend credit. Since, in principle, the increase in quotas also gives members greater access to the resources of the IMF, the "Policy on Enlarged Access" was ended at the same time, but without there being any reduction in the absolute level of potential drawings in practice. The financial basis of the Fund was also strengthened – in accordance with a decision

Official German assistance measures for the reforming countries *

Table 13

DM billion; expenditure and existing and planned commitments since the beginning of 1990

I. Central and east European countries excluding the successor states to the Soviet Union	
Technical assistance by the Federal Government	0.5
Food, pharmaceuticals and energy supplies	0.4
Interest subsidies	0.3
Debt relief for Poland	5.8
Guarantees for trade and financial credits	15.3
Transferable rouble balance 1	7.3
Interest costs for transferable rouble balance	1.7
Subtotal	31.3
II. Successor states to the Soviet Union	
Technical assistance by the Federal Government	0.7
Food and pharmaceuticals	2.5
Expenditure in connection with the withdrawal of troops (including interest on loans guaranteed by the Federal Government)	14.7
Loan guarantees	
– Balance of payments credit for the former Soviet Union (including covered interest liabilities)	9.2
– Borrowing by the former Soviet Union to finance the withdrawal of troops	3.0
– Export credit guarantees (including covered interest liabilities and still unutilised ceilings)	28.5
Investment financing (Jamburg, Kriwoi Rog)	4.2
Transferable rouble balance 1	15.0
Interest costs for transferable rouble balance	3.4
Subtotal	81.2
III. Grand total (I plus II)	112.5

Source: Federal Ministry of Finance. — * Excluding German shares in the assistance granted by international organisations (IMF, World Bank, European Bank for Reconstruction and Development, European Investment Bank, EC). Most of the burdens arising from the rescheduling arrangement with Russia of the beginning of April 1993, totalling DM 8 billion, are included in the export credit guarantees shown. — 1 Internal financing expenditure on foreign trade claims of the former GDR arising mainly in the second half of 1990.

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taken at the end of 1992 – by the fact that the General Arrangements to Borrow, through which the countries belonging to the Group of Ten extend a credit line to the Fund totalling SDR 17 billion for exceptional bridging finance operations, are to be prolonged for a further five years from December 1993 onwards. As a result of increases in its capital in 1988 and 1992, the World Bank likewise has greater financial scope to provide its assistance on an appropriate scale in the new member states without neglecting its activities in the traditional developing countries. The satisfactory performance of all these tasks in the field of development policy by the World Bank and a number of regional development banks is of great importance to the IMF as well. By collaborating with these institutions – especially with the World Bank – the Fund can exert greater influence on the borrowing countries to ensure more effectively that they implement the reform and adjustment measures that the IMF considers to be necessary and possible. At the same time, such collaboration can also avert the danger of the Fund being pushed into activities more in the nature of development policy. This would run counter to its real tasks, and it would not have appropriate resources either. Since its financial resources have to be available to all members, they can only be utilised for short to medium-term balance of payments assistance. Moreover, endeavours to undertake new allocations of special drawing rights with the aim of bringing about a transfer of resources would be seen as attempts to utilise this instrument in a way that is at variance with the legal prerequisites that have been laid down.

Urgent need to ease the burden on Germany through assistance from international agencies

The financial commitments assumed in the reforming countries by the various international agencies are of great importance to Germany, too. Germany has borne the greatest burden up to the present as regards official assistance to the countries undergoing reform. Counting technical assistance, humanitarian measures and various kinds of financial support together, Germany's bilateral contributions (including existing and projected commitments) add up to a total of DM 113 billion since 1990. Germany has thus probably assumed the greatest part of all the assistance provided to the reforming countries by the west. In relation to the successor states to the Soviet Union, Germany's share is actually distinctly above 50 %. In view of the great financial problems associated with the process of transformation in the new Länder, Germany lacks the resources to provide the reforming countries with assistance in the future on the same scale as in the past. The increasing activity of international agencies in these countries is thus also a welcome contribution towards spreading the burdens more evenly on the shoulders of the western donor countries ("burden sharing").

Operations of the Deutsche Bundesbank

I. Processing of cash payments and cashless payments

1. Cash payments

Banknotes and coins in circulation

The amount of banknotes in circulation at December 31, 1992, at DM 213.4 billion, was DM 32.1 billion (or almost 18 %) larger than at end-1991. The amount of coins in circulation, by contrast, rose only moderately, viz. by DM 0.6 billion (+ 4.5 %). At the end of 1992 about 94 % of all currency in circulation consisted of banknotes, and 6 % of coins.

Issue of new banknotes

In the year under review the Bank completed the issue of its new banknotes. The DM 20 note issued on March 30, 1992 was followed on October 27, 1992 by the remaining denominations of notes (DM 5, DM 500 and DM 1,000). The entire new banknote series, comprising eight denominations, was thus put into circulation within roughly two years (a time-frame which had been planned prior to German monetary union). At the end of 1992 no fewer than 1.8 billion notes of the new series were in circulation. In the denominations from DM 10 to DM 100 (which are important for everyday cash payments) the new notes – with shares ranging between 79 % (DM 20) and 88 % (DM 100) of the respective total amounts in

Currency in circulation

Table 14

Trends over time

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
1988	154,822	143,942	10,881
1989	162,144	150,548	11,596
1990	179,690	166,909	12,781
1991	194,615	181,300	13,315
1992	227,285	213,355	13,930

Pattern at the end of 1992

Banknotes in circulation			Coins in circulation		
Notes of DM	DM million	Percentage of total	Coins of DM	DM million	Percentage of total
1 000	64,299	30.1	10.00	1,916	13.8
500	24,017	11.3	5.00	5,299	38.0
200	11,508	5.4	2.00	2,009	14.4
100	82,149	38.5	1.00	2,230	16.0
50	19,356	9.1	0.50	1,040	7.5
20	7,355	3.5	0.10	877	6.3
10	4,365	2.0	0.05	279	2.0
5	305	0.1	0.02	129	0.9
			0.01	152	1.1
Total	213,355	100	Total	13,930	100

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circulation – have already largely superseded the old banknote series. Even so, the old notes will remain legal tender for any amount for the time being. Even after their withdrawal from circulation these banknotes will not become worthless, because the Bank will go on replacing them at their face value.

Destruction of banknotes

The following banknotes were destroyed as being no longer fit for circulation or after having been called in:

	1988	1989	1990	1991	1992
Number (millions)	554	719	506	1,099	1,697
Value (DM billion)	29.2	27.4	25.8	62.6	97.5

The strong rise in the banknotes destroyed in 1991 and 1992 is due to the fact that during that period banknotes of the old series flowed back to the Bank on an increased scale and were not reissued.

Coins

The amount of German coins held by the Bank at the end of 1992 came to DM 1,661 million (end-1991: DM 1,556 million). In 1992 DM 745 million was credited to the Federal Government in respect of coins received from the mints and DM 25 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1992 the Bank – acting for account of the Federal Government – received coins amounting to DM 17,443 million and redeemed coins which were no longer fit for circulation or had been called in to the value of DM 1,851 million. At the end of 1992 coins totalling DM 13,930 million were in circulation, equivalent to DM 173 per head of the population (given just over 80 million inhabitants). Furthermore, the DM 10 commemorative coins "Käthe Kollwitz" and "Order 'Pour le Mérite' for Sciences and Arts" were put into circulation in 1992.

Counterfeits detained in payments, as recorded by the Bundesbank Table 15

Year	Banknotes		Coins	
	Number	DM thousand	Number	DM thousand
1988	6,232	539	9,861	31
1989	3,425	304	8,324	31
1990	4,120	327	12,132	49
1991	6,632	754	4,412	16
1992	14,057	2,520	21,257	103

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Counterfeits

The number and amount of the counterfeit DM banknotes detained in payments and appraised by the Bank increased very steeply during the year under review.

All denominations other than the DM 5 note were counterfeited, DM 100 note forgeries predominating (about four-fifths). Some 84 % of the counterfeits were colour photocopies. The counterfeiting of Federal coins also increased strongly, the DM 5 coin being almost the only one involved.

2. Cashless payments

Overview

In 1992 3.1 billion collection and credit transfer orders to the total amount of DM 167,467 billion were channelled through the payment facilities of the Bank for local and intercity payments. The number of orders thus fell by 2.5 % compared with 1991, while the amount increased by 15.9 %. As in previous years, the payment pattern was characterised by the fact that the bulk of the turnover (88 %) was processed in local payments; particularly in the field of clearing operations, large amounts are cleared in the form of credit transfers from interbank business. In intercity payments, by contrast, 85 % of the payments, but only 12 % of the turnover was processed.

Implications of the burden of charges

The decline of 2.5 % in the payment orders presented mainly affects those bulk payments which are processed through the Bank's computer centres. It probably

Cashless payments

Table 16

Year	Total	Credit transfers presented			Collection orders presented		
		Total	of which: passed on		Total	of which: passed on	
			in local transfers	in intercity transfers		in local transfers	in intercity transfers
	Millions						
1988	2,340	724	259	465	1,616	48	1,568
1989	2,449	750	249	501	1,699	44	1,655
1990	2,695	848	220	628	1,847	40	1,807
1991	3,197	1,128	378	750	2,069	46	2,023
1992	3,118	1,149	404	745	1,969	59	1,910
	DM million						
1988	92,742	89,081	81,521	7,560	3,661	703	2,958
1989	123,245	119,337	110,522	8,815	3,908	701	3,207
1990	134,111	129,768	118,880	10,888	4,343	728	3,615
1991	144,500	139,634	126,176	13,458	4,866	798	4,068
1992	167,467	162,488	146,707	15,781	4,979	944	4,035

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owes something to the transaction charges which have had to be paid by all giro account holders (other than certain public cash offices) since July 1, 1991. These charges (in paper-based transactions, DM 0.05 per credit transfer or DM 0.10 per collection item; in the paperless exchange of data media, DM 0.01 per data record, at least DM 10 per data medium) are intended to meet at least part of the Bank's costs on the processing of cashless payments, to encourage paperless procedures by means of relatively low charges, and to reduce the Bank's share in the area of bulk payments, especially collections, to an acceptable level. The credit institutions have responded to these cost burdens either by increasingly routing payments through their own networks or by intensifying the mutual exchange of bulk payments on a bilateral basis. In sporadic cases payments were also increasingly processed via local payments, which are free of charge (conventional clearing operations).

Credit transfers via the computer centres

In the field of intercity payments, virtually all credit transfer orders presented (other than express bulk credit transfers and telegraphic payments) were processed on an automated basis in the Bank's computer centres. The proportion of paperless intercity transfers rose to 60 % in the year under review, while the share of paper-based credit transfers declined further. In addition to the introduction of transaction charges, this trend probably owes a good deal to the obligation incumbent on credit institutions since January 20, 1992 to convert paper-based intercity transfers of amounts from DM 10,000 upwards into data records and to transmit them in the form of electronic payments (EZÜ obligation). Efficient and low-cost paperless credit transfers are being fostered still further by the paperless cash inpayment credit transfer system (BZÜ), which came into force on January 19, 1993. Under the paperless cash inpayment credit transfer system, the particulars of the coding line of a credit transfer voucher or a credit voucher are registered by machine-optical reading and processed through the paperless exchange of data media. This is of particular interest to recipients of payments who to a large extent issue credit transfer forms/cash inpayment forms themselves (for example, financial authorities, insurance enterprises, public utilities), in the process stating the data that are important for internal processing in the coding line, so as to be able to handle the incoming payments more effectively.

Collections via the computer centres

In the case of collections, too, it is to be observed that there has been both an increased shift to paperless procedures and a decline in the volume of payments. This trend was probably likewise influenced by the above-mentioned introduction of transaction charges. In the year under review 78 % of the collection and credit

Automation of intercity transfers

Table 17

Millions

Year	Credit transfers presented: Total	Credit transfers: of which passed on in direct operations between branch offices	Credit transfers: via computer centres in automated paper-based operations	Credit transfers: via computer centres through the paperless exchange of data media	Collection orders presented: Total	Collection orders: of which passed on in direct operations between branch offices	Collection orders: via computer centres in automated paper-based operations	Collection orders: via computer centres through the paperless exchange of data media
1988	465	4	270	191	1,568	3	355	1,210
1989	501	4	290	207	1,655	3	346	1,306
1990	628	6	353	269	1,807	7	324	1,476
1991	750	6	347	397	2,023	5	320	1,698
1992	745	3	297	445	1,910	2	292	1,616

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transfer orders channelled through the computer centres were processed by the paperless exchange of data media.

Direct operations between branch offices

In direct operations between the branch offices, the EZÜ obligation likewise led to a change of pattern. Intercity transfers from DM 10,000 upwards, which formerly could be processed in paper-based operations, have had to be converted into data records since January 20, 1992 and can now be submitted by credit institutions only through the paperless exchange of data media (EDM) or as paperless express credit transfers. This is why, simultaneously with the introduction of the EZÜ obligation in the banking industry, the Bank has taken another major step towards the implementation of its "electronic opening". After Electronic Clearing with File Transfer (ECFT) had started operation in Frankfurt am Main in March 1990, the electronic counter at the branch offices was opened on January 20, 1992. Since then, in intercity payments giro account holders have been able to place credit transfer orders for telegraphic transfers and express transfers (intercity transfers from DM 10,000 upwards) via data telecommunication or via diskette. The branch offices accept the orders issued on a paperless basis at the electronic counter and transmit them in direct transactions through the existing data telecommunication network to the recipient branch office. There the payments are delivered – provided that the recipient is also a participant in the electronic counter arrangement – either per data telecommunication or by handing over diskettes. The delivery of telegraphic transfers is effected every 20 minutes, the delivery of express credit transfers on an hourly basis. For those giro account holders who are not participating in the electronic counter arrangement, vouchers are made out and handed over.

Local transfers

In contrast to the largely automated intercity transfers, only about 9 % of the items presented in local transfers are processed automatically, namely paper-based credit transfers in local transfers in Hamburg and paperless credit transfers via ECFT in Frankfurt am Main. Since August 1992, moreover, local credit transfers (without minimum amounts) may be presented via the electronic counter. In the year under review, more than 56 % (in terms of value) of total local transactions (local payments and clearing operations) processed through the Bank were channelled through the ECFT.

3. Special trends in cross-border payments

Cross-border payments

In contrast to domestic payments, the Bank has always shown restraint in the case of cross-border commercial payments and left the processing very largely to credit institutions. However, international linkages and the growing-together of the countries of the European Community are calling for its increased attention. In the years to come, the single European market, in particular, warrants expectations of an increase both in cross-border interbank payments, for which special large-scale payment systems are available, and in bulk payments involving relatively small amounts (consumer payments).

For several years now the Bank has participated in international cooperation among central banks in the field of payments, which is effected on the one hand through the Committee of Governors of the EC Central Banks and on the other hand through the working party of payment experts of the G-10 countries. The focal points of this cooperation are the integrity and security of payment systems, the containment of systemic risks and the enhancement of the efficiency of systems of cross-border payments.

Cooperation at EC level

For this purpose the central bank governors of the EC member states set up a working group which was to analyse payments within the European Community and submit proposals for their further development in the single market. In 1992, in its report "Payment Systems in EC Member States" (known as the "Blue Book"), which was published by the Committee of EC Central Bank Governors, this "Ad hoc Working Group on EC Payment Systems" for the first time presented a detailed picture of the payment systems of the individual EC member states.

In a report on "Issues of Common Concern to EC Central Banks in the Field of Payment Systems", which was approved by all EC central bank governors, the working group submitted recommendations on the future structuring of payments in the EC, in which the security and integrity of payment systems were considered with particular attention.

G-10 countries

In addition, the Bank is represented on the "Committee on Payment and Settlement Systems" of the Group of Ten countries at the Bank for International Settlements (BIS) in Basle. There, global payment activities are discussed and, if necessary, coordinated. The basis is a description of the respective payment systems according to a uniform framework, supplemented by comparative tables in what is known as the "Red Book" (Payment Systems in Eleven Developed Countries). Moreover, the G-10 central banks express their views on various subjects, such as the settlement and risk situation of international payments, in studies of fundamental importance. In keeping with the report on interbank netting systems which was published by the BIS in 1990, the committee, among other things, continuously monitors the extent to which the minimum requirements set for cross-border netting systems are met by the operators.

The risks that may be posed by certain netting systems have led in the individual countries to a lively debate on measures to contain the risks. The Bank has started corresponding discussions with the banking industry regarding the execution of the clearing operations at its branch offices.

II. External transactions of the Bank

Foreign exchange spot deals

The Bank's turnover in foreign exchange spot deals increased strongly during the year under review. The decisive factor here was the support purchases of EMS currencies effected in September 1992, where they were made in Frankfurt. (Compulsory and intramarginal Deutsche Mark sales by EMS partner central banks are not included in the turnover statistics; although they are financed by the Bank, they are conducted in other centres.) In addition, off-market spot transactions with foreign monetary authorities contributed to the increase in turnover. In 1992 2,576 foreign exchange purchases were effected, totalling DM 25.4 billion, and 2,110 sales, amounting to DM 21.3 billion. In the previous year purchases had come to DM 5.5 billion and sales to DM 19.4 billion.

Other foreign exchange deals

In the second half of 1992 the volume of foreign-exchange-based repurchase transactions increased considerably, in connection with the foreign exchange inflows and the corresponding absorption of liquidity. In addition, five US dollar sales equivalent to DM 6.0 billion were effected in the form of forward transactions, in the context of the conversion into US dollars of Deutsche Mark balances lodged with the Bank by foreign monetary authorities. In the year under review the volume of cross deals (foreign currency against another foreign currency) reached the equivalent of DM 1.1 billion, against DM 1.2 billion in the previous year; the number of deals rose from 16 to 28. The volume of SDR-US dollar and SDR-Deutsche Mark deals increased from DM 0.3 billion to DM 0.8 billion, whereas the number of deals declined from 56 to 38. Moreover, 333 US dollar inter-centre switch transactions totalling US$ 113 million were entered into (1991: 256 such transactions amounting to US$ 69 million).

Foreign bill-of-exchange and cheque deals

In the context of refinancing operations, the Bank bought foreign bills of exchange totalling DM 73 billion in 1992 (see page 106). In addition, 27,477 foreign cheques payable to order amounting to DM 203 million were sold in 1992 (1991: 27,124 cheques totalling DM 260 million). In 1992 66,454 cheques worth DM 321 billion were presented under the simplified collection procedure for foreign cheques (in 1991: 65,554 cheques totalling DM 474 million). For the rest, in 1992 the Bank accepted 14,404 items bought on a commission basis (mainly bills and cheques) for realisation in foreign commission business; a year earlier 20,569 items were bought on a commission basis. In addition, transactions in foreign notes and coins were effected on a small scale.

III. The Bank's money market deals and refinancing operations

Dealing in money market paper

In order to fine-tune the money market, the Bank sold mobilisation and liquidity Treasury bills, running as a rule for three days, on eleven days in 1992 (on the basis of sections 42 and 42a of the Deutsche Bundesbank Act). On the basis of section 42 of the Deutsche Bundesbank Act (as amended on November 1, 1992), which broadened the scope available to it, the Bank offered liquidity discount paper with maturities of three, six and nine months by tender for the first time on March 1, 1993.

Foreign-exchange-based repurchase transactions, foreign exchange swaps

Primarily in the context of the heavy inflows of foreign exchange in September 1992, the Bank also absorbed liquidity at short notice by means of foreign-exchange-based repurchase transactions, so as to stabilise the money market. In 1992 135 transactions equivalent to DM 123 billion were conducted with domestic credit institutions. The Bank was in the market on seven days. Market liquidity was augmented on one day by means of foreign exchange swaps.

Shifts under section 17 of the Deutsche Bundesbank Act

To bolster the money market's short-term liquidity, the Bank shifted Federal Government balances lodged with it into the market on 42 days.

Securities repurchase agreements

The most important instrument of central bank money provision was open market transactions under repurchase agreements in securities ("securities repurchase agreements"). In 1992 48 such transactions were conducted in all, 18 of which were in the form of a "double-decker", i.e. with two tranches of differing maturities. Up to September 16, 1992 the standard maturities of these transactions were four or eight weeks. To increase the flexibility of money market policy after the foreign exchange inflows of September and the associated reduction in the volume of securities repurchase agreements to DM 68.6 billion, the standard maturity was reduced to two weeks. The outstanding volume of securities repurchase agreements at the end of 1992 was DM 124.1 billion, against DM 148.5 billion at end-1991.

Quick tenders

In response to sudden sharp changes in the money market situation, the Bank twice entered into so-called "quick tenders" in 1992. These are securities repurchase agreements which, in contrast to the normal transactions, are processed within only a few hours and in respect of which only a few dozen banks (ones active in the money market) are invited to submit tenders. The amounts involved in these two quick tenders were DM 15.6 billion and DM 20.1 billion, and their maturitities were four and two days.

Purchases of domestic bills of exchange

In 1992 1.5 million domestic bills of exchange were purchased under the rediscount quotas and refinancing quotas, or under the special rediscount facilities (ceiling B) granted to the AKA Ausfuhrkreditgesellschaft mbH, to the total amount of DM 261 billion (in 1991 1.6 million were bought, amounting to DM 200 billion). In the absence of payment, 5,486 bills totalling DM 161 million (in 1991: 4,489 bills totalling DM 125 million) were returned and charged to the parties presenting them for rediscount.

Purchases of foreign bills of exchange

Purchases of foreign bills of exchange, which are counted towards the rediscount quotas and refinancing quotas, numbered 131,199 in 1992, totalling DM 73 billion (1991: 204,096 bills totalling DM 167 billion). The share of foreign bills denominated in foreign currencies came to 1.9 % (in 1991: 1.1 %). The decline in foreign bill purchases is a consequence of the abolition of German bill tax from January 1, 1992, which eliminated the cost advantage of foreign bills of exchange (which were formerly not or only partly liable to bill tax).

Lombard loans

Throughout 1992 recourse to lombard loans was open to banks to meet short-term liquidity needs. In the main, recourse was had in order to offset unforeseeable debit balances arising in payments in the form of a "giro overdraft lombard loan"; this type of lombard loan was taken up during the whole of 1992. Substantial lombard loans were recorded on only a few days; the heaviest recourse was on November 30, 1992, at DM 19.5 billion.

Note

In future the Bank will publish the current monetary policy regulations in a booklet appearing parallel to the Annual Report. The German text for the present year has already appeared, viz: Deutsche Bundesbank, Kreditpolitische Regelungen, Frankfurt am Main, April 1993. This publication is available to interested parties free of charge. An English translation will be appearing shortly.

IV. Participation of the Bank in the issuing of Federal securities

Issue of bonds

In 1992 the Bank was again closely involved in the issuing and placing of securities launched by public issuers at the Federal level. Twelve bond issues in all were floated by the Federal Bond Consortium, which is under the direction of the Bank. In addition to the regular issuers Federal Government, "German Unity" Fund, Federal Post Office and Federal Railways, the Treuhand privatisation agency and the ERP Special Fund had recourse to the capital market for the first time with "traditional" bonds.

An important factor in the market position of the Treuhand agency and the ERP Special Fund is that, under the Treuhand Borrowing Act *(Treuhandkreditaufnahmegesetz)* of July 3, 1992 and the First Act Amending the Act on the Management of the ERP Special Fund *(Erstes Gesetz zur Änderung des Gesetzes über die Verwaltung des ERP Sondervermögens)* of December 21, 1992, the Federal Government has assumed direct and unlimited liability for these issuers' debts. Hence the German Financial Futures and Options Exchange (DTB) and the London International Financial Futures Exchange (LIFFE) have added the bonds of

Bond issues by the Federal Government, its special funds and the Treuhand privatisation agency in 1992

Table 18

Issuer	Issue amount in DM billion				Terms				
	Total [1]	of which: Syndicate amount	of which: Allotment amount by tender procedure	of which: Market regulation amount	Nominal interest rate (% p.a.)	Maturity (years/ months)	Issue price or average allotment rate (%)	Yield on the issue price or average allotment rate (% p.a.)	Start of sales
"German Unity" Fund	14.0	3.0	4.5	2.5	8	10/0	100.40/ 99.96	7.94/ 8.01	Jan. 2
Federal Government	4.0	–	–	4.0	8.25	9/8	.	.	Jan. 14
Federal Post Office	5.0	2.0	2.0	1.0	8	10/0	100.70/ 100.00	7.90/ 8.00	Feb. 4
ERP Special Fund	5.0	2.0	0.7	2.3	8	10/0	100.30/ 99.18	7.96/ 8.12	May 4
Federal Railways	6.0	3.1	1.8	0.1	8	10/0	99.90/ 99.10	8.01/ 8.13	June 11
Federal Government	15.0	3.0	5.2	1.8	8	10/0	101.00/ 100.55	7.85/ 7.92	July 9
Federal Post Office	5.0	3.0	1.3	0.7	8.25	10/0	100.30/ 99.40	8.20/ 8.34	Aug. 4
"German Unity" Fund	3.0	–	2.3	0.7	8	9/4	./ 100.06	./ 7.97	Sep. 4
Treuhand agency	10.0	4.0	2.1	3.9	7.75	10/0	101.00/ 100.25	7.60/ 7.71	Sep. 15
Federal Government	10.0	3.0	3.9	3.1	7.25	10/0	100.00/ 99.32	7.25/ 7.35	Oct. 6
Federal Railways	3.0	2.6	–	0.4	7.50	10/0	100.70/ .	7.40/ .	Oct. 22
Federal Post Office	5.0	2.0	2.0	1.0	7.50	10/0	100.60/ 99.75	7.41/ 7.54	Nov. 16
Treuhand agency	10.0	4.0	4.1	1.9	7.375	10/0	100.50/ 99.54	7.30/ 7.44	Dec. 1
Federal Government	12.0	3.0	5.7	3.3	7.125	10/0	100.40/ 99.72	7.07/ 7.17	Dec. 29

1 Including the subsequent increases.

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the Treuhand agency to the range of instruments available under their bund futures contracts (LIFFE only from delivery month June 1993).

The issue of bonds by a combined syndicate and tender procedure proved to be successful, and was continued systematically. The quotas in the Consortium were again brought into line with the placing capacity, after taking due account of the allocations in the tenders.

Issue of other Federal securities

In 1992 the Bank continued to act as selling agent for the account of the Federal Government (sales through credit institutions and sales of its own) in respect of Treasury financing paper, Federal savings bonds and five-year special Federal bonds issued on tap. Moreover, the Bank took over the tendering and placement of Federal Treasury notes and Treasury discount paper. In the case of Federal Treasury notes (which were remodelled in May 1991), which at first were issued regularly at two-monthly intervals, the Federal Government changed to three-monthly intervals as from August 1992.

Market-smoothing operations

The market regulation amounts withheld on the issue of listed Federal securities, which the Bank sells on the stock exchanges by order and for the account of the issuer concerned, again facilitated market-oriented, flexible and continuous financing in 1992. Federal issuers continued to avail themselves of the option of increasing their issues for sale through the stock exchanges, and thus built up large-scale and highly liquid issues, which met the needs of national and international investors alike.

Besides selling the market regulation amounts, in the year under review, as in previous years, the Bank conducted (for the account of the issuers) price support operations on the German stock exchanges for the listed securities issued by the Federal Government, its special funds and the Treuhand agency, and for securities issued by the Reconstruction Loan Corporation, the German Equalisation Bank and the State Bank, Berlin.

Issues of five-year special Federal bonds in 1992

Table 19

Designation of series	Start of sales	Amount issued (DM million) [1] Sales	Market regulation amount	Total	Terms Nominal interest rate (% p.a.)	Issue price (%)	Yield (% p.a.)	Date of stock exchange listing
S. 97 of 1991 (1996)	Jan. 2 [2]	[3] 4,787	3,213	8,000	8.500	99.60	8.58	Jan. 13
S. 98 of 1992 (1997)	Jan. 6				8.375	99.80	8.43	
	Jan. 13					100.20	8.32	
	Jan. 17					100.60	8.22	
	Jan. 21					100.90	8.15	
	Jan. 23	3,940	4,060	8,000		101.20	8.07	Mar. 9
S. 99 of 1992 (1997)	Feb. 28				8.000	100.00	8.00	
	Apr. 10					99.50	8.12	
	May 13	1,973	6,027	8,000		99.10	8.21	July 2
S. 100 of 1992 (1997)	June 26				8.250	99.70	8.33	
	July 7					100.20	8.20	
	July 22					99.50	8.38	
	Sep. 9	5,132	4,868	10,000		100.00	8.23	Sep. 21
S. 101 of 1992 (1997)	Sep. 15				8.000	100.00	8.00	
	Sep. 18					101.00	7.75	
	Sep. 21					101.50	7.63	
	Oct. 5	3,260	4,740	8,000		101.90	7.52	Oct. 12
S. 102 of 1992 (1997)	Oct. 6				7.500	100.00	7.50	
	Oct. 7	1,884	2,116			100.60	7.35	
			[4] 3,000	7,000				Oct. 27
S. 103 of 1992 (1997)	Oct. 20				7.250	100.60	7.10	
	Oct. 21					101.20	6.96	
	Nov. 24	801	[5] ...	[5] ...		101.35	6.91	[5] ...

1 Cumulated from the first day of sale. — **2** Start of sales on September 27, 1991. — **3** Sales from September 27, 1991 to December 31, 1991 = DM 3,208 million. — **4** Increase from December 28, 1992. — **5** Sales not completed on December 31, 1992.

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Issues of Treasury notes by the Federal Government and its special funds in 1992

Table 20

Issuer	Amount issued (DM million) Total	Allotment amount by tender	Market regulation amount	Terms Nominal interest rate (% p.a.)	Maturity (years/ months)	Average allotment rate (%)	Average yield (% p.a.)	Bidding day
Federal Government	6,000	3,116	2,884	8.125	4/0	99.71	8.21	Jan. 27
Federal Railways	2,000	1,225	775	8.250	4/0	99.82	8.31	Feb. 12
"German Unity" Fund	4,000	1,467	2,533	8.500	4/0	99.86	8.54	Mar. 25
"German Unity" Fund – increase –	5,000	2,887	2,113	8.500	3/9	99.96	8.48	May 26
Federal Post Office – increase –	1,000	–	1,000	8.750	3/6	.	.	.
Federal Government	5,000	3,207	1,793	8.500	4/0	99.68	8.60	Aug. 25
Federal Government	4,000	2,368	1,632	7.125	4/0	100.04	7.11	Nov. 25

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Issues of Federal savings bonds in 1992

Table 21

Issue	Sales period 1992	Gross sales (DM million) Total	Federal savings bonds type A	Federal savings bonds type B	Nominal interest rates (% p.a.)	Final yield (% p.a.) Type A	Type B
1991/ 7+ 8	Jan. 2 —Jan. 3 1	1,896 2	972	924	7.50—9.00	8.52	8.64
1992/ 1+ 2	Jan. 6 —Jan. 20.	1,074	530	544	7.50—9.00	8.36	8.50
1992/ 3+ 4	Jan. 21—May 12	2,828	1,656	1,172	7.50—8.50	8.04	8.14
1992/ 5+ 6	May 13—July 21	828	472	356	7.50—8.75	8.11	8.25
1992/ 7+ 8	July 22—Sep. 14	1,060	681	379	7.50—9.00	8.36	8.50
1992/ 9+10	Sep. 15—Oct. 5	939	770	169	7.00—9.00	8.17	8.36
1992/11+12	Oct. 6 —Oct. 19	606	485	121	7.00—8.50	7.89	8.03
1992/13+14	Oct. 20—Nov. 23	1,545	1,283	262	6.50—8.25	7.55	7.71
1992/15+16	Nov. 24— 3	1,086	924	162	6.00—8.00	7.30	7.46

1 Start of sales on November 1, 1991. — **2** Sales from November 1 to December 31, 1991: DM 1,530 million, of which FSB/A DM 772 million and FSB/B DM 758 million. — **3** Sales not completed on December 31, 1992.

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Money market paper issued in 1992 for account of the Federal Government and its special funds

Table 22

DM million

Type of paper	1991 Outstanding at December 31	1992 Issued	Redeemed	Outstanding at December 31
Treasury discount paper of the Federal Republic of Germany types "B" 1 and "BN" 2	22,764	19,351	14,171	27,944
of which: "Treasury financing paper"	(21,294)	(19,351)	(13,231)	(27,414)
Treasury discount paper of the Debt-Processing Fund type "KAF N" 2, 3	16,211	11,909	14,815	13,305
Treasury discount paper of the east German Railways type "RBa N" 2)	1,136	.	749	387
Total	40,111	31,260	29,735	41,636

1 The letter "B" serves to distinguish these bonds from mobilisation and liquidity paper. — **2** The Bundesbank has not undertaken to buy securities distinguished by the letter "N" before maturity. — **3** Including the Treasury discount paper issued in 1990 on behalf of the former GDR ("DDR N").

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V. Participation of the Bank in banking supervision, and changes in banking supervision legislation

1. International harmonisation of banking supervision

In 1992 the Bank once again participated in the relevant international bodies engaged in the harmonisation of banking supervision legislation. The main forum for the world-wide debate in this connection is the "Basle Committee on Banking Supervision" of the central bank governors of the Group of Ten (the name of which committee derives from the seat of its Secretariat at the Bank for International Settlements in Basle).

Basle Committee on Banking Supervision

In 1992 the Basle Committee concerned itself in depth with the implications and consequences of the failure of the internationally operating BCCI Bank. The main outcome of its deliberations was an amendment of the principles for the supervision of the foreign branches of banks (the "Basle Concordat"). These "Minimum standards for the supervision of international banking groups and their cross-border establishments" provide as follows:

- All international banking groups and internationally operating banks should be supervised by a home-country authority capable of performing consolidated supervision.

- The setting-up of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank's and, if different, the banking group's home-country supervisory authority.

- Supervisory authorities should have the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home-country supervisor.

- If a host-country authority concludes that any one of the foregoing minimum standards is not being met to its satisfaction, it may impose the restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the setting-up of banking establishments.

The minimum standards were published by the Basle Committee in June 1992; in October they were also on the agenda of the Seventh International Conference of

Bank Supervisors in Cannes. Hence the capital requirements have become an internationally accepted standard. The supervisory authorities represented on the Basle Committee should ensure, to the best of their ability, that their own national regulations are in line with the minimum standards.

The efforts towards establishing common capital standards for the securities business of banks and securities firms have been continued with differing degrees of success. At a joint meeting of the Basle Committee on Banking Supervision and the Technical Committee of IOSCO, an international organisation of securities regulators, provisional agreement was reached on some major points in January 1992. Unfortunately, however, no further progress was made in the course of that year, and the chances of greater success in 1993 are very slim since the IOSCO members have been unable to agree on a common approach to minimum capital standards.

European Communities

A significant outcome of discussions within the European Communities was the adoption of a common position regarding a Council Directive on the Capital Adequacy of Investment Firms and Credit Institutions (Capital Adequacy Directive). This Directive is closely related to the Investment Services Directive, on which a common position was likewise reached in the Council of Ministers in December 1992. Both Council Directives are likely to be finally adopted and published jointly in the first half of 1993. Member states are required to translate the Capital Adequacy Directive and the Investment Services Directive into national law by July 1, 1995. Both Council Directives will come into force not later than December 31, 1995.

Capital Adequacy Directive

The Council Directives are further major steps on the road towards a common EC financial market. In Germany the Capital Adequacy Directive, after its translation into national law, will modify the capital requirements for the securities business of universal banks. It is a significant stride in the direction of avoiding competitive distortions between banks and securities firms, and conforms to the principle (advocated primarily by the German delegation) of "same business, same risk, same capital backing". A factor of major importance in this connection is the building-block approach (also discussed on the Basle Committee), which involves a clear division of the risk into market risks and credit risks. To cover the general market risk, i.e. the risk associated with general stock market trends, and the specific risk of the default of a particular issuer, banks and securities firms will in future have to back their securities position with capital.

Another major regulatory aspect of the Capital Adequacy Directive is the extension of the definition of capital. While hitherto, in accordance with the Own Funds Directive, it has been permissible to use subordinated liabilities to cover traditional credit risks, but only up to an amount not exceeding 50 % of the core capital, the Capital Adequacy Directive now enables banks to back risk assets included in what is known as their "trading book" by subordinated debt securities up to 250 % of their equity capital as well, since this form of subordinated own funds is customary among securities firms. A further new feature is the limitation of large exposures in respect of securities transactions, along the lines of the Large Exposures Directive adopted for the banking industry.

Investment Services Directive

The Investment Services Directive primarily regulates the freedom of establishment and the freedom to provide services, above all for securities firms. It provides the basis for the "European passport" of these institutions. The passport means that securities firms, like credit institutions under the Second Banking Directive, will in future be able, without any further authorisation, to provide services and operate branches in other EC member states. Surveillance of the ongoing operations of these branches will then likewise primarily be the responsibility of the home-country regulatory authority which is responsible for the head office.

Large Exposures Directive

The Council Directive on Monitoring and Controlling Large Exposures of Credit Institutions (Large Exposures Directive) was adopted by the Council on December 21, 1992. It was needed in order to adjust the limits for large exposures to the Own Funds Directive adopted in 1989. The Directive limits the exposures to a single client or to a group of associated clients to 25 % of the liable capital of the lending bank. If the client is a parent or subsidiary of the credit institution, this limit is even reduced to 20 %. The aggregate limit on the large exposures of a credit institution has been set – like the limit hitherto applicable under German banking supervision legislation – at 800 % of the own funds. The reporting threshold for individual exposures is no longer 15 %, but 10 % of the liable capital. The EC Council Directive is expected to come into force on January 1, 1994. However, it allows member states long transitional periods for its implementation.

Deposit protection

On April 14, 1992 the EC Commission presented a draft of a "Council Directive on deposit protection schemes", which provides for the mandatory membership of all credit institutions in a deposit protection scheme. Branches of these institutions in other EC member states are included in the protection scheme of their country of origin (home-country principle). Moreover, they are to be eligible to join a host-country deposit protection scheme to supplement the protection afforded by their home country. According to the draft Directive, deposits are to be protected up to not less than ECU 15,000, though compensation may be limited to a particular percentage of a deposit. A higher level of deposit protection may be retained or introduced. From the German point of view, this provision is particularly important, to enable the existing German guarantee schemes to be preserved. At the request of other member states, the draft Directive has meanwhile been amended, on competitive grounds, to the effect that the protection afforded by the home-country scheme to deposits held at branches in other EC member states must not exceed the protection provided by the host-country deposit guarantee scheme for the latter's banking system.

EC member states have not yet agreed on a common position. Against the backdrop of the proven system of voluntary self-help schemes operated by the banking associations in Germany, and of the controversy surrounding the formulation of the draft Directive, the German legislature is of the opinion that a Deposit Guarantee Directive is not an essential prerequisite of the single European market.

Pursuant to section 23a of the German Banking Act, credit institutions must, if appropriate, draw their customers' attention to the fact that they are not a member of a domestic deposit guarantee scheme. Not least for this reason, some private building and loan associations are following the example of the Land Building and Loan Associations, and have set up a deposit guarantee scheme of their own or are in the process of doing so. There is no guarantee yet that the terms and conditions of these schemes will come up to the proven standard of the universal bank system.

2. Amendments of national banking supervision legislation

Fourth Act Amending the Banking Act

The Fourth Act Amending the Banking Act, promulgated at the end of December 1992 and effective from January 1, 1993, has now created the conditions for the single European banking market in the German legal system, too. The Amendment translates the Second EC Banking Directive and the EC Own Funds Directive into German law.

The Second Banking Directive ensures identical regulations, Community-wide, for the authorisation and ongoing supervision of credit institutions. In addition to the introduction of the above-mentioned "European passport" and of the principle of home-country control, the Amendment provides for a sort of aptitude test for banks' shareholders. Given the scope for influencing the management of a credit institution available to major shareholders, the authorities must be satisfied, when first granting a licence to credit institutions or when there are subsequent major changes in shareholdings, that the shareholders have the special qualifications required. If it seems advisable, enterprises will not be granted a licence to conduct banking business, or the Federal Banking Supervisory Office may prohibit the acquisition of shares.

The minimum amount of capital of credit institutions wishing to be newly authorised that accept deposits or other repayable funds from the general public and grant loans for their own account is now ECU 5 million (about DM 10 million).

The incorporation of the regulations of the EC Own Funds Directive in the German Banking Act means that new capital components which hitherto were not considered to have the characteristics of capital are now sanctioned. At the same time, however, broader capital backing of transactions involving risk is required. The most controversial issue was the recognition of unrealised (revaluation) reserves as capital. With a view to levelling the international playing field, the banks demanded – and for the most part got their way – that such reserves (included in assets in the form of real estate and securities) should be recognised, even though the Bundesbank had been opposed to such recognition, among other things for monetary policy reasons.

Besides the changes required by the two EC Council Directives, the Amendment of the Banking Act involves some other revisions. For instance, from mid-1993 the reporting threshold for *"Millionenkredite"*, which had remained unchanged for decades, will be raised from DM 1 million to DM 3 million.

Work is currently in progress on the translation into German law (as part of a Fifth Amendment of the Banking Act) of the EC Council Directives of 1992 on the supervision of credit institutions on a consolidated basis and on the monitoring and control of large exposures of credit institutions.

Principles Concerning the Capital and Liquidity of Credit Institutions

The Principles Concerning the Capital and Liquidity of Credit Institutions had to be amended from January 1, 1993, because
- the Solvency Ratio Directive had to be applied to German credit institutions, too, not later than that date and

- the Fourth Act Amending the Banking Act affected Principles I and Ia, in particular, and marginally also the Liquidity Principles II and III, because of the adoption of a new capital definition taken from the Own Funds Directive.

Principle I

The creation of a single EC banking market from January 1, 1993 called, in particular, for the revision of Principle I. In addition to an extension of the list of items which are used to measure the adequacy of the banks' liable capital and a further refinement of the risk-weighting factors, above all a new parameter for measuring capital adequacy was introduced. Whereas hitherto the risk assets were not allowed to exceed 18 times the liable capital, this limit has now been replaced by the internationally customary minimum standard of 8 % of the liable capital, based on the risk assets; the old standard was equivalent to a ratio of 5.56 %.

For the rest, in future Principle I will not apply to branches of credit institutions from EC member states holding a "European passport", since the capital of these branches will be monitored from January 1, 1993 by the home-country supervisory authorities. Branches of credit institutions from non-EC member states, by contrast, must continue to comply with Principle I.

Principle Ia

In future Principle Ia will not apply either to branches of banks from EC member states, but will apply to branches of credit institutions from non-EC countries. As the concept of liable capital has been extended under the Fourth Act Amending the Banking Act, this would in fact have broadened the scope available under Principle Ia for transactions involving a market price risk; this did not seem advisable on prudential grounds. The Principle Ia limits have therefore been lowered accordingly.

Principles II and III

The text of Principles II and III has not been changed. These Principles continue to apply to branches of credit institutions from EC member states since monitoring the liquidity of branches will remain the responsibility of the host country. They will, however, be indirectly affected by the Fourth Act Amending the Banking Act because branches of banks from EC member states no longer require endowment capital.

Provisions regulating savings business

The cancellation of the provisions regulating savings business in the Banking Act by the Fourth Act Amending the Banking Act will come into effect on July 1, 1993. As reference is made to "savings deposits" both in the Principles concerning Capital and Liquidity and in the minimum reserve provisions, it will still be necessary to define them in future. It is planned to incorporate the requisite definition in the Accounting Regulation for Credit Institutions; at the same time, the deregulation intended by the cancellation of the provisions on savings business will be taken into account. An early withdrawal penalty will no longer be stipulated. In future it will be possible to withdraw up to DM 3,000 per calendar month without notice. Credit institutions are free to accept savings deposits on different terms and conditions, but these will not be eligible for inclusion in the annual accounts, in the Principles Concerning Liquidity and in the minimum reserve regulations as savings deposits in the old sense.

Other regulations

A draft Auditor's Report Regulation pursuant to section 29 (3) of the Banking Act, whereby the Federal Banking Supervisory Office will issue detailed provisions governing the contents of auditor's reports on the annual accounts of credit institutions, is currently in the process of being coordinated with the Bundesbank, which must be consulted with respect to the proposed Regulation. This Regulation will supersede the Banking Supervisory Office's Auditing Guidelines of 1968, and place them on a new legal footing.

Savings banks and credit cooperatives have to elucidate their annual accounts for the Banking Supervisory Office by means of notes. As provided by the Fourth Act Amending the Banking Act, the legal basis for this is specified in section 330 (2) sentence 4 of the German Commercial Code. The specimen notes are currently being revised. They will probably be issued in the form of a separate regulation by the Federal Minister of Justice, in agreement with the Federal Minister of Finance and in consultation with the Bundesbank.

Equalisation claims

As the allocation of equalisation claims arising from the currency conversion in eastern Germany to credit institutions in the new Länder (pursuant to section 40 of the D-Mark Balance Sheet Act) has been seriously delayed by a host of unsettled valuation issues and by failure to meet the deadlines for the submission of the requisite documentation, the Regulation Concerning the Confirmation of the Conversion Account and the Procedure for the Allocation and Acquisition of Equalisation Claims *(Verordnung über die Bestätigung der Umstellungsrechnung und Verfahren der Zuteilung und des Erwerbs von Ausgleichsforderungen (BUZAV))* was amended once again in September 1992. The Federal Banking Supervisory Office may now, without any thorough prior checks, provisionally allocate equalisation claims up to 65 % of the arithmetical equalisation item and sanction their conversion into bearer bonds. By virtue of this simplification, the Banking Supervisory Office had provisionally allocated equalisation claims to the value of DM 64.6 billion to roughly 500 credit institutions by the end of 1992.

Ongoing banking supervision operations

Table 23

Number of operations conducted

Item	1989	1990	1991	1992
Individual reports pursuant to section 13 of the Banking Act	54,619	60,793	69,593	72,267
Borrowers included in the lists submitted in accordance with section 13 of the Banking Act	69,354	70,411	73,012	82,626
Reports on loans of DM 1 million or more pursuant to section 14 of the Banking Act	1,570,350	1,683,592	1,875,105	2,116,425
Reports pursuant to section 16 of the Banking Act	8,949	10,068	23,755	24,503
Reports pursuant to section 24 of the Banking Act	10,283	12,124	16,905	16,781
Monthly returns pursuant to section 25 of the Banking Act	53,057	53,306	53,147	54,776
Reports on the volume of external lending	894	953	983	973
Annual accounts of credit institutions	4,614	4,811	4,652	4,837
Auditor's reports on annual accounts	2,670	2,767	2,317	2,454
Reports on the auditing of safe custody accounts	470	471	393	527
Routine, special and deposit guarantee fund auditor's reports	510	693	738	489
Audits commissioned by the Federal Banking Supervisory Office pursuant to				
section 44 (1) of the Banking Act	19	15	33	27
section 44 (2) of the Banking Act	113	117	117	128
Reports under the Capital Accord of the Basle Committee on Banking Supervision	–	112	106	104

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Note

The text of the Principles Concerning the Capital and Liquidity of Credit Institutions, in the wording applicable since January 1, 1993, has been published (hitherto in German only) in the form of a special booklet: Deutsche Bundesbank, Gesetz über das Kreditwesen, 11th edition, Frankfurt am Main, March 1993. A free copy of this publication is available on request.

3. Ongoing banking supervision operations

At the end of 1992, 4,234 credit institutions (3,809 institutions in the old Länder and 425 in the new Länder) were covered by banking supervision. That was 274 institutions fewer than in the preceding year. Most of the reduction was again due to mergers in the credit cooperative sector (236, including 61 east German institutions). In the savings bank sector there were only 20 mergers (including 9 in eastern Germany). The scale of the participation in banking supervision operations

Credit register for loans of DM 1 million or more *

Table 24

4th qtr	Volume of loans of DM 1 million or more: DM billion	Volume of loans of DM 1 million or more: Change in %	Number of loans of DM 1 million or more reported: Number	Number of loans of DM 1 million or more reported: Change in %	Number of reporting credit institutions	Number of reporting insurance enterprises
1988	1,533	+ 6,7	392,644	+ 3,2	3,264	492
1989	1,687	+ 10,0	417,801	+ 6,4	3,311	508
1990	1,927	+ 14,2	452,696	+ 8,4	3,280	525
1991	2,463	+ 27,8	511,255	+ 12,9	3,665	537
1992	2,731	+ 10,9	582,171	+ 13,9	3,611	508

* Credit institutions domiciled in the new Länder were subject to reporting requirements pursuant to section 14 of the Banking Act for the first time on June 30, 1991.

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of the Land Central Banks and – until November 1, 1992 – of the Provisional Administrative Office in Berlin increased further in 1992.

Credit register for loans of DM 1 million or more

The credit register for loans of DM 1 million or more reported the following at December 31, 1992: the volume of such loans rose against the previous year by DM 268 billion or 10.9 % to DM 2,731 billion. The volume of loans to resident borrowers increased by DM 239 billion or 13.6 % to DM 1,994 billion, and that of loans to non-resident borrowers by DM 29 billion or 4.1 % to DM 737 billion. 87 foreign subsidiaries of domestic credit institutions reported loans of DM 1 million or more totalling DM 196 billion, i.e. about DM 14 billion or 7.7 % more than a year before.

Altogether, the credit register recorded 464,000 borrowers on the appointed reporting date (as against 413,000 in 1991), of whom 230,000 (207,000) were combined in 84,000 (75,000) borrower units (pursuant to section 19 (2) of the Banking Act). In the case of 150 (130) borrower units, the debt as defined in section 14 of the Banking Act was in excess of DM 1 billion; the total debt amounted to DM 376 billion.

The number of loans of DM 1 million or more registered has risen since the entry into force of the Banking Act in 1962, when only about 30,000 such loans were registered per reporting period, to about 580,000 such loans per reporting period today, and thus has grown almost twentyfold over a period of 30 years.

In order to keep within bounds the workload associated with the processing of the reports, which has been growing all the time, the reporting threshold for loans of

DM 1 million or more is being raised to DM 3 million with effect from July 1, 1993 under the Fourth Act Amending the Banking Act. The raising of the reporting threshold will appreciably reduce the workload for both the credit institutions and the Bundesbank. Even after the raising of the reporting threshold to DM 3 million, the banking supervisors' interest in a comprehensive and up-to-date picture of the lending pattern of individual credit institutions and the credit institutions' interest in information on the level and structure of the debts of major borrowers will be duly safeguarded.

The number of insolvencies of enterprises and individuals recorded by the credit register, in respect of which loans as defined in section 14 of the Banking Act were reported at the time of the announcement of insolvency, increased by 459 in 1992 to 1,251. This figure includes 258 insolvent debtors of loans of DM 1 million or more in the new Länder, who were included in the reporting requirements pursuant to section 14 of the Banking Act for the first time as from the reporting date June 30, 1991. The volume of loans of DM 1 million or more raised by insolvent enterprises and individuals went up by DM 3.7 billion to DM 7.3 billion, with DM 1.7 billion being accounted for by borrowers in the new Länder.

VI. Authorisations under monetary law

Value guarantee clauses

Decisions on the authorisation of value guarantee clauses are taken by the Bundesbank in accordance with its "Principles Governing Decisions on Applications for Authorisations Pursuant to Section 3 of the Currency Act (No. 2(c) of the Currency Regulation for Berlin)", as last amended in 1978.[1]

Under article 3 of Annex I of the Treaty of May 18, 1990 between the Federal Republic of Germany and the German Democratic Republic Establishing a Monetary, Economic and Social Union, the authorisation requirement of section 3 of the Currency Act was extended to cover the new Länder; the general authorisations

1 Deutsche Bundesbank Notice No. 1015/78 of June 9, 1978, published in Federal Gazette No. 109 of June 15, 1978. For the Bundesbank's policy in granting such authorisations, see also Deutsche Bundesbank, "Value guarantee clauses – synopsis of the Bundesbank's policy in granting permits", Monthly Report, April 1971, page 24 ff. Regarding the incurrence of liabilities denominated in the European currency unit ECU or the special drawing right of the International Monetary Fund (SDR), see Deutsche Bundesbank Notice No. 1002/90 of January 5, 1990, published in Federal Gazette No. 3 of February 5, 1990.

Applications for authorisations pursuant to section 3 sentence 2 of the Currency Act, and the decisions taken Table 25

Year	Applications	Authorisations	Certificate of non-applicability of authorisation requirement	Applications rejected
1970	33,796	24,999	6,585	2,212
1971	40,884	31,189	7,554	2,141
1972	42,964	33,254	7,583	2,127
1973	49,033	36,747	10,045	2,241
1974	44,975	33,830	8,813	2,332
1975	39,686	29,712	7,778	2,196
1976	38,529	29,189	7,494	1,846
1977	39,344	30,145	7,323	1,876
1978	40,002	30,617	7,555	1,830
1979	41,761	32,231	7,632	1,898
1980	43,375	33,237	8,032	2,106
1981	45,375	35,129	7,960	2,286
1982	44,036	34,096	7,798	2,142
1983	43,078	33,654	7,293	2,131
1984	42,526	32,997	7,416	2,113
1985	46,629	37,343	7,312	1,974
1986	40,064	30,998	7,367	1,699
1987	37,083	28,069	7,523	1,491
1988	37,812	29,899	6,313	1,600
1989	38,633	30,349	6,448	1,836
1990	42,552	33,232	7,123	2,197
1991	48,806	37,837	8,197	2,772
1992	54,129	41,689	8,840	3,600

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and authorisation principles under section 3 of the Currency Act were put into effect in the new Länder by Notice No. 1006/90.[1]

VII. Technical assistance by the Bank

Demand for technical assistance

The political and economic reform processes in central and eastern Europe and in the former Soviet Union caused these countries' demand for technical assistance from western central banks to shoot upwards last year. Key areas of the reforms are the financial sector and the building-up of an efficient central bank system geared to meeting the requirements of a market economy. In the light of historical, political and economic considerations, many of the countries eager to undergo

1 Deutsche Bundesbank Notice No. 1006/90 of June 13, 1990, published in Federal Gazette No. 114 of June 23, 1990, page 3215

reforms are orientated towards the west. The Federal Republic of Germany and the success it scored in economic reconstruction after the Second World War are seen as a model by many reforming countries, as is the stability of the Deutsche Mark. Hence it comes as no surprise that a number of central banks have approached the Bundesbank, to request its assistance in setting up their own central bank systems. The Bundesbank, for its part, considers it an important task to help those central banks by proffering advice and training their staff members. To enable such help to be provided in an efficient manner, the Bundesbank set up a special coordination unit at its Central Office in autumn 1991.

Tasks involved

Given the heavy demand for technical assistance, the Bundesbank is setting definite priorities in formulating and implementing its policies in respect of such assistance. As a matter of principle, the Bundesbank is providing support only to foreign central banks, its operations normally being coordinated with those of international organisations, notably the International Monetary Fund. The regional focus of its activities is on countries in central and eastern Europe, as well as on the former Soviet Union. In 1992 its advisory services were concentrated on Czechoslovakia, Poland, Slovenia, Latvia, Lithuania, Ukraine, Belorus and Russia. The Bundesbank's assistance encompasses a broad range of tasks, such as central banking legislation, payments, the setting-up and organisation of central banks, and domestic and external monetary policy. In a number of countries the Bundesbank has provided assistance in the preparation of new central bank legislation. In 1993 the Bundesbank will implement two major payments projects in Bulgaria and Vietnam, where it will be able to draw on its experience of introducing an up-to-date banking system in the former GDR.

Supplementary training programmes

Advisory services are normally supplemented by training programmes for executives of foreign central banks. The Bundesbank attaches importance to its measures being tailored to specific needs and conditions in the countries concerned. The staff members of foreign central banks are being trained in the context of visits by experts, as well as of special seminars, which may take place either at the Bundesbank or abroad. For training schemes and advisory services, the Bundesbank relies on its own staff only. Experts from the Land Central Banks are deployed for this purpose, too, as far as this is possible. In the course of last year the Bank seconded about 35 advisers from the Bundesbank to some 15 countries in central and eastern Europe and the former Soviet Union, and carried out 60 advisory missions. At the same time, about 250 staff members from foreign central banks participated in its training programmes. On top of its bilateral assistance, the Bundesbank also fosters, with advisers of its own, the technical assistance provided by the International Monetary Fund to countries in central and eastern Europe and the former Soviet Union.

VIII. Changes in organisational structure and trends in staff figures

Restructuring of the Land Central Bank areas

By the Amendment of the Deutsche Bundesbank Act which came into effect on November 1, 1992, the unification of Germany has now also been taken into account in the organisational structure of the Bundesbank. At the same time this provided a reason, and afforded an opportunity, for restructuring the Bank in the old Federal Republic, too. When the Act entered into force, the Provisional Administrative Office in Berlin wound up its operations, after having duly performed – in cooperation with the Land Central Banks and the Central Office of the Bundesbank – its task of creating a viable infrastructure for the currency conversion and for the business operations of the Bank.

The reorganisation of the Bundesbank's structure, which was described in detail in the August 1992 Monthly Report, involved a streamlining of the organisational structure, which was desirable on an international comparison and in the light of European developments as well. The reduction in the number of Main Offices owing to the creation of Main Offices extending across state borders resulted in the emergence of Land Central Bank areas of approximately equal size and economic significance. The Provisional Administrative Office in Berlin, which had been in charge of the new Länder, was superseded by the Land Central Bank in the Free State of Saxony and in the Land of Thuringia. One joint Land Central Bank each was set up in Berlin and Brandenburg, in Lower Saxony, Saxony-Anhalt and Bremen, in Hamburg, Mecklenburg-Western Pomerania and Schleswig-Holstein, and in Rhineland-Palatinate and Saarland.

Impact of the restructuring on staffing

A total of roughly 450 staff members at the Main Offices in Bremen, Kiel and Saarbrücken were affected by the amalgamations. Necessary transfers of civil servants, other salaried staff and wage earners to jobs at other locations were accompanied by a number of provisions to provide "social cushioning", with the staff representative bodies having a say in this. In cases of special hardship (e.g. involving severely handicapped and older employees) transfers were avoided wherever possible, and employment at a branch office located in the same town or not far

Trends in staff figures

Table 26

Beginning of 1992

Employed persons	Central Office	Land Central Banks 1	Total	of whom: male	of whom: female
Civil servants	1,037	5,944	6,981	6,137	844
Other salaried staff	1,679	8,441	10,120	4,544	5,576
Wage earners	257	879	1,136	221	915
Total 2	2,973	15,264	18,237	10,902	7,335

Beginning of 1993

Employed persons	Central Office	Land Central Banks	Total	of whom: male	of whom: female
Civil servants	1,058	6,021	7,079	6,189	890
Other salaried staff	1,600	8,205	9,805	4,466	5,339
Wage earners	242	868	1,110	222	888
Total 2	2,900	15,094	17,994	10,877	7,117

1 Including the Provisional Administrative Office in Berlin with 15 branches.
2 The following are included in the total number of employed persons:

	Start of 1992	Start of 1993
Trainee civil servants and other trainees	1,199	1,086
Part-time employees	1,740	1,708
Persons seconded to work abroad	33	31

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from it was aimed at. In cases in which it was impossible, for personal reasons, for salaried staff or wage earners to move, the Bank granted employees leaving it voluntarily a lump-sum severance payment, the size of which depended on the length of service with the Bank. About 40 employees have so far availed themselves of this option.

The staffing of the Land Central Bank in the Free State of Saxony and in Thuringia and of the branch offices in the new Länder has been virtually completed. Approximately 1,600 residents of the new Länder are employed at these places of work. After numerous temporary secondments, about 200 employees from the old Länder have been permanently transferred to the new Länder. The Bank is taking special pains with regard to the integration and training of its staff members from the new Länder. For instance, roughly 140 university graduates from the new Länder have so far been admitted to a trainee programme and prepared quickly and in a manner geared to practical needs for the performance of middle-management duties.

Streamlining the branch office network

Other organisational changes affected the branch offices. Last year twelve branch offices were closed down as part of a new strategy for the branch offices. The impact of these structural changes on staff is being accompanied by welfare measures. In particular, the collective agreement on protection in the event of rationalisation generally applying to public sector salaried staff and wage earners is being complied with as a matter of principle.

Organisational changes at the Central Office

The organisational structure of the Central Office of the Bundesbank, which had remained unchanged for a long time, was brought into line with changed requirements by a redefinition, or the combination, of duties. Special mention should be made of the establishment of a new Department of "Controlling, Accounting and Organisation", which also includes duties so far performed by other departments (with a view to improving cost management, among other things). In addition, data processing functions were concentrated in a likewise newly established Department in order to cope more effectively with the increased requirements in this area. The old "Organisation Department" has therefore ceased to exist. At the same time, the old "Audit Department" has been transformed into a division. The streamlining of the organisational structure was accompanied by the weeding-out of some levels in the hierarchy in order to speed up decision-making. These measures are being backed by new instruments for the more efficient allocation of labour resources and more effective personnel management.

Training schemes of international scope for staff members

The internationalisation of central bank functions and the envisaged development towards a European monetary system prompted a search for new ways of preparing and motivating a significant number of employees in the Higher Service and the Upper Intermediate Service for duties in the international arena. By including in its training programme a special scheme designed to prepare participants for functions with an international bias, the Bank has introduced a forward-looking benchmark that takes due account of this need. Simultaneously, this opens up attractive new career prospects for staff members.

In addition, a staff exchange scheme has been agreed upon with the central banks of the other EC member states in order to acquaint the employees of the EC central banks with conditions and methods of work at other central banks, and to promote mutual understanding. Experience gained in this way will enhance the vocational and personal qualifications of central bank employees in the EC for the tasks they will soon be facing at the European level.

Trends in staff figures

The organisational changes described above have already begun to affect staff figures. Compared with a year earlier, the number of employees decreased by 243 (or 1.3 %) to 17,994.

Annual accounts of the Deutsche Bundesbank for 1992

I. Balance sheet of the Deutsche Bundesbank as at December 31, 1992

Assets

			DM	31.12.1991 DM million
1 Gold			13,687,518,821.70	13,687
2 Reserve position in the International Monetary Fund and special drawing rights				
2.1 Drawing rights within the reserve tranche		6,842,450,992.52		(5,407)
2.2 Loans under special borrowing arrangements		–		(–)
2.3 Special drawing rights		1,356,769,952.02		(2,906)
			8,199,220,944.54	8,313
3 Claims on the European Monetary Cooperation Fund (EMCF) in connection with the European Monetary System				
3.1 ECU balances	34,825,550,668.05			
less Difference between the ECU value and the book value of the gold and dollar reserves contributed to the EMCF	8,039,727,365.15			
		26,785,823,302.90		(17,329)
3.2 Other claims		6,833,578,271.34		(–)
			33,619,401,574.24	17,329
4 Balances with foreign banks and money market investment abroad			85,824,533,673.79	55,404
5 Foreign notes and coins			20,391,576.43	20
6 External loans and other external assets				
6.1 Loans in connection with EC medium-term balance of payments assistance		–		(–)
6.2 Other loans to foreign monetary authorities		–		(–)
6.3 Loans to the World Bank		2,417,750,500.–		(2,423)
6.4 Other external assets		190,019,000.–		(169)
			2,607,769,500.–	2,592
7 Lending to domestic credit institutions				
7.1 Securities bought in open market transactions under repurchase agreements		124,098,890,000.–		(148,457)
7.2 Domestic bills of exchange		50,036,665,807.12		(36,244)
7.3 Foreign bills of exchange		13,150,377,634.25		(38,715)
7.4 Lombard loans		1,643,330,300.–		(1,902)
			188,929,263,741.37	225,318
8 Cash advances				
8.1 Federal Government		4,353,500,000.–		(–)
8.2 Equalisation of Burdens Fund and ERP Special Fund		–		(–)
8.3 Länder Governments		188,184,655.–		(189)
			4,541,684,655.–	189
9 Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			8,683,585,988.93	8,684
10 Lending to the Federal Railways and Federal Post Office				
10.1 Cash advances		–		(–)
10.2 Treasury bills and Treasury discount paper		–		(–)
			–	–
11 Securities			6,065,509,978.82	4,797
12 German coins			1,661,299,740.91	1,556
13 Balances on postal giro accounts			298,729,819.66	152
14 Land and buildings			2,819,003,750.06	2,835
15 Furniture and equipment			281,150,414.78	276
16 Items in course of settlement			7,704,682,044.17	15,130
17 Other assets			3,344,211,030.97	3,530
18 Prepayments			51,311,307.89	48
			368,339,268,563.26	359,860

Liabilities

		DM	31.12.1991 DM million
1 Banknotes in circulation		213,354,941,390.–	181,300
2 Deposits of credit institutions			
2.1 Deposits on giro accounts	88,844,159,082.05		(81,242)
2.2 Other	27,662,953.84		(31)
		88,871,822,035.89	81,273
3 Deposits of public authorities			
3.1 Federal Government	79,429,035.43		(11,638)
3.2 Equalisation of Burdens Fund, ERP Special Fund, "German Unity" Fund	14,149,558.85		(9)
3.3 Länder Governments	301,863,806.89		(1,010)
3.4 Other public depositors	33,407,943.26		(65)
		428,850,344.43	12,722
4 Deposits of other domestic depositors			
4.1 Federal Railways	4,612,882.12		(9)
4.2 East German Railways	14,392,740.66		(16)
4.3 Other depositors	773,934,437.53		(899)
		792,940,060.31	924
5 Liabilities arising from liquidity paper sold		2,011,600,000.–	6,914
6 Liabilities arising from external transactions			
6.1 Deposits of foreign depositors	24,636,659,846.95		(39,373)
6.2 Other	16,097,246.94		(76)
		24,652,757,093.89	39,449
7 Counterpart of special drawing rights allocated		2,686,979,130.–	2,626
8 Provisions			
8.1 for pensions	2,554,000,000.–		(2,391)
8.2 for other purposes	7,265,897,982.29		(6,759)
		9,819,897,982.29	9,150
9 Other liabilities		596,282,568.18	643
10 Accruals		753,117,509.60	721
11 Capital		290,000,000.–	290
12 Reserves			
12.1 Legal reserves	9,065,000,000.–		(8,345)
12.2 Other reserves	290,000,000.–		(290)
		9,355,000,000.–	8,635
13 Unappropriated profit		14,725,080,448.67	15,213
		368,339,268,563.26	359,860

II. Profit and loss account of the Deutsche Bundesbank for 1992

Expenditure

		DM	1991 DM million
1 Interest expenditure		3,354,375,199.22	4,304
2 Staff costs			
2.1 Wages and salaries	1,007,724,966.43		(931)
2.2 Social security contributions and spending on retirement pensions and on maintenance payments	499,525,292.62		(458)
		1,507,250,259.05	1,389
3 Other operating expenditure		504,987,492.91	657
4 Banknote printing		289,635,016.81	331
5 Depreciation			
5.1 of land and buildings	242,774,350.37		(206)
5.2 of furniture and equipment and of other assets	159,091,447.06		(150)
		401,865,797.43	356
6 Write-downs of monetary reserves and other foreign currency positions		6,868,057,563.70	2,936
7 Other expenditure		66,919,991.48	57
8 Profit for the year (= unappropriated profit)		14,725,080,448.67	15,213
		27,718,171,769.27	25,243

Receipts

	DM	1991 DM million
1 Interest	27,467,537,230.15	25,072
2 Fees	116,329,043.18	63
3 Other receipts	134,305,495.94	108
	27,718,171,769.27	25,243

Frankfurt am Main, February 17, 1993

Deutsche Bundesbank
The Directorate

Prof. Dr Drs h.c. Schlesinger Dr Tietmeyer
Gaddum Hartmann Prof. Dr Issing Schieber Dr Storch

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

Frankfurt am Main, March 16, 1993

C&L TREUARBEIT
DEUTSCHE REVISION
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

WOLLERT-ELMENDORFF
DEUTSCHE INDUSTRIE-TREUHAND GMBH
Wirtschaftsprüfungsgesellschaft

Windmöller
Certified Auditor

Langen
Certified Auditor

Thoennes
Certified Auditor

Flaig
Certified Auditor

III. Notes on the annual accounts for 1992

1. Legal basis and classification

Legal basis

Regardless of its public-law status, the Bundesbank is a trader within the meaning of section 1 (2), no. 4 of the Commercial Code *(Handelsgesetzbuch)* because it conducts banking operations. Hence it is also subject to the principles of orderly bookkeeping. Specifically, the legal basis for its accounts is provided by section 26 (2) and section 27 of the Deutsche Bundesbank Act *(Gesetz über die Deutsche Bundesbank)*, in the wording of October 22, 1992. In accordance with these provisions, the layout of, and the notes on, the annual accounts must take due account of the functions of the Deutsche Bundesbank. Regarding valuation, the provisions of the Commercial Code relating to corporations apply as appropriate.

In particular, the current assets (which include, first and foremost, the monetary reserves) are to be shown in the balance sheet in line with the strict lower value principle (section 253 (3) of the Commercial Code). In addition, write-downs may be made in order to avoid the need to change the valuation in future on account of fluctuations in value. Any such lower valuation may also be retained in the following years (section 253 (5) of the Commercial Code). The creation of liability items in respect of general risks encountered in domestic and external transactions is regulated by section 26 (2) of the Deutsche Bundesbank Act.

In accordance with section 27 of the Deutsche Bundesbank Act, 20 % of the net profit, but not less than DM 20 million, is to be transferred to the legal reserves until such time as these have reached 5 % of the amount of banknotes in circulation. Up to 10 % of the residual amount of the net profit may be used to create other reserves, which must not exceed the amount of the capital stock. DM 30 million must be transferred to the Fund for the Purchase of Equalisation Claims. The balance is to be paid over to the Federal Government.

Classification

Since the amendment of the Deutsche Bundesbank Act as at November 1, 1992, the Bank has no longer sold "mobilisation paper". Only "liquidity paper" is now put into the market, the issue volume of which has been increased to DM 50 billion. It is shown in the balance sheet item "Liabilities arising from liquidity paper sold". Other formal changes arise from the reform of the structure of the Federal Post Office. As it is only the "Postbank", and no longer the "Federal Post Office", that holds balances with the Bundesbank, the balance sheet item "Deposits of other domestic depositors – Federal Post Office" has been deleted. The Postbank's balances are therefore included in the "Deposits of credit institutions", which also applies to the figures for the previous year.

Auditing and approval of the annual accounts

The annual accounts of the Deutsche Bundesbank for 1992 were audited by C & L Treuarbeit Deutsche Revision AG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft, of Frankfurt am Main, and Wollert-Elmendorff Deutsche Industrie-Treuhand GmbH Wirtschaftsprüfungsgesellschaft, of Düsseldorf, whom the Central Bank Council had appointed to be auditors in accordance with section 26 of the Deutsche Bundesbank Act. In their certificate of audit the auditors confirmed without qualification that the annual accounts for 1992 and the Bank's bookkeeping comply with German law and present an accurate picture of the Bank's assets and liabilities, financial position and profitability. The Central Bank Council approved the annual accounts for 1992 on April 22, 1993 and accepted the Directorate's proposal in respect of the profit distribution.

2. Assets

Gold

The balance sheet value of the Bank's total gold reserves is about DM 17 billion. However, since the establishment of the European Monetary System (EMS) in 1979, the item "Gold" has included only 80 % of the gold holding, because 20 % of the gold and dollar reserves has been transferred to the European Monetary Cooperation Fund (EMCF) in the form of three-month revolving swaps. The item "Gold" comprises 95 million ounces of fine gold with a balance sheet value of DM 13,687 million. As in the previous year, the gold was valued at its purchase price; the average value per ounce therefore works out at DM 144.

Reserve position in the International Monetary Fund and special drawing rights

This item contains the claims on the International Monetary Fund (IMF) financed and held by the Bank which arise from Germany's membership of the IMF. The drawing rights within the reserve tranche correspond to the amounts actually paid to the IMF in gold, special drawing rights and Deutsche Mark under the German quota. At December 31,1992 their level came to DM 6,842 million (= SDR 3,083 million), compared with DM 5,407 million (= SDR 2,494 million) at end-1991. It represents the difference between the German quota of SDR 8,242 million and the Deutsche Mark balances equivalent to DM 11,447 million (= SDR 5,159 million) at the disposal of the IMF at the end of the year. The rise of SDR 589 million in the holding of drawing rights during 1992 is due to the seventh quota increase of November 11, 1992 and to Deutsche Mark drawings and repayments by other members.

During the year under review the Bank did not grant any new loans to the IMF under special borrowing arrangements. At present only one credit line in favour of the IMF amounting to SDR 2.4 billion is outstanding under the General Arrangements to Borrow, but the IMF can utilise it only subject to certain conditions.

Special drawing rights, by means of which convertible currencies can be obtained at any time, were originally allocated to the extent of SDR 1,211 million free of charge. The counterpart thereof is shown on the liabilities side. The amount of special drawing rights held at the end of 1992 came to DM 1,357 million (= SDR 611 million). Increases totalling SDR 223 million owing to SDRs purchased and interest received were accompanied by decreases amounting to SDR 952 million owing to the quota increase and to 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 34,826 million result mainly from the provisional contribution of 20% of the Bank's gold and dollar reserves to the EMCF. In addition, these balances include the reserve ECUs (DM 7,607 million) transferred to the Bank by other central banks participating in the EMS. The gold and dollar reserves provisionally contributed to the EMCF under the terms of the EMS against the crediting of ECUs were transferred at market prices and therefore mostly at values higher than those shown in the balance sheet. The resulting difference of DM 8,040 million is deducted from the ECU balances. At the end of 1992 there were other claims denominated in ECUs totalling DM 6,833 million as a result of lending under the very short-term financing mechanism. The increase of DM 16,290 million in ECU claims is a consequence of the considerable interventions in the foreign exchange market within the EMS since September last year.

Balances with foreign banks and money market investment abroad

The balances with foreign banks and money market investment abroad, most of which are denominated in US dollars and bear interest, amounted to DM 85,825 million at the end of 1992, against DM 55,404 million at December 31, 1991 (excluding the dollar reserves provisionally contributed to the EMCF). The increase in these assets likewise mirrors the financing by the Bank of foreign exchange market interventions in the EMS in the past year. The assets and liabilities denominated in US dollars were valued at the balance sheet rate of US$ 1 = DM 1.3870, which corresponds to the all-time lowest level of the dollar on September 2, 1992.

External loans and other external assets

The main constituents of this item are loans to the World Bank (which were mostly granted against borrowers' notes denominated in Deutsche Mark). No loans under the EC medium-term balance-of-payments assistance arrangement or other loans to foreign monetary authorities were outstanding in the year under review. The other external assets include some fairly long-standing claims in respect of limited investments with foreign institutions. Because of their lower liquidity, external loans and other external assets do not count towards the monetary reserves.

Lending to domestic credit institutions

This item reflects the volume and structure of domestic credit institutions' refinancing. Most of it is made up of the securities repurchase agreements used as part of flexible money market management. In this context, the Bank buys securities eligible as collateral for lombard loans subject to the condition that the sellers repurchase them forward. At the end of the year the claims deriving from these transactions amounted to DM 124,099 million; the decline of DM 24,358 million against the previous year is mainly due to the liquidity-boosting effect of foreign exchange inflows in 1992. The portfolio of domestic and foreign bills of exchange, which the Bank purchases within the rediscount quotas at the discount rate, decreased by DM 11,772 million compared with December 31, 1991. In the process there were structural shifts in favour of domestic bill transactions owing to the abolition of bill tax on January 1, 1992, because that meant that a cost advantage for foreign bills of exchange ceased to apply. On December 31, 1992 the share of domestic bills in the Bank's portfolio was 79 %, against 48 % a year before. Lombard loans, by means of which the Bank provides central bank money against the collateral of securities and Debt Register claims, serves to bridge short-term liquidity requirements on the part of credit institutions. Compared with the other refinancing facilities, recourse is therefore low; at the balance sheet date it amounted to DM 1,643 million.

Cash advances

Asset item 8 "Cash advances" comprises advances to the Federal Government, the Equalisation of Burdens Fund, the ERP Special Fund and the Länder Governments. They are used solely to meet a temporary financial need and are limited in volume (credit ceilings in accordance with section 20 of the Deutsche Bundesbank Act). Interest is paid on cash advances at the lombard rate. As in previous years, the Equalisation of Burdens Fund and the ERP Special Fund raised no such loans. Not only cash advances but also Treasury bills which the Bank holds in its portfolio or has undertaken to purchase are likewise to be counted towards these credit ceilings. However, lending to public authorities against Treasury bills has been of virtually no significance for years.

Equalisation claims

The equalisation claims on the Federal Government and the non-interest-bearing debt certificate in respect of Berlin date back to the currency reform of 1948. They form the balance sheet counterpart of the amounts then paid in cash per head and per enterprise, and of the initial provision of credit institutions and public corporations with central bank money. The equalisation claims yield interest at the rate of 1 % p. a., but are not repaid. The non-interest-bearing debt certificate dates back to the currency reform in Berlin (West); it neither attracts interest nor is repaid.

Lending to the Federal Railways and Federal Post Office

"Lending to the Federal Railways and Federal Post Office" is not carried in the balance sheet under "Public authorities". It is shown in separate items, because these special funds of the Federal Government are usually assigned to the enterprise sector. Cash advances to the Federal Railways and Federal Post Office (excluding the Postbank) are subject to special ceilings, as in the case of the Federal Government and Länder Governments. The Federal Railways and Federal Post Office both had recourse to cash advances during 1992, though not on the balance sheet date. Treasury bills and Treasury discount paper issued by these borrowers were not held in the Bank's portfolio.

Securities

During the year under review the Bank's portfolio of securities, which chiefly comprises bonds issued by the Federal Government, the Federal Railways and the Federal Post Office, increased from DM 4.797 million to DM 6.066 million on account of transactions in the open market.

German coins

The Bank's portfolio of coins is held as a reserve for use in payments. The Bank, acting for the account of the Federal Government (which holds the coinage prerogative), receives new coins from the public mints at face value. At the end of 1992 the amount of coins in the Bank's portfolio was equivalent to about 12 % of the volume of coins outstanding (DM 13,930 million); the maximum level permissible under the Coinage Act is 15 %.

Land and buildings

The balance sheet value of land, office and residential buildings once again declined somewhat. Additions of DM 227 million were accompanied by depreciation totalling DM 243 million.

Furniture and equipment

In the year under review the furniture and equipment of the Bank increased slightly in value after additions of DM 153 million and depreciation amounting to DM 148 million.

Items in course of settlement

The "Items in course of settlement", the volume of which is influenced by return date effects, in particular, mainly consist of the cheques, direct debits and credit transfers in transit within the Bank at the end of the year. The balance of these items stood at DM 7,705 million at December 31, 1992 against DM 15,130 million at the end of 1991.

Other assets

These primarily comprise the interest income from external assets and from securities transactions not due until 1993 but assignable to the profit and loss account for 1992. At DM 3,344 million, the total almost reached the previous year's level. The "Other assets" also include participating interests in the Bank for International Settlements, Basle, the cooperative society S.W.I.F.T., La Hulpe (Belgium), and the Liquiditäts-Konsortialbank GmbH, Frankfurt am Main. The 30 % interest in the Liquiditäts-Konsortialbank GmbH entails for the Bank a maximum commitment of DM 558 million.

Prepayments

The prepayments consist almost entirely of salary and pension payments already effected in the year under review, but relating to 1993.

3. Liabilities

Banknotes in circulation

Compared with end-1992 the amount of banknotes in circulation rose by DM 32,055 million to DM 213,355 million, representing an increase of about 18 %. After the remaining notes of the new banknote series had been issued in the year under review, in value terms they accounted for as much as about two-thirds of the total amount in circulation at the end of 1992.

Compared with the previous year, the amount of currency in circulation rose by DM 32,670 million to DM 227,285 million; DM 13,930 million of this sum was accounted for by coins.

Deposits of credit institutions

Credit institutions' deposits on giro accounts, totalling DM 88,844 million (1991: DM 81,242 million), mainly constitute the minimum reserves to be held at the Bank. They now also include the deposits of the Deutsche Bundespost Postbank. The sub-item "Other" contains the deposits of domestic credit institutions and of the branches of foreign banks on US dollar accounts (DM 28 million).

Deposits of public authorities

This item encompasses the balances of the Federal Government, the Equalisation of Burdens Fund, the ERP Special Fund and the Länder Governments, which are required to deposit their liquid funds with the Bank in accordance with section 17 of the Deutsche Bundesbank Act. In the case of the Länder Governments and the Federal Government's special funds, the Bank permits exceptions, so that they are able to invest some of their liquid funds at interest outside the Bank. In addition, this item includes deposits of the "Germany Unity" Fund. The deposits of other public depositors relate to balances of the social security funds and local authorities. At December 31, 1992 such deposits came to only DM 429 million (1991: DM 12,722 million), because the Federal Government, in particular, tried to avoid holding large balances at the end of the year.

Deposits of other domestic depositors

This balance sheet item contains the deposits of the Federal Railways and the east German Railways and the deposits of enterprises and individuals. At the end of 1992 they totalled DM 793 million, against DM 924 million a year before.

Liabilities arising from liquidity paper sold

"Liabilities arising from liquidity paper sold" include Treasury bills and Treasury discount paper issued by the Federal Government. They are sold by the Bank to public authorities, foreign monetary authorities and international organisations to enable these institutions to invest such balances as they do not require for payment purposes in an interest-bearing manner. Moreover, liquidity paper was sold to credit institutions as part of money market management to mop up liquidity at short notice. Of the money market paper outstanding at the end of the year, to the value of DM 2,011 million (1991: DM 6,914 million), DM 1,853 million was accounted for by Treasury bills, and only DM 158 million by Treasury discount paper; such paper was used only for the investment of excess deposits.

Liabilities arising from external transactions

This balance sheet item, totalling DM 24,653 million (1991: DM 39,449 million), consists mostly of Deutsche Mark deposits of foreign monetary authorities, resulting in the main from their Deutsche Mark interventions in the foreign exchange markets. Specifically, DM 24,457 million (1991: DM 39,216 million) was accounted for by balances of foreign banks and DM 196 million by other deposits. The decline in the deposits of foreign monetary authorities, compared with end-1991, is accounted for by the exchange into US dollars of Deutsche Mark balances lodged with the Bundesbank, which exchange was conducted outside the market by means of direct transactions.

Counterpart of special drawing rights allocated

The counterpart of the special drawing rights allocated by the IMF free of charge and shown in item 2 on the assets side matches the allocations of SDRs to the Federal Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,211 million.

Provisions for pensions

After an increase of DM 163 million, the provisions for pensions amount to DM 2,554 million; they are in line with the actuarially computed requirements.

Provisions for other purposes

On December 31, 1992 DM 507 million net was added to the provisions for other purposes, which serve primarily to cover general risks inherent in domestic and external operations and in doubtful liabilities; this was mainly in order to take due account of the risks posed by the external position. Since then, these provisions have amounted to DM 7,266 million (see the notes below on the expenditure items "Write-downs of monetary reserves and other foreign currency positions" and "Other operating expenditure").

Other liabilities

The other liabilities, amounting to DM 596 million (1991: 643 million), concern amounts not yet passed on and interest expenditure falling due in 1993 but relating to 1992.

Accruals

Accruals amounted to DM 753 million at December 31, 1992 (1991: DM 721 million). This item comprises the interest received during the year under review, but relating to the following year, on domestic and foreign bills of exchange and US Treasury notes.

Reserves

In accordance with the decision taken by the Central Bank Council on April 2, 1992, the legal reserves were increased by DM 720 million out of the unappropriated profit for 1991. Since that increase, the legal reserves have totalled DM 9,065 million; they have thus reached the maximum level permissible by law of 5 % of the amount of banknotes in circulation, which was DM 181,300 million at the end of 1991. The other reserves reached the statutory ceiling of DM 290 million as long ago as end-1980.

Unappropriated profit

See the notes on "6. Profit for the year" in this Report.

4. Expenditure

Interest expenditure

Interest expenditure decreased by DM 950 million to DM 3,354 million, compared with the previous year; this was mainly due to the decline in interest expenditure in external transactions. The lower level of liabilities arising from external transactions was the decisive factor in this. The amount of interest paid on mobilisation and liquidity paper came to DM 226 million.

Staff costs

Staff costs rose during the year under review by DM 118 million to DM 1,507 million. Not counting the increase in the provisions for pensions, staff costs were 8.1 % higher than in the preceding year. In addition to the general pay rise of 5.4 %, this owed something to the fact that the incomes of government employees in the new Länder were raised in two steps from 60 % to 74 % of the level applying in the west. On the other hand, the staffing level of the Bank declined by 1.3 %. DM 353 million (1991: DM 323 million) of the staff costs was accounted for by retirement pensions. This sum includes the increase of DM 163 million in the provisions for pensions, as well as the payments made to staff members of the former Deutsche Reichsbank under the Act concerning Article 131 of the Basic Law, and to other persons for whom the Bank is required to provide in accordance with section 41 of the Deutsche Bundesbank Act.

Payments to serving members of the Central Bank Council and the Directorate of the Bank amounted to DM 9,037,157.41 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 of the Managing Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 11,702,041.84.

Other operating expenditure

The other (non-staff) operating expenditure decreased by DM 152 million, compared with 1991, to DM 505 million. This reflected, in particular, the smaller increase than in previous years in provisions for doubtful liabilities, which affected other operating expenditure.

Banknote printing

In the year under review expenditure on banknote printing declined by DM 41 million to DM 290 million. This is attributable to the high level recorded in the previous year in connection with the issue of the new banknote series.

Depreciation of fixed assets

Depreciation both of land and buildings and of furniture and equipment was discussed in connection with the respective balance sheet items. Further depreciation relates to computer software, which is shown on the assets side under other assets.

Write-downs of monetary reserves

This item contains the outcome of the valuation of the monetary reserves and other foreign currency positions. It also includes the profits and losses arising from purchases and sales of foreign currencies and changes in provisions, which affect the external position, too. Altogether, expenditure totalled DM 6,868 million. Specifically, there were considerable write-downs of the dollar reserves, which could partly be offset by releasing other provisions, and losses arising from the ECU position as a consequence of massive interventions in the foreign exchange markets.

5. Receipts

Interest

In the year under review interest received, at DM 27,468 million, was DM 2,396 million higher than in 1991. The crucial factor here was interest income from lending to domestic credit institutions, which rose by DM 1,486 million. This was because the average volume of refinancing was larger than in the previous year, and because central bank interest rates were higher. Interest income from securities and cash advances, at DM 404 million and DM 95 million, respectively, had only a minor impact on overall interest receipts. Interest income from external transactions increased by DM 686 million against the previous year. It was mainly the interest income from EMS intervention transactions that went up, while dollar assets – owing to declining average yields – generated lower interest receipts.

Fees

Fees accrue first and foremost in connection with payments, which fact has lately increased in significance because of the Bank's more cost-orientated fee policy. Thus, receipts almost doubled in 1992 to DM 116 million.

6. Profit for the year

The profit and loss account for 1992 shows a profit for the year of DM 14,725,080,448.67, which is entered in the balance sheet as unappropriated profit (net profit). In acccordance with the Directorate's proposal for the distribution of the profit, DM 1,602,700,000.00 will be transferred to the legal reserves and DM 30,000,000.00 to the Fund for the Purchase of Equalisation Claims. The balance of DM 13,092,380,448.67 will be paid over to the Federal Government. After this appropriation, the legal reserves will amount to DM 10,667,700,000.00; they will thus reach the statutory ceiling of 5% of the amount of banknotes in circulation.