Deutsche Bundesbank
Annual Report
1995

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on April 1, 1996

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to April 1, 1996

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Deutsche Bundesbank
Wilhelm-Epstein-Strasse 14
60431 Frankfurt am Main

P.O.B. 10 06 02
60006 Frankfurt am Main
Federal Republic of Germany

Telephone (0 69) 95 66-1
or (0 69) 95 66 . . . plus extension number

Telex 41 227 within Germany
4 14 431 from abroad

Fax (0 69) 5 60 10 71

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Deutsche Bundesbank, Monetary policy regulations, Frankfurt am Main, April 1995;
Deutsche Bundesbank, Gesetz über das Kreditwesen (Banking Act), Frankfurt am Main, March 1996 (German-language edition only); the English-language edition of this booklet is expected to appear in May 1996.

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	Figure unknown, not to be published or not meaningful
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

1995 was not an easy year for the German economy. Although the pace of price rises continued to slacken, the optimistic expectations entertained for business activity were disappointed. In Germany (and not only there) the economic upswing came to a halt; the number of unemployed soared to 3.8 million in the course of the year. Undesirable developments at home and pressures from abroad joined forces and distinctly clouded the economic outlook. The wage increases agreed last year markedly exceeded the level warranted by the improvement in productivity and exacerbated many firms' cost situation, which was difficult anyway in view of the heavy burden of taxes and social security contributions. On the external front, business operations were additionally hampered by the volatility of the global exchange markets and the temporary sharp appreciation of the Deutsche Mark; a wait-and-see attitude spread among exporters and investors.

Open borders for goods, services, capital and labour undoubtedly imply potential disruptions of domestic economic activity, and therefore call for a high degree of adaptability. In the light of such risks, however, it should not be forgotten that Germany's embedment in the world economy affords it growth opportunities extending beyond its own markets, and thus enhances its inhabitants' prosperity. Even though economic risks are inseparably associated with the market economy, much of what individual market players regard as a source of uncertainty is not actually inherent in business activity but is, as it were, imported to the economy from outside. Frequently it is political developments and changed assessments that give rise to uncertainties. Given the ever-increasing interdependence of the markets, instabilities that are triggered in such ways often spread in the twinkling of an eye from country to country, from continent to continent; last year's exchange market turmoil once again bore witness to that.

Economic and social policy makers in Germany must pay greater attention not only to the exigencies of their day-to-day duties but also to the implications for economic actions of underlying conditions that are calculable and stable over the longer term. That has certainly not been easy in recent years. German unification entailed some radical changes in the accustomed environment. It was not always possible in that context to gauge reliably in advance which measures were required, or on which scale. In particular, the financial burdens imposed by unification were not precisely foreseeable at the outset – especially since the economic impact of the rapid adjustment of wages in the new Länder to west German levels made itself felt only gradually. In the upshot, all of this resulted in a succession of interventions in economic activity that was occasionally hectic.

Five years after unification, the time now seems ripe to provide for greater calculability in underlying national conditions once again. The German economy needs longer-term benchmarks beyond the factors determined by policy makers and the parties to wage settlements. That does not signify political standstill, by which all the pressures faced by the "industrial location Germany" that have accumulated in recent years would be sealed. Calculability as to the underlying conditions means, rather, upholding the basic principles of our regulatory system, and carrying out foreseeable and self-consistent adjustments wherever they are imperative.

First and foremost among such adjustments are certainly the labour market problems, which have become ever more pressing. The primary responsibility here lies with the parties to wage settlements, who will have to pave the way to more employment. Furthermore, it will be necessary to break up entrenched regulatory positions and, via a sustained consolidation of public finance (including the social security systems) and a reduction of taxes and public levies, to widen the scope for new growth and for creating new jobs.

A concentration of forces likewise seems to be appropriate in view of the international challenges and, above all, of the preparations for European economic and monetary union. In 1995, with a public sector deficit amounting to 3.5 % of the gross domestic product, Germany overshot the threshold of the deficit criterion of the Maastricht Treaty (3 %). To ensure that the convergence test can be passed with flying colours in 1998, the stage must be duly set soon, since long periods elapse before fiscal and social policy measures take effect.

Clear medium-term benchmarks and greater continuity in the basic conditions for economic action would also facilitate the Bundesbank's task in the field of anti-inflation policy. In the past few years government borrowing, changes in taxes and subsidies, and transfers of funds to and from foreign countries on tax grounds have led to a number of short-lived disruptions of money holding that have obstructed the attainment of the Bundesbank's monetary targets.

Despite such problems of monetary management, the Bundesbank's policies have been successful on the whole. With the reduction of the inflation rate to distinctly less than 2 %, the Bank has largely reached its real goal of maintaining monetary stability. The orientation of monetary policy towards annual monetary targets has proved to be helpful in this connection, even if the Bank has had to accept some marked deviations of the money supply from the potential path from time to time.

The present Annual Report analyses monetary policy in Germany against the background of current economic activity, and also discusses in detail the changes in global monetary conditions. At the same time, the Bundesbank hereby presents its annual accounts for 1995, which have been audited by two firms of auditors and were approved by the Central Bank Council on April 18, 1996. In 1995, as in earlier years, the Bundesbank performed a wide variety of tasks in discharging its statutory mandate: the provision of currency, the execution of payments, foreign exchange trading, the issue of Federal securities, and in the fields of monetary legislation and national and international banking supervision.

Acting on behalf of the Central Bank Council, as well as personally, I should like to take this opportunity of thanking all the staff members of the Bank for the commitment with which they performed their duties in 1995. I also wish to express to the staff representative bodies my appreciation of their cooperation in a spirit of mutual trust.

Frankfurt am Main, April 1996

Dr Dr h.c. Hans Tietmeyer
President of the Deutsche Bundesbank

The currency and the economy

I. International economic fundamentals

Slackening of global economic growth

In 1995, too, the world economy was on the path of growth overall. The expansion of output and world trade was quite rapid at average rates of 3 ½ % and 8 ½ %, respectively, while the rise in prices was predominantly moderate. Nevertheless, the industrial countries had a much smaller share in this than had been expected in many quarters. It was, above all, in the industrial countries that there was a perceptible loss of momentum in economic activity in the course of last year. The newly industrialising countries in south-east Asia, on the other hand, which have firmly established themselves as a centre of growth in the world economy, continued to generate powerful stimuli. The process of recovery also continued in the great majority of central and east European countries in transition – sometimes at a strikingly fast pace, in fact. In other countries in transition, the dramatic decline in output in the last few years at least appears to have slowed down. The trend in Latin America was varied, some countries suffering from the effects of the Mexico crisis which erupted at the end of 1994 and from home-grown problems, whereas others were scarcely affected in terms of their economic growth, and won over the markets by pursuing economic policies that bolstered confidence.

Soft landing of the US economy

The slackening of growth in the industrial countries was initially determined by the slower pace of economic activity in the United States. In 1995 the growth of the US economy fell to 2 %, compared with 3 ½ % in the year before. In terms of its trend, this process of normalisation, often referred to as "soft landing", may be deemed to be quite welcome in the light of the inflationary distortions which had become apparent in the late phase of the upswing that had already lasted four years. Owing to an early tightening of the monetary policy reins, which the Federal Reserve felt to be appropriate at the beginning of 1994 (not least on account of increasing inflationary fears on the part of market players), the cyclical trend in the United States was successfully steered into calmer waters, evidently interacting with the preceding rise in capital market rates. In addition, the Mexico crisis unsettled the financial markets in the United States and, as a result, restrained the progress of economic activity, too.

Stagnation in Japan

The trend was disappointing in Japan. The long-expected recovery was delayed, in particular, by the dramatic appreciation of the yen, which reached its peak in the first half of 1995, and by persistent structural problems in the financial sector. Even government spending programmes were unable to change this. It was not until

Key macroeconomic variables in selected industrial countries*

Table 1

Country	Real gross domestic product		Consumer prices 1		Financial balance of the public sector 2		Balance on current account	
	1994	1995 p	1994	1995 p	1994	1995 p	1994	1995 p
	Change from previous year in %				as % of GDP		US$ billion	
Industrial countries	2.7	2.0	2.3	2.2	– 3.8	– 3.5	+ 7	+ 31
of which								
European Union	2.9	2.5	2.9	3.0	– 5.7	– 5.1	+ 23	+ 58
of which								
France	2.9	2.4	1.7	1.7	– 6.0	– 5.0	+ 8	+ 17
Germany	2.9	1.9	2.7	1.8	– 2.6	– 3.5	– 21	– 17
Italy	2.2	3.2	4.0	5.2	– 9.0	– 7.4	+ 16	+ 27
United Kingdom	3.8	2.4	2.4	3.5	– 6.8	– 5.1	– 3	– 10
United States	3.5	2.0	2.6	2.8	– 2.3	– 2.0	– 151	– 153
Japan	0.5	0.9	0.7	– 0.1	– 2.1	– 3.1	129	110
Canada	4.6	2.2	0.2	2.1	– 5.3	– 4.2	– 16	– 9

Sources: EC Commission, IMF, OECD and national statistics. — * EU countries and United States, Japan, Canada, Switzerland and Norway. — 1 Cost-of-living index. — 2 As defined in the national accounts.

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autumn 1995 that there were increasing signs of the Japanese economy returning to a sounder footing; on an average of 1995, overall output grew by only just under 1%.

Recovery in Europe held up

The stimuli for growth from world trade remained below expectations for the European industrial countries. To this were added strains resulting from the exchange rate turbulence, which weakened the price competitiveness of those countries whose currencies appreciated, and, at times, unsettled the economy considerably. Apart from Germany, the countries mainly affected were France, the Benelux countries and Austria, whereas the south European countries and, in particular, Italy and Spain benefited from competitive advantages due to depreciation. Later in 1995, however, some restraining influences became perceptible even in those countries after their currencies had recovered, while persistently high risk premiums had prevented a decline in interest rates. For that reason, the growth process in Europe made only faltering progress, despite an overall increase in investment activity, particularly as consumer demand remained comparatively weak owing to the consistently high level of unemployment and higher taxes and levies. The European industrial countries' gross domestic product expanded at an average rate of 2 ½ % in 1995, and hence less strongly than in 1994.

Improved prospects for growth

The waning expansionary forces in the industrial countries stood in stark contrast to the almost uninterrupted buoyancy of the Asian growth regions and the welcome upward trend in some countries in transition. It should nevertheless be highlighted as positive that the basic conditions for continued and, at the same time, largely smooth economic growth improved in the industrial countries, too. Measured in those terms, the prospects that the present sluggishness will soon be overcome are not unfavourable. Overall, the risks of inflation were successfully brought under control. This restored and strengthened the confidence of investors in the international capital markets. At the same time, the exchange rate distortions between the world's major currencies receded.

Easing in global and intra-European monetary patterns

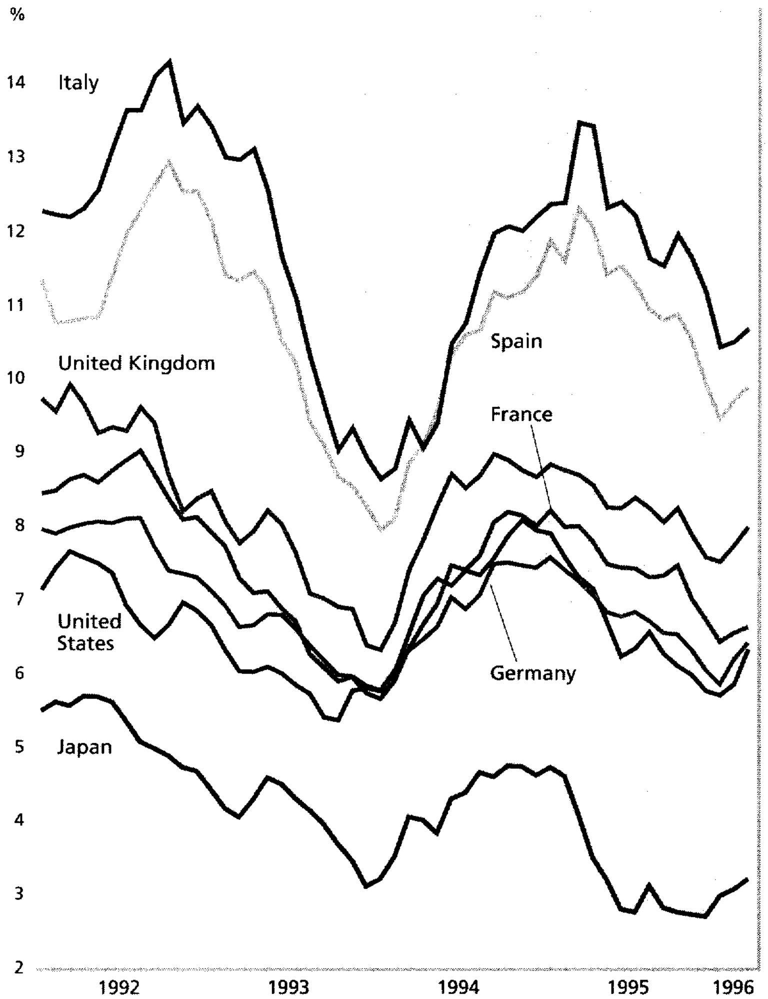
The US dollar made a perceptible recovery after its steep downward slide in spring 1995 and after the intensity of major strains, such as the Mexico crisis and the trade conflict between the United States and Japan, had declined markedly. At DM 1.51, the US currency was quoted at the time of going to press around 11 % higher against the Deutsche Mark than at its lowest point of DM 1.36 per dollar in April 1995. As mentioned above, other European currencies which are of importance for Germany's foreign trade, and which had fallen particularly sharply against the Deutsche Mark, were also able to firm again. Since last spring, for example, the Italian lira and the Spanish peseta have appreciated by 20 % and 11 %, respectively. The reverse was true in the case of the yen, which was recently around 12 % lower against the Deutsche Mark than in spring 1995. The fundamentals for the exchange rates have thus gained greater importance overall. From a German point of view, the outcome of the ups and downs of the major currencies between the beginning of 1995 and the present was nevertheless, on a weighted average, an appreciation of the Deutsche Mark of around 1 ½ %, compared with a peak of 6 % reached in spring 1995. Looked at in the somewhat longer term, including 1994, the present appreciation rate of the weighted external value of the Deutsche Mark, at 4 ½ %, is still high.

Continuing moderate price inflation

The preconditions for a continuation of the growth process are more favourable in terms of prices than they have been for a long time. Much the same as in the preceding year, consumer prices in the industrial countries in 1995 rose on average by a little more than 2 %. Along with the slowdown in growth in the major industrial countries, the inflationary pressures emanating from the commodity markets also receded markedly during 1995. In some countries of southern Europe, whose currencies had temporarily depreciated more strongly, an appreciable rise in import prices generated a powerful inflationary surge. Much depends here on the easing effects resulting from the recent exchange rate

Capital market rates in selected industrial countries *

Chart 1



* Government bonds with maturities of approximately ten years.

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movements being quickly perceived, so that exaggerated inflationary expectations do not become entrenched. In the other countries, which are able to look back on a more favourable price performance, it will be a matter of safeguarding the stabilisation success that has already been achieved.

Fall in capital market rates

The slowdown in economic growth in the major industrial countries was accompanied by an easing in the international capital markets, which was a reflection of the fact that burgeoning fears of inflation had been successfully repelled and that, as a result, confidence in the anti-inflation policy resolve of major partner central banks was strengthened. Both the share and the bond markets reached ever-new record levels. In a similar way to what had been the reverse case in 1994, the stimuli behind this trend were imparted by the US capital market. Owing to the close linkages between US dollar and Deutsche Mark interest rates, this opened up scope for lowering interest rates in the European financial markets, too, but this was reflected to varying extents in the capital market rates in the individual countries. In some countries with weak currencies, in particular, a contrary trend in the spreads appears to have hampered the easing of the capital markets. Apart from that, even when taking the recent market pressures into consideration, the previous year's rise in yields was largely offset as a result of the world-wide decline in interest rates in 1995.

Budget consolidation imperative despite slacker economic activity

The hoped-for economic recovery might be slowed down by the fact that most industrial countries have to struggle with considerable budgetary problems. Following the general slowdown in growth, the task of fiscal policy consolidation appears to be even more difficult than before. At any rate, the progress made in this respect up to now is still inadequate. On an average of all industrial countries, the budget deficits in 1995, at 3 ½ % of gross domestic product, were still appreciable, and government debt again grew more than overall income. The associated rise in interest liabilities is not only increasingly restricting the government's fiscal policy leeway. It also limits the financial incentives for private sector expenditure on investment and consumption by perpetuating the need for high tax rates and impeding a reduction of real longer-term interest rates.

Credible strategies required

With a view to the substantial burdens ensuing from this for the future, the trend in public finance is being watched with serious concern also by investors in the international capital markets. In most countries it will therefore be necessary to bring fiscal policy on to a lasting course of consolidation, even under difficult economic conditions. Instead of piecemeal intervention, convincing and credible strategies are required, which are designed – and this is crucial – to bring about lasting expenditure cuts. Any short-term adverse effects on aggregate demand could then be offset relatively quickly by gains of confidence and ensuing interest rate reductions in the capital market – which would have a positive influence on investors' and consumers' behaviour.

Sound fiscal policy also in the common interest of all countries

In a world of closely integrated financial markets, in which the individual countries' aggregate demand for capital influences the real interest rate level world-wide, it is in the national interest and in the enlightened common interest alike that every country should – as a priority and with determination – pursue a policy

Trends on the labour market in the OECD countries*

Table 2

Country	Labour force 1982–93	Labour force 1994	Labour force 1995 e	Employed 1982–93	Employed 1994	Employed 1995 e	Unemployment rate 1 1982–93	Unemployment rate 1 1994	Unemployment rate 1 1995
	Change from previous year in %						as % of the total labour force		
OECD countries	1.1	1.0	0.7	1.0	0.9	1.0	7.4	7.9	7.5
of which									
European Union	0.6	0.3	0.2	0.3	- 0.2	0.7	9.9	11.3	11.0
of which									
France	0.5	1.1	0.4	0.1	0.5	1.2	9.8	12.3	11.6
Germany 2	0.7	0.1	- 0.5	0.4	- 0.7	- 0.3	6.1	8.4	8.2
Italy	0.3	0.3	1.2	- 0.1	- 0.8	0.5	10.0	11.1	3 12.2
United Kingdom	0.5	- 0.8	- 0.3	0.3	0.3	0.5	10.0	9.5	8.7
United States 4	1.4	2.3	1.1	1.4	3.1	1.6	6.9	6.0	5.5
Japan	1.2	0.4	0.4	1.2	0.1	0.2	2.5	2.9	3.1
Canada	1.5	1.1	0.7	1.1	2.1	1.6	9.9	10.3	9.5

Source: OECD. — * Excluding the Czech Republic. — 1 Standardised unemployment rate according to OECD calculations; excluding Austria, Denmark, Greece, Luxemburg, Mexico and Turkey. — 2 Until 1991 only western Germany. — 3 January to October 1995. — 4 As from 1994 statistical adjustments which by themselves increase the recorded unemployment rate (by roughly 0.2 percentage point).

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of budget consolidation. In doing that, the budget deficits should be reduced to such an extent that the ratios of government debt to gross national product decline again. This is the conclusion also arrived at by the study published by the Group of Ten in October 1995 on the links between saving, investment, and trends in real interest rates. The common conviction of the industrial countries is that a curbing of government expenditure must be the main starting point; increases in taxes and levies would inhibit the confidence-boosting effects mentioned.

High unemployment in Europe requires a broadly based counterstrategy

The task of fiscal policy consolidation represents a particular challenge for Europe in view of the fact that the employment problems which have remained unsolved for some considerable time have been revealed even more starkly by the slackening of economic growth. Although, for the first time since 1991, a slight rise in employment was apparent in the countries of the EU in 1995, this trend did not continue because of the slowdown in economic growth. The unemployment rate in the European Union, which, at 11 ½ % of the total labour force resident in the EU countries, had reached its highest level so far in 1994, therefore fell only a little below that figure in 1995 (11 %). In particular, when measured against the major industrial nations, such as the United States and Japan, it occupies an inglorious top position. Unemployment in Europe is not due primarily to a lack of demand, which could be countered by expansionary monetary and fiscal policy means; such measures would scarcely hold out the promise of more than a flash in the pan. The main causes of unemployment consist in the structural rigidities and inflexibilities on most European labour markets and a wage policy which, on the one hand, has not taken adequate account of high unemployment in pay settlements (notwithstanding their generally moderate nature) and, on the other, tends to hamper a necessary differentiation of wages in line with labour qualifications and job productivity. For that reason, structural reforms on the labour markets and in the pay bargaining process are long since overdue in most EU member states. The major international organisations and individual governments have presented a large number of specific proposals on this, and there exists a large measure of consensus with regard to their importance for improving conditions on the labour market. It is now a matter of implementing these programmes as a priority in the day-to-day workings of politics.

Progress in integrating the central and east European countries in transition into the world economy

The rapidly advancing integration of the central and east European countries in transition into the world economy is posing new challenges to the adjustment potential of the goods and labour markets of the European Union. Although it is opening up new sales and employment prospects for the western industrial countries, this process is also being accompanied by significant shifts in existing competitive conditions, which are already becoming apparent in a sharp expansion of cross-border trade flows. Poland and Hungary, for instance, are now transacting around three-quarters and two-thirds, respectively, of their foreign trade with western industrial countries – a considerable part of which is with Germany and other EU countries. The rapidly increasing integration of trade is, in turn, the result of western industrial countries' direct investment in the new industrial locations. The competitive conditions on the labour markets of the European Union have likewise not remained unaffected by this opening-up to the east. In the less skilled groups, in particular, the pressure on the supply side has become so intense that renewed calls for protectionist measures have arisen. In the longer run, however, the member states would be doing a poor service both to themselves and to the countries in central and eastern Europe. The inevitable adjustment to the changed underlying conditions for the international division of labour not only makes the process of reconstruction easier for the countries in transition, but also benefits the established industrial countries. In this connection, those international organisations which are responsible for the economy and trade in global terms – IMF, WTO and OECD – are especially called upon to inform the public and to defend the free world economic system.

II. Economic trends in Germany and central bank policy

1. Slacker growth in Germany

Unexpectedly low increase in real gross domestic product

The German economy continued to grow in 1995 but the increase in real gross domestic product, at just under 2 %, slowed down distinctly compared with the previous year (almost 3 %), and – unlike in 1994 – remained somewhat below the simultaneous expansion of productive capacities, i.e. overall production potential. Both in western Germany and in the new Länder economic growth (at 1 ½ % and 5 ½ %, respectively) was substantially lower than expected after the start of the year. The cyclical slowdown was one of the reasons why employment declined again in Germany as a whole, albeit only slightly, and unemployment increased further in the course of the year. One of the positive features of the record for 1995 is that – fostered by the cyclical situation and relief on the external side – the German economy largely achieved the goal of price level stability.

Statistical database uncertain

As a result of several statistical changes, in particular the change-over of the industrial statistics to EC-consistent classifications at the beginning of the year (because of which, for example, the data on manufacturing output as well as other figures for this cyclical key sector are distorted), the national accounts statistics are subject to greater uncertainty than in preceding years. These changes, which led to considerable delays in the availability of major economic indicators from the beginning of 1995, made an assessment of the current macroeconomic situation much more difficult in the course of the year.

Causes of the slowdown in growth

One of the prime reasons for the deceleration of growth last year was, firstly, the considerable appreciation of the Deutsche Mark; this had a marked retarding effect on foreign demand for German industrial products, which was hampered anyway by the cyclical downturn in major partner countries in the course of 1995. All in all, exports of goods and services, in real terms, increased by barely 4 % in 1995; the rise was only half as large as in 1994 and as had been initially expected by some observers for last year. Secondly, the weaker economic growth was probably also associated with the comparatively high wage increases in the 1995 pay round. On average, the agreed rates of increase (on a monthly basis) came to about 4 % in western Germany (actual earnings per employee rose by just under 3 ½ %). In large parts of the east German economy, further steps to adjust earnings to the west German wage and salary levels came on top of the respective pay increases; the result was that compensation per employee went up by 6 ½ % and hourly earnings by an average of over 7 %. In conjunction with the consequences of the Deutsche Mark appreciation on the international and domestic markets, the sharp wage increases were largely responsible for the fact that, above all in the manufacturing sector, profit margins came under pressure in the course of the year, and profit expectations increasingly deteriorated, as is suggested by the ifo business survey.

Only a small rise in corporate investment

As the profit outlook dimmed, the initially expected further revival of corporate investment activity, which had begun to pick up towards the end of 1994 and which had promised to become an additional cyclical driving force in 1995, did not materialise. German enterprises spent only 2 % more on machinery, equipment and buildings than in 1994, and merely 1 ½ % more in real terms.

Investment in capacity extensions and rationalisation measures

Given the slower growth, which was reflected, among other things, in a declining degree of capacity utilisation in the manufacturing sector, enterprises had comparatively little cause to extend their production plant, i.e. to implement projects which are usually associated with construction measures. As a result, industrial construction investment presumably declined again in 1995, in real terms, at least in western Germany. Enterprises' expenditure on machinery and equipment, by contrast, was slightly higher than a year before. This may be seen as an indication of ongoing efforts, above all of industrial enterprises, to rationalise and modernise their production. These efforts, which, especially in western Germany, caused further job losses in the manufacturing sector, were prompted by the persistent wage cost pressures which were intensified further by last year's pay agreements.

Strong expansion of gross fixed assets in the east German corporate sector

At the beginning of 1995 the calculation of separate national accounts for western and eastern Germany was largely abandoned so that an accurate regional classification, inter alia, of corporate investment is no longer available. However, there is much to suggest that enterprises in the new Länder (still considerably fostered by government subsidies) again expanded their investment perceptibly, albeit to a lesser degree than in the years before. Consequently, the sharp expansion of gross fixed assets in the east German corporate sector continued, as is shown by the provisional data for the last few years calculated by the Federal Statistical Office. According to these data, the real capital stock of the enterprise sector (excluding housing) increased by just over one-quarter between 1991 and 1994, i.e. by an average of 8 ½ % per year; in

Key economic variables in Germany

Table 3

Item	1994	1995	1994	1995
			Change from previous year in %	
Growth (real) 1	DM billion			
Private consumption	1,698.1	1,726.2	+ 0.9	+ 1.7
Fixed capital formation	668.2	678.4	+ 4.3	+ 1.5
Machinery and equipment	251.6	256.6	– 1.2	+ 2.0
Construction	416.6	421.8	+ 7.8	+ 1.2
Domestic demand	2,979.6	3,029.1	+ 2.8	+ 1.7
Foreign balance 2	– 14.5	– 6.3	.	.
Exports	739.8	768.1	+ 7.5	+ 3.8
Imports	754.3	774.4	+ 7.1	+ 2.7
Gross domestic product	2,965.1	3,022.8	+ 2.9	+ 1.9
Western Germany	2,706.8	2,750.1	+ 2.4	+ 1.6
Eastern Germany	258.3	272.7	+ 8.5	+ 5.6
Employment	Millions			
Employed 3	35.0	34.9	– 0.7	– 0.3
	Thousands			
Unemployed	3,698.1	3,611.9	+ 8.2	– 2.3
Western Germany	2,556.0	2,564.9	+ 12.6	+ 0.3
Eastern Germany	1,142.0	1,047.0	– 0.6	– 8.3
do. as % of the total labour force	9.6	9.4	.	.
Western Germany	8.2	8.3	.	.
Eastern Germany	15.2	14.0	.	.
Prices	1991 = 100			
Cost-of-living index	112.8	114.8	+ 2.7	+ 1.8
Western Germany	110.6	112.5	+ 2.7	+ 1.7
Eastern Germany	130.0	132.7	+ 3.7	+ 2.1
Producer prices of industrial products 4	102.2	104.0	+ 0.6	+ 1.8
Overall construction price level	112.9	115.3	+ 2.0	+ 2.1
Import prices	96.9	97.3	+ 0.8	+ 0.4
GDP deflator	112.0	114.5	+ 2.3	+ 2.2
Value added and labour costs	Deutsche Mark			
GDP per employed person 5	94,980	99,230	+ 6.0	+ 4.5
Western Germany	103,770	108,350	+ 5.7	+ 4.4
Eastern Germany	55,040	58,710	+ 10.7	+ 6.7
Eastern Germany as % of western Germany	53.0	54.2	.	.
Gross compensation per employee 3	57,840	60,030	+ 3.3	+ 3.8
Western Germany	61,180	63,290	+ 2.8	+ 3.4
Eastern Germany	43,100	45,920	+ 7.1	+ 6.6
Eastern Germany as % of western Germany	70.4	72.6	.	.
Labour costs per unit of value added in the economy as a whole 6	0.61	0.60	– 2.6	– 0.7
Western Germany	0.59	0.58	– 2.8	– 0.9
Eastern Germany	0.78	0.78	– 3.3	– 0.1
Eastern Germany as % of western Germany	132.8	133.9	.	.

1 At 1991 prices. — **2** Balance of transactions in goods and services with the rest of the world. — **3** Work-place concept. — **4** Domestic sales. — **5** At current prices. — **6** Gross compensation per employee generated in Germany divided by nominal GDP per employed person. — The data from the national accounts and the figures on employed persons are provisional.

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1995 the corresponding volume of productive assets once again rose very sharply and, according to our estimates, might have reached DM 855 billion. Over the entire period from 1991 to 1995, it grew at more than three times the pace of the west German capital stock. In this context, it should be borne in mind that in the years following reunification an increasing proportion of the fixed assets inherited from the previous system proved to be obsolete and was withdrawn. This means at the same time that gross investment was far larger still than is indicated by the growth in the capital stock. The significance of this reconstruction is to be seen, above all, in the fact that, over and above the improvement in the current standard of living, production capacities have been created for the future which lay the foundations for further economic growth and an expansion of employment.

Structure of east German productive assets

The structure of east German gross fixed assets changed fundamentally in these years as a result. From the second half of 1990 up to and including 1995, real gross fixed capital formation in the corporate sector alone is estimated to have amounted to approximately DM 440 billion. The volume of investment since unification thus accounted for almost half of the entire east German productive assets in the corporate sector. The relevant ratio for western Germany is about one-quarter. This suggests that what is probably among the most modern capital stocks in Europe is being created in the east German Länder.

Sharp increase in capital intensity in the new Länder

The strong growth of east German productive assets was accompanied by an even sharper increase in capital intensity. To some extent, the steep rise in the capital input per job in the new Länder is a consequence of the high wage cost pressure resulting from the rapid adjustment of east German wages and salaries to the west German level; this stimulated the substitution of capital for labour and intensified the reduction in jobs over and above the decline in employment caused by the economic transformation process. In 1995 just over DM 170,000 of real capital, calculated at 1991 prices, was invested on average per job in the east German enterprise sector;[1] within four years capital intensity increased by nearly two-thirds, thereby climbing from 48 % to 67 % of the level in western Germany – a trend which (together with the reduction in employment) made a considerable contribution to the steep rise in productivity in the east German corporate sector.

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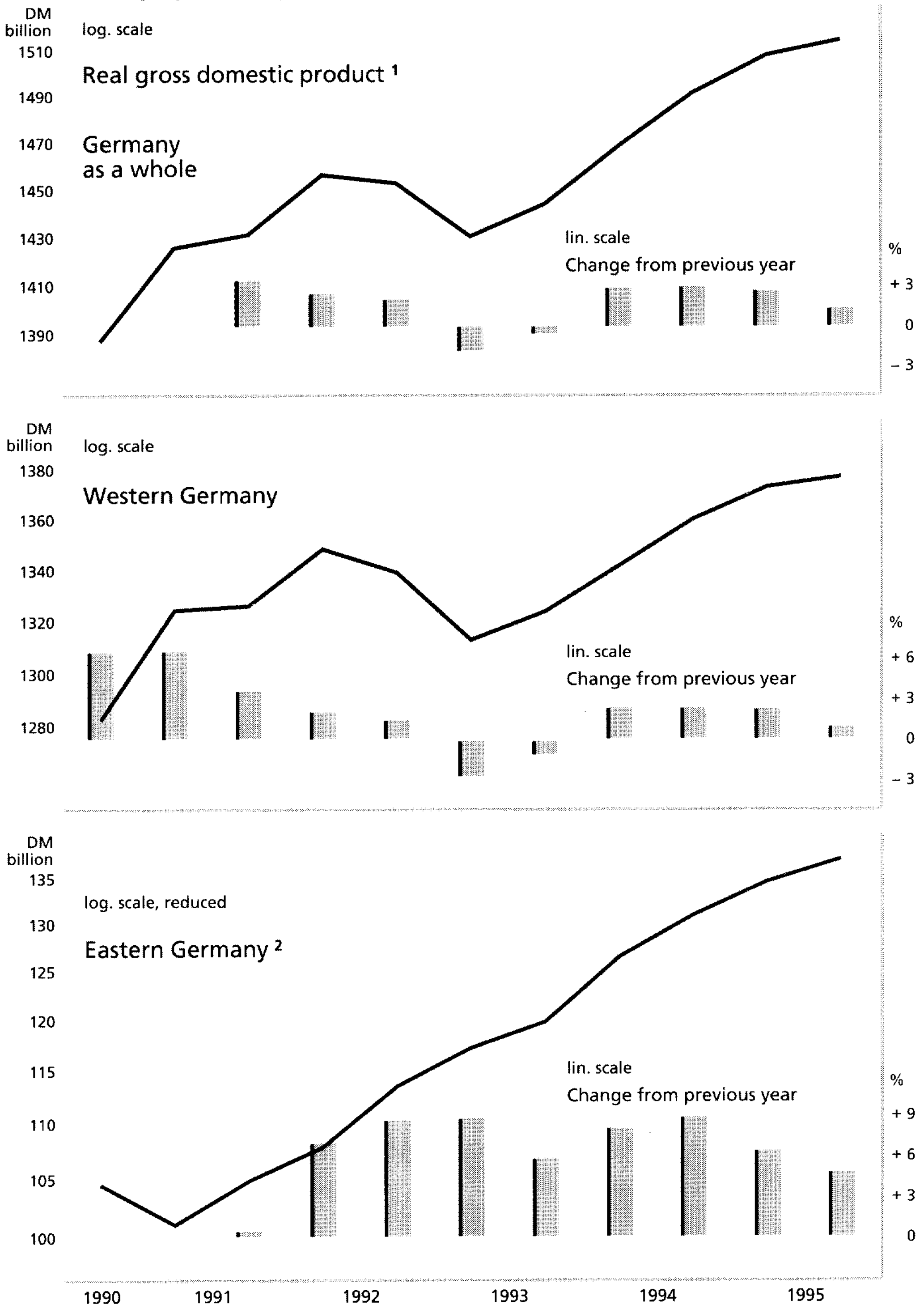
1 At current prices, the capital needed to create one job is estimated to amount to just under DM 200,000 and thus to almost twice as much as in 1991.

Economic growth in Germany

Chart 2

Seasonally adjusted, half-yearly



1 At 1991 prices. — 2 Seasonal adjustment subject to major uncertainty.

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East-west ratio of wages

The strength of the wage cost pressure in the east German economy is illustrated, among other things, by a comparison with the old Länder. With the further steps towards the adjustment of the east German wage level to that in western Germany, per capita compensation of employees in the new Länder reached 72 ½ % of the level in the old Länder (in net terms, wages and salaries per employee came to as much as 81 ½ %). In 1991 this ratio had been only 46 ½ % (and just under 55 %, respectively). Calculated per employed person, a nominal gross domestic product was generated in the new Länder in 1995 which corresponded to just over 54 ½ % of the west German level (against only 31 % four years earlier). As a result of the disparity between wage adjustment and the level of productivity, unit labour costs of overall production in the new Länder last year (as in 1994) were roughly one-third higher than in the western part of Germany (1991: 51 %).

Declining construction activity

Construction activity in Germany clearly lost momentum last year. In 1995 real construction investment, which had increased by nearly 8 % in 1994, merely rose by just over 1 %. Its contribution to the growth of gross domestic product was correspondingly lower: less than one-tenth of the rise in GDP last year resulted from the increase in construction investment, compared with over one-third in 1994. One of the main reasons for this was the changing trend in west German housing construction whose years of sharp expansion came to an end in 1995. Owing to the considerable backlog of demand, which had accumulated in earlier years and which was eliminated last year, the number of housing units completed in 1995 nevertheless again amounted to almost 500,000.

Housing provision . . .
. . . in western Germany

The declining trend in building permits (whose number lagged considerably behind that of completed units) suggests a marked reduction in new housing construction for the current year. This mirrors the fact that in 1995, following the increased housing construction efforts of the last few years, the provision of the west German population with dwellings – seen in the aggregate – more or less regained the level of 1987, in which the wave of immigrations began. This aggregate view conceals gaps in individual regions and in certain segments of the housing market between the demand for and the supply of housing as well as surpluses elsewhere.

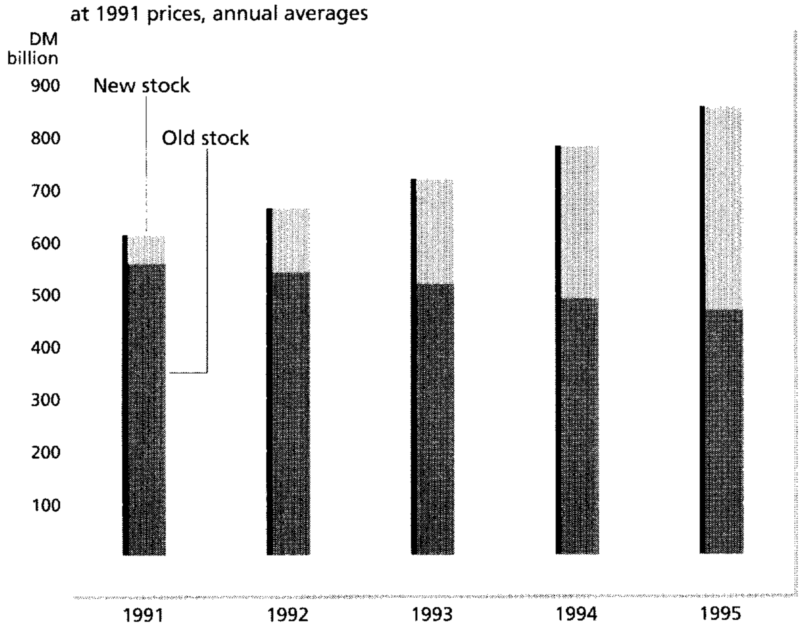
. . . in eastern Germany

In eastern Germany both housing construction demand and residential building activity increased further last year, though not as fast as before. The same applies to the number of completed housing units. In assessing residential construction activity account must be taken of the fact that in the new Länder –

Trend in and structure of east German gross fixed assets *

Chart 3

at 1991 prices, annual averages



* Enterprises excluding housing.

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again on an aggregate view – the supply situation is even slightly more favourable than in western Germany. However, apartments in eastern Germany are on average not only smaller but, above all, of much poorer quality than in the west; the restoration and modernisation of the stock of housing, which has been under way for some time and which accounts for a considerable proportion of residential construction investment, will therefore most likely be continued in the foreseeable future and will require corresponding resources in the construction industry.

Industrial and public construction investment

All in all, real housing construction investment in 1995 rose by 3 % in Germany as a whole. Compared with 1994 (+ 13 %), this was a significant decline which – contrary to expectations at the beginning of the year – was not partly offset by a greater increase in industrial and public construction investment. The former grew more slowly than in 1994, and the latter actually decreased.

Private consumption

Private consumption proved to be relatively robust in 1995, although German households' purchasing power was diminished at the beginning of the year by the renewed levy of the solidarity surcharge and by the contributions to the new nursing insurance scheme. In 1995, as in 1994, households expanded their consumption expenditure by 3 ½ %; thanks to the advances achieved in price stability, the real growth, at 1 ½ %, was, however, higher than a year earlier. Demand for passenger cars (of which 3 ½ % more were newly licensed) was particularly high. By contrast, other retail purchases on the whole scarcely reached their previous year's level, according to the partial information available. In 1995, too, consumption patterns probably shifted further towards those goods which are not marketed through the retail trade. In the past five years their share in private consumption in western Germany is likely to have risen by more than 5 percentage points to over 60 %. Rents continued to increase sharply, mainly because of the greater supply of apartments in new buildings. Distinctly more than in 1994 was also spent on domestic services.

Households' income

The income trend in 1995 was marked by varying tendencies. Total gross wages and salaries rose by 3 % in the wake of the high pay rate increases. However, after deduction of social security contributions and taxes (which went up sharply owing to the new solidarity surcharge), the net increase was only ½ %. On the other hand, current transfers to households from public cash offices grew much more, inter alia on account of the high pension adjustment rate in eastern Germany. Including property income and private withdrawals from entrepreneurial income (which grew sharply), German households' disposable income increased by 3 ½ % over the year and by 2 % after allowing for the perceptibly lower rate of inflation. The trends in income and consumption expenditure were thus largely parallel.

Saving

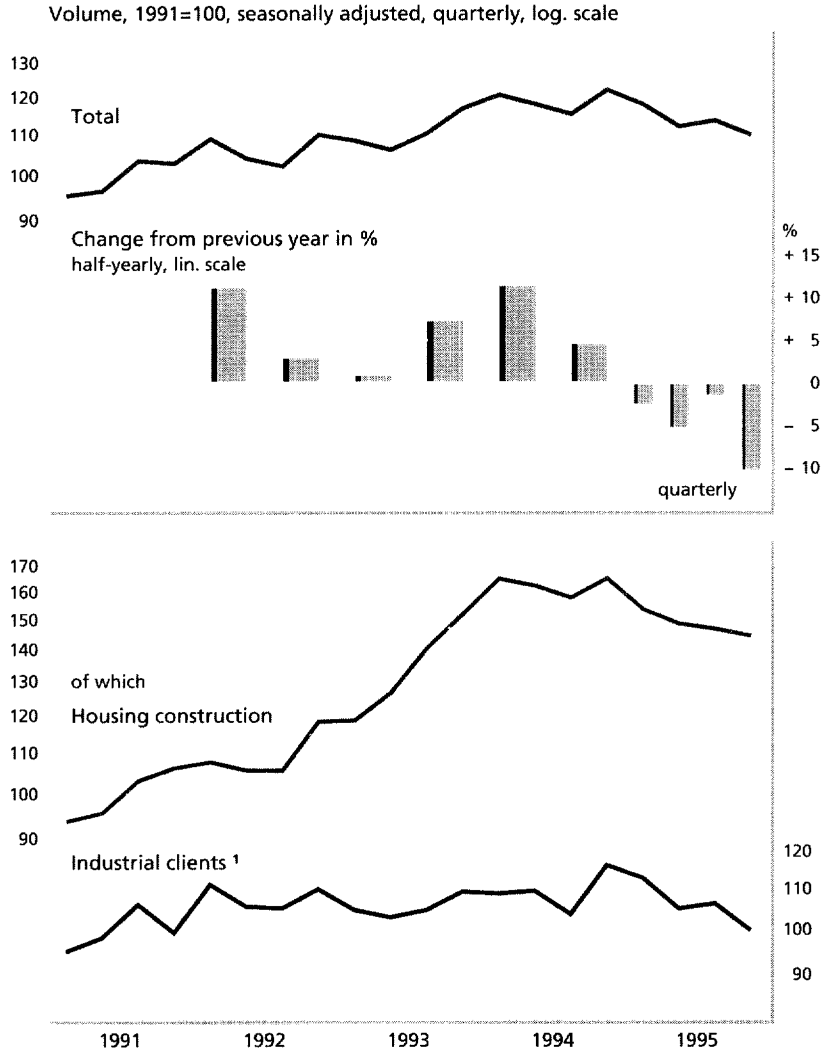
Unlike in earlier years, the saving ratio did not decline further in 1995; it amounted to just under 12 ½ %.

Forms of investment

As far as the acquisition of financial assets is concerned, the weights shifted, in the wake of the sharp decline in capital market yields and the associated growing risk potential, from securities purchases to various forms of bank saving which are free from price risks and bear comparatively favourable interest. Special saving programmes were particularly popular, and there was also a demand for savings bonds, on balance, after sizeable volumes of such paper had matured in the preceding years. These shifts in emphasis were, moreover, reinforced by transfers between the various forms of investment with banks at the expense, for instance, of time deposits and the traditional savings deposits. All in all, the accumulation of private cash balances in 1995 amounted to as much as about one-third of private financial asset acquisition.

Orders received by construction

Chart 4



1 Including railways and post office.

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Worsened situation on the labour market

The situation on the German labour market deteriorated significantly in the course of last year. On the one hand, this was no doubt associated with the deceleration of growth; on the other, however, there are manifold structural causes whose effects become particularly apparent in cyclical phases such as that in 1995. These include not least the high labour cost in Germany and the lack of flexibility in labour input. The results of the 1995 pay round raised rather than lowered these hurdles.

Employment and unemployment on an annual average in 1995

On average in 1995, the number of employed in Germany as a whole declined once again by 95,000 (or 0.3 %) to 34.86 million. However, the decrease was initially confined to the old Länder, whereas in eastern Germany employment increased on an annual average but stagnated in the second half of the year. Taking eastern and western Germany together, unemployment, like employment, fell on an annual average by about 85,000 persons to 3.61 million (or 9.4 % of the total labour force). The supply of labour (the sum of employed and unemployed persons) consequently declined again last year. On balance, more persons temporarily or permanently withdrew from the labour force than were integrated into it. This shows that the link between employment and unemployment is by no means as simple as is sometimes assumed in the public debate. An increase in the number of employed is, for instance, not always more or less automatically accompanied by a corresponding reduction in unemployment as the supply of labour responds flexibly to a growing demand for labour.

Unemployment at the end of 1995

The deterioration of the situation on the German labour market is vividly illustrated by a comparison of the number of unemployed at the end of last year with the corresponding level a year earlier. After adjustment for seasonal fluctuations, the labour exchanges registered 3.81 million unemployed persons in Germany as a whole at the end of December 1995, or 230,000 more than a year previously.

Rise in unemployment at the start of 1996

In the first few months of 1996 unemployment increased further, both in western and in eastern Germany. A major reason for this in the new Länder is the reduction of labour market policy measures. In March 1996 235,000 persons were participating in further training and qualification courses, while 265,000 persons were employed under job-creation schemes; in total, this meant a decline of 85,000 against March 1995; at the same time, the number of unemployed, at 1.27 million, exceeded its previous year's level by 210,000.

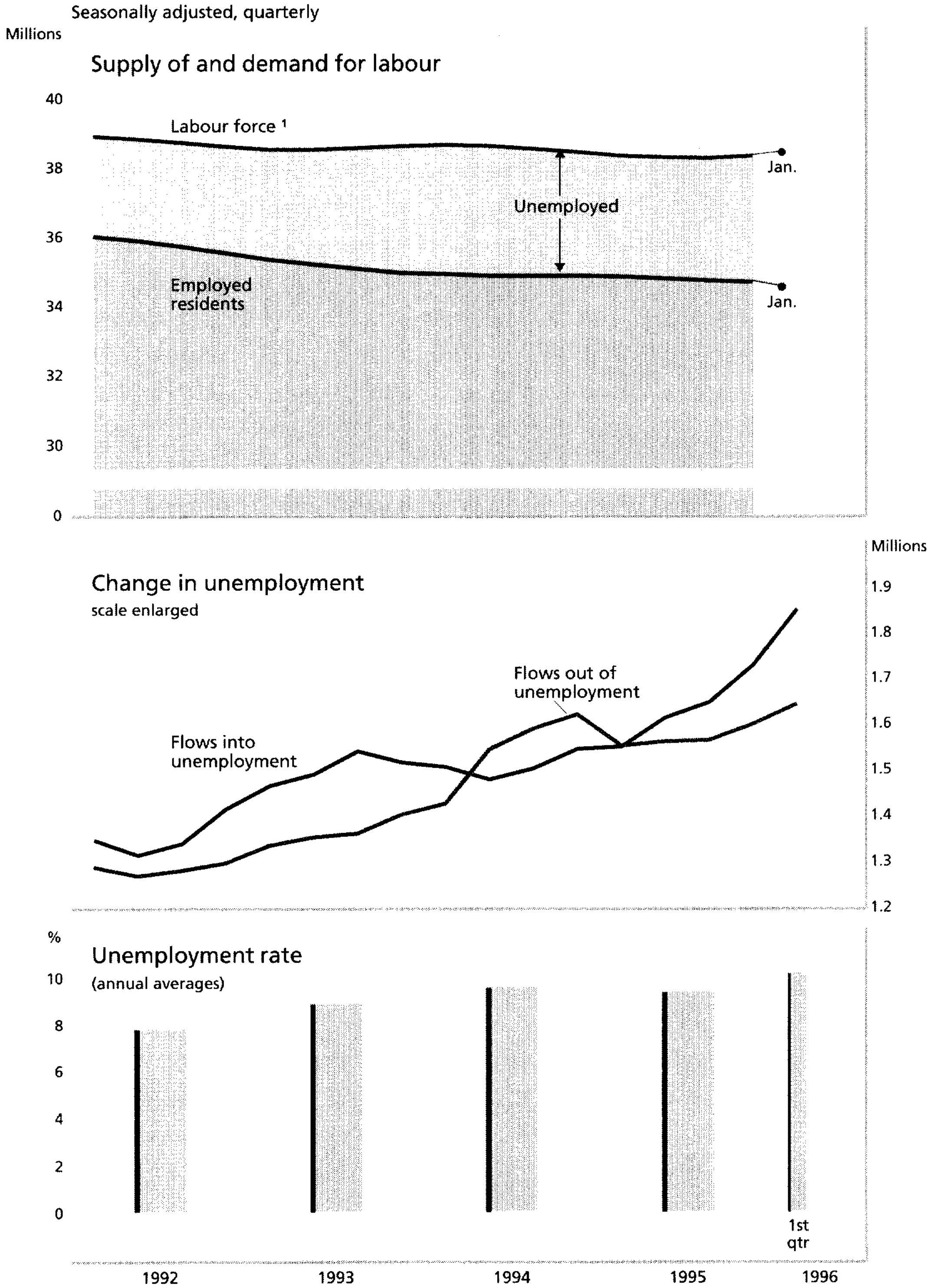
Labour market flows

The growing number of unemployed are by no means only persons who have lost their jobs. Roughly 44 % of all newly registered unemployed were not employed immediately prior to their registration. The significance of this group of persons, which in the mid-eighties accounted only for about one-third of all new registrations and which includes a disproportionate number of women, has thus continued to grow right up to the present. It is a reflection of the continuously increasing willingness to work among large parts of the population. Of the 56 % of newly registered unemployed who had been employed before, about two-fifths had worked in the producing sector – a share which distinctly

Labour market

Chart 5

Seasonally adjusted, quarterly



1 Calculated as the sum total of employed and unemployed.

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exceeds the weight of this sector in the total number of employed and therefore points to the kernel of the employment problem.

Flows into unemployment

In 1995 the number of newly unemployed persons rose by 7 ½ % to 6 ½ million. At the same time, however, the average duration of unemployment decreased to just under 29 ½ weeks, approximately 6 ½ % less than a year earlier. More than 6 million persons terminated their unemployment. As in the years before, some of them probably retired either after having reached pensionable age or prematurely, or stopped looking for a job, at least temporarily. Others – a fairly high proportion – found a new job. In the course of the year as many as 3.2 million vacancies were registered with the labour exchanges, or 2 ½ % more than in 1994. At the end of December 1995 the labour exchanges still registered a seasonally adjusted total of roughly 305,000 unfilled jobs. Past experience suggests that the real number of vacancies is much higher; last year it probably ranged between ½ and ¾ million. Compared with the high number of unemployed, too, this ratio was considerable, pointing to one of several causes of unemployment, namely the manifold differences in the structure of demand and supply on the labour market.

Placements

Over 3 million job-seekers found work in 1995 with the help of the Federal Labour Office, 75 % of them longer-term employment. Nearly half of the persons placed had been unemployed beforehand. In the old Länder this share came to only 37 %, however, while it was almost 80 % in eastern Germany. One reason for this was that nearly half of the new jobs were supported by employment-creating measures.

Long-term unemployment

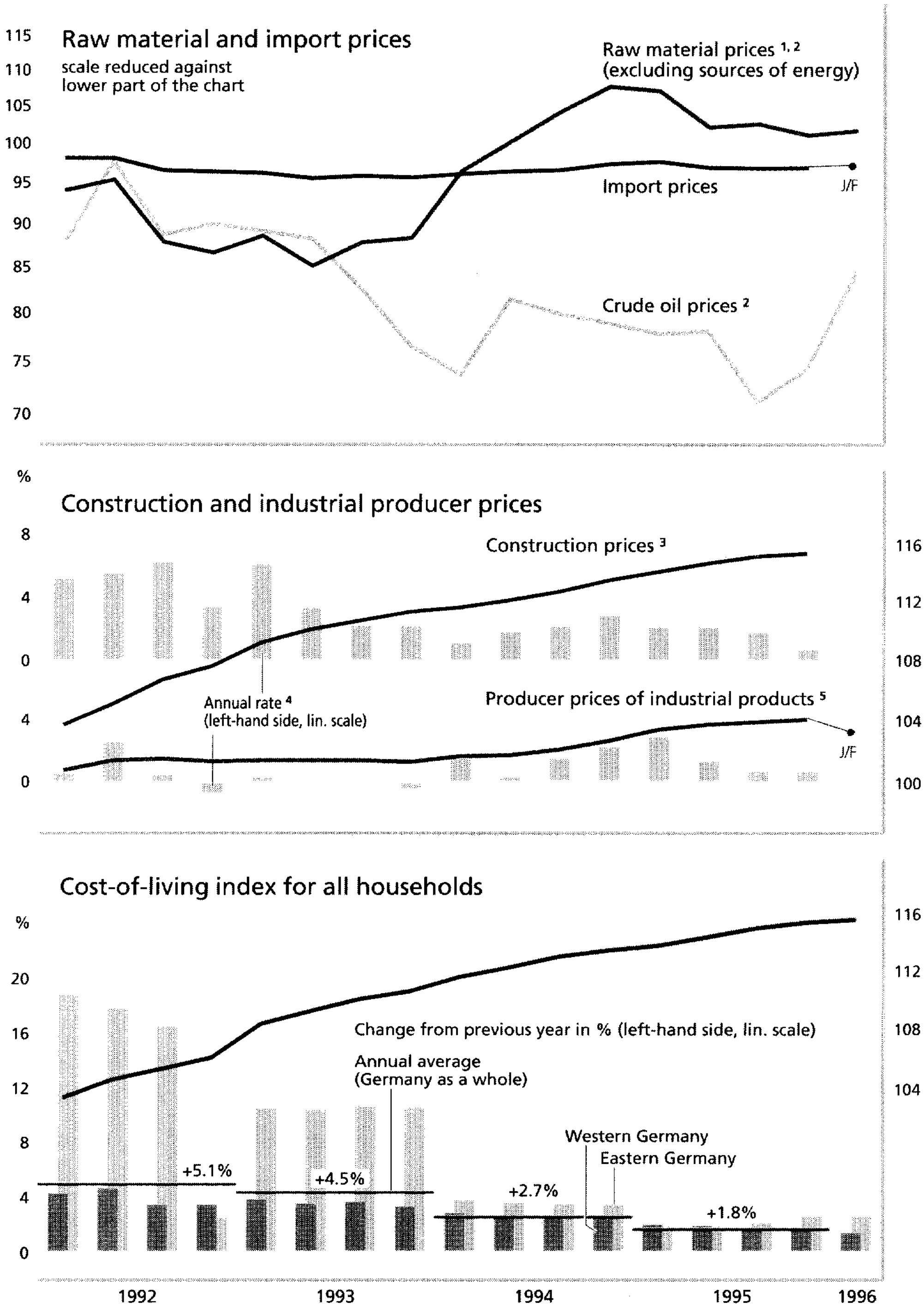
Although labour market policy makers seek to counter long-term unemployment and unemployment among older employees through special labour cost subsidies, the number of unemployed persons in these categories increased further in 1995. On an annual average no fewer than 1.14 million members of the labour force were without jobs for one year and longer, and roughly ¾ million of them were at least 55 years old. To this must be added more than 150,000 employees aged 58 or older who are no longer counted as being unemployed as they no longer wish to be placed.

Relaxed price climate

In 1995 the stabilisation of the price level made considerable headway at all stages, inter alia because of the cyclical downturn in the second half of 1995 and the price-curbing effects on the external side. The cost of living for the German consumer increased by 1.8 % on an average of last year against 1994, Prices

Chart 6

1991=100, seasonally adjusted, quarterly, log. scale



1 HWWA index of raw material prices; DM basis. — 2 Not seasonally adjusted. — 3 Calculated by the Bundesbank. — 4 Seasonally adjusted change from previous quarter, expressed as an annual rate. — 5 Domestic sales.

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and in the first quarter of 1996 the year-on-year rate of increase was only 1.6 %. The upward thrust of prices slackened for all major components of private consumption in 1995. Price movements were particularly favourable in respect of energy, industrial products and food. The rise in the prices of services was still above average; besides the sharp wage increases, this owes something to the fact that the charges for transportation services were raised at a faster pace.

Rents

In 1995 rents grew more slowly than in the years before. The wave of rent increases, which started in western Germany with a certain time-lag after the beginning of the surge in immigration, is gradually abating, not least under the impact of the high level of housing provision now achieved. However, sharp increases in ancillary charges and levies, in particular, are continuing to push up the cost of accommodation. In eastern Germany a further step was taken in mid-1995 towards the adjustment of rents to the west German comparative rent system and thus to the real cost of rented dwellings; as a result, the level of rents in the new Länder in the first quarter of 1996 was 9.5 % higher than a year earlier, and the overall consumer price level was 2.6 % up on the year, compared with 1.4 % in western Germany.

Price movements at the primary and intermediate levels

In the course of the year external factors had stabilising effects on the domestic price climate. The steep rise in dollar quotations on the international commodity and energy markets, which is indicated, for instance, by the HWWA index for the first half of 1995, gave way to a decline in the second half of the year. An additional factor was the strong appreciation of the German currency against the US dollar. On an average last year, raw materials and energy, taken together, were 2 ½ % cheaper (calculated in Deutsche Mark) than a year before. This greatly curbed the increase in the import price level, which exceeded the 1994 level by only ½ %.

Industrial producer prices

At the industrial producer level, the external influences likewise had a price-dampening effect. On the one hand, these influences reduced the cost burden of industrial firms by way of cheaper imported intermediate goods. On the other, they led to fiercer competition from foreign suppliers on the domestic markets, too, which reduced the scope for price increases to an ever-greater extent, especially in view of the cyclical downturn towards the end of last year. On an average last year, west German industrial producer prices (domestic sales) were 1.7 % up on the year, and at the end of last year the rate of increase was 1.1 %. After the abolition of the "coal penny" levy on electricity bills, the producer price level in February 1996 was as much as 0.3 % below the preceding year's figure. The movement of construction prices, for example, shows that the advances are not only due to external influences but that the price climate has relaxed in general. In November last year (later information is not available) construction work in Germany was only 1.7 % more expensive than a year earlier.

Economic prospects for the current year

Export business, on the demand side, and wage settlements in this year's pay round, on the supply side, will play a crucial role in cyclical developments this year. The preconditions for an improvement in foreign demand are quite favourable. According to the forecasts of international organisations, world trade will continue to rise sharply in 1996, too, though not quite as strongly as last year. The significant appreciation of the Deutsche Mark has meanwhile declined perceptibly from its peak in March 1995. Furthermore, as a result of its rationalisation and modernisation efforts, the German export industry has successfully improved its competitiveness. Around the turn of 1995-6 the export orders received by the manufacturing sector increased distinctly, seasonally adjusted; in January-February they exceeded the level of the last quarter of 1995 by 3 % in terms of volume. Domestic orders, by contrast, continued to decline, with the result that the overall order position in German industry tended to deteriorate further. Nevertheless, the aforementioned rise in foreign demand is at least a ray of hope; whether this implies a sustained reversal in export business remains to be seen.

Hope of a more favourable consumption climate

Private consumption, too, might likewise become a mainstay of economic activity following the income tax cut which came into force at the beginning of the year and which, even after it has been netted with the increase in social security contributions, benefited households, mainly in the lower income brackets. However, when this Report went to press, there was hardly any information on the trend in consumption after the turn of the year; for example, there have been no data on retail sales since the beginning of the year. The seasonally adjusted number of new car registrations increased in January-February 1996 compared with the last quarter of 1995; it exceeded the comparable level a year earlier by 11 %.

Initial results of the 1996 wage round

The current macroeconomic situation and the unfavourable conditions on the labour market were clearly reflected in the wage settlements reached so far in the 1996 pay round. For instance, wages and salaries in the west German textile and clothing industry – a sector which is undergoing a particularly severe structural crisis – will, as a rule, be increased by 1.5 % on May 1 and June 1, respectively;

in addition, the agreement (which is limited to one year) includes a whole series of measures (including the option to defer the pay rate adjustment for one year) which will contribute to rendering working time and labour costs more flexible, i.e. ultimately to preserving jobs. Negotiated wages and salaries in the chemical industry in western Germany were raised by 2 % from March 1; according to the pay agreement (with a duration of likewise one year), 25,000 new jobs are to be created in this economic sector within one year. The most recent pay agreement (which is also valid for one year) for the construction sector provides for an increase in pay rates of 1.85 % which in western Germany will come into force retroactively as from April 1. In eastern Germany this increase will not become effective until September 1, but wages there will be additionally raised on October 1 by a further adjustment from 92 % to 95 % of west German basic pay.

Revival in the second half of the year somewhat more likely

All in all, the prospect of a revival in the German economy in the course of the second half of this year has become more likely of late. However, owing to the "bad start" to the current year caused by the long cold winter, only moderate economic growth is to be expected on an annual average, even in these favourable circumstances.

2. Public finance influenced by consolidation requirements

(a) Trends in 1995

Further steps to overcome financial burdens of German unification

The burdens arising from unification finally made their full impact on public sector budgets last year after the expiry of transitional regulations. The accumulated debt of the Treuhand agency and part of the liabilities of the east German housing sector were assumed by the Redemption Fund for Inherited Liabilities, established as a new special fund of the Federal Government; as a result, the level of government debt shot up dramatically.[1] In addition, the revised revenue-sharing scheme came into force at the beginning of 1995, whereas up to 1994 the east German regional and local authorities had received transfers from the "German Unity" Fund. Substantial resources were rechannelled to the new Länder in order to put their budgeting on a sounder basis. Moreover, the Federal Consolidation Programme, which was adopted in 1993 to regulate the burdens inherited from the GDR regime and the new revenue-sharing scheme,

1 By contrast, the liabilities of the Debt-Processing Fund, which were also assumed by the Redemption Fund for Inherited Liabilities, were part of public debt from the outset.

Public sector finance*

Table 4

Item	1993 pe	1994 pe	1995 pe	1993 pe	1994 pe	1995 pe
	DM billion			Change from previous year in %		
Central, regional and local authorities						
Expenditure						
Expenditure on personnel	340	359.5	369.5	+ 4.5	+ 6	+ 3
Other operating expenditure	157.5	159	158	+ 2.5	+ 1	– 0.5
Transfers [1]	335.5	346.5	359	+ 11.5	+ 3.5	[8] + 3
Interest paid	102.5	114	129	+ 1.5	+ 11.5	+ 13
Fixed capital expenditure	103.5	99	95.5	– 3.5	– 4	– 3.5
Financial aid [2]	82	82	82	+ 0.5	+ 0.5	– 0.5
Total expenditure [3]	1,121	1,159	1,195.5	+ 5	+ 3.5	+ 3
of which						
Federal Government [4]	462	478.5	489.5	+ 7	+ 3.5	+ 2.5
West German Länder Governments [5]	368.5	374	388	+ 4.5	+ 1.5	+ 3.5
East German Länder Governments	96	100	105.5	+ 9	+ 4	+ 6
West German local authorities	261.5	264.5	268	+ 4.5	+ 1	+ 1
East German local authorities	67.5	67.5	68.5	+ 4	– 0.5	[8] – 0.5
EC [6]	37	41	40	+ 7.5	+ 11	– 2
Receipts						
Tax revenue	749.1	786.2	814	+ 2.4	+ 4.9	+ 3.5
Other receipts	236.5	272.5	273	+ 3.5	+ 15	+ 0.5
Total receipts [3]	989.5	1,054.5	1,085	+ 3	+ 6.5	+ 3
of which						
Federal Government [4, 7]	401	439	439	+ 0.5	+ 9.5	– 0
West German Länder Governments [5]	342	347	354	+ 2	+ 1.5	+ 2
East German Länder Governments	80.5	83.5	92.5	+ 6.5	+ 4	+ 11
West German local authorities	252.5	259	255.5	+ 4.5	+ 2.5	– 1.5
East German local authorities	63	61.5	66.5	+ 10	– 2.5	[8] + 5.5
EC	37	41	40	+ 7.5	+ 11	– 2
Deficit (–)	– 132	– 105	– 110.5	.	.	.
of which						
Federal Government	– 61	– 39.5	– 50.5	.	.	.
West German Länder Governments [5]	– 26.5	– 27	– 34	.	.	.
East German Länder Governments	– 16	– 16.5	– 13	.	.	.
West German local authorities	– 9.5	– 5.5	– 12.5	.	.	.
East German local authorities	– 4.5	– 5.5	– 2	.	.	.
"German Unity" Fund	– 13.5	– 3	+ 2.5	.	.	.
Debt-Processing Fund	.	.	+ 7.5	.	.	.
ERP Special Fund	– 1.5	– 2	– 2.5	.	.	.
Federal Railways Fund	.	– 5.5	– 7	.	.	.
Social security funds						
Expenditure	669	705	754.5	+ 6.5	+ 5.5	+ 7
Receipts	672.5	706	743	+ 8.5	+ 5	+ 5.5
Surplus (+) or deficit (–)	+ 3.5	+ 0.5	– 11.5	.	.	
Public sector, total						
Expenditure	1,692.5	1,770.5	1,857.5	+ 4.5	+ 4.5	+ 5
Receipts	1,564	1,666.5	1,735.5	+ 4	+ 6.5	+ 4
Deficit (–)	– 128.5	– 104	– 122	.	.	.
Memo item						
Deficit of the Treuhand agency	– 38	[9] – 37	.	.	.	.

* As defined in the financial statistics; including hospitals keeping commercial accounts, and other special accounts. — **1** Mainly social expenditure and current grants to the corporate sector. — **2** Expenditure on investment grants and loans to third parties, plus the acquisition of participating interests. — **3** Including differences in clearing operations. — **4** The supplementary Federal grants are included here on a gross basis. — **5** Including Berlin. — **6** EC expenditure financed out of EC revenue in Germany. — **7** Up to 1994 the Bundesbank's profit transfer is included in full in the figure; for 1995, the figure includes the amount of DM 7 billion provided for in the budget. The amount in excess of this was booked as revenue of the Redemption Fund for Inherited Liabilities. — **8** Adjusted for the inclusion of Landeswohlfahrtsverband Sachsen (charitable association of the state of Saxony), which was covered for the first time in 1995. — **9** Including the transfers to the Debt-Processing Fund which are not provided for in the budget.

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envisaged tax increases from the beginning of 1995, particularly in the form of a "solidarity surcharge" on income taxes, to help cope with the additional financial burdens. According to the announcements of the coalition government, this surcharge is to be phased out as soon as possible.

Course of financial policy

Medium-term financial planning is basically geared towards achieving consolidation through a sustained retrenchment of expenditure growth, as the altogether very heavy burden of taxes and social security contributions impairs prospects for economic growth and employment. After retrenchment efforts had been intensified in 1994, this course was continued in the budget for 1995; however, considerably increased interest expenditure – particularly owing to the assumption of the debt burden – had to be accepted.

Budgeting burdened by unexpectedly low tax revenue

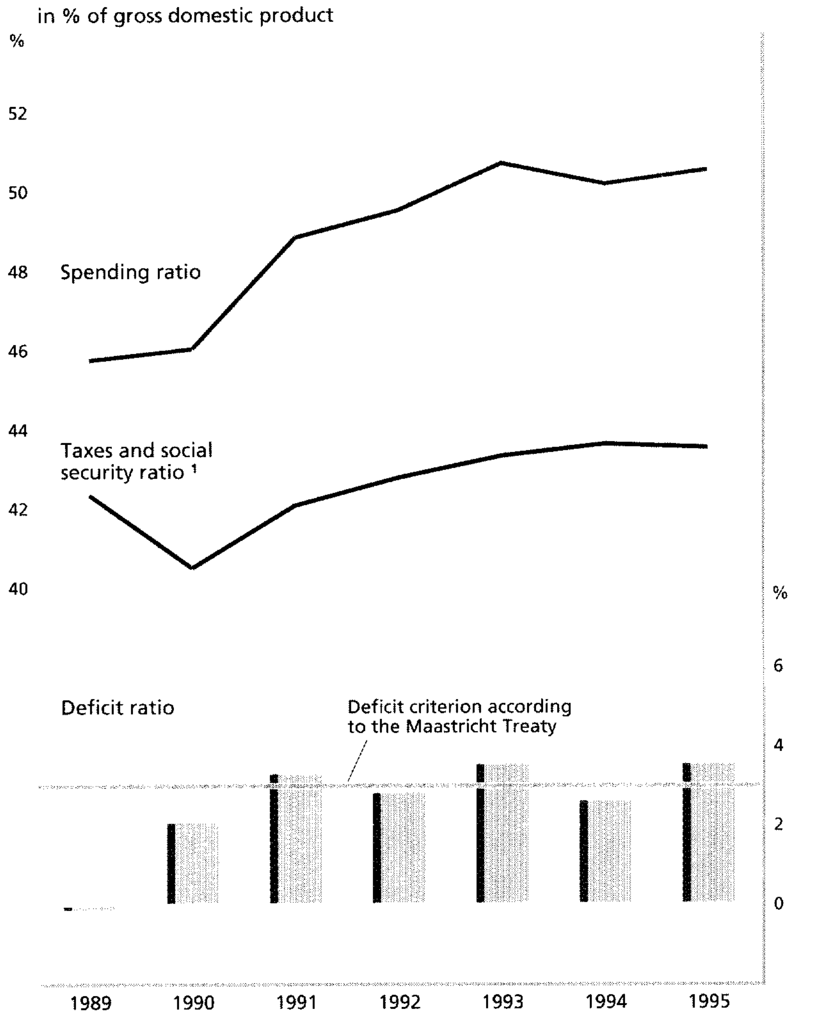
In view of this financial policy course and the originally favourable cyclical expectations, there was initially some prospect of the budget deficit of the central, regional and local authorities decreasing somewhat in 1995. However, in the course of the year the trend in tax revenue turned out to be very disappointing. Compared with 1994, it grew by no more than 3 ½ %, and was thus just over DM 35 billion lower than in the official tax estimate of November 1994. This was partly due to the cyclical slowdown, but it owed more to the fact that the 1992/93 recession had unexpectedly strong after-effects on assessed taxes and that the numerous tax-related concessions – particularly on investment in eastern Germany and on housebuilding – were utilised to a larger extent than previously assumed. This shows that frequent intervention in tax legislation and uncertainty about the extent to which this changes behaviour substantially increase the "margin of error" allowed for in tax estimates.

Burdens not fully offset

Owing to the massive shortfall in tax revenue since the summer, the central, regional and local authorities were put under additional pressure to act. Restrictive measures were widely imposed on current expenditure. Although the shortfall in revenue could be largely offset by these measures and by the fact that in some sectors expenditure was lower than expected while non-tax receipts were higher, the budget deficit of the central, regional and local authorities in 1995, at DM 110 ½ billion, ultimately overshot the level reached a year previously by DM 5 ½ billion. In addition, the social security institutions incurred a deficit of just over DM 11 billion, whereas in 1994 they had been in balance. The position of the health insurance institutions and the pension insurance institutions deteriorated considerably. On the one hand, expenditure increased sharply and, on

Ratios of public sector budgets *

Chart 7



* As defined in the national accounts. From 1991, including the new Länder. — 1 Taxes and social security contributions; the other revenue of the public sector budgets is not included here (1995: 3.4% of GDP).

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the other hand, the growth in revenue from contributions was adversely affected by the decline in employment.

Public deficit larger than expected

The deficit of all public sector budgets, at DM 122 billion, exceeded the level reached in 1994 by DM 18 billion. Trends in public finance as reflected in the national accounts are even more unfavourable, in a year-on-year comparison, than the budget figures, particularly since privatisation proceeds – which rose considerably last year – are not regarded as revenue in the national accounts. According to the provisional figures provided by the

Federal Statistical Office in March, the public deficit increased from 2.6 % of gross domestic product in 1994 to 3.5 % in 1995. This means that, contrary to the initial expectations, Germany failed last year to comply with the convergence criterion on deficits laid down in the Maastricht Treaty (maximum of 3 % of GDP). While it has to be borne in mind when assessing trends in public finance in 1995 that the deficit of the Treuhand agency, which is "quasi-government" but in statistical terms is allocated to the corporate sector, ceased to exist when the Treuhand agency was dissolved, this simply means that, on an overall view, the public sector deficit up to 1994 was larger than shown in the statistics; it does not affect the current need for consolidation. The need to reduce the deficit is also reflected in the fact that at the end of 1995 the level of public debt, at DM 2,007 billion, or 58 % of GDP, came close to the debt level criterion laid down in the Maastricht Treaty (maximum of 60 % of GDP).

Expenditure

Last year the expenditure of the central, regional and local authorities rose by 3 %, and thus ½ percentage point less than a year before. If interest expenditure is excluded, the increase amounted to 2 %; in this context, funds for investment were considerably limited. In the field of social security, expenditure continued to grow quite steeply, however (by 7 %). The public spending ratio (according to the national accounts) increased in 1995 by almost ½ percentage point to 50.6 % of gross domestic product.

Taxes and social security ratio

The overall taxes and social security ratio (taxes and social security contributions as defined in the national accounts), at 43.6 % of GDP, persisted more or less at the high level reached in 1994.[1] In spite of the increased burden on income arising from the "solidarity surcharge", the tax ratio decreased somewhat. This owed much to the fact that – as mentioned above – the unfavourable assessment result for earlier years and the increased utilisation of tax concessions had an adverse effect on revenue.

Federal budget and special funds

In 1995 the Federal budget incurred a deficit of DM 50 ½ billion. It was only slightly larger than planned, since the DM 16 ½ billion shortfall in estimated tax revenue was offset by an increase in revenue from other sources and by considerably lower expenditure, particularly on interest and transfers to the successor organisations of the Treuhand agency. In a year-on-year comparison, the deficit

1 In 1995 overall public sector revenue came to 47 % of GDP; it not only includes taxes and social security contributions but also receipts from investment and transfers.

Indebtedness of the central, regional and local authorities Table 5

DM billion

Item	1994	1995 pe	1994	1995 pe
	Level at end of year		Change from previous year	
Borrowers' note loans	677.2	808	+ 73.6	+ 131
Securities	896.2	1,084.5	+ 78.5	+ 188
Other debt	88.8	102.5	+ 0.9	+ 13.5
Total indebtedness	1,662.1	5 1,995	+ 153.0	6 + 333
Federal Government	712.5	757	+ 27.2	+ 44.5
West German Länder Governments	415.1	442.5	+ 21.5	+ 27.5
East German Länder Governments	55.7	69	+ 15.5	+ 13.5
West German local authorities 1	155.7	162.5	+ 6.5	+ 6.5
East German local authorities 1	32.5	35.5	+ 8.2	+ 3
"German Unity" Fund	89.2	87	+ 1.5	– 2
Debt-Processing Fund 2, 3	102.4	.	+ 1.2	– 102.4
ERP Special Fund	28.0	34	– 0.2	+ 6
Federal Railways Fund	71.2	78.5	+ 71.2	+ 7
Redemption Fund for Inherited Liabilities 3	.	329	.	+ 329
Memo item				
Treuhand agency 3, 4	204.6	.	+ 36.3	– 204.6

1 Including municipal special-purpose associations. — 2 Including the hitherto assumed liabilities to the Currency Equalisation Fund. — 3 At the beginning of 1995 the debt of the Debt-Processing Fund and the Treuhand agency was transferred to the Redemption Fund for Inherited Liabilities. — 4 Including assumption of old loans and liabilities arising from equalisation claims of enterprises. — 5 In the definition relevant for compliance with the EMU convergence criterion, the indebtedness comes to DM 2,007 billion. — 6 The increase in the debt level is higher than the net borrowing for financing the deficits (DM 99 billion), since it includes the assumption of the debt of the Treuhand agency and of old loans.

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persisted at the level reached in 1994. However, the result for 1994 appears in a more favourable light if the total amount of the Bundesbank profit, viz. DM 18 billion – instead of only the basic amount of DM 7 billion provided for in the budget – is regarded as Federal revenue. Considered from that angle, the deficit of the Federal Government rose by DM 11 billion, compared with 1994. In 1995 the Bundesbank's profit transfer decreased to just over DM 10 billion. Of that amount, DM 7 billion was entered again in the Federal budget, and just over DM 3 billion flowed direct to the Redemption Fund for Inherited Liabilities, thus increasing the latter's revenue (arising from Federal transfers to the tune of 7 ½ % of the fund's liabilities). This new fund achieved a surplus of revenue over interest expenditure totalling DM 7 ½ billion, which was also enlarged by the decline in interest rates and which was used to repay debt. For the rest, the "German Unity" Fund reduced its debt, which is serviced by resources from the Federal Government and the Länder Governments, for the first time in 1995; it therefore recorded a surplus of DM 2 ½ billion, compared with a deficit of DM 3 billion in 1994. The Federal Railways Fund and the ERP Special Fund incurred deficits totalling DM 7 billion and DM 2 ½ billion, respectively, which was somewhat less favourable than in 1994.

Länder Governments and local authorities

According to provisional figures, the west German Länder budgets (excluding that of Berlin) in 1995 incurred a deficit which, at DM 23 billion, was DM 4 billion higher than a year before, although the growth in expenditure (excluding the payments to the east German Länder Governments made under the new revenue-sharing scheme) was cut back to a rate of 1 ½ %. The west German local authorities' deficit was actually more than twice as high (at DM 12 ½ billion), in spite of the fact that expenditure had risen by no more than 1 %. In view of the decreasing flow of revenue and the still substantial increase in burdens, particularly social assistance payments, the local authorities were forced to step up their retrenchment efforts; thus, investment expenditure, which had already been reduced in 1994, decreased further. Although the deficit in the budgets of the new Länder decreased by DM 3 ½ billion to DM 13 billion and funding provisions had been considerably increased through the new revenue-sharing scheme, the financial situation still failed to improve materially. On the one hand, eastern Germany also incurred tax losses. On the other hand, expenditure – particularly owing to the growth in expenditure on personnel – grew quite steeply (by 6 %), even if the budgeted figures were undershot here as well. By contrast, the expenditure of the east German local authorities remained virtually the same as in 1994, despite structural changes which were similar to those in western Germany. Although the deficit, compared with last year, decreased by DM 4 billion (to DM 2 billion), the financial situation remained quite difficult in many areas. A particular problem arose from the extremely strained budget situation of Berlin where the deficit expanded once again by DM 2 ½ billion to DM 10 ½ billion. While revenue declined, expenditure rose by just over 4 %.

Social security institutions

In respect of the statutory pension insurance institutions, there had been plans from the outset to run down the reserves in 1995 to the statutorily prescribed minimum volume of one month's expenditure and to reduce the contribution rate by 0.6 percentage point; however, the deficit, at DM 10 ½ billion, was higher than planned. This was mainly attributable to cyclically-induced shortfalls in contributions and a sharp increase in the number of early retirement pensions. The deficit increased by DM 8 ½ billion compared with 1994. In the case of the statutory health insurance institutions, the surplus of DM 2 billion in 1994 was replaced by a deficit of DM 7 billion in 1995. By contrast, the deficit of the Federal Labour Office (covered by Federal grants), at just under DM 7 billion, was slightly over DM 3 billion lower than a year before. Increased spending on unemployment benefit, vocational training schemes and job creation measures was offset by the sharp decline in expenditure associated with the early retirement scheme in eastern Germany. The newly created nursing insurance scheme made a considerable surplus (of DM 5 ½ billion) in its inaugural period, but this will not last.

(b) Outlook for 1996 and further prospects

Increased retrenchment efforts in view of marginal growth in tax revenue

When preparing the 1996 budget plans, the central, regional and local authorities had to come to terms with considerable additional burdens arising from decisions of the Federal Constitutional Court. The exemption of subsistence incomes from income tax had to be regulated and the tax equalisation of family burdens improved by the beginning of 1996. The 1996 Annual Tax Act, which also streamlined the tax-related promotion measures for eastern Germany and simultaneously extended the period of entitlement, will result in revenue losses estimated at DM 21 billion in 1996. In addition, the "coal penny" levy, which had been used to subsidise the use of coal for generating electricity, was abolished. Taken together, this resulted in cuts in levies of approximately DM 30 billion. Thus, there was considerable pressure to retrench from the outset in order to avoid a setback in respect of the budget consolidation, which is indispensable over the medium term. In view of the fact that tax revenue was lagging behind expectations, additional means of compensation had to be found in the course of the budget deliberations. In October the official tax estimate put the result for 1996 almost DM 30 billion lower than in May; in a year-on-year comparison, tax revenue was expected to grow by no more than 1 %. As a result, the original plans were considerably revised.

Federal Government budget plans

The Federal budget adopted in November closed a financial gap of almost DM 20 billion (tax losses totalling DM 13 billion, additional labour-market-induced expenditure totalling DM 6 ½ billion) that had not been taken into account in the budget draft of July. The funds for this came, in particular, from the additional provision of privatisation proceeds in the budgets (just under DM 9 billion) and the cuts in the existing expenditure appropriations (DM 7 ½ billion, notably as a result of lower interest expenditure and of transfers to the successor organisations of the Treuhand agency and to the Redemption Fund for Inherited Liabilities). In view of a decline in expenditure of 1.4 %, compared with the amount planned for 1995 (adjusted to account for the revision of the child benefit system), the final plans, like the draft, provide for a deficit of DM 60 billion. Although it would thus be higher than in 1995, this is offset by the fact that the deficit of the Federal Railways Fund will cease to apply; new borrowing by this special fund was admissible up to the end of 1995 only. The fact that the originally planned deficit of the Federal Government is not to be overshot emphasises the significance of consolidation for budgetary policy. However, some of the measures will bring relief only in 1996.

Budget plans of the Länder Governments

The budget plans of the Länder Governments in both the east and the west have been marked by efforts to make small reductions in the deficits through retrenchments despite the weak flow in revenue. On an average, the estimated expenditure overshot the 1995 result by about 2 %, if it is adjusted to allow for special factors (particularly the regionalisation of the local passenger transport system and the revision of the child benefit system). According to the survey conducted by the local authority central associations, the local governments, too, are endeavouring to reduce their large deficits somewhat by continuing to cut back on expenditure – particularly regarding investment.

Risks in respect of tax revenue

According to the 1996 budgets, the deficit of the central, regional and local authorities will be about as high as in 1995, on balance. However, there are signs of other risks that will endanger the implementation of the plans. For example, tax revenue in 1995 turned out to be DM 6 billion below the revenue estimated last October. In addition, in its Annual Economic Report, the Federal Government has estimated that economic growth in 1996 will be weaker than the rate predicted last autumn, and thus will also affect tax receipts and labour-market-induced expenditure.

Strict retrenchment course

In view of the very tight budget situation, the central, regional and local authorities will have to utilise any retrenchment possibilities which still exist in the course of the year. The Federal Minister of Finance has emphasised that the deficit of the Federal Government is to be kept within the limits planned. In mid-March 1996 he imposed a "budget freeze"; accordingly, significant expenditure of individual government departments cannot be effected without his approval. Both the necessity to comply with the fiscal criteria laid down in the Maastricht Treaty and the consolidation requirements over and above these criteria argue against tolerating larger deficits simply to encourage demand for cyclical reasons, especially as some major macro-economic conditions have nourished hopes that the break in growth will be overcome in the course of this year. Apart from moderate wage and salary agreements, this presupposes *inter alia* that confidence in the ability of German fiscal policy makers to exercise strict discipline is strengthened as this confidence is necessary for ensuring a favourable economic outlook.

Social security institutions

Nevertheless, there are prospects of a reduction in the social security deficit in 1996. However, this will be accompanied by increases in contributions. Thus, the contribution rate in respect of the pension insurance institutions was raised by 0.6 percentage point at the beginning of 1996, and another increase is to be expected for 1997. Owing to cyclically-induced shortfalls in contributions, it is likely that, contrary to original expectations, the institutions will once again incur a deficit, but this will probably not be quite as high as in 1995. The statutory health insurance institutions cannot tolerate another massive deficit either. On the one hand, an Act on the Stabilisation of Hospital Expenditure was adopted this year. On the other hand, some health insurance institutions have already raised contribution rates. In respect of the nursing insurance scheme, there will be additional expenditure in the field of in-patient nursing care, owing to the fact that payments will presumably be made from mid-1996 onwards, and the contribution rate will rise from 1.0 % to 1.7 %. All in all, social security contributions are expected to reach about 41 % of eligible income in mid-1996. It is estimated that the increase in contribution rates will bring in a further DM 20 billion or so in 1996.

Total burden of levies

Hence, the burden of levies will be eased considerably less, on balance, than would have been possible on the basis of the tax cuts alone. Nevertheless, the overall tax and social security ratio will presumably decline somewhat in the current year; owing to the change in levies, the resources available to households will probably be improved by about ½ percentage point, on balance.

Budget for 1997

The budget for the coming year will have to be based on the necessity of achieving perceptible progress in terms of consolidation and of complying with the requirements set by the fiscal policy convergence criteria for entry into the third stage of economic and monetary union (EMU). The reduction in the solidarity surcharge (from 7.5 % to 5.5 %, as of July 1, 1997) decided by the Federal Government in the context of the "programme of action for investment and employment" in January 1996, together with the legal implications of the ruling of the Federal Constitutional Court on property taxation, make it all the more necessary to step up retrenchment efforts. In addition, the Federal Government's taxation plans for 1997 include the continuation of the corporate tax reform originally envisaged for 1996 (abolition of the trading capital tax and reduction of the trade earnings tax, to the benefit of small and medium-sized enterprises); this is to be effected in a way which leaves revenue unaffected, although the matter of appropriate compensation has not yet been settled. In addition, it is imperative to limit the financial burdens in important areas of social policy. Legislation is currently being drafted for the future framework for the statutory health insurance institutions and for a revision of the social assistance and unemployment assistance schemes; so far the Bundestag and the Bundesrat have not come to an agreement in this area. A revision of the Work Promotion Act is being prepared by the Federal Government.

Medium-term objectives

Over the medium term, too, German fiscal policy makers will be faced with some very thorny problems. The Federal Government set several targets with its concept of "symmetrical fiscal policy" submitted in June 1995. By the year 2000, the public sector spending ratio is to be reduced to the level reached before German unification (46 % of GDP). The resulting leeway is to be used to reduce the deficit (to 1 % of GDP) and to cut taxes. That would reduce the deficit to an order of magnitude which, according to the "stability pact for Europe" proposed by the Federal Government in November, is to serve as a guideline for normal economic situations in the third stage of EMU. Admittedly, in view of the fact that since the summer of last year the state of German public finance has become less favourable, the realisation of the medium-term concept presupposes that efforts are stepped up.

Need to reduce tax burden

Apart from the limiting of new public borrowing, reducing the heavy tax burden is particularly important for fostering growth in Germany as an industrial location – not least with respect to the international competitiveness of domestic production. The Federal Government plans another income tax reform for the year 2000; in addition, according to its "action programme", overall contributions to the social security institutions are to be reduced again to less than 40 % of eligible income; this, however, requires other measures which still have to be defined more closely. In view of the high social security contributions, which also seriously affect labour costs, social security benefits cannot be exempted from the review in order to identify potential savings in respect of public sector expenditure. In this context, it is imperative, on the one hand, to remove disincentives to work, and, on the other hand, to strengthen investment propensity.

Continuation of the pension reform

It is of particular importance, in continuing with the pension reform of 1992, to ensure the financeability of the pension insurance scheme over the long term in view of the foreseeable demographic trends. If further measures were taken at an early stage, this would counteract concern about the economy being burdened to an ever increasing extent by social security contributions, and the risk of having to effect all the more drastic changes later would be precluded; at the same time, the insured would be in a better position to assess the need for appropriate additional provision for old age. The revision of pensions in the event of unemployment and partial pensions in the case of part-time work of older persons (planned in accordance with the Federal Government's draft bill of March) will counteract, over both the medium and long term, the excessive utilisation of the pension insurance system for early retirement measures; however, this revision can be no more than a single component of an overall concept for restraining the tendency to increase contribution rates and the Federal grant to the pension insurance institutions financed through tax resources.

3. Economic relations with the rest of the world influenced by currency turbulence and sluggish global growth

Slide of the dollar . . .

External relations last year were characterised by pronounced shifts in the international currency pattern. The Mexican crisis in the autumn of 1994, which had resulted in growing pressure being exerted on the dollar, was one of the main causes of this. Despite repeated purchases by various central banks, including, at times, the Bundesbank, to support the dollar, the US currency had fallen to an all-time low of DM 1.36 by the middle of April; that was equivalent to an appreciation of the Deutsche Mark of 14 % during the first three and a half months of last year. It is likely that the structural weaknesses in the US Federal budget and the adoption at times of harder attitudes in the trade conflict with Japan played an important role here.

. . . and some European currencies

Some European currencies also lost heavily against the Deutsche Mark in the wake of the weakening dollar. The Italian lira, in particular, came under pressure as a result of the persistent lack of political and economic policy orientation, and by April it had fallen to a historic low of DM 0.80 to L 1,000. The slide of the pound sterling was of similar proportions. The British currency weakened for a time as a result of the advanced cyclical upswing in the United Kingdom and the self-perpetuating fears about inflation. At its peak in mid-April the Deutsche Mark was being quoted 20 % and 10 % higher against the Italian lira and the pound sterling, respectively, than at the beginning of the year. At 7 % and 3 ½ %, respectively, the devaluations of the Spanish peseta and the Portuguese escudo were less pronounced but nevertheless noteworthy; these devaluations were part of a realignment of exchange rates within the European Monetary System, which took place on March 6, 1995 at the request of the two countries concerned. Finally, during the spring of last year the French franc also went through a period of weakness associated with the presidential election in France and the consequent uncertainty about France's future economic policy course.

Change of sentiment and of policy . . .

After the currency turbulence in the spring and an ensuing period of relatively high exchange rate volatility at the level reached, the situation in the foreign exchange markets eased perceptibly from the summer onwards. Quite apart from the growing conviction of market participants that the extent of the exchange rate losses was hardly justifiable given the trend in the relevant fundamentals, the announcement of measures to consolidate the US Federal budget over the medium term was evidently just as instrumental as another more optimistic assessment of the economic situation in the United States, which was underpinned by a simultaneous change in US interest rate policy. Finally, the trade agreement reached in the summer between the United States and Japan helped to ease the tense relationship between the dollar and the yen. Nevertheless, the markets continued to focus their attention on the high exchange rate level of the yen and the disadvantages that this entailed for the Japanese economy after the crisis in the Japanese financial system also worsened.

. . . in the case of the dollar . . .

Although the dollar had risen again to almost DM 1.50 by the autumn, it was unable to maintain this level during the rest of the year. Renewed uncertainty about developments in Mexico and in the US budget dispute caused the currency to slide again to under DM 1.39 towards the end of October. However, less favourable news about economic trends in Germany and in Europe soon gave the US currency a fresh impetus to rise above this level. Nevertheless, the relationship between the dollar and the Deutsche Mark remained susceptible to disturbance during the ensuing period. Since the autumn of 1995 the exchange rate of the dollar has been ranging between DM 1.39 and just over DM 1.50; by the time this Report went to press, the US currency was being quoted at DM 1.51.

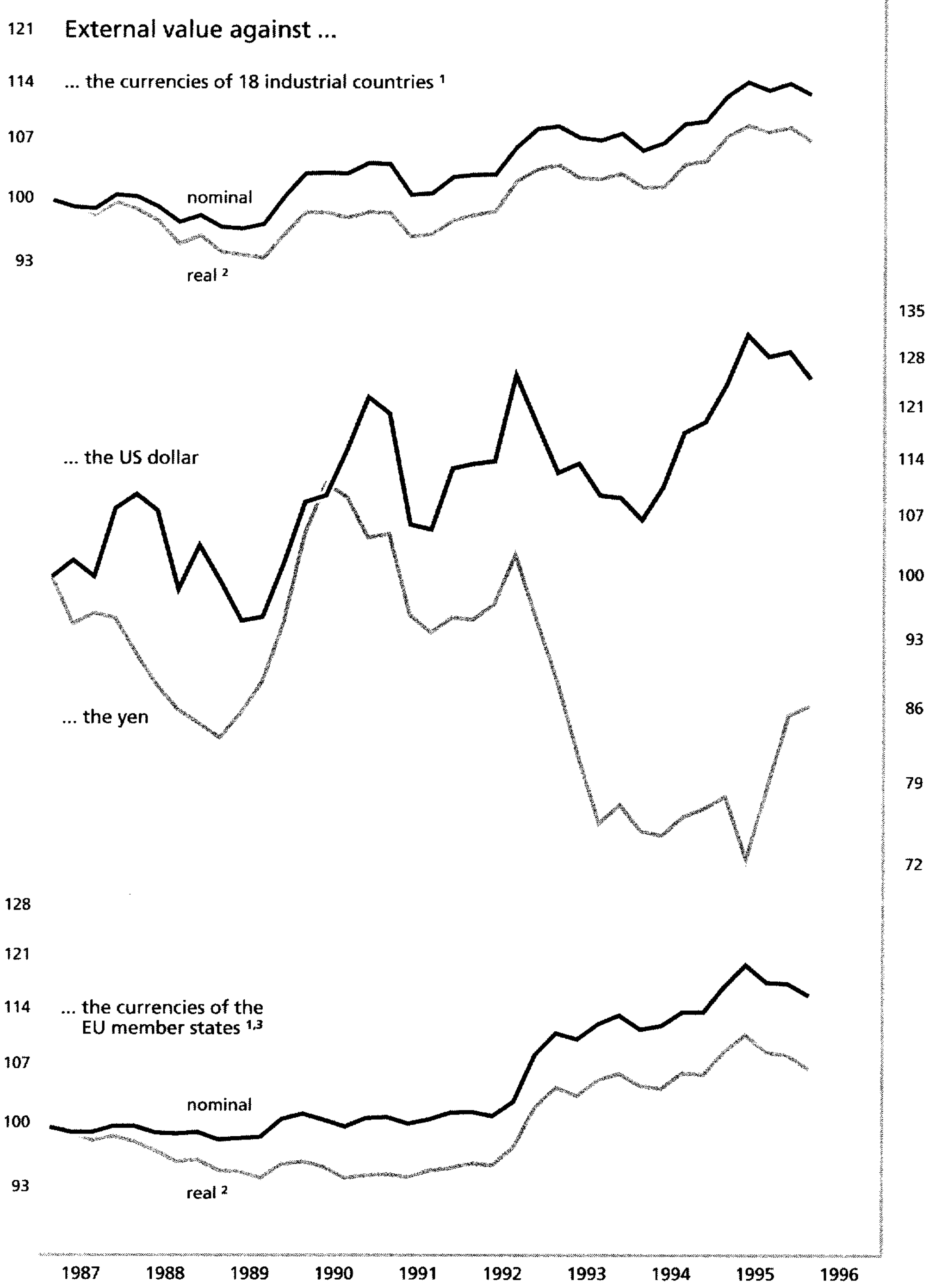
. . . and the European currencies

With the change of mood in the world's foreign exchange markets the exchange relationships within Europe have also relaxed discernibly since the summer. The change in rates against the Italian lira has been particularly striking since investors became somewhat more confident again about Italian policy makers' ability to act. The relationship to the pound sterling has also returned more or less to normal. The Spanish peseta has likewise regained considerable

External value of the Deutsche Mark

Chart 8

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). — **3** Including the Austrian schilling, the Swedish krona and the Finnish markka.

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ground; after last year's devaluation it was actually decidedly firm for a time around the turn of 1995-6. And the French franc, which had come under some pressure towards the end of 1995 in connection with the internal political debate and the strikes over the government's fiscal and social policy stance, has likewise firmed again. Overall, the appreciation of the Deutsche Mark against the other European currencies in the spring of 1995 has been largely reversed; the weighted external value of the Deutsche Mark against the other EU currencies recently barely exceeded its level at the end of 1994.

Burden on international competitiveness

Generally speaking, the appreciation of the Deutsche Mark against the currencies of the 18 major industrial countries since the beginning of 1995, which reached a peak of 6 % during the currency turmoil last year, had declined to 1 ½ % by the time this Report went to press. After the elimination of the different price trends in Germany and in its partner countries, there is actually a slight depreciation of ½ % in real terms. The other burdens on Germany's international competitiveness are admittedly greater than this figure seems to suggest. If a somewhat longer-term comparison is made from the beginning of 1994, the real appreciation of the Deutsche Mark is almost 5 ½ %.

Share of export markets falls . . .

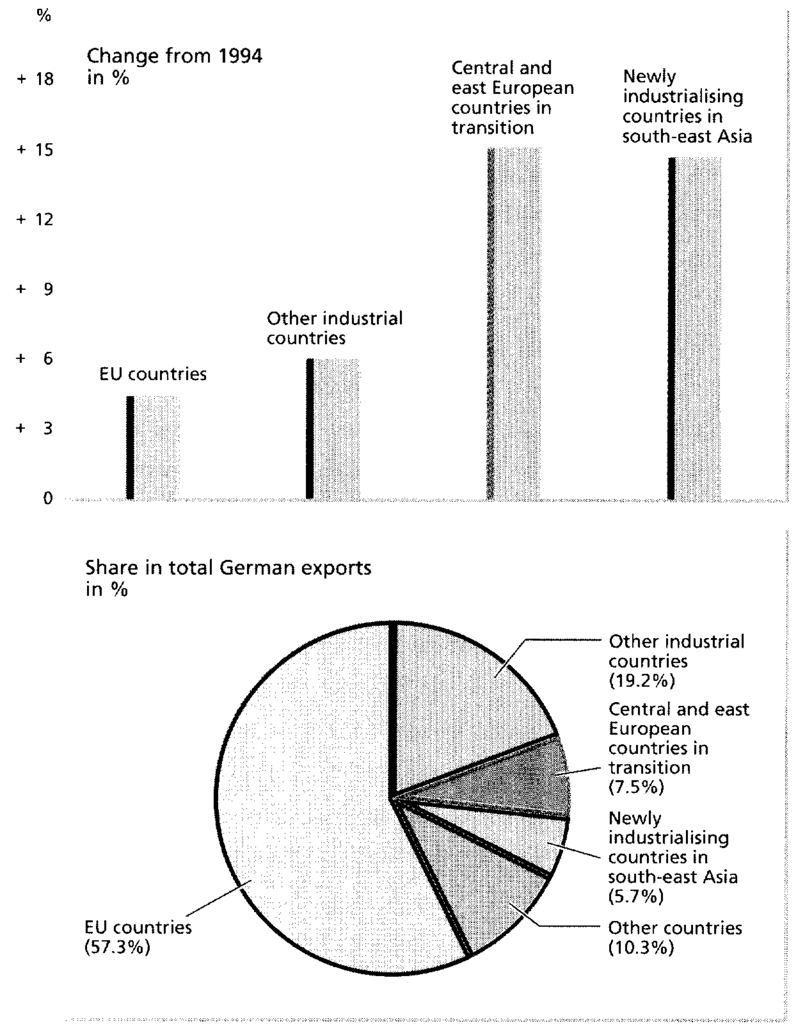
After the export successes of 1994 foreign business became more difficult for German trade and industry last year. It is true that, owing to the number of orders on hand, the disadvantages associated with the appreciation of the Deutsche Mark are not immediately reflected in a corresponding downturn in export deliveries. However, in terms of the growth in real world trade, which international organisations calculate to be in the region of 8 ½ % in 1995, German exporters recorded significant losses in market shares. At all events, the rise in the exports of German goods was considerably lower. In terms of value, the growth rate amounted to 5 ½ %, but when the simultaneous increase in export prices is taken into consideration, real exports probably rose by no more than 4 %.

. . . but appreciable regional differences

This is a reflection not only of the – for a time – considerable burdens which the appreciation of the Deutsche Mark had on the price competitiveness of German exporters and which was aggravated from the cost side by the large pay rises in the spring of last year. To a large extent it also reflects the slowdown in economic growth in Germany's traditional export markets. On the other hand, German exporters recorded double-digit growth rates in the newly industrialising countries in south-east Asia and in the countries in transition in central and eastern Europe, which benefited from the shift in the world's economic growth impetus. However, the corresponding share of Ger-

German exports by region in 1995 *

Chart 9



* January to November 1995.

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man exports attributable to these countries is still relatively low, despite the considerable increases over the past few years.

Restrained growth in imports

The growth in German imports of goods was even more restrained than that in exports last year; imports rose by just under 3 % in 1995 compared with an increase of 9 % in the previous year. While the appreciation of the Deutsche Mark tended to enhance the price competitiveness of foreign suppliers, the overall trend in imports in 1995 was determined by the downturn in domestic demand which was accompanied by a correspondingly lower need for raw materials and primary products as well as a lower demand for finished capital and consumer goods. Nevertheless, suppliers in some countries whose currencies were depreciating fairly sharply against the Deutsche Mark achieved above-average sales on the German market as a result of their more favourable competitive position.

Current account deficit lower

As a result of the relatively low demand for imports and, at the same time, the appreciation-related decline in import prices compared with export prices (improvement in the terms of trade), Germany's foreign trade surplus in 1995 rose appreciably by DM 18 billion to DM 98 billion (on an f.o.b. / f.o.b. basis).[1] However, Germany's traditional deficit on invisibles also increased again on the whole. Substantial profits from foreign direct investment in Germany were a particularly important contributory factor; they reflect the favourable cyclical situation in 1994. On the other hand, interest payments to non-residents, which had been a severe burden on Germany's investment income account in previous years, tended to be more stable.[2] This applies even more to the trend in German net expenditure on foreign travel. Much the same as in the case of the terms of trade "gains" in merchandise transactions, this is at least partly a reflection of the lower cost of travel to numerous holiday countries as a result of the appreciation of the Deutsche Mark. Owing to the uncertainty over income and the greater risks to employment, consumers may also have been somewhat more reluctant to travel abroad recently. Overall, Germany's current account deficit declined in 1995 by DM 10 billion to DM 25 billion.

Significant improvement in external conditions since reunification

The degree of external economic adjustment achieved since German reunification, however, is not adequately reflected in this. A number of additional difficulties which have been burdening Germany's current account since the beginning of the nineties conceal the progress and improvements made in Germany's foreign trade position at the same time. After all, no later than the fifth year after reunification Germany can again achieve in this area the same

1 In line with international practice, the freight and insurance costs payable on imports are included under services in this calculation.

2 Various factors (such as portfolio transactions through foreign banks, transfers by German investors of safe custody accounts abroad) have made the statistical recording of financial transactions and investment income in the German balance of payments more difficult during the past few years. Where possible, attempts have been made to eliminate the resultant distortions by estimates. Nevertheless, the figures on investment income and portfolio transactions are subject to greater uncertainty than in previous years.

Balance of payments

Table 6

DM billion

Item	1992	1993 1	1994 1	1995 1
I. Current account	– 33.5	– 26.9	– 34.4	– 24.9
1. Goods	+ 41.4	+ 65.7	+ 80.0	+ 98.0
Exports (f.o.b.) 2	671.6	632.7	696.0	732.6
Imports (f.o.b.) 2	630.2	567.0	616.0	634.6
2. Services	– 42.5	– 52.1	– 61.2	– 62.9
of which				
Foreign travel	– 39.9	– 44.9	– 49.7	– 50.5
3. Factor income	+ 22.5	+ 17.8	+ 8.2	– 2.0
of which				
Investment income	+ 26.3	+ 22.6	+ 12.9	+ 2.4
4. Current transfers	– 54.9	– 58.3	– 61.4	– 58.0
of which				
Net contributions to the EC budget 3	– 24.7	– 26.7	– 31.0	– 29.1
Other official current transfers to non-residents (net)	– 13.6	– 14.2	– 12.7	– 10.8
II. Capital transfers	+ 0.9	+ 0.8	+ 0.3	– 0.9
III. Financial account (capital exports: –)	+ 92.2	+ 13.4	+ 59.0	+ 55.8
1. Direct investment	– 26.3	– 22.4	– 25.9	– 37.1
2. Portfolio investment 4	+ 46.9	+ 182.4	– 43.9	+ 41.8
Equities	– 5.8	+ 0.3	– 11.0	+ 0.7
Investment fund certificates	– 61.0	– 14.7	– 17.3	– 2.4
Bonds and notes	+ 113.2	+ 198.0	– 6.3	+ 58.6
German investment abroad (increase: –)	– 7.7	– 12.5	– 27.4	– 24.3
Foreign investment in Germany (increase: +)	+ 121.0	+ 210.5	+ 21.1	+ 82.8
Other portfolio investment 5	+ 0.5	– 1.2	– 9.3	– 15.1
3. Credit transactions 4	+ 74.4	– 144.0	+ 130.6	+ 55.5
Credit institutions	+ 81.0	– 87.6	+ 141.7	+ 43.3
Long-term	+ 13.9	+ 12.0	+ 15.9	+ 39.8
Short-term	+ 67.1	– 99.7	+ 125.8	+ 3.6
Enterprises and individuals	+ 5.4	– 51.1	– 17.6	+ 17.5
Public authorities	– 12.1	– 5.3	+ 6.5	– 5.4
4. Other investment	– 2.8	– 2.6	– 1.7	– 4.3
IV. Balance of unclassifiable transactions	+ 9.1	– 23.0	– 12.7	– 12.3
V. Change in the Bundesbank's net external assets at transaction values (increase: +) 6, 7	+ 68.7	– 35.8	+ 12.2	+ 17.8
Memorandum item				
Change in the Bundesbank's net external assets at balance sheet rates (increase: +) 7, 8	+ 62.4	– 34.2	+ 8.6	+ 15.1

1 Figures subject to major uncertainty owing to changes in the method of data collection in foreign trade. — **2** Special trade, according to the official foreign trade statistics, including supplementary trade items; imports excluding freight and sea transport insurance costs, which are included under services. — **3** Excluding collection expenses, EAGGF (Guidance Fund) and Regional Fund. — **4** Excluding direct investment. — **5** Money market instruments, warrants and the balance of other payments in financial derivatives. — **6** Excluding SDR allocation and changes due to valuation adjustments. — **7** From March 1993 to March 1995 including the Treasury discount paper (liquidity paper) held by non-residents during that period. — **8** Including SDR allocation and changes due to the end-of-year revaluation.

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level of success that it had enjoyed in the years prior to reunification. Whereas the surplus on Germany's foreign trade had shrunk by over DM 100 billion to no more than DM 30 billion (on an f.o.b. / f.o.b. basis) between 1989 and 1991, a surplus of almost DM 100 billion was achieved through merchandise transactions in 1995. In addition, Germany, despite the substantial "unification burdens" which it has had to overcome since the beginning of the nineties, had increased at the same time the unilateral net transfers that it makes annually to non-residents from approximately DM 37 billion before German unification by DM 20 billion to DM 58 billion by 1995. Payments to the EC rose in particular, and therefore represent a discernible burden on Germany's current account.

Ensuring international competitiveness as a central task

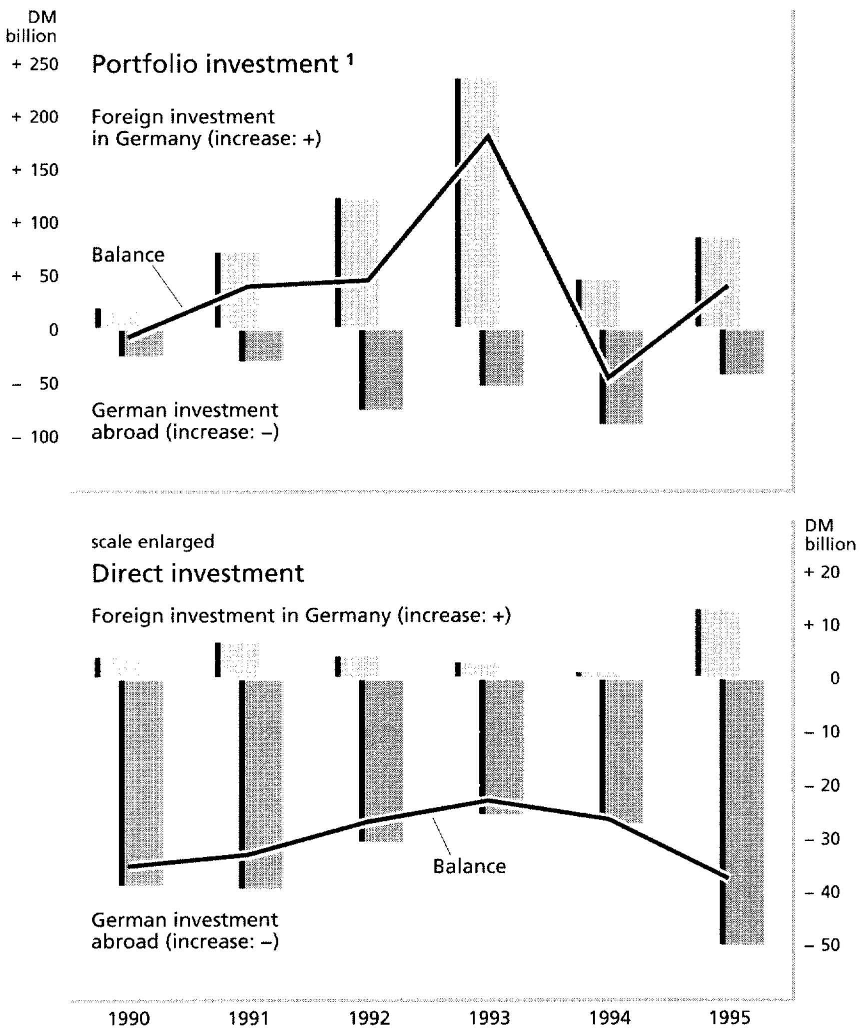
In view of the importance of exporting as a major pillar and growth motor of the German economy, ensuring international competitiveness remains one of the most urgent tasks for economic policy makers. Particularly as a result of the rapidly changing conditions on the world markets, the German economy is faced with challenges here which are not to be underestimated. The penetration by the newly industrialising countries in south-east Asia into the former domains of the highly developed industrial countries and the increasing significance of the market-oriented countries in transition in central and eastern Europe are calling the role of the industrial countries in the international production process based on the division of labour into question as new markets with considerable growth potential are opening up in the process.

Wage policy of crucial importance

This requires a willingness to accept change on all sides. Subjecting the total cost burden on the German economy in the widest sense of the term to a critical examination is not the least of the essential measures that will have to be taken in this connection. Particularly in the past few years German enterprises have made considerable efforts to restructure production processes and organisational routines on the basis of such cost considerations and to internationalise their production locations in the interest of strengthening and safeguarding market positions. To ensure that these changes are not made at the expense of Germany as an industrial location and at the expense of German jobs, however, a wage policy which takes due account of the competitive situation is of the utmost importance.

Financial transactions with the rest of the world

Chart 10



1 Excluding direct investment.

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Large capital outflows through direct investment, a sign that Germany is a poor industrial location?

The large capital outflows in the field of direct investment are often seen as an alarming warning sign in this connection. German enterprises purchased foreign participating interests for a record DM 50 billion last year, which, in terms of the amount involved, was almost twice as much as in 1994. There are many reasons for this. To ascribe the rise exclusively to cost factors would therefore be too simple. In addition, the decisions taken by investors are often significantly influenced by the cyclical and earnings situation, exchange rate considerations, efforts to ensure sales outlets and the development of new fields of business. Examples of this are, in regional terms, investment in central and eastern Europe and, in industry and sectoral terms, foreign telecommunications, utilities and financial markets, which have so far been largely sealed off. Just how important market strategy considerations are can be seen from the fact that last year, at 84 %, by far the largest share of direct investment went into industrial countries which are important for German exports, even though cost was certainly also a major reason why these locations were chosen. On the other hand, given the fact that direct investment in central and eastern Europe as well as in Asia is growing rapidly, although its weight is still relatively insignificant, such cost considerations have probably been of key importance – but here, too, they may have been mixed with market and sales strategy considerations.

Foreign direct investment in Germany relatively low

Incidentally, German enterprises were not alone in showing greater interest in holdings abroad; non-residents increased their investment in Germany again, and reunification was probably one of the reasons for this. Overall, foreign capital amounting to DM 13 billion flowed into Germany as a result. In terms of German enterprises' foreign investment at the same time and by international comparison, the amount involved was admittedly fairly modest. That is the real reason for concern about location policy. However, this discrepancy has also to be seen in the light of the fact that foreign investors had already built up considerable holdings of participating interests in Germany owing to the early liberalisation of financial transactions here.

Reversal in portfolio transactions

The net capital exports arising from direct investment were accompanied by influxes of funds through financial transactions. For example, there was a surplus of DM 42 billion net in portfolio transactions compared with capital outflows of DM 44 billion a year earlier. Foreign investors alone purchased German securities – almost exclusively bonds and notes – worth DM 84 ½ billion net. The firm Deutsche Mark and the very positive sentiment on the German bond markets certainly contributed considerably to the lively interest of non-residents. It was for precisely the same reasons that German residents showed a certain degree of reserve in investing in foreign currency bonds. Consequently, German investors acquired foreign paper worth no more than DM 43 billion net last year; this was half as much as in the year before. The foreign bonds sold in Germany were placed mainly with credit institutions. Sales of foreign money market instruments, which were acquired primarily by institutional investors, were, at DM 12 ½ billion, approximately as high as in 1994. On the other hand, demand for foreign equities was rather modest, given the bullish trend on foreign stock exchanges. However, it is striking that the interest of German investors in foreign money market funds and in general investment funds,

Changes in the net external position of the Deutsche Bundesbank*

Table 7

DM billion; inflow of foreign exchange: +

Period	Net external position, total	Operations in the foreign exchange market 1			Other transactions				
		Total	Deutsche Mark / dollar market	EMS intervention and debt settlement 2	Total	US dollar interest income and US dollar receipts from US troops	Public authorities (net)	Other foreign exchange movements (net)	Sales of Bundesbank Treasury discount paper (liquidity paper)
1995 Jan.	+ 1.0	–	–	–	+ 1.0	+ 0.9	+ 1.1	– 0.9	– 0.1
Feb.	+ 0.5	–	–	–	+ 0.5	+ 1.3	– 0.1	– 1.0	+ 0.3
Mar.	+ 6.4	+ 0.7	+ 0.7	–	+ 5.7	+ 1.0	– 0.6	+ 1.0	+ 4.3
Apr.	+ 3.2	+ 0.6	+ 0.6	–	+ 2.6	+ 0.9	– 0.9	+ 2.6	–
May	+ 1.4	–	–	–	+ 1.4	+ 1.7	+ 0.4	– 0.7	–
June	+ 2.0	+ 0.6	+ 0.6	–	+ 1.4	+ 1.0	+ 0.1	+ 0.3	–
July	– 0.4	–	–	–	– 0.4	+ 0.9	– 1.2	– 0.1	–
Aug.	+ 1.5	+ 1.2	+ 1.2	–	+ 0.3	+ 0.9	– 0.2	– 0.4	–
Sep.	+ 1.5	–	–	–	+ 1.5	+ 0.9	+ 0.3	+ 0.3	–
Oct.	– 0.2	–	–	–	– 0.2	+ 0.8	– 0.0	– 1.0	–
Nov.	+ 1.3	–	–	–	+ 1.3	+ 1.3	+ 0.4	– 0.4	–
Dec.	– 0.4	–	–	–	– 0.4	+ 1.1	+ 0.2	– 1.7	–
Total	+ 17.8	+ 3.0	+ 3.0	–	+ 14.8	+ 12.7	– 0.5	– 2.0	+ 4.6
1996 Jan.	+ 0.7	–	–	–	+ 0.7	+ 0.8	+ 0.0	– 0.1	–
Feb.	– 0.1	–	–	–	– 0.1	+ 1.1	– 0.5	– 0.7	–
Mar.	+ 0.5	–	–	–	+ 0.5	+ 1.0	– 0.2	– 0.3	–

* Transactions recorded according to the date of entry. — 1 Including operations by other central banks where they affect the external position of the Bundesbank. — 2 Debt settlement: Deutsche Mark repayments to the Bundesbank by EMS partners.

Deutsche Bundesbank

which has been characterised in the past few years by tax considerations, declined.

Influx of funds in credit transactions, too

On balance, inflows of funds again predominated in credit transactions, too, in 1995 (DM 55 ½ billion). This was partly due to the banks' long-term borrowing abroad. Another reason was that German enterprises and individuals neither added to their short-term bank balances abroad nor to their short-term time deposits in Germany but, instead, reduced them for the first time in over ten years (DM 18 billion).

Short-term external position of the credit institutions

Overall, the changes in current and financial transactions mentioned above largely cancelled out last year, with the result that the short-term external position of the banks, which together with the external position of the Bundesbank constitutes in a way the counterpart of this, was little changed compared with the previous year. After considerable inflows in 1994 (DM 126 billion), the short-term net external assets of the credit institutions declined by DM 4 billion in 1995.

External position of the Bundesbank

Compared with earlier periods when there was a considerable degree of tension in the foreign exchange markets, the changes in the external position of the Bundesbank remained within fairly clear limits. Although there were substantial inflows through financial transactions, some of which were certainly due to currency speculation, there were no massive waves of speculation such as those that had occurred during the periods of currency turmoil in 1992-3. Flexible market-related exchange rate adjustments quickly prevented the threatening financial market turbulence from reaching a crisis. Accordingly, the Bundesbank's intervention in the foreign exchange markets played only a relatively minor role. The changes in the external assets and liabilities were mostly due to other factors, which led to an overall rise of just under DM 18 billion (at transaction values) in the Bundesbank's net external assets. The total increase in monetary reserves amounted to DM 10 ½ billion, essentially as a result of the regular dollar receipts from foreign military agencies and interest income from the Bundesbank's US dollar assets. The changes on the liabilities side were marked by the maturity of the Bundesbank Treasury discount paper ("Bulis") at the end of March 1995; the external liabilities declined by DM 4 ½ billion as a result of this alone. In addition, foreign central banks and international organisations again withdrew balances they held at the Bundesbank, with the result that the external liabilities overall fell by DM 8 billion.

Revaluation of the external position

As usual, the external position of the Bundesbank was revalued at the end of the year. The balance sheet rate for US dollar assets was reduced from DM 1.3870 to DM 1.3620 per dollar. In line with the usual valuation and accounting principles, the new balance sheet rate is determined by the lowest rate of the US dollar in April 1995. The valuation of the ECU fell from DM 1.89636 per ECU to DM 1.83408 per ECU, and the special drawing rights were shown in the balance sheet at DM 2.13088 (previously: DM 2.26102) per SDR. The book value of the net external assets declined by DM 2 ½ billion as a result of the revaluation.

Holdings at the end of 1995

Taking account of the changed valuations, the monetary reserves stood at just under DM 121 ½ billion at the end of 1995. Excluding the dollar reserves transferred to the EMI, dollar assets account for just over one-half of these, namely DM 68 ½ billion. After deducting the difference (which was somewhat lower due to value adjustments) between the ECU value and the book value of the reserves contributed, the Bundesbank's ECU-denominated balances at the EMI amounted to DM 29 billion. At DM 13 ½ billion, the holdings of gold in the Bundesbank's balance sheet remained unchanged. Moreover, the reserve position in the IMF, including the special drawing rights allocated and accepted, came to DM 10 ½ billion and the credits to and other claims on the rest of the world which do not count towards the monetary reserves to DM 2 billion. After the maturity of the Bundesbank Treasury discount paper, the Bundesbank's external liabilities – mainly the Deutsche Mark deposits of foreign monetary authorities and international organisations – amounted to DM 16 ½ billion. On balance, the net external assets of the Bundesbank at balance sheet rates came to DM 107 billion at the end of 1995.

4. Monetary policy characterised by a bright outlook on inflation and weak monetary growth

(a) Marked lowering of central bank rates

Substantial cut in interest rates . . .

The Bundesbank made a large cut in central bank rates last year. The discount rate was reduced in three steps from 4.5 % to 3 %, and the lombard rate in two steps from 6 % to 5 %. In April 1996 these rates were lowered further to 2.5 % and 4.5 %, respectively. The repurchase rate was reduced from 4.85 % to 3.3 % (the most recent figure). The discount rate has thus dropped to the all-time low it had reached following the stock market crash in the autumn of 1987. At the same time, German capital market rates edged down throughout 1995 – except for a brief hiatus during the summer – and, at 5 ¼ %, even reached an all-time low at the beginning of 1996. Thereafter, capital market rates have risen again to around 5 ¾ % owing to international influences, but the present level of interest rates continues to support a renewed acceleration of economic growth.

. . . to foster monetary growth

The main reason for lowering central bank rates last year was the weakness of monetary growth. Initially the money stock M3 continued to fall at the beginning of 1995 and, as the year progressed, also remained below the target corridor of 4 % to 6 % adopted for 1995. The interest rate cuts were designed to bring monetary growth closer to the target corridor and to make it conform with a path consistent with the potential. The relaxation of interest rates was, moreover, encouraged by the monetary policy setting, notably the improved outlook for inflation. This owed something to the strong appreciation of the Deutsche Mark in the spring of 1995. Even though this was partly reversed in the ensuing period, the remaining appreciation of the Deutsche Mark still restrained the growth of the money stock and the rise in domestic prices. The outlook for domestic prices brightened, however, in the course of the year independently of

Record of domestic and external monetary policy measures

January 1, 1995

Austria, Finland and Sweden join the European Union and the European Monetary System.
The newly established Federal Supervisory Office for Securities Trading, which is domiciled in Frankfurt am Main, commences operation.

January 9, 1995

Austria joins the exchange rate and intervention mechanism of the European Monetary System.

March 6, 1995

The Spanish peseta and the Portuguese escudo are devalued by 7% and 3.5%, respectively, in the EMS.

March 16, 1995

The Central Bank Council decides to discontinue the last remaining special rediscount facility (ceiling B of the *AKA Ausfuhrkredit-GmbH*) at the close of business on May 31, 1996.

March 30, 1995

The Central Bank Council lowers the discount rate from 4.5% to 4% with effect from March 31. At the same time, it decides to offer the next securities repurchase transaction at a fixed rate of 4.5% (i.e. 0.35 percentage point less than the preceding transactions), and to offer the next two repurchase transactions in the form of variable-rate tenders. By taking this decision, the Bundesbank takes due account of the persistent weakness of monetary growth and the changes in the monetary policy environment.

April 20, 1995

The Central Bank Council approves the annual accounts for the financial year 1994; DM 10.24 billion of the net profit is paid over to the Federal Government.

July 1, 1995

Deutsche Mark banknotes with the dates of issue 1960, 1970, 1977 and 1980 cease to be legal tender. However, the Bundesbank will continue to exchange them at face value for notes of the new series free of charge.

July 13, 1995

The Central Bank Council reviews the 1995 monetary target, which provides for an increase of 4% to 6% in the money stock M3 in the course of 1995, and deems it to be appropriate in principle. By its decision to abide by the monetary target, the Bundesbank underlines the fact that it continues to regard the money stock M3 as its key reference variable for monetary policy. At the same time, the Central Bank Council completes the restructuring of the minimum reserve regulations, which has taken place in three steps. With effect from August 1, the minimum reserve ratio for sight liabilities is lowered from 5% to 2%, that for savings deposits is reduced from 2% to 1.5% and the deductibility of banks' cash balances when complying with the minimum reserve requirements, which was limited to 25% of the required reserves, is rescinded.

August 24, 1995

The Central Bank Council lowers the discount and lombard rates by ½ percentage point each. With effect from August 25, the discount rate will be 3.5% and the lombard rate 5.5%. The main reason for the interest rate cut is the persistent sluggishness of monetary growth.

September 12, 1995

By an agreement between Germany and the European Monetary Institute on the country of domicile, Frankfurt am Main is officially confirmed as the domicile of the EMI.

December 14, 1995

The Central Bank Council adopts the monetary target for 1996. The decision provides that in 1996 the Bundesbank will conduct its monetary policy in such a way as to ensure that the regained price stability can be safeguarded and, simultaneously, that the monetary conditions for sustained economic growth remain in place. To this end, the Bank regards it as appropriate for the money stock M3 to expand by 4% to 7% between the fourth quarter of 1995 and the fourth quarter of 1996. The widening of the target corridor to three percentage points takes due account of the increased volatility of shorter-term monetary movements and provides leeway for a faster pace of monetary growth in the context of the medium-term-oriented monetary targeting strategy. At the same time, the Bundesbank lowers the discount rate from 3.5% to 3% with effect from December 15, and the lombard rate from 5.5% to 5%. The interest rate reduction is designed to help durably to raise monetary growth on to a path consistent with the potential. The next three securities repurchase transactions are offered in the form of fixed-rate tenders at a rate of 3.75%, so as to make end-of-year liquidity management, which is difficult, easier for credit institutions.

December 15-16, 1995

The decisions of the European Council in Madrid flesh out major conditions underlying the third stage of European economic and monetary union (EMU). In particular, the strategy for the change-over to a single European currency (known as the change-over scenario) is approved. Among the most important features of that scenario are the confirmation of the scheduled implementation of stage three of EMU on January 1, 1999 in accordance with the convergence criteria and the choice of "euro" as the name of the future European currency.

January 1, 1996

The cooperation agreement between the stock exchanges in Berlin, Düsseldorf, Frankfurt am Main and Munich enters into force, with the intention of enhancing cooperation in the field of supervising listing, trading operations and pricing.

April 18, 1996

The Central Bank Council lowers the discount rate from 3 % to 2.5 % and the lombard rate from 5 % to 4.5 % with effect from April 19. The Bundesbank announces its intention of offering the next two securities repurchase transactions in the form of fixed-rate tenders at an unchanged rate of 3.30 %. The interest rate cut is motivated by the favourable price outlook. The Bundesbank also assumes that the pace of monetary growth, which was rapid in the first quarter of 1996, will slacken in the further course of the year. By leaving the repurchase rate unchanged, the Bundesbank keeps its policy options open for the period ahead. At the same time the Central Bank Council approves the annual accounts for the financial year 1995; DM 10.32 billion of the net profit is paid over to the Federal Government.

Record of general economic and fiscal policy measures

January 1, 1995

Major new provisions enter into force: the restructuring of the Federal revenue-sharing scheme, including radical improvements in the financial position of east German central, regional and local authorities; the establishment of the Redemption Fund for Inherited Liabilities, which assumes the debts incurred as a result of German unification (including those of the Treuhand agency); the introduction of a "solidarity surcharge" at the rate of 7.5% of income and corporation tax liabilities; and the introduction of a statutory nursing care insurance scheme.

January 13, 1995

The deficit in the 1994 Federal budget comes to DM 50.6 billion, and is thus DM 19.1 billion below the amount envisaged (cuts in expenditure totalling DM 8.7 billion, additional receipts amounting to DM 10.3 billion).

February 2, 1995

In its Annual Economic Report for 1995, the Federal Cabinet subscribes to the generally optimistic assessment of an increase in aggregate output. It likewise expects the strong growth in the new Länder to persist.

March 23, 1995

The Federal Cabinet approves the 1996 Tax Bill, containing the following basic features: tax exemption of subsistence incomes by the granting of "basic relief" not included in the scheduled tax scheme, which tapers off as income rises; continued restructuring of corporate taxation, including the abolition of trading capital tax and relief from trade earnings tax and inheritance tax on company assets, accompanied by the reduction of the diminishing-balance depreciation of machinery and equipment; the prolongation and simultaneous streamlining of investment promotion in the new Länder.

June 2, 1995

The Bundestag (rejecting the objections raised by the Bundesrat) approves the Federal budget for 1995, involving an expenditure volume of DM 477.7 billion and a deficit of DM 49.5 billion. It also approves the 1996 Tax Act, which has been amended in some respects compared with the Bill, and has been supplemented by new provisions governing the equalisation of family burdens, which provide either for a right to an increased rate of child benefit or for a tax allowance for children. The restructuring of corporate taxation has been detached from these provisions during the legislative procedure; it will be pursued further in a separate operation.

July 5, 1995

The Federal Cabinet approves the draft budget for 1996, involving an expenditure volume of DM 452.0 billion, which (adjusted for the reorganisation of child benefit payments) is 1.3% below the target amount for 1995; a deficit of DM 60.0 billion is envisaged. According to the medium-term financial plan up to 1999, which is submitted simultaneously, the annual rise in expenditure is to be limited to 1.3%, and the deficit to be reduced to DM 29 billion by 1999.

July 18, 1995

The Federal Cabinet approves a bill modifying the use of coal for generating electricity from 1996, which provides for the abolition of the "coal penny" (which has been declared unconstitutional by the Federal Constitutional Court) and for the thus financed subsidies being met out of the Federal budget.

July 31, 1995
Following a lengthy mediation procedure, the Bundestag and the Bundesrat agree in the Mediation Committee on the final wording of the 1996 Tax Act. The tax exemption of subsistence incomes required by the Constitution is accomplished by raising the scheduled basic allowance rather than by introducing "basic relief" on top of the scheduled tax scheme; the existing linear-progressive scale is "bent" in such a way as to ensure that the tax burden remains unchanged in the upper part. Both the basic allowance and child benefit are raised somewhat by comparison with the earlier decision of the Bundestag.

August 8, 1995
The Federal Cabinet approves a bill restructuring the promotion of owner-occupied dwellings. The existing basic promotion under section 10 e of the Income Tax Act (which is dependent on income) is superseded by a building allowance that is independent of income, and what is known as "building child benefit" is increased.

August 18, 1995
The Federal Constitutional Court publishes its rulings of June 22, 1995 on the taxation of property and inheritance, which declare the existing unequal treatment of real property and financial assets to be unconstitutional, and lay down general principles for the limits to taxation.

November 9, 1995
The Bundestag approves the Federal budget for 1996, which, with an expenditure volume of DM 451.3 billion and a deficit of DM 60.1 billion, provides for only minor changes in the benchmark figures vis-à-vis the draft. The gap of around DM 20 billion which has arisen in the course of the budget planning is closed mainly by means of additional receipts from privatisation and by lowering the expenditure appropriations.

November 14, 1995
According to its Annual Report for 1996, the Council of Economic Experts expects real GDP to grow by 1½ % in western Germany and 7% in the new Länder. In Germany as a whole, aggregate output is likely to rise by 2%. Expansionary stimuli are to be expected mainly from exports and corporate investment in machinery and equipment. Much as in 1995, the rise in consumer prices in 1996, too, will be low.

November 24, 1995
The Bundestag approves an act supplementing the 1996 Tax Act, by means of which the levying of trade earnings tax in the new Länder is postponed for another year.

January 1, 1996
Major acts regulating fiscal policy come into effect: the 1996 Tax Act, the Act Restructuring the Promotion of Owner-Occupied Dwellings in Tax Terms, the Act Modifying the Use of Coal for Generating Electricity as from 1996.

January 12, 1996
According to preliminary budget figures, the deficit in the Federal budget for 1995 comes to DM 50.6 billion, and (owing to higher other receipts and particularly because of spending cuts) is thus only DM 1.1 billion above the envisaged amount, in spite of sizeable tax shortfalls.

January 29, 1996
In its Annual Economic Report for 1996, the Federal Cabinet expects the economic upswing to pick up again in the second half of the year and real GDP to grow by about 1% in western Germany and by 4% to 6% in the new Länder. However, a decline in unemployment is expected only if – in addition to the economic upswing – management and labour agree upon greater labour-market flexibility.

January 30, 1996
In the shape of an "action programme to boost investment and employment", the Federal Cabinet approves a host of measures to improve economic locational conditions in Germany – measures which are still to be fleshed out in detail. They include the reform of corporate taxation from 1997 onwards, which was postponed in 1995, the lowering of the solidarity surcharge to 5.5% as from mid-1997, the ad hoc encouragement of small and medium-sized enterprises, and cuts in social security expenditure.

March 15, 1996
Given the additional burdens in prospect, a "budget freeze" is imposed on the Federal budget, according to which expenditure not subject to contractual or statutory commitments in excess of certain sums may only be effected subject to the approval of the Federal Minister of Finance.

the effects of the appreciation. There was a distinct slackening of the inflationary pressure on the preliminary stages of production, notably producer prices. The liquidity overhangs from the past were gradually eliminated. No capacity bottlenecks are to be expected at the current level of economic activity. Overall, there is a good prospect that the price stability which has been regained can continue to be safeguarded.

After an extended period of "steady as she goes" in interest rate policy . . .

At the beginning of 1995 the Bundesbank initially continued its "steady as she goes" approach. It left central bank interest rates at the level reached in the summer of 1994, and, moreover, announced in advance the terms of each of the weekly securities repurchase transactions – fixed-rate tenders with two-week maturities at a rate of 4.85 %. By doing so, it hoped to stabilise interest rate expectations and to counter volatility in the financial markets which had increased at the turn of 1994-5. Another argument in favour of holding steady in interest rate policy at that time was that the overall economic setting did not signal any need for action.

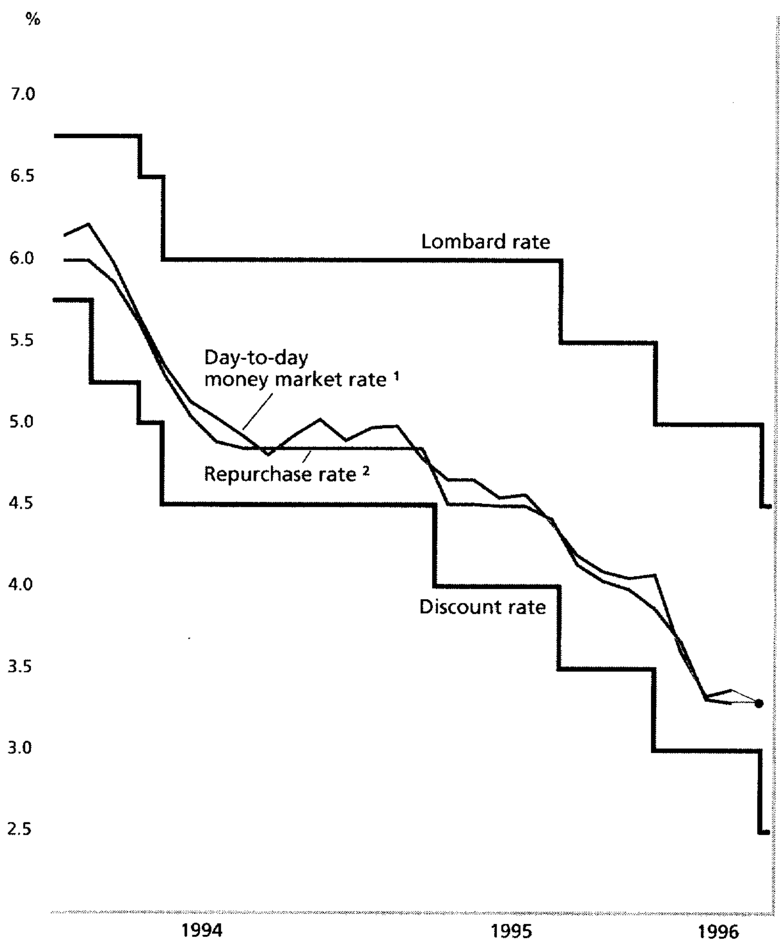
. . . discount rate cut at the end of March . . .

This changed when, in the spring of 1995, it became evident that the trend of monetary expansion was slackening, too, and the Deutsche Mark appreciated sharply in the exchange markets. The Bundesbank therefore reduced the discount rate and the fixed-rate tender rate to 4 % and 4.5 %, respectively, at the end of March. It left the lombard rate at the previous level, which caused the gap between it and the discount rate to widen to two percentage points, once again emphasising more clearly that the lombard loan facility is intended as emergency funding in the money market. In April the Bundesbank switched back to variable-rate tenders without the repurchase rate declining. Time deposit rates likewise changed only marginally; the yield curve in the money market remained flat. It was not until the summer, when there was a further improvement in the outlook on inflation and the pace of monetary growth slackened again after a temporary acceleration, that market players' perception of the downward potential of interest rates increased. There was a distinct easing of money market rates following the further reduction in officially controlled interest rates at the end of August. The lowering of the discount rate and (this time) the lombard rate, too, by half a percentage point each ushered in a period of comparatively steady easing of money market rates. The allocation rate applied to the variable-rate tenders went down in moderate steps and settled down to about 4 % in the autumn together with the time deposit rates for all maturity categories.

. . . further interest rate cuts in August . . .

Bundesbank interest rates
and day-to-day money market rate

Chart 11



1 Monthly averages. — 2 Average rate during month applied to securities repurchase agreements with two-week maturities; uniform allotment rate (fixed-rate tender) or marginal allotment rate (variable-rate-tender). — • = Latest position: April 18, 1996.

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. . . in December . . .

In December, the Bundesbank lowered the central bank rates again in order to bring monetary expansion into line with the monetary target for 1996, which calls for more rapid monetary growth. At the same time, it offered the repurchase transactions extending beyond the turn of 1995-6 in the form of a fixed-rate tender likewise at a reduced rate, thus providing the money market with a new benchmark. When it resumed its variable-rate tenders at the beginning of January, the repurchase rate dropped sharply. In response, it once again switched to a fixed-rate tender in February and set the key interest rate for the money market at 3.3 % to provide guidance to the market and to

... and in April 1996

prevent a further rapid fall in short-term interest rates. In mid-April 1996 the Bundesbank lowered the discount rate further to 2.5 % and the lombard rate to 4.5 %. By doing so, it took account of the continued favourable inflation outlook. It also assumed that monetary growth, which was vigorous at the beginning of 1996, would decelerate in the course of the year. It continued to offer the next two securities repurchase transactions in the form of fixed-rate tenders at a rate of 3.30 %. It thereby kept its policy options open for the future.

International interest rate pattern

The Bundesbank's decisions to cut interest rates were, as a rule, accompanied by mostly simultaneous easing measures on the part of other European central banks. To support their exchange rate and contain rising inflationary expectations, some countries had to accept temporary increases in their interest rate levels, however. Against the backdrop of the economic slowdown and the headway made on the road to stabilising the general price level, the interest rate trend in countries outside Europe was clearly pointing downwards, too. German money market rates and capital market yields, however, remained in the lower part of the international interest rate spectrum. This is a clear indication that not only a counter-inflationary monetary policy, but also fiscal and wage policies geared to non-inflationary growth, are of significance for a sustained low interest rate level.

Revision of the minimum reserve regulations completed

Last summer the Bundesbank completed the phased revision of the minimum reserve regulations initiated in March 1993. With effect from August 1995, it lowered the minimum reserve ratio for sight liabilities from 5 % to 2 %, and that for savings deposits from 2 % to 1.5 %; it left the reserve ratio for time liabilities unchanged at 2 %. It simultaneously abolished the deductibility of the banks' cash holdings from the required minimum reserves. The restructuring of the minimum reserve system had the aim of lessening the incentives to circumvent the regulations and of safeguarding the long-term viability of this monetary policy instrument in liberalised and globalised financial markets. To this end, the reserve regulations were simplified and the reserve ratios markedly lowered.

Significance of minimum reserves for monetary policy unchanged

At the same time, the monetary policy function of the minimum reserve instrument was preserved. Minimum reserves, in particular, ensure a stable demand for central bank money and act as a liquidity cushion in money market management, thereby enabling the Bundesbank to adopt a fundamentally "non-interventionist" stance in the money market. For that

Monetary developments

Table 8

Changes during year

Item	1992	1993	1994	1995
	DM billion			
I. Central bank money requirements of banks and liquidity policy measures of the Bundesbank 1				
1. Provision (+) or absorption (–) of central bank balances by:				
Changes in central bank money 2 (increase: –)	– 38.7	– 21.5	– 15.0	– 9.8
Foreign exchange movements (excluding foreign exchange swaps)	+ 63.6	– 16.6	+ 6.3	+ 9.0
Changes in domestic non-banks' net balances with the Bundesbank (including shifts of Federal balances under section 17 of the Bundesbank Act 3)	+ 15.5	– 9.2	+ 6.4	+ 0.1
Other factors	– 23.8	– 18.9	– 28.8	– 26.9
Total 1	+ 16.6	– 66.2	– 31.1	– 27.6
2. Lasting provision (+) or absorption (–) of funds:				
Change in minimum reserve ratios 4	– 0.9	+ 32.6	+ 29.5	+ 19.6
Change in refinancing facilities	– 15.5	+ 0.1	– 0.1	+ 0.0
Recourse to unused refinancing facilities (reduction: +)	+ 2.0	– 4.2	+ 2.7	+ 0.3
Open market operations in liquidity paper and the debt securities market	+ 3.3	– 26.5	+ 11.9	+ 9.5
Transfer of the Bundesbank's profit to the Federal Government	+ 14.5	+ 13.1	+ 18.3	+ 10.2
Total 2	+ 3.4	+ 15.0	+ 62.2	+ 39.7
3. Change in the banks' short-term liquidity gap (total 1 plus total 2, increase: –)	+ 20.0	– 51.2	+ 31.1	+ 12.1
4. Meeting of remaining deficit (+) or absorption of surplus (–) by:				
Securities repurchase transactions	– 16.0	+ 46.6	– 27.2	– 12.6
Very short-term assistance measures by the Bundesbank 5	– 2.6	+ 3.6	– 3.2	± 0.0
Changes in lombard loans (increase: +)	– 1.4	+ 1.1	– 0.7	+ 0.5
	%			
II. Key monetary indicators 6				
Money stock M3 7	+ 8.5	+ 8.8	+ 3.8	+ 3.3
Money stock M3 extended 8	+ 9.9	+ 11.9	+ 4.1	+ 3.2
Lending by the banking system to domestic non-banks 9	+ 9.4	+ 9.5	+ 8.3	+ 7.5
	DM billion			
III. The money stock and its counterparts 9				
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 117.1	+ 186.2	+ 31.9	+ 86.1
Counterparts in the balance sheet:				
1. Volume of credit 10	+ 299.9	+ 333.9	+ 318.9	+ 310.5
of which				
Lending by credit institutions to domestic non-banks	+ 294.3	+ 339.8	+ 320.5	+ 312.8
– to enterprises and individuals 11	+ 247.9	+ 242.3	+ 256.1	+ 223.0
– to public authorities	+ 46.4	+ 97.5	+ 64.4	+ 89.8
2. Next external assets 12	– 40.7	– 6.7	– 141.2	– 31.7
3. Monetary capital formation	+ 101.5	+ 96.5	+ 166.8	+ 181.7
of which				
Savings deposits at over three months' notice and bank savings bonds	+ 12.3	+ 9.0	+ 1.5	+ 15.4
Time deposits for four years and more	+ 26.3	+ 32.9	+ 62.1	+ 69.1
Bank debt securities outstanding 13	+ 41.0	+ 31.1	+ 73.5	+ 74.8
4. Federal Government deposits in the banking system 14	– 12.3	+ 13.1	– 10.0	– 0.8
5. Other factors	+ 52.9	+ 31.4	– 11.1	+ 11.9

1 Based on daily averages of the last month of the period. — **2** Currency in circulation in the hands of non-banks and minimum reserves on domestic liabilities at current reserve ratios; but excluding changes in required reserves due to changes in the reserve ratios. — **3** Under section 17 of the Bundesbank Act as amended up to July 15, 1994. — **4** Including changes in minimum reserves due to the growth of reserve-carrying foreign liabilities. — **5** Quick tenders, foreign exchange swaps and repurchase transactions, sales of short-term Treasury bills and shifts of Federal balances (under section 17 of the Bundesbank Act as amended up to July 15, 1994). — **6** Seasonally adjusted. — **7** Currency in circulation plus the sight deposits, time deposits for less than four years and savings deposits at three months' notice held at domestic credit institutions, computed as a monthly average. — **8** Money stock M3 extended to include deposits abroad, short-term bank debt securities and (from August 1994) the certificates of domestic and foreign money market funds held by domestic non-banks, less the bank deposits and short-term bank debt securities of domestic money market funds; average of end-of-month levels. — **9** Based on end-of-month figures. — **10** Credit institutions and the Bundesbank; including lending against securities. — **11** Including housing loans. — **12** Credit institutions and the Bundesbank. — **13** Excluding banks' portfolios. — **14** Until December 1993 central bank deposits of domestic public authorities.

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reason, the Bundesbank adheres to the minimum reserve system and would like to see this instrument introduced into the European System of Central Banks.

Restructuring extended over a longer period

The Bundesbank extended the minimum reserve reductions over a longer period in order not to jeopardise the buffer function of the minimum reserves and to enable the banks to adjust their liquidity management gradually. The function of the minimum reserves as a liquidity buffer was maintained because it is not only the minimum reserve requirements but also the banks' working balances which have fallen sharply of late. On the one hand, credit institutions increased their central liquidity holdings, on the other, the volatility of bank liquidity, and hence also the need for "precautionary balances", was reduced by a number of institutional and technical changes. These included the abolition of the public authorities' deposit requirement at the beginning of 1994, the introduction of the settlement of pension payments on a same-day basis in September 1994, the implementation of the large-value cheque collection procedure (GSE procedure) in the Bundesbank system at the end of 1994 and its extension in July 1995.

Fluctuations in the patterns of compliance smoothed out

Nevertheless, the gap between the minimum reserves and the banks' working balances has narrowed markedly following the restructuring of the minimum reserves. To that extent, the greater part of the "cost" caused by the minimum reserves has to be counted towards the payment system. As a result of them coming closer together and the smaller fluctuations in bank liquidity, credit institutions' reserve compliance profile has also changed. Whereas a large degree of "advance compliance" in the first half of the month used to be common, they now aim at a compliance profile that is as steady as possible. The Bundesbank has adapted its money market management to this change. It seeks to gauge the provision of funds in such a way that the difference between the credit institutions' daily central bank balances and the required reserves is as small as possible and fluctuates as little as possible throughout the month. Its main purpose in this context is to offset fluctuations in currency in circulation and in the float.

Liquidity management through securities repurchase transactions

Moreover, credit institutions' bill-based borrowing was subject to major fluctuations in connection with speculation about discount rate changes. Nevertheless, the Bundesbank was able largely to satisfy the changed needs of the banking system by the customary weekly conclusion of securities repurchase transactions with two-week maturities. It has deployed very short-term assistance measures only three times since the beginning of 1995: in February and November 1995, and in January 1996 it supplied the banks with additional funds by means of quick tenders. Lombard borrowing mostly remained restricted to minor amounts; it was only at the end of the month that credit institutions occasionally took up lombard loans on a major scale as part of their final minimum reserve management.

Further decline in demand for central bank credit

Once again, there was a distinct drop in credit institutions' need for central bank credit during 1995 (see table on page 65). This owed something, firstly, to the rise in the Bundesbank's external position, which was mainly caused by autonomous inflows of foreign exchange. Secondly, the lowering of the minimum reserves in August and the simultaneous abolition of the deductibility of the banks' cash holdings reduced the demand for central bank money by DM 7 ½ billion. On April 20, 1995 the Federal Government's share in the Bundesbank profit for 1994, which amounted to DM 10.2 billion, was transferred to it. Finally, last spring the remaining Bundesbank liquidity paper ("Bulis") still outstanding matured, the auctions of which had been discontinued as early as the autumn of 1994. These factors, which overall strongly increased liquidity, were only partly offset by a reduction in the Bundesbank's securities portfolio and its current entries to the profit and loss account, and an only moderate increase in the banks' central bank money requirements.

(b) Monetary target for 1995 undershot

Monetary target for 1995

The Bundesbank adhered to its strategy of published monetary targets in the past year, too. In line with the target adopted by the Central Bank Council in December 1994, the money stock M3 was to grow by 4 % to 6 % between the fourth quarter of 1994 and the fourth quarter of 1995. Setting the monetary target for 1995 was made more difficult, firstly, by the fact that monetary expansion was extremely unsteady in 1994 and very strong as an annual average. A deduction was made when deriving the target corridor for 1995 to take account of this fact. Some offsetting of the previous excess provision of liquidity was intended to prevent the emergence of any inflationary risks. Secondly, there was uncertainty as to the length of time of the reversal in monetary growth following the liquidity blockage at the beginning of 1994. Finally, there was no telling what repercussions the money market funds authorised in August 1994 would have on the demand for money.

Monetary target markedly undershot

Monetary developments presented a mixed picture last year, too. At the beginning of the year the fall in money balances which had started in the autumn of 1994 accelerated; one particular reason for this was a large statistical negative overhang from the end of 1994 due to exceptionally heavy tax-induced buying of money market fund certificates in December 1994. M3 then grew fairly moderately until well into the summer. The subdued monetary expansion primarily reflected a surge in monetary capital formation by domestic non-banks. Monetary capital formation did not return to normal until September when capital market rates dropped more than 1 ½ percentage points below their multi-year average. Whereas the money stock M3 expanded only at a seasonally adjusted annual rate of 1 ¼ % in the first half of the year, it rose at an annual rate of 5 ½ % in the second half and moved to a growth which was in line with production potential. The immediate objective of the Bundesbank's interest rate cuts was thus met on balance.

Volatile monetary expansion

Monetary expansion remained quite volatile, however, even in the later course of the year. The monetary target was distinctly undershot at the end of the year despite the stronger growth in the second half. In the fourth quarter of 1995, the average level of the money stock M3 exceeded that in the fourth quarter of 1994 by a mere 2.1 %; the target corridor of 4 % to 6 % was thus missed by a wide margin. Last year, too, the Bundesbank's monetary policy, which is geared to annual targets, was made considerably more difficult by the increased volatility of short-term monetary growth. This does not, however, negate the basic advantages of monetary targeting; in particular, the long-term relationships between the development of the money stock and of prices appear to have remained stable (see page 75 ff.).

Fall in time deposits

Viewed in terms of the individual money stock components, the moderate monetary growth last year can be traced back on balance solely to the weak growth of shorter-term time deposits. They started to decline in the spring of 1994, and went on falling virtually throughout 1995. Owing to the "dual nature" of time deposits which are used both as transaction and store of value media, fixed-term deposits were switched not only into sight deposits and/or savings deposits at three months' notice, but also into money market fund certificates and longer-term assets which are included in monetary capital.

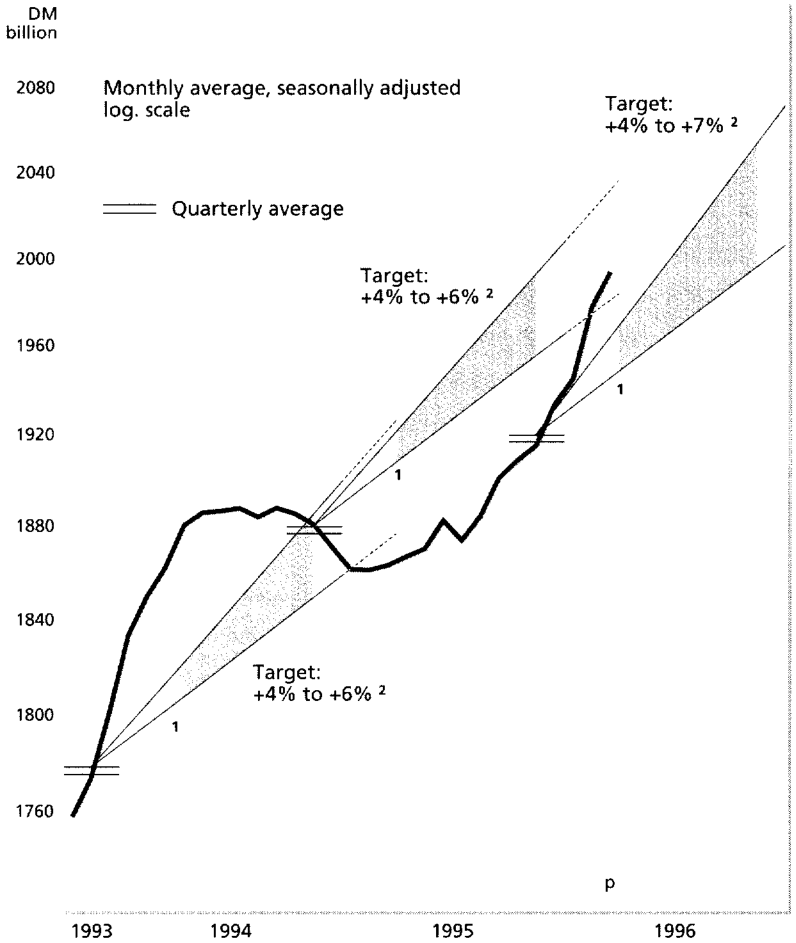
Growth of the other money stock components

All the other components of the money stock expanded in 1995. Growth of currency in circulation was rather moderate, whereas sight deposits – with major fluctuations from month to month – increased vigorously. As in the preceding year, the rise in savings deposits at three months' notice was by far

Growth of the money stock M3 *

Chart 12

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.

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the most rapid. Essentially, almost all of this rise was accounted for by special forms of savings. These often have a short formal maturity but carry interest rates that are more in line with market conditions than traditional savings deposits. The diverging trends of the individual money stock components were reflected in marked differences in the rates of growth of the individual monetary aggregates. The fastest growth in the past year (just over 7 ½ %) was recorded by the money stock M1 (currency and sight deposits), which measures the liquidity immediately available for transaction purposes.

Moderate growth of M3 extended

As part of its strategy of monetary targeting, the Bundesbank keeps a close watch in the financial field not only on the money stock M3 but also monitors the movement of other indicators. Besides the aggregate M1, this particularly applies to M3 extended.[1] The computation of the latter aggregate also captures the provision of liquidity outside the definition of M3. During 1995 the extended money stock M3, at just over 3 %, had risen at a similarly moderate pace as M3. One reason for this very moderate expansion in comparison with longer-term trends was the low propensity of domestic non-banks to invest funds in the Euro-market. Following a vigorous growth of Euro-deposits between the end of 1985 and the end of 1993 – they became 15 times greater during this period –, such deposits stagnated in the past two years. With the sharp fall in short-term interest rates, the steep yield curve and initial success in sales of money market fund certificates, not only domestic time deposits but also those in the Euro-market have evidently become less attractive. The marked reduction in the minimum reserve burden placed on domestic deposits may likewise have played a part in this.

Moderate impact of money market fund certificates on monetary developments

The demand for money market fund certificates likewise had only a moderate overall impact on the growth of M3 extended. Genuine money market funds have been allowed in Germany since August 1994. Up to the end of 1994 domestic non-banks purchased DM 45.8 billion net of such certificates, of which DM 26.6 billion was bought in December alone. Besides their attractiveness as a novelty, the increase in holdings of such certificates was to a large extent due to their "preferential treatment" for property tax purposes. This gave rise to the problems already mentioned surrounding the transition to the new monetary target for 1995 and to a limited downward shift in the demand for money for M3. In the further course of the year the money market funds did not affect monetary growth to any significant extent, however. It was only in December 1995 that net purchases of such paper shot up again. This time the surge was probably due only in part to tax considerations. Large reinvestment needs in that month on account of interest payment dates, maturing securities, and the low capital market rates were additional factors which evidently prompted many investors to temporarily lodge resources in money market funds. Altogether, domestic non-banks purchased only just under DM 7 billion in money market fund certificates in 1995. From the present perspective it

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1 Money stock M3, the bank deposits of domestic non-banks with the foreign subsidiaries and foreign branches of German credit institutions and the short-term bank debt securities and certificates of domestic and foreign money market funds in the hands of domestic non-banks, less the bank deposits and short-term bank debt securities of domestic money market funds, calculated as the average of two end-of-month levels.

remains to be seen whether major sums of money will continue to be placed in money market funds if interest rate uncertainty persists. Essentially, such investments in the "forecourt" of the capital market should be seen as being more in the nature of monetary capital than as counting towards the money stock. In those terms, the Bundesbank would appear to be still justified in its decision not to include money market fund certificates in the money stock M3.

Supply of liquidity in the economy adequate

Some of the muted growth of the money stock M3, notably in the first half of 1995, is likely to have been monetary capital formation's continuing response to the disruptions of 1994. Another factor was a slight weakening of private credit expansion compared with previous years on account of some special influences ceasing to be operative. Finally, bank deposits were switched into money market fund certificates to a limited extent. These factors brought about a reversal or normalisation of the demand for money on a scale which could not be anticipated when the monetary target for 1995 was derived. A shortage in the supply of liquidity to the economy cannot therefore be inferred from the marked undershooting of last year's monetary target. A look at the longer-run monetary growth leads to a similar conclusion. If the three years 1993 to 1995 are taken together, for example, actual M3 growth during that period largely corresponds to the monetary growth which was established ex post – i. e. taking account of the actual rise in prices – as being in line with potential. M1 growth, at just over 7 ½ % last year, as mentioned, likewise gives the impression of an adequate supply of liquidity. Other financial indicators, such as the growth of bank lending, and the movement of interest rates and the yield curve, likewise suggest that it is by no means possible to describe monetary conditions in 1995 as having been restrictive.

Monetary target for 1996

Because the longer-term demand for money has remained stable, the Bundesbank is adhering to its strategy of monetary targeting and to the money stock M3 as the key variable for its policy. It therefore also set a monetary target for 1996 and announced it to the general public. This provides for a 4 % to 7 % growth in the money stock M3 between the fourth quarter of 1995 and the fourth quarter of 1996. The growth of all-German real production potential was put at 2 ½ %, and is thus unlikely to be faster than growth last year. The medium-term price assumption was set – in line with the Bundesbank's practice since the mid-eighties – at a maximum of 2 %. Given that the rise in the cost-of-living index was somewhat lower last year, this may not at first sight appear to be overly ambitious in terms of anti-inflation policy. It should be borne in mind, however, that the conversion of real production potential into nominal potential is based on the GDP deflator, the increase in which tends to be somewhat greater than that in the cost-of-living index. Moreover, the 2 % norm should definitely be regarded as an upper limit, and not by any means as a short-term target in the event of the actual rate of inflation being lower. Finally, when deriving the monetary target, allowance was again made for the declining trend of the "velocity of circulation of money" by making an addition of one percentage point.

Extended target corridor

The sum of the above-mentioned benchmark figures yields an average annual growth of the money stock M3 of (not more than) 5 ½ %, which was translated into a rate of growth between the fourth quarter of 1995 and the fourth quarter of 1996 that is in line with potential and a target corridor of 4 % to 7 %. The Bundesbank thus adhered to the lower limit of the past two monetary targets while widening the corridor to three percentage points. By retaining the lower edge of the corridor it takes due account of the favourable outlook on inflation for the current year. A widening of the target corridor seemed appropriate in view of the increased volatility of shorter-term monetary developments. Moreover, it leaves scope for an acceleration in the growth of the money stock M3, which had been subdued in 1995.

Vigorous M3 growth in the first quarter of 1996

The money stock M3 grew vigorously in the first quarter of 1996. Monetary expansion was stimulated by the distinct weakness of monetary capital formation caused by the low level of capital market rates and the interest rate uncertainty that emerged in the international financial markets. Another factor was the fairly strong expansion of bank lending to the private sector, which probably owed something to the changes in housing promotion which came into effect at the beginning of 1996. In March, the money stock M3 exceeded its level in the fourth quarter of 1995 by 3.9 % or an annual rate of 12.2 %, according to provisional data. Since the fourth quarter of 1994 it has risen at an annual rate of 4.6 %. In the first few months of each new year the Bundesbank uses the basis of the previous year's monetary target as an additional reference for assessing monetary developments to ease the problems of interpretation associated with the transition from the old to the new basis of the monetary target.

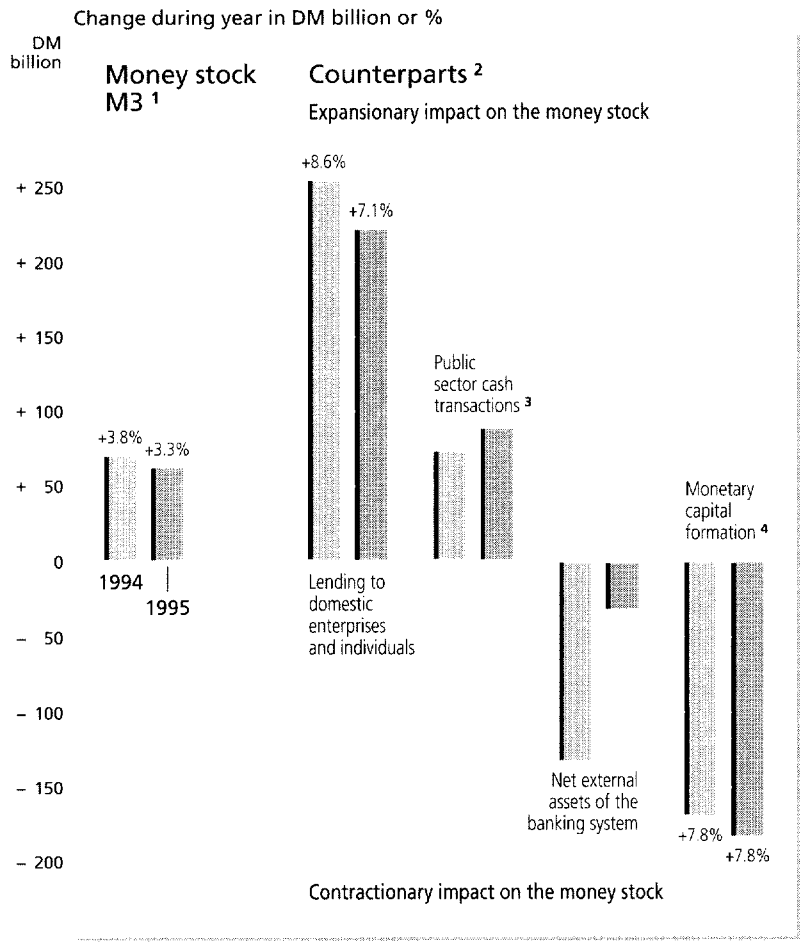
(c) Determinants of monetary growth

Overall monetary capital formation high in 1995, but slowing down in the last four months

As mentioned above, monetary developments last year – much as in 1994 – were again mainly determined by monetary capital formation. It was very strong in the first eight months of the year when the reversal following the liquidity backtail in 1994 was still continuing – during this period monetary capital formation grew at a seasonally adjusted annual rate of 9 % – and sharply

The money stock
and its principal counterparts

Chart 13



1 Calculated on the basis of monthly averages. — **2** Calculated on the basis of end-of-month levels. — **3** Lending by the banking system to the public sector less Federal Government deposits in the banking system. — **4** Monetary capital formation of domestic non-banks at domestic credit institutions.

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curtailed the expansion of the money stock. In the last four months of the year there followed a discernible slackening – between September and December monetary capital went up at a seasonally adjusted annual rate of only 5 % – which played a crucial part in the normalisation of monetary growth from the late summer. Over the year 1995 as a whole, DM 182 billion in longer-term funds accrued to the banks from domestic sources – which is equivalent to a rate of growth of 8 %. The focus of investors' interest was on bank debt securities, from sales of which credit institutions received DM 75 billion, followed by long-term time deposits, which increased by DM 69 billion. With net acquisitions of DM 11 ½ billion, there was also some demand for bank savings bonds again in 1995; in the previous two years portfolios of such paper had been reduced on balance. Demand for savings deposits at over three months' notice, on the other hand, was only slight.

Lending to the private sector remains at a high level

Lending to the private sector slackened somewhat last year, but still remained at a fairly high level. Bank lending to enterprises and individuals rose by DM 223 billion or 7 %. Following the rapid pace of expansion in the wake of German unification and the associated heavy borrowing requirements for restructuring in eastern Germany – lending to the private sector increased at an annual rate of 9 ½ % between the end of 1990 and the end of 1994 – the deceleration which occurred in 1995 fundamentally implies a normalisation. This is also true to the extent that it was accompanied by an increase – compared with 1994 – in the public sector's demand for credit and by smaller outflows of funds generated by domestic non-banks' external payments. The "money supply" produced by credit institutions' asset-side business (which determines the underlying monetary trend) thus remained at a high level. In contrast to the preceding years, short-term lending to the private sector and longer-term lending grew at an equally rapid pace in 1995. In view of the easing of long-term interest rates and probably also the further cuts in housing promotion which came into effect at the beginning of 1996, demand for long-term credit picked up again in the second half of the year. Short-term borrowing, on the other hand, was higher in the first half of the year than in the second half. It is likely that the slower growth towards the end of the year owed something to the weakness of economic activity and a consolidation of short-term debt.

Housing loans once again in the forefront

In 1995, as in the two preceding years, over one-half of direct bank lending to domestic private borrowers was accounted for by housing loans. Demand for credit in this sector was, however, not quite as strong as it had been in 1993 and 1994, when strong anticipatory effects had been produced by the phasing out of some tax privileges associated with the acquisition of residential property. Lending to this sector increased by 10 ½ %, after 12 % in 1993 and 13 % in 1994. Lending to the corporate sector, on the other hand, accelerated last year; it expanded at a rate of 6 % (1994: 3 ½ %). One reason for this was probably that enterprises were no longer able to draw on own funds to the same extent as in the previous year. The growth of consumer credit slackened further compared with the previous year owing to the gloomier consumption climate; after expanding by almost 6 % in 1994, such lending grew at a rate of only just over 3 ½ % in 1995.

Expansionary impact of the public sector

There was a marked rise in public sector credit demand last year. At DM 90 billion or 9 ½ %, public sector debt to banks grew much faster than in 1994. In particular, this was a reflection of higher public sector deficits and non-banks' decreasing propensity towards the end of the year to purchase public debt securities. The Länder Governments, above all, sharply stepped up their borrowing from banks in view of their strained budgetary situation. Altogether, just under one-third of total bank lending consisted of lending to the public sector in 1995; on balance all of the loans took the form of direct lending.

Net external assets restrain monetary growth to a lesser extent

Domestic non-banks' external payments had a distinctly smaller contractionary impact on monetary growth in 1995 than in the year before. The net external assets of the banking system, the fall in which reflects outflows of funds in domestic non-banks' current and financial transactions, decreased by DM 31 ½ billion, after DM 141 billion in 1994. One major factor which contributed to the slower decline was the fact that the persistent price rises in the German debt securities markets induced non-residents to buy debt securities on a major scale again.

5. Monetary management since reunification

(a) Initial situation following the currency conversion in eastern Germany

Monetary targets since 1975

The Deutsche Bundesbank announced a monetary target for the first time in 1975. The adoption of monetary targeting was prompted by the difficulties which the Bundesbank – like other central banks, too – had encountered in implementing its traditional strategy. Another factor was the floating of the Deutsche Mark exchange rate in 1973 and (associated with this) the regaining of control over domestic monetary developments. Finally, the move to monetary targeting was also underpinned by recent advances in monetary theory and empirical evidence which had pointed to the close relationship between the growth of the money stock and price trends. Monetary targeting hence appeared to be particularly appropriate for a central bank with a statutory commitment to safeguarding price stability.

The Bundesbank's loyalty to its strategy

The Bundesbank has abided by the concept of monetary targeting for over twenty years now; this continuity has virtually become the symbol of German "stability culture". By contrast, the central banks in most other major industrial countries, after pursuing this strategy temporarily, have in the meantime abandoned it. This was principally due to structural changes in the financial markets in the wake of frequent surges of deregulation and liberalisation in the eighties, which (in combination with high and very volatile inflation rates) had produced a spate of financial innovations. Germany, by contrast, did not undergo such radical changes in the financial system and an erosion of the underlying monetary relationships, thus making the Bundesbank's strategic continuity possible. Nevertheless, monetary targeting has repeatedly been faced with problems in Germany, too. This has been especially true since the early nineties, when it had to meet the special challenge of German monetary union and reunification.

Challenges in the wake of monetary union with eastern Germany

The initial problem that was posed for the strategy of monetary targeting by monetary union with the former GDR, which came into force on July 1, 1990, was an adequate initial provision of eastern Germany with Deutsche Mark. In the event, a solution was found which led to an expansion of the money stock M3 of almost 15 % of the west German money supply. Based on subsequent data on the east German production potential, this was, if anything, generous. What was of greater medium-term importance than the initial jump in the money stock level, however, was the question of the lasting expansion of the money stock. Furthermore, it was doubtful whether the underlying monetary relationships which had applied hitherto in the Federal Republic of Germany would remain unchanged in the extended currency area. It was important to analyse whether the preconditions for monetary targeting were still met, and whether the money stock M3 was still able to perform its function as a guide for monetary policy.

(b) Monetary policy in united Germany: monetary targeting strategy retained unchanged

1990: gearing to the west German monetary target

In this basic given situation the Bundesbank geared its ongoing monetary policy in the second half of 1990 – i.e. immediately after German monetary union – primarily to the monetary target announced for western Germany. This seemed to be advisable because significant portfolio adjustments and an associated fall in the money stock were to be expected in eastern Germany, in view of the fact that savings deposits had been the sole form of investment available in the former GDR. The adjustments likely to take place in the corporate sector pointed in the same direction. It was not possible, however, to make a reliable prediction of the scale or pace of the adjustment of money holdings.

Monetary targets and their implementation*

Table 9

in %

Year	Target: Growth of the central bank money stock or the money stock M3 1			Actual growth (rounded figures)		Target achieved
	in the course of the year 2	as an annual average	More precise definition during the year	in the course of the year 2	as an annual average	
1975	8	–	–	10	–	no
1976	–	8	–	–	9	no
1977	–	8	–	–	9	no
1978	–	8	–	–	11	no
1979	6 – 9	–	Lower limit	6	–	yes
1980	5 – 8	–	Lower limit	5	–	yes
1981	4 – 7	–	Lower half	4	–	yes
1982	4 – 7	–	Upper half	6	–	yes
1983	4 – 7	–	Upper half	7	–	yes
1984	4 – 6	–	–	5	–	yes
1985	3 – 5	–	–	5	–	yes
1986	3 ½ – 5 ½	–	–	8	–	no
1987	3 – 6	–	–	8	–	no
1988	3 – 6	–	–	7	–	no
1989	about 5	–	–	5	–	yes
1990	4 – 6	–	–	6	–	yes
1991	3 3 – 5	–	–	5	–	yes
1992	3 ½ – 5 ½	–	–	9	–	no
1993	4 ½ – 6 ½	–	–	7	–	no
1994	4 – 6	–	–	6	–	yes
1995	4 – 6	–	–	2	–	no
1996	4 – 7	–	...	...	...	...

* From 1991 figures for Germany as a whole. — 1 From 1988: money stock M3. — 2 Between the fourth quarter of the previous year and the fourth quarter of the current year; 1975: December 1974 to December 1975. — 3 In accordance with the adjustment of the monetary target in July 1991.

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Adoption of all-German monetary targets

When setting the target for 1991, the Bundesbank changed over to all-German monetary targets, as it was soon apparent that it was becoming less and less possible to separate monetary expansion in eastern Germany from that in western Germany (see the above table). At the same time, in deriving the target the Bundesbank was well aware of the increased degree of uncertainty about the underlying macroeconomic benchmarks. For one thing, this was true of forecasting production potential in eastern Germany, which was difficult given the expected adjustments in the real sector of the economy. For another, it was not possible simply to assume that east German money holding habits – even after a period of adjustment – would correspond to the pattern of behaviour that applied hitherto in western Germany. It was safe to assume, however, that any disruptions which might occur would be limited, if only because of the differences in size between the old Federal Republic and the former GDR.

Reasons for adhering to the strategy of monetary targeting

It was against this backdrop that the Bundesbank, by retaining its strategy of monetary targeting, set a signal of continuity and its unchanged commitment to price stability. A lack of any convincing alternative likewise pointed to the approach which was adopted. As the adjustment problems in the real sector of the economy in eastern Germany were much larger than in the monetary sphere, a policy primarily geared to interest rates, in particular, seemed to be even less advisable. At the same time, the Bundesbank made it clear from the very outset that it would continuously monitor and take due account of the adjustment processes in eastern Germany. The lowering of the monetary target for 1991 in mid-year by one percentage point to 3 % to 5 % illustrates this point. One persistent problem, besides the reliable assessment of east German productive capacity, was that of determining the addition to be made in deriving the target for the trend decline in the velocity of circulation. In the light of experience of German reunification, an addition which, at one percentage point, was slightly larger than in the preceding years was used by the Bundesbank for the first time for 1993.

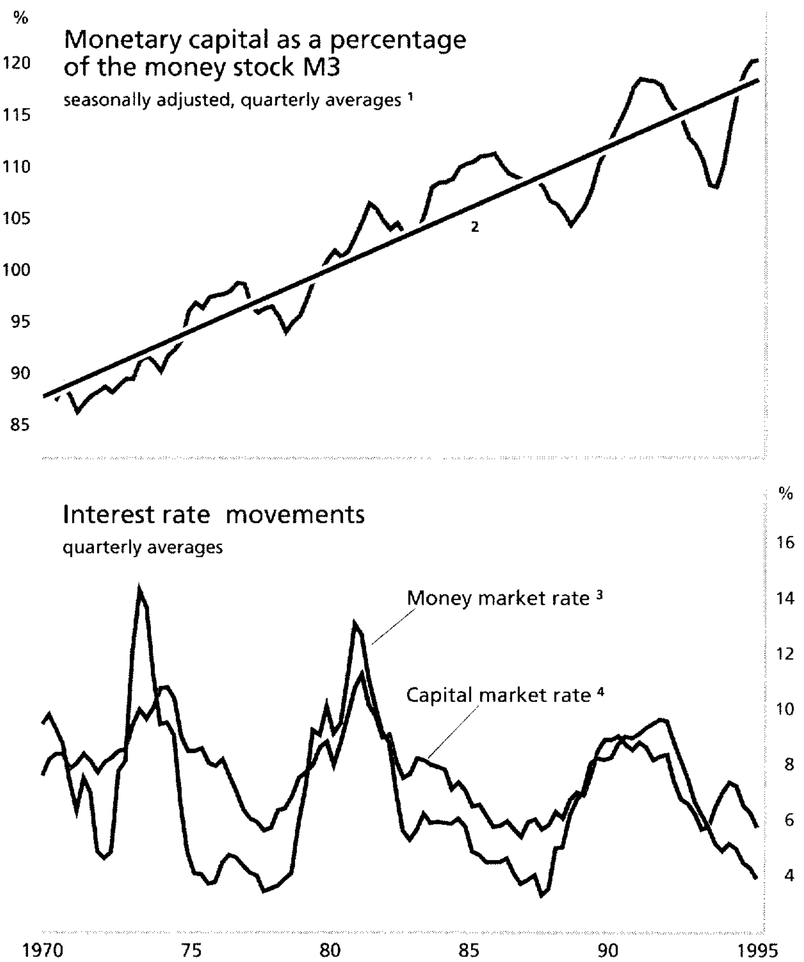
(c) Monetary growth in the nineties

Monetary growth in the nineties

Following monetary union with eastern Germany the growth of the money stock M3 initially remained within the limits envisaged by the Bundesbank. The monetary targets derived for western Germany for 1990 and for Germany as a whole for 1991 were both met. As early as the second half of 1991, however, monetary expansion accelerated sharply, and this acceleration lasted – with temporary interruptions – into 1994. It was followed by a normalisation and reversal which marked monetary growth well into 1995. As a result, the annual monetary targets failed to be achieved several times: the monetary target for 1992 was overshot markedly and that for 1993 slightly, for example. While, in 1994, the target was met, monetary expansion in 1995 remained well below the rate which would have been consistent with the targeted expansion of the money stock. In assessing these deviations it should be borne in mind, however, that the Bundesbank sees its annual targets in the light of a medium-term trend.

Monetary capital in relation to the money stock M3 and interest rate movements

Chart 14



1 Derived from end-of-month levels. — 2 Trend between 1970 and 1995. — 3 Rate for three-month funds quoted by banks in Frankfurt. — 4 Yield on bonds outstanding of domestic issuers.

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Disruptive influences on monetary developments due to unification

The growth of the money stock M3 in recent years, which has been described above, was affected by a number of short-run as well as long-run disruptive factors. Only some of them, however, were connected, either directly or indirectly, with the unification process. Increased public sector borrowing in the wake of unification had an expansionary impact on monetary growth, for instance. The heavy "deficit spending" by the public sector had the impact of a Keynesian reflation programme on the money stock, too. Furthermore, the government heavily promoted private investment in eastern Germany by means of tax relief, direct grants and interest subsidies. Interest rates were therefore not always able to perform their traditional control function for a substantial part of credit demand.

Other disruptive factors

Apart from the impact of unification, other special factors also affected monetary growth. Modifications of the tax framework – in particular interest income and property taxation – temporarily influenced private investment behaviour, for example. Besides this, changes in the financial markets, such as the introduction of money market funds, have left their mark on the growth of the money stock. This also applies to the external constraints on German monetary policy which, in particular, became apparent during the currency turmoil in 1992 and 1993 in the European Monetary System, which was marked by heavy inflows of funds. It also became evident, however, in the increasing globalisation of financial markets and the resulting greater dependence of German capital market rates on international interest rate movements.

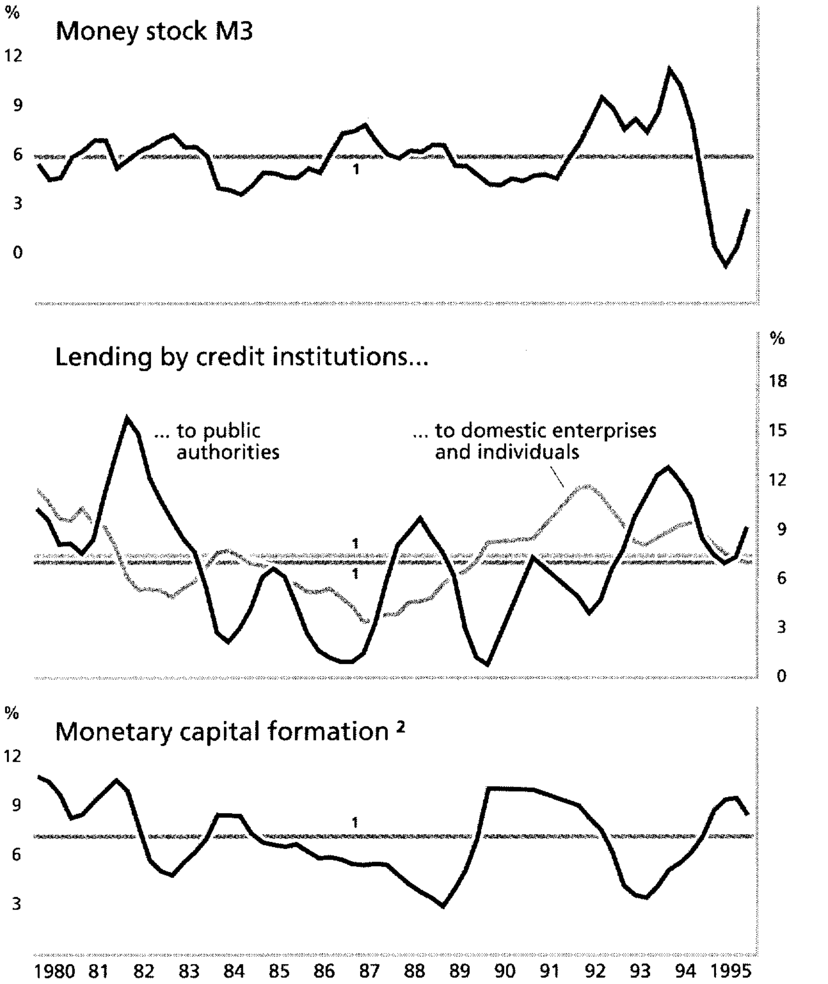
Determinants of monetary growth

Bank lending strongly fuelled monetary growth throughout the period under review. Initially, the main factor was enterprises' and individuals' increased demand for credit in the wake of the unification process. About one-third of lending to the private sector is likely to have benefited the east German economy either directly or indirectly in the first few years following reunification. In view of the marked rise in public sector deficits, heavy government borrowing came more to the fore in the years from 1992. Furthermore, in 1993 and 1994 private credit demand was affected towards the end of the year by tax-induced anticipatory effects in connection with the reduction in housing promotion, followed by a subsequent weakening. Special factors also influenced monetary capital formation: especially in 1994 and 1995, monetary developments were mainly determined by the general public's propensity to lock in funds at longer term with banks (which propensity had initially been extremely subdued and later became very pronounced). These movements were triggered by modifications in the tax withheld on interest income, which resulted in substantial amounts of funds being shifted back to Germany from Luxemburg investment funds. Under the impact of sharp fluctuations in international interest rates and the associated uncertainty and expectations concerning their future trend, this surge in liquidity led to a liquidity blockage in the spring of 1994, which was later reversed. These factors stimulated monetary growth exceptionally strongly in the first half of 1994 and curbed it equally strongly between the end of 1994 and mid-1995.

Money stock, credit and monetary capital

Chart 15

quarterly averages *, change from previous year



* Derived from end-of-month levels. — 1 Average growth between the 1st qtr of 1980 and the 4th qtr of 1995. — 2 Monetary capital formation by domestic non-banks at domestic credit institutions.

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Components of the money stock M3

These unsettling factors had differing effects on the individual components of the money stock M3. Time deposits, in particular, were subject to special developments. Their pronounced fluctuations – their average share in the money stock M3 increased in 1992 and 1993 before falling distinctly in the past two years – at first reflected the effects of the high money market rates and inverse yield curve prevailing at that time. Later on, they were affected not only by falling short-term interest rates but, above all, also by the dissolution of the liquidity log-jam and the (not least tax-induced) acquisition of money market fund certificates. The growth of savings deposits at three months' notice ran counter to that of shorter-term time deposits. Their share in M3 decreased in the period of high interest rates and went up again when interest rates were low. The latter trend obviously also owed something to the revision of the regulations governing savings in mid-1993. Since then, there has been a growth particularly in special savings facilities, which offer rates of interest that are more closely related to market conditions than those of traditional savings deposits if, for example, the depositor does not take advantage of the legally prescribed terms of notice. The rise in the money stock M3 may therefore be somewhat overstated. On the other hand, short-term savings deposits have always been used for personal asset acquisition purposes by savers who are averse to taking risks. From the present perspective it remains to be seen, therefore, whether they have really changed their monetary character. There has likewise been a disproportionate growth of currency since the beginning of the nineties. This is likely to be due mainly to the fact that the Deutsche Mark is used as a parallel currency in some central and eastern European countries. Another factor was the hoarding of cash in Germany in the wake of the revision of interest income taxation. Because the share of currency in M3 is small, this had only a minor impact on monetary growth, however.

Increased volatility

The accumulation of disruptive influences occasionally hampered the short-run performance of the money stock M3 as a guide. The volatility of short-term monetary growth has increased since the early nineties. In the period from mid-1990 to the present the variation coefficient of quarterly changes in the money stock M3 has more than doubled compared with any previous period of equal length. In the final analysis, the advantages of monetary targeting are now more clearly evident in the medium term. By widening the target corridor for 1996 to three percentage points the Deutsche Bundesbank has made allowance for this more volatile trend of the money stock in its strategy of monetary targeting.

Interest rate policy geared to M3

In the light of the short-term special influences which affect the growth of the money stock, the Bundesbank has geared its interest rate policy primarily to the money stock's medium-term trend. As in the past, it has taken the overall domestic and external environment into consideration in its decisions. In 1992, for instance, the Bundesbank indicated that, not least in view of the special influences described, it was to tolerate the overshooting of the monetary target and would not tighten its monetary policy stance further. Even so, the monetary targets served a useful purpose even in the years when they were overshot. They demonstrated the Bundesbank's unconditional commitment to price stability, helped build up confidence and facilitated the policy of low inflation. The timing and extent of the interest rate cuts were mainly determined by monetary developments.

Success of the monetary targeting strategy

The monetary strategy can indeed be considered successful. It has made it possible to tame inflationary expectations (which on occasion were very persistent) and to overcome the risk of domestic and foreign investors losing confidence in the Deutsche Mark. The outlook on inflation has progressively brightened since the revaluation of the Deutsche Mark in the autumn of 1992. In September 1992 the Bundesbank was able to embark on a series of interest rate cuts and continue this process – though at a varying pace – until quite recently.

(d) No alternative to the Bundesbank's strategy

Stability of the demand for money

An increase in the short-time volatility of the money stock does not confront policy makers with problems of a fundamental nature as long as the long-term relationship between the money stock and prices remains in place. The fact cannot be overlooked that conflicts do arise in implementing annual monetary targets. With regard to the demand for money, however, a number of external and internal studies show that the long-term stability of underlying monetary relations in Germany has remained unchanged after reunification.

Direct inflation targeting only a "stopgap" solution

Even though this finding should be interpreted with some caution (if only because of the brevity of the observation period since reunification), it does not suggest that the strategy of monetary targeting should be abandoned and that another strategy should be adopted. It does indicate, however, that the monetary targets should be managed flexibly. The monetary policy strategy of direct inflation targeting therefore continues to be merely a "stopgap solution" in the event of a collapse of the traditional underlying monetary relations. Typically enough, direct inflation targeting has been adopted, above all, by those countries where there have been disruptions in the financial environment or where it was no longer possible to maintain a monetary policy geared to the exchange rate. Even its purported advantages – placing the emphasis on price stability and the medium-term orientation of monetary policy – seem to be of little relevance for Germany as these aspects have always played a major role in the Bundesbank's policy of monetary targeting. Points that are more worth noting from the German perspective are the transparency of the monetary targeting strategy and the associated self-commitment on the part of the central bank. They make the central bank's "performance" "verifiable" and help to reinforce expectations on the part of the general public that are consistent with low inflation. Direct inflation targets are, by contrast, less transparent in view of the large number of indicators used and the long and variable time-lags with which monetary policy measures take effect; this makes it more difficult to assess the adequacy of monetary policy.

Risks involved in multi-year monetary targets

Adoption of a multi-year monetary target, on the other hand, would, in principle, offer an opportunity of reducing the conflicts described above between the desired monetary growth and disruptive factors which affect monetary developments in the short run. Furthermore, the medium-term orientation of the Bundesbank's monetary policy would be more strongly emphasised. It is by no means certain, however, that these potential advantages can be translated into a practicable monetary policy strategy. On the contrary, multi-year monetary targets also harbour risks: for example, the disciplining effects of multi-year targets on monetary policy and their transparency for the general public are likely to be less than those of annual targets. Moreover, much depends on the nature of the disruptive factors which affect monetary developments. Given the rough waters into which German monetary policy has sometimes moved in recent years, multi-year targets are by no means a panacea.

Adherence to the current strategy

Because of these considerations, the Bundesbank continues to adhere to its annual monetary targets which, however, must be seen and assessed even more than before in a medium-term perspective. Furthermore, it is continuing to formulate its monetary target in terms of the money stock M3. It is true that this monetary aggregate has been subject to major fluctuations in the nineties so far. The Bundesbank has made allowance for this fact by also capturing liquidity holdings not included in M3 by means of the extended money stock M3. In addition, it uses the narrowly defined aggregate M1 to monitor the liquidity which is available immediately for payment purposes. Finally, it bases its assessments on a wide range of financial and real indicators. The volatility of the short-term movement of the money stock M3 is not a sufficient reason, however, for changing the intermediate target variable. Empirical studies show that, in comparison with other monetary aggregates, the money stock M3 continues to perform best in terms of the stability of the demand for money pattern, its lead over prices and its controllability. Past experience of monetary targeting in the nineties likewise supports a retention of the Bundesbank's strategy which has proven its worth for more than 20 years. There can be no doubt, for instance, that the strategy of monetary targeting has helped monetary policy to cope with reunification. Above all, it has made it possible to prevent inflationary pressures in the wake of monetary union with eastern Germany from getting out of hand (which had been feared in many quarters).

6. Buoyant interest rate conditions in the financial markets

(a) Nosedive in capital market rates

Sharp drop in capital market yields

In 1995 yields in the German capital market declined by over two percentage points, with only short-lived hold-ups and relatively slight price swings. At the beginning of this year the yield on domestic debt securities outstanding reached an all-time low, at less than 5 ¼ %. On balance, the interest rate increase of 1994 was fully offset. In view of the very low level of yields, uncertainty and volatility in the debt securities market increased again at the end of January. In the wake of the upturn in interest rates in the US capital market, a sharp reversal took place. By mid-April 1996 German debt securities, at about 5 ¾ %, were again yielding just over one-half of a percentage point more than at the beginning of the year.

Favourable global interest rate situation

The sharp decline in interest rates in 1995 took place against the backdrop of favourable interest rates world-wide. Capital market rates fell markedly in all major industrial countries. For example, in the United States, Treasury notes with a maturity of ten years yielded 2 ¼ percentage points less at the end of 1995 than at the beginning of the year, whereas in Germany yields in the ten-year maturity category decreased by 1 ¾ percentage points. From May 1995 onwards debt securities issued by the Federal Government with a maturity of ten years had an overall yield advantage over the US market that, however, evened out in the spring of 1996 and has even been reversed of late. The fall in interest rates was greatly fostered by the prospect of a "soft landing" of the US economy, without any major inflationary tensions, and by the slackening of economic activity in other countries, which led to a revision of the growth forecasts, some of which had initially been very optimistic.

Closer international interest rate linkages

The momentum of interest rate movements in recent years and the fresh decline in yields on debt securities to very low levels suggest that not only cyclical influences but also structural changes are shaping the interest rate situation. Given the ever-increasing interdependence of markets and the intensive use of new instruments and techniques, which permit rapid and cost-effective shifts in portfolios, international interest rate linkages have become closer and the short-term response potential of the markets has significantly increased. In such circumstances, changes in expectations may trigger swift and vigorous price movements. On the other hand, the prospects of durably lower interest rates have likewise tended to improve in this situation. This primarily applies to the crucial precondition of consistently lower inflation expectations. The pressure exerted by markets on national economic policy makers to keep their own house in order has increased. This has also reinforced the consensus that monetary policy contributes most effectively to stable economic conditions and steady growth by adopting a stance orientated towards the medium term and geared to safeguarding the value of money.

Favourable stability prospects in Germany

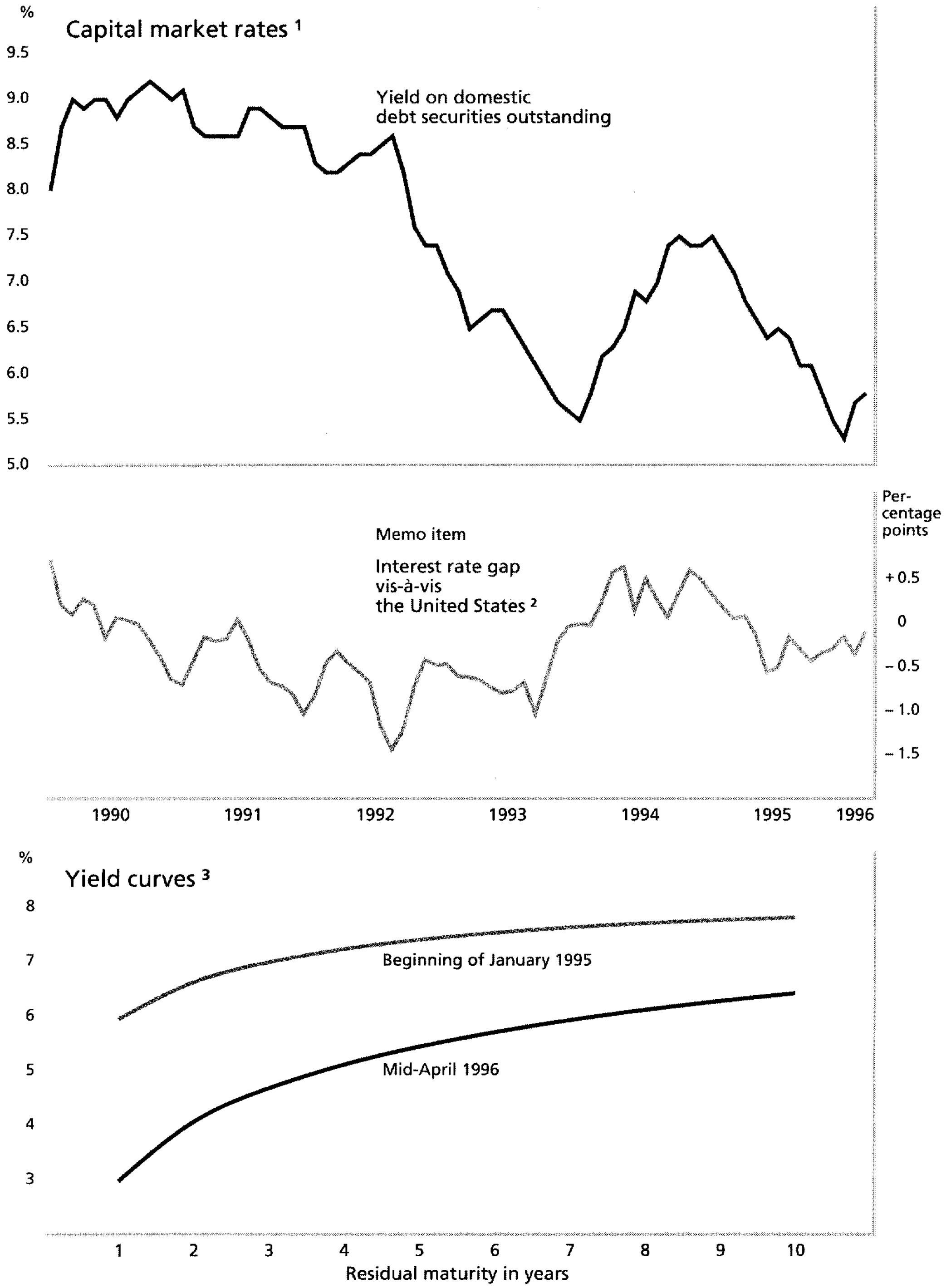
In domestic terms, the interest rate decline in the debt securities market was mainly fostered by the favourable stability prospects. The relatively sluggish pace of monetary growth and the sustained efforts at consolidation on the part of the public sector operated in the same direction. Towards the end of the year, moreover, market players' attention was focused more on the muted business activity. Against this background, the interest rate relaxation in the capital market was buttressed by the reductions in the Bundesbank's interest rates, which dispelled all doubts as to the continuation of a credible anti-inflation policy. They had a particular impact on the short maturity categories in the debt securities market. Thereafter, the yield curve fanned out further and, with an interest rate spread between ten-year and one-year paper of over three percentage points, showed an unusually steep slope at times. On balance, over the entire maturity range, nominal interest rates fell to a level that was very low by historical and international standards.

Real rates of interest not high

In real terms, too, interest rates cannot by any means be considered high. Money market rates, adjusted for the current pace of price increases at the consumer level, at less than 2 %, are lower than at any time since the beginning of the eighties. The real capital market rate, computed in the same way, at 4 ¼ % in the first quarter of 1996, was about half as high as the average of the last twenty years. However, investors' decisions are governed by the real rate of interest that results if the future inflation rate to be expected over the financing period is taken into account. This "true" real rate of interest is probably somewhat lower, since long-term inflation expectations have presumably not yet fully adjusted to the current rate of price rises. Altogether, the interest rate level undoubtedly provides a good starting point for the reinvigoration of business activity. The reversal of capital market rates in January and February, which was due more to the inherent dynamics of the market and to international interest

Interest rate movements in the debt securities market

Chart 16



1 Monthly averages. — **2** Yields on US Treasury paper with a maturity of approx. ten years less yields on Federal securities that are deliverable at the German Financial Futures Exchange with a residual maturity of over nine up to and including ten years. — **3** Regression figures for listed Federal securities.

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rate uncertainties than to a fundamental reassessment of interest rate prospects in Germany, likewise did nothing to change this appraisal.

Capital market in the run-up to European monetary union

The smaller decline in long-term capital market rates by comparison with the United States, or with the short end of the market, last year gave rise to fears that the yields on long-term Deutsche Mark debt securities might include a premium for the risks involved in European economic and monetary union (EMU). In principle, doubts as to the anti-inflationary stance of the European System of Central Banks (ESCB) or major uncertainties about the progress of the monetary integration process are likely to be reflected in such premiums, but hitherto there has been no unequivocal empirical evidence of their existence. The smaller decline in interest rates in Germany as against the United States, for instance, may also owe something to the above-mentioned reassessment of the monetary policy outlook abroad, while the distinctly steep slope of the yield curve is to be regarded for the time being as a reflection of sharply dropping money market rates. But even if there has been no unambiguous evidence of "foreshadowing effects" of EMU so far, the debate on possible adverse repercussions on capital market rates has to be taken seriously. In order to nip in the bud the danger of an EMU-induced increase in capital market rates, and of speculative capital movements with corresponding volatility, all doubts as to the future ESCB's anti-inflationary stance must be dispelled. When deciding on the participants in the monetary union, arrangements are required (besides the strict interpretation and application of the convergence criteria) that ensure a sufficient degree of fiscal discipline after the start of monetary union.

(b) Attractive Deutsche Mark debt securities market

Issuing activity remains at a high level

Issuing activity in the German debt securities market stabilised at a high level in 1995. Gross sales of debt securities, at a market value of DM 618 ½ billion, reached approximately the same magnitude as a year earlier (DM 621 ½ billion). The amount raised by sales of domestic debt securities, after deduction of redemptions and after taking due account of changes in issuers' holdings of own-debt securities, at DM 202 ½ billion, was nearly one-fifth lower than the previous year's figure (DM 249 ½ billion).[1] Altogether, the debt securities market

1 Net sales of domestic debt securities in 1994 were DM 26.7 billion higher than the actual amount raised, as the conversion of book debts of the German Federal Post Office to the Postbank into Post Office bonds and notes (to the extent of DM 21.3 billion) and the allocations of debt securities by the Currency Conversion Equalisation Fund (to the tune of DM 5.4 billion) did not involve any direct recourse to the market. In 1995 the allocations of debt securities by the Currency Conversion Equalisation Fund amounted to no more than DM 0.6 billion.

was not quite able to hold its ground in the overall financing process, with a share of just under one-fifth in the amount raised by all domestic sectors. However, it has to be borne in mind in this context that the unusually substantial amounts raised between 1992 and 1994 owed much to the borrowing requirements associated with unification. In 1995 foreign debt securities worth DM 24 ½ billion were placed in the German debt securities market (as against DM 27 ½ billion a year before). The comparatively large difference between the net funds placed in the debt securities market and the gross sales of debt securities shows that nowadays, on balance, a major part of the issue proceeds stems from maturing funds. While, during the eighties, redemptions of securities averaged just under DM 150 billion a year, between 1990 and 1995 they averaged almost twice that figure. In 1995 this sum was joined by an estimated DM 200 billion of interest payable on debt securities. This great "self-funding" capacity is an indication of the high degree of maturity that the German debt securities market has meanwhile reached.

Significant structural changes among public issuers

Last year saw a marked change in the weight and structure of public issuers' recourse to the debt securities market. In 1995 the public sector's direct borrowing in the capital market, at DM 41 billion, came to under one-third of the figure for the previous year, when public borrowers raised DM 132 billion net by selling debt securities. This owed a great deal to the winding-up of the Treuhand agency; at DM 58 ½ billion (net), it had actually raised more funds than the Federal Government in the debt securities market in 1994. The Redemption Fund for Inherited Liabilities, which assumed the Treuhand agency's debts at the beginning of 1995, has not yet issued any securities, but has so far mostly raised funds by taking up loans against borrowers' notes. Furthermore, the outstanding amounts of issues launched by the former Federal Post Office and the Federal Railways have declined (by DM 6 billion and DM 3 ½ billion, respectively). The Federal Government's new borrowing in the debt securities market amounted to just under DM 39 billion last year, compared with DM 48 billion a year before. The decline in public issuers' significance was partly due to the fact that credit demand has shifted perceptibly to borrowers who meet only a relatively small part of their requirements direct in the debt securities market. The Länder Governments sold debt securities to the tune of DM 6 ½ billion net, and thus on a scale comparable to that of the previous year, although they took up distinctly more loans against borrowers' notes.

Large amount raised by sales of bank debt securities

The noticeably smaller amount raised by selling public debt securities was accompanied by bond issues of credit institutions amounting to the record sum of DM 162 ½ billion (net). On the one hand, the issuing of bank debt securities was fostered by the buoyant demand for bank credit on the part of individuals and public authorities. On the other hand, in view of the rising securities prices and the sluggish issuing activity of the public sector, conditions were particularly favourable for raising funds by means of debt securities. The amount of communal bonds outstanding in the market, in particular, rose sharply, increasing by DM 89 billion. Sales of other bank debt securities remained at a high level (DM 54 billion net). Mortgage bonds and debt securities issued by specialised credit institutions were sold to the value of DM 15 ½ billion (net) and DM 4 billion, respectively.

Measures to enhance market liquidity

Both the Federal Government, as the biggest public issuer, and credit institutions took steps in 1995 to enhance the liquidity of their debt securities and to make them more attractive to institutional investors, in particular. In the summer the Federal Government streamlined its range of securities by discontinuing the issue of four-year Federal Treasury notes. At the same time, it started to step up sales of special Federal bonds by tender, after the termination of the sales of a series in the open market, in order to boost liquidity in the five-year maturity range in this way. In the case of bank debt securities, activity focused on issues launched by mortgage banks. A number of credit institutions issued mortgage bonds and public mortgage bonds with a volume of DM 1 billion and more.[1] At the end of the year 48 such "jumbo issues", with a total volume of DM 64 ½ billion, were outstanding, whereas at the end of 1994 only 12 comparable issues with a volume of DM 14 billion had existed. The issuer or the syndicate of these "liquid mortgage bonds" also commit themselves to quoting the buying and selling rates within a fixed range in order to improve the negotiability of such paper. The introduction of a mortgage bond index and the creation of an electronic trading system in the market for mortgage bonds operated in the same direction.

Spate of issues of foreign Deutsche Mark bonds

In 1995 a spate of new issues was recorded in the market for foreign Deutsche Mark bonds. Overall, non-residents launched debt securities denominated in Deutsche Mark to the value of DM 102 ½ billion gross (against DM 61 ½ billion a year before); the amount raised, at DM 61 billion, actually tripled compared with 1994. The great interest evinced in such paper was primarily due to

1 In the statistics, public mortgage bonds are included among communal debt securities.

Sales and purchases of debt securities

Table 10

DM billion

Period	Sales				
		Domestic debt securities [1]			
			of which		
	Total	Total	Bank debt securities	Public debt securities	Foreign debt securities [2]
1985	102.7	76.1	33.0	42.7	26.7
1990	244.8	220.3	136.8	83.6	24.5
1991	232.0	219.3	131.7	87.0	12.6
1992	291.8	284.1	106.9	177.4	7.7
1993	395.1	382.6	151.8	230.6	12.5
1994	303.4	276.1	117.2	158.9	27.4
1995	227.3	203.0	162.5	40.8	24.3
1995 1st qtr	57.3	53.6	33.4	20.7	3.7
2nd qtr	41.1	34.0	29.7	4.2	7.2
3rd qtr	69.0	60.7	48.7	12.0	8.3
4th qtr	59.9	54.7	50.7	3.9	5.1
	Purchases				
			Non-banks [4]		
	Total	Banks (incl. the Bundesbank) [3]	Total	Domestic debt securities	Non-residents [2]
1985	102.7	32.8	39.3	16.5	30.6
1990	244.8	91.8	133.3	121.1	19.8
1991	232.0	45.8	127.3	125.8	58.9
1992	291.8	133.5	37.4	45.6	120.9
1993	395.1	163.1	21.0	24.2	211.0
1994	303.4	125.3	156.4	135.5	21.8
1995	227.3	46.9	97.7	92.5	82.7
1995 1st qtr	57.3	- 11.4	53.0	55.0	15.7
2nd qtr	41.1	0.8	13.9	12.3	26.4
3rd qtr	69.0	19.5	33.8	29.7	15.7
4th qtr	59.9	38.0	- 3.0	- 4.5	24.9

1 Net sales at market values plus/less changes in issuers' holdings of own-debt securities. — **2** Transaction values. — **3** Book values; statistically adjusted. — **4** Residual.

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temporary exchange rate tensions, as a result of which Deutsche Mark assets were increasingly in demand. Foreign investors, in particular, bought foreign Deutsche Mark bonds in order to diversify their portfolios in currency terms. Almost 90 % of the net sales in 1995 were placed abroad.

Slackening interest of non-banks in buying bonds

In 1995 the buyers' side of the German debt securities market was characterised by the waning interest of domestic non-banks. Although they purchased domestic debt securities worth DM 92 ½ billion net and foreign bonds to the value of DM 5 billion (as against DM 135 ½ billion and DM 21 billion, respectively, in 1994), their interest in debt securities issued by residents diminished noticeably as capital market yields fell in the course of the year. While non-banks increased their holdings of such paper by DM 55 billion in the first quarter, they actually sold domestic debt securities worth DM 4 ½ billion net in the last quarter of 1995. By contrast, towards the end of the year investment fund certificates, which benefited from preferential treatment in the context of property tax (and particularly the liquid certificates of money market funds), met with great interest. After investment funds open to the general public had recorded inflows totalling barely DM 2 billion in the first nine months of the year, in the last quarter they registered inflows amounting to DM 15 billion, two-thirds of which accrued to money market funds. Specialised funds likewise recorded almost one-half of their inflows of funds (totalling DM 37 ½ billion) in the final quarter of 1995. Compared with the previous year, however, 1995 was a somewhat disappointing year for investment funds, as domestic non-banks (by a wide margin the most important buyer group) added certificates issued by domestic and foreign investment funds totalling only DM 44 ½ billion to their portfolios, as against DM 117 ½ billion.

Marked increase in foreign purchases

In 1995 foreign investors, with net purchases amounting to DM 82 ½ billion, accounted for over one-third of the total amount raised in the domestic debt securities market, after only DM 22 billion in 1994. While non-residents mainly bought public debt securities (totalling DM 48 billion) at first, in the second half of the year they increasingly purchased bank debt securities, too. But the "liquid mortgage bonds" mentioned above played only a minor role. Domestic credit institutions were initially reluctant to purchase debt securities in 1995, after they had been forced to accept large write-downs of the market prices of their debt securities portfolios at the end of 1994. It was only from the late summer of 1995 onwards that credit institutions once again bought debt securities in large quantities – particularly bank debt securities. They apparently also served as a buffer for the flagging demand of non-banks. All in all, credit institutions' debt securities holdings increased by DM 47 billion in 1995, compared with DM 125 ½ billion a year earlier.

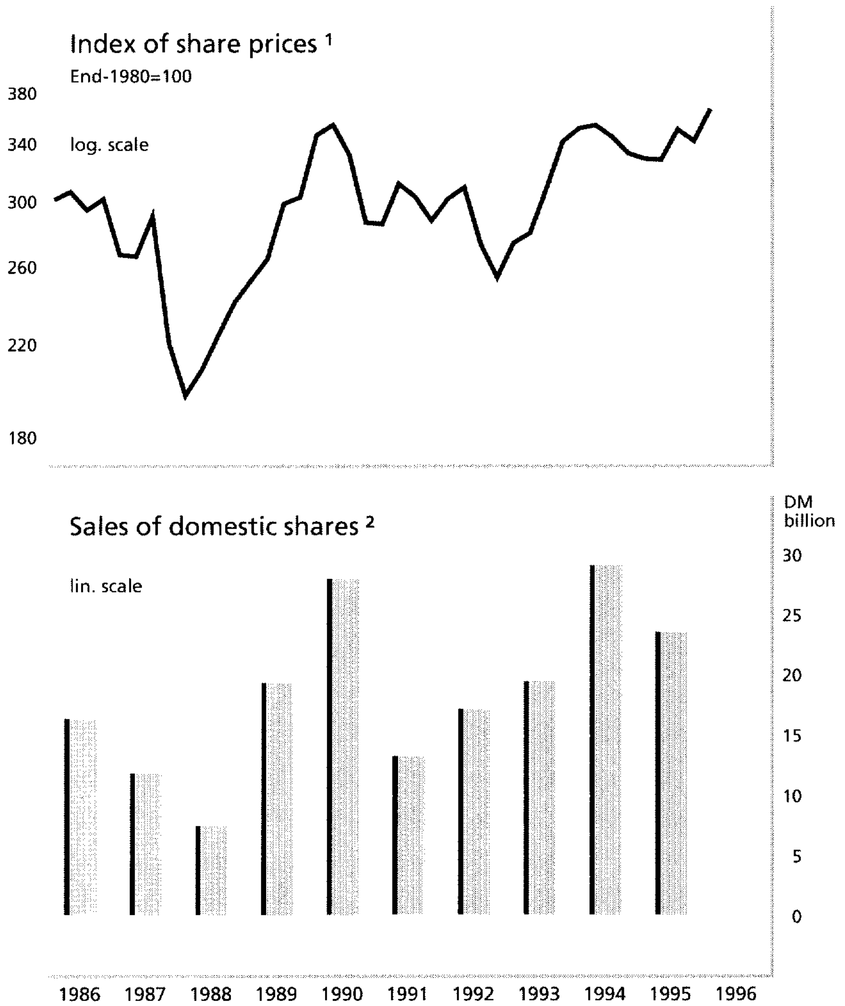
(c) Ups and downs in the share market

Sharp reversals in prices in the spring and autumn

In 1995 the German share market was hard hit by the unexpectedly high wage settlements and the appreciation of the Deutsche Mark. In March and between mid-September and end-October, when the US dollar depreciated against the Deutsche Mark by 5 ½ % and 6 ½ %, respectively, share prices (as measured by

Conditions in the share market

Chart 17



1 Composite DAX share price index of the German Stock Exchange plc; quarterly averages. — 2 At issue prices.

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the Composite DAX share price index) declined by almost 9 %. The broadly-based and sustained decrease in interest rates constituted a major counterweight to the pressures emanating from the exchange rate side and the wage round. Viewed over the whole of 1995, however, the prices of the shares officially listed on the Frankfurt stock exchange increased by only 2 ½ % on average.

Price movements diverge in different sectors

Share price movements differed considerably in the various economic sectors. While the prices of shares in electrical engineering enterprises and public utilities showed sharp gains (of 33 % and 14 %, respectively), the prices of shares in credit institutions were adversely affected by less favourable earnings prospects, especially in the first half of the year; in 1995 they ended up slightly below the final figure of the year before. Shares in construction firms, which fell by almost 31 % in the light of the slowdown in that sector, were at the bottom end of the price range. Since the beginning of 1996 sentiment in the share market has picked up distinctly, and in January alone prices rose by 7 %. When this Report went to press, they were 8 % higher than at the end of 1995.

Buoyant issuing activity

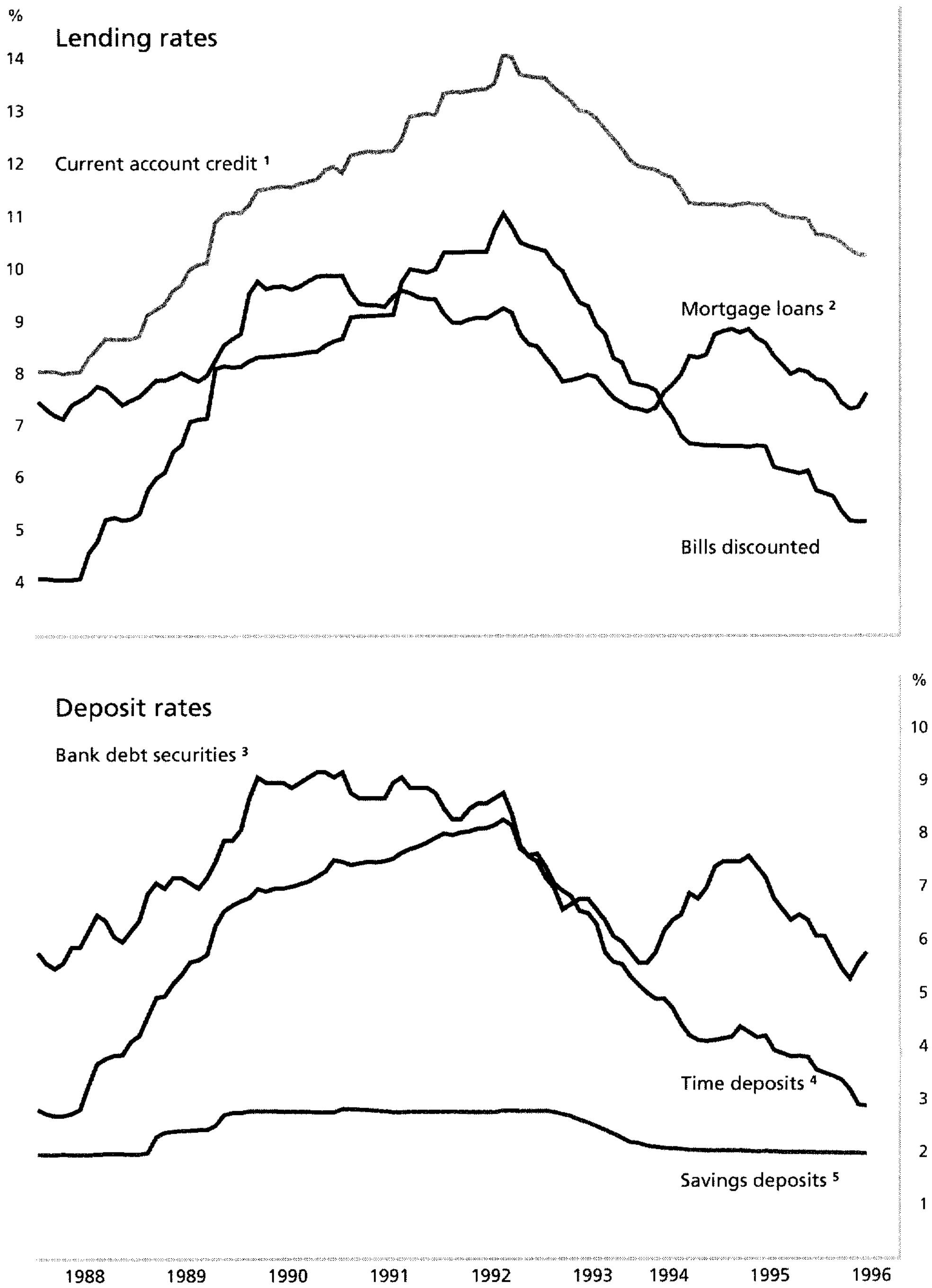
In spite of the volatile price situation, issuing activity in the German share market was buoyant in 1995. The issue volume, at DM 23 ½ billion, did not come up to the previous year's record level (DM 29 billion), but it was the third highest ever. In addition, an unusually large number of new enterprises "went public" last year. At twenty, the number of enterprises that were admitted to official trading or to the regulated market was twice as high as a year before. Among them were two major new issues by producing enterprises with a volume of over DM 2 billion each. All the new issuers – like a substantial number of already listed enterprises – availed themselves of the option afforded by the Second Financial Market Promotion Act of issuing shares with a face value of DM 5. It remains to be seen to what extent a broader distribution of share holdings among the general public can be achieved by means of such "lighter" shares. In 1995 a number of share issuers in Germany for the first time used the book-building method, whereby – in contrast to fixed-price issues – new shares are sold on an ad hoc basis, after the collection of subscription orders ("book-building"), to those bidders who meet the issuer's wishes with respect to price and quality. In 1995 foreign participatory instruments worth DM 20 ½ billion were placed in Germany. In contrast to the situation in the previous year, when portfolio investment accounted for approximately one-half of the additional purchases, in 1995 only direct investment was involved on balance.

Residents dominate the buyers' side

Overall, only domestic investors figured on the buyers' side of the share market in 1995. Domestic non-banks bought about three-quarters of the shares sold, at DM 33 billion. Almost DM 21 billion of this sum was accounted for by direct investment abroad, virtually all of which is held by enterprises in the form of share portfolios. The greater part of the remaining purchases were effected by domestic institutional investors, notably specialised investment funds. Private investors apparently showed little interest in direct share purchases; there was also very little "indirect" demand for equities through investment funds. Among

Movements in selected bank interest rates *

Chart 18



* 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 ten years. — 3 Yield on bank debt securities outstanding with a residual maturity of over nine but not more than ten years. — 4 With an agreed maturity of 1 month to 3 months inclusive and sums of DM 100,000 and over but less than DM 1 million. — 5 Until the end of June 1993, savings deposits at statutory notice, then at three months' notice; excluding bonus-carrying savings deposits and special savings schemes.

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investment funds open to the general public, share-based funds, at just over DM 1 billion, recorded only a fraction of the amount raised a year earlier. Domestic credit institutions increased their share holdings by almost DM 12 billion, consisting exclusively of domestic paper. Non-residents continued to eschew the German share market; they sold German shares worth DM 1 billion net.

(d) Trends in the banking sector

Lending operations by the various categories of banks

Last year mortgage banks and big banks increased their market shares in lending operations. Their lending to domestic non-banks rose by 17.3 % and 10.1 %, respectively, which was distinctly above the average of all banks (7.6 %). Mortgage banks benefited primarily from the buoyant demand of the public sector for credit, while big banks markedly increased their lending to the private sector. The regional institutions of the savings bank and cooperative bank sectors were likewise able to improve their market position slightly. Savings banks (6.0 %) and credit cooperatives (5.8 %), by contrast, fared worse in 1995, following a period of above-average growth in the preceding years. This seems to have been mainly due to less lending to the public sector against securities. In the case of regional banks, the growth in lending operations, at just over 4 %, was only about one-half as strong as a year earlier; this was primarily because of subdued public authority loan business and stagnating short-term lending to the private sector. Banks with special functions continued to reduce their lending to domestic non-banks (– 4.5 %), as they have been doing since 1993; between 1990 and 1992 such lending had increased sharply as a result of unification.

Prospective trends in earnings

According to the data available at present, the profitability of German credit institutions in the financial year 1995 seems to have been satisfactory. True, the interest rate margin was subject to mounting pressure in 1995 owing to a persistent increase in the cost of funds, as reflected in the sustained sharp rise in higher-yielding special savings facilities and other forms of investment. Moreover, the out-turn in non-interest business stagnated, no doubt mainly owing to increasing price competition as a result of new direct sales institutions in payment operations and securities business. On account of the favourable trends in the capital market, however, market-price-related write-downs of own securities portfolios will hardly occur, in contrast to 1994, so that, even in the event of higher net charges arising from the valuation of assets in lending operations, satisfactory operating results and profits for the year are to be expected.

Balance sheet structures

In the last five or six years, the balance sheet structures of German credit institutions have changed markedly. In lending operations, the ratio of lending to non-banks to the volume of business has increased from 58 % to almost 63 % since 1990; interbank lending has correspondingly declined in importance (from 35 % to 32 %). This trend was particularly pronounced among savings banks, credit cooperatives and mortgage banks; big banks' asset structure changed contrary to the general trend towards interbank operations. Taking the average of all banks, the ratio of long-term lending to the volume of business increased markedly between 1990 and 1995 (from nearly 43 % to almost 50 %), benefiting from the demand for housing loans and from the borrowing requirements of the public sector. In the same period, lending against securities to non-banks rose from 4.2 % to 7.7 %, although the trend once again fell slightly in the course of 1995. The persistent tendency towards securitisation in credit institutions' deposit business can be gauged from the continuously rising proportion of bearer debt securities issued, which amounted to over 21 % in 1995, compared with 17 % in 1990. Correspondingly, the share of deposits of non-banks has declined from 46 % in 1990 to just over 43 % today.

III. International monetary policy cooperation

1. State of progress towards convergence in the EU

Progress in curbing inflation

In accordance with the provisions of the Maastricht Treaty, the economic and monetary union (EMU) which the EU countries are aspiring to create presupposes a high degree of economic convergence. In this respect further considerable advances were generally made in 1995 in terms of combating inflation. According to the protocol on the convergence criteria, a country meets the requirements of price stability if its inflation rate does not exceed that of the – at most three – best-performing member states by more than 1½ percentage points. If the average rate of inflation of the three best-performing countries is taken as the reference basis, nine of the 15 member states complied in 1995 with the threshold value which, as one of the test criteria, would have restricted entry to EMU, conceived, as it is, as a community of stability. The inflation rate figures for 1995 are based on partly harmonised consumer price indices. These new indicators exclude some areas of private consumption, which hitherto had not been treated uniformly by all the countries, from the data set used for calculating the index (notably owner-occupied dwellings, spending on health care, education, package tours, insurance and financial services). Hence these interim indices do not capture all the components of the cost of living; however, their more limited basis improves cross-country comparability. Owing to diverse methodological problems, more broadly based indices in a harmonised form will not be available before 1997.

Insufficient fiscal policy consolidation

By contrast, the advances made in the field of fiscal policy consolidation were less satisfactory. Although most countries managed to further reduce their budget deficits in 1995 (some quite considerably), only three countries – Denmark, Ireland and Luxemburg – met the deficit criterion by keeping their budget deficit below 3 % of GDP. At the same time, the ratio of gross debt to gross domestic product increased further in most countries, with the consequence that the Maastricht ceiling of 60 % was overshot even more substantially in many cases. The failure to use previous phases of economic strength sufficiently vigorously for consolidation measures is now taking its toll. It is more difficult, however, to rectify past omissions under the worsened cyclical conditions. The vast majority of member states thus still have a long way to go in order to attain a degree of fiscal policy consolidation sufficient to comply with the budget criteria on a lasting basis.

Progress in convergence as measured by the EMU criteria (disregarding the exchange rate criterion)

Table 11

EMU criterion fulfilled

Country	Change in consumer prices from previous year in % 1: Traditional index 1994	Traditional index 1995	Partly harmonised index 1995	Financial balance of the public sector as % of GDP 2: 1994	1995
EMU threshold value 3	3.1	2.9	2.7	– 3	– 3
Austria	3.0	2.2	2.0	– 4.4	– 5.5
Belgium	2.4	1.5	1.4	– 5.3	– 4.5
Denmark	2.0	2.1	2.3	– 3.8	– 2.0
Finland	1.1	1.0	1.0	– 5.8	– 5.4
France	1.7	1.7	1.7	– 6.0	– 5.0
Germany	2.7	1.8	1.6	– 2.6	– 3.5
Greece	10.9	9.3	9.0	– 11.4	– 9.3
Ireland	2.4	2.5	2.4	– 2.1	– 2.7
Italy	4.0	5.2	5.4	– 9.0	– 7.4
Luxemburg	2.2	2.0	1.9	2.2	0.4
Netherlands	2.7	2.0	1.1	– 3.2	– 3.1
Portugal	5.3	4.1	3.8	– 5.8	– 5.4
Spain	4.8	4.6	4.7	– 6.6	– 5.9
Sweden	2.3	2.9	2.9	– 10.4	– 7.0
United Kingdom	2.4	3.5	3.0	– 6.8	– 5.1

Country	Yield on long-term public bonds in %: 1994	1995	Gross government debt as % of GDP 2: 1994	1995
EMU threshold value 3	10.0	9.7	60	60
Austria	7.0	7.1	65.2	68.0
Belgium	7.8	7.5	135.0	134.4
Denmark	7.8	8.3	75.6	73.6
Finland	9.1	8.8	59.8	63.2
France	7.2	7.5	48.4	51.5
Germany	6.9	6.9	50.4	58.1
Greece	20.8	17.3	113.0	114.4
Ireland	7.9	8.3	91.1	85.9
Italy	10.5	12.2	125.4	124.9
Luxemburg	7.7	7.6	5.9	6.3
Netherlands	6.9	6.9	78.0	78.4
Portugal	10.4	11.4	69.4	70.5
Spain	10.0	11.3	63.0	64.8
Sweden	9.7	10.2	79.7	81.4
United Kingdom	8.2	8.3	50.1	52.5

Sources: European Commission, BIS, EMI and national statistics. — 1 For Sweden: official inflation rate. — 2 As defined in the national accounts (including social security funds). — 3 The rate of inflation must not exceed that of the – at most three – best-performing countries by more than 1 ½ percentage points. The yield on long-term public bonds must not exceed that of the – at most three – best-performing countries by more than 2 percentage points. The threshold values listed here for the inflation rate and the yield relate to the unweighted average of the three best-performing countries in terms of price stability. In this table, fulfilment of the criteria is measured in terms of these threshold values.

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Exchange rate movements between EU currencies again moderate . . .

Exchange rate movements between the EU currencies displayed a much more tranquil pattern following the turbulence at the beginning of 1995. However, of the currencies participating in the exchange rate mechanism of the EMS, the French franc and the Irish pound traded in 1995 predominantly and uninterruptedly, respectively, at a rate of exchange to the Deutsche Mark outside the previous fluctuation margin of ± 2 ¼ %. On the other hand, the Dutch guilder, the Austrian schilling and the Belgian franc recorded remarkably little volatility vis-à-vis the Deutsche Mark, whereas the Spanish peseta and the Portuguese escudo recovered perceptibly after their devaluation of March 1995 and in the meantime – on their lower exchange rate basis – are within the previous narrow exchange rate band. Of those currencies which withdrew from the exchange rate mechanism of the EMS in 1992, the Italian lira has improved noticeably from the level to which it plummeted in April 1995, but its persistently low valuation reflects continuing economic and political uncertainties in Italy. The British pound, on the other hand, remained at the low level it reached in spring 1995, although since 1992 it has depreciated less sharply than the lira.

. . . but persisting convergence deficits in exchange rate policy

In the light of the convergence requirements, this exchange rate situation is only partly satisfactory. In order to fulfil the exchange rate criterion, countries must not only have participated in the exchange rate mechanism of the EMS for the two years prior to the examination date but must also have respected the normal fluctuation margins without severe tensions. Furthermore, a candidate for EMU must not have devalued its currency during this period. The precise definition of what constitutes the normal fluctuation margins needs to be clarified following the widening of the margins in 1993, and the concept is not due to be defined until the contractually envisaged date of the convergence examination. However, the present fluctuation margins of ± 15 % can certainly not be adopted as the gauge. Besides the requirement of participation in the exchange rate mechanism, the other convergence deficits in respect of exchange rate policy should therefore not be underestimated either. The attendant risks can best be averted by pursuing a monetary and fiscal policy strictly geared to stability. The readiness to pursue such a policy could be signalled to the markets, not least, by ensuring that all countries which wish to participate in EMU secure the independence of the national central bank already in the second stage, at as early a point as possible, but at the latest by the time the European System of Central Banks (ESCB) is set up.

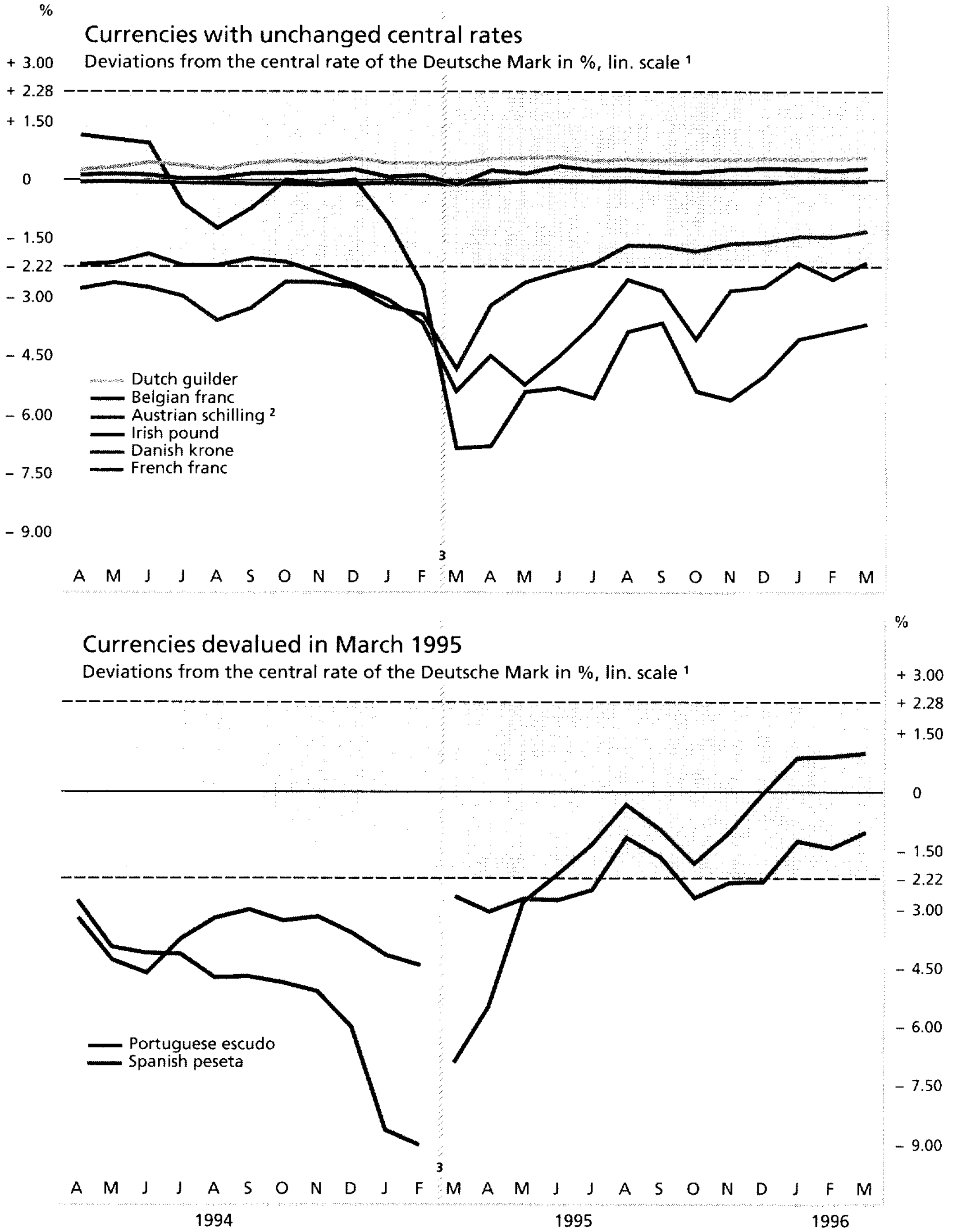
Extensive convergence of long-term interest rates

Despite the convergence problems which remain, the interest rate criterion was fulfilled in 1995 by a great majority of member states (even if less comprehensively than in 1994). The interest rate reference value is deemed to be met if the

Movements of selected EU currencies against the Deutsche Mark

Chart 19

Monthly averages



1 Depiction of the narrow fluctuation margin (± 2¼%) for the period subsequent to its widening to ±15% in July 1993 serves merely to facilitate assessment of exchange rate movements. — 2 Joined the exchange rate mechanism at the start of 1995. — 3 Peseta and escudo devalued by 7% and 3½%, respectively.

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long-term interest rates of the – at most three – best-performing countries are not exceeded by more than 2 percentage points. If, in this case, too, the interest rates solely of the three countries with the lowest rates of inflation are taken as the yardstick, only five countries failed to meet the corresponding threshold value (Greece, Italy, Portugal, Spain and Sweden). However, this favourable result owes something to the fact that the best-performing country at present (Finland) still has a fairly high interest rate level, which thus pushes up the reference value accordingly. Hence the interest rate convergence achieved conceals the fact that so far only very few countries have attained long-term interest rate levels which are both close together and low. Consequently, the high degree of interest rate convergence (in terms of the convergence criterion) can be interpreted only with reservations as an indication that the markets are displaying growing confidence in the determination and ability of the member states to pursue a policy geared to stability.

Equal importance of all convergence criteria

If the proposed European currency is to be put on a sound footing, all and any attempts to soften the convergence criteria, for example with a view to securing a particular desired range of participants in EMU, must be resolutely rejected. This also implies that the various criteria – as envisaged by the Treaty – must, as a matter of principle, all be regarded as being of equal importance. In December 1995 the European Council accordingly confirmed that the strict observance of all the convergence criteria is a fundamental precondition for the introduction of the single currency.

2. Institutional preparations for EMU

(a) Agreement on the basic rules for the change-over to the euro

Multiphase change-over scenario

In December 1995 the European Council agreed to adopt the name "euro" for the future European currency and expressed the view that monetary union, subject to the achievement of a sufficient degree of convergence, should start at the beginning of 1999. At the same time, the European Council agreed on certain major basic rules for the transition to the euro. This so-called change-over scenario subdivides the time required for completely replacing the national currencies by the euro into three phases. An interim period lasting about a year, which will begin as soon as the decision is made on which member states qualify[1] and during which notably the European System of Central Banks is to be set up and the concluding conceptual and technical preparations for stage three are to be made, will be followed from January 1, 1999 by a phase lasting up to three years during which the single currency will be introduced progressively for book-entry transactions. A period not exceeding six months is specifically envisaged subsequently for the issue of banknotes and coins denominated in euro and for the recall of national monetary tokens. If this phase does not already begin within the aforementioned three-year period, it will start on January 1, 2002 at the latest.

No compulsion to change over quickly

The agreed rules are aimed at accomplishing the transition to the European currency, in keeping with the interests and technical possibilities of all economic agents, as gently as possible and in maximum harmony with market conditions so as to foster the public acceptability of the new currency. Accordingly, the procedure for introducing the single currency is largely devoid of coercive elements. The dominant principle of the change-over is, rather, that – prior to the issue of European banknotes and coins – anyone may use the new currency in book-entry transactions within the framework of contractual agreements but that there will be no compulsion to use it during this phase.

Conversion facilities to avoid currency dualism

The European System of Central Banks, consisting of the ECB and the national central banks of the participating countries, will conduct its monetary policy operations in euro right from the start of stage three. To enable those credit institutions which have not yet changed over to the European currency nevertheless to participate in the refinancing and payment system facilities of the central bank system, and hence to protect them against competitive disadvantages, the national central banks can provide conversion services during the transitional period. The Bundesbank will make such facilities available. The conversion systems which will be set up to this end will facilitate automatic conversion between the euro and the national currencies at the irrevocably fixed conversion rates. That will leave each individual bank free to set its own date for switching to the euro completely in accordance with its own requirements.

No leading role for the public sector

It is likely that the public sector will not make comprehensive use of the euro until the end of the change-over period, if only because of the time needed for the extensive technical preparations. This also accords with the principle of not

1 The selection is to be made as early as possible in 1998 by the Heads of State or Government on the basis of the actual economic data for the year 1997.

forcing the private sector to adopt the euro at an early stage. However, the member states participating in the euro currency area are to denominate all new issues of listed public paper, especially issues which do not mature until after the end of the transitional period, in euro right from the start of EMU. The use of conversion systems will ensure that purchasers of such debt instruments, if they so desire, will be able to pay the equivalent amount in national currency throughout the change-over period and will likewise be able to have the interest credited to them in national currency. The stock of public debt securities outstanding denominated in national currencies will be converted to euro, together with the remaining transactions of the public sector, on July 1, 2002 at the latest, and all interest payments and capital repayments thereafter will be denominated in the single currency. That gives the participating states a certain leeway the specific utilisation of which will require detailed consideration in respect both of the national and of cross-border implications.

(b) Intermediate results of the preparations for a European monetary policy

Preparations for the ESCB's strategy and instruments

The ESCB must have a suitable strategy and appropriate instruments at its disposal at the beginning of stage three of EMU in order to be able to carry out its statutory mandate of ensuring stable prices. The Council of the European Monetary Institute (EMI Council) therefore discussed questions regarding the monetary policy strategy and instruments in depth last year. However, the Maastricht Treaty stipulates that the final decisions are to be reserved for the European System of Central Banks, which is to be set up in 1998. Given the considerable amount of preparation and implementation time which will be needed in some cases, detailed and rapidly executable "blueprints" are to be elaborated in good time, particularly for the array of instruments, of which the ESCB can make use in due course.

Monetary targeting strategy versus direct inflation targets

For the choice of the monetary policy strategy, the discussions to date have focused on two alternatives: on the one hand, on a strategy which uses an intermediate target for monetary growth as the main reference variable for a non-inflationary monetary policy and, on the other hand, on an approach which directly targets price movements. A number of partner central banks, unlike the Bundesbank, prefer direct inflation targets because the intermediate target variables which they used previously were considered unsatisfactory under the conditions prevailing in their respective countries. If a "direct strategy" is used, however, the transmission channel from the deployment of the monetary policy instruments up to the final objective of monetary policy needs to be sufficiently well known and calculable if a planned monetary policy is to be possible. The Bundesbank, together with other central banks, is in favour of a monetary target for the ESCB, too, because insufficient information is available on the transmission mechanism and experience has shown that inflation is always a monetary phenomenon, irrespective of the different factors which trigger price rises (see also the comments on monetary targeting since reunification on page 75 ff.). Such intermediate targets have proved their worth in 20 years of use as the key target variable for monetary policy decisions in Germany. In particular, they make it easier for the general public to understand the aims and to assess the effectiveness of monetary policy and so promote the credibility of the central bank. The adoption of such a strategy by the ESCB will require, however, that the links between the money stock and prices are similarly stable in the monetary union as they have been hitherto in Germany. A number of independent studies have substantiated the assumption that this requirement is likely to be satisfied.

Agreement on open market policy, marginal refinancing and a deposit facility as the core instruments

Whereas the issue of the European monetary policy strategy needs to be discussed further, the EMI Council has meanwhile reached agreement that the linchpin of the ESCB's arsenal of monetary policy instruments is to be an open market policy based mainly on securities repurchase agreements. Accordingly, a start is to be made already this year on the detailed technical work for this instrument. The Council has further agreed that the ESCB should have at its disposal a credit facility to serve marginal refinancing needs and a deposit facility. The former, resembling the German lombard loan, is to provide a ceiling for upward interest rate movements in the money market, whereas the deposit facility is envisaged as constituting the floor for the money market rate.

Need for further discussion on minimum reserve requirements and basic refinancing

The EMI Council also decided to perform the necessary preparatory work so that the ESCB will have available the minimum reserve instrument from the outset of EMU. Minimum reserves, which would have to be maintained as an average of a specified period, would serve, in particular, to smooth short-term interest rate fluctuations in the money market and to safeguard and stabilise the demand for central bank money. The required minimum reserve amounts could be recorded on the basis of the monthly banking statistics, thereby obviating the need for separate minimum reserve statistics, at least at the beginning of stage three. Discussions are still continuing on the possibility of creating a separate basic refinancing facility for credit institutions. In Germany this task is performed at present by the rediscount credit facility.

Bundesbank recommends appropriate use of private sector debt instruments as collateral

Another task still to be done in preparing the future instruments is to further specify which types of collateral are to be eligible for central bank loans. The choice of eligible collateral must take into account both the requirement of a future single European monetary policy and the fact that the existing financial market structures vary from country to country. An additional major principle must be that public paper is not to be favoured over private paper. An adequate inclusion of private debt instruments in refinancing operations is also appropriate in the light of the banking structure and the rooting of monetary policy in the real economy. One possible solution would be a Union-wide list of securities eligible as collateral at the central bank, which would be drawn up by the ECB, plus a second list of collateral with a more regional significance (such as trade bills), with the national central banks being responsible for drawing up this supplementary list in accordance with a uniform set of basic rules. A number of specific questions also need to be clarified, for example whether the cross-border use of collateral should be permitted, or the method of apportioning any losses incurred by the ECB and the national central banks in selling the collateral.

(c) Initiatives for fiscal policy coordination and political integration

Safeguarding EMU through fiscal policy and through progressive political integration indispensable

Whereas complete responsibility for monetary policy will be transferred to the Community level from the start of the final stage of EMU, fiscal policy will remain the province of the member states. The monetary union will only be able to function satisfactorily on a lasting basis, however, if the fiscal policies of all the member countries are likewise kept on a stability-oriented course. It is essential that the fiscal policy of each individual member state is firmly integrated because if just one country – especially a major country – followed a misaligned course, negative consequences would ensue for the capital market and for the external position of the entire Community, and ultimately it could also jeopardise the external value of the euro. As a monetary union represents a lasting commitment to integration which encroaches on the core area of national sovereignty, the EMU participants must be prepared, in addition, to take further steps towards a more comprehensive political union.

German proposal for a "stability pact for Europe"

With a view to safeguarding fiscal policy discipline in the EMU, the Federal Minister of Finance submitted a proposal in November 1995 for a "stability pact for Europe". The objective of this initiative is to define more precisely the Maastricht Treaty's fiscal policy stability criteria, which are to apply permanently, and the regulations envisaged for ensuring that they are observed, and at the same time to render them operational. The stability pact envisages two key obligations: firstly, the growth rate of government expenditure should be kept, if possible, below the rate of increase of the nominal national product in the medium term and, secondly, the budget deficit ceiling of 3 % of GDP should not be exceeded even during economically unpropitious periods. That would require keeping the deficit well below 3 % of GDP during normal cyclical phases. The EMU participants are to pursue fiscal consolidation in a way that will enable them steadily to lower the ratio of government debt to GDP. The stability pact also proposes that the sanctions contained in the Maastricht Treaty be defined more precisely and that their operational application be tightened up. As currently worded, the procedure for avoiding excessive budget deficits provides for the imposition of sanctions in stage three of EMU on member states which are undertaking insufficient convergence efforts. Such steps are subjected, however, to a very complicated and protracted mechanism which therefore holds out little prospect of success. The German proposal envisages that any EMU member which overshoots the deficit limit would automatically – i.e. without requiring further complex decision-making procedures – have to lodge a non-interest-bearing stability deposit with the Community amounting to ¼ % of its gross domestic product for each full or partial percentage point by which it breaches the ceiling. If it fulfils the deficit criterion in the two subsequent years, the deposit would be repayable; otherwise it would be converted into a fine.

Positive response from partners to fiscal policy proposals

After the German proposal of a stability pact had met with a positive response from the Council of Economic and Finance Ministers, the European Council, at its meeting in Madrid in December 1995, likewise reaffirmed that, after the transition to stage three of EMU and in accordance with the obligations arising from the Maastricht Treaty, a sound course of public finance must be ensured in the long run. The details of the German proposals and the associated legal aspects are currently being examined in depth. The European Commission intends to submit its conclusions on this issue in the course of the current year.

Requisite progress towards a more far-reaching political union still awaited

Besides EMU, the Maastricht Treaty also enshrined certain other elements of a so-called political union in the EC Treaty, notably the objectives of a common foreign and security policy, cooperation in the areas of justice and home affairs and of a common Union citizenship. The Union's political structure has also been further developed through the extension of the decision-making powers of the European Parliament and the improvement of the Council's decision-making procedure. These first steps do not suffice, however, to ensure the necessary embedding of EMU in a more far-reaching political union. That makes it all the more desirable that the Intergovernmental Conference on the further political and institutional development of the EU, which opened in Turin in March 1996, will yield substantive results.

(d) Exchange rate relationships between EMU and the other EU countries

Safeguarding the single market

As things stand today, there is much to indicate that not all EU countries will belong to the euro currency area from the outset. The EC Treaty expressly provides for this eventuality. That raises the important question for the EU economic area of how the exchange rate relationships between the EMU participants and the other EU countries are to be structured. A fundamental consideration is that the single European market functions satisfactorily only with undistorted exchange rates. Given the extensive intra-Community integration of trade, exchange rate aspects are very pertinent, especially for Germany. The relevant Community institutions are currently studying this question closely. There is agreement that the basic prerequisite for achieving the goal of exchange rate stability is that all EU countries must pursue an anti-inflationary convergence policy. For the rest, attention has focused so far on the forms of exchange rate policy cooperation which are appropriate in the light of the above stipulation, although complete agreement has not yet been reached. The Bundesbank is fundamentally in favour of a system of central rates with wide fluctuation margins which, at the same time, must contain additional adequate safeguards against unacceptably high interventions in the foreign exchange market. At any rate, a completely free exchange rate for the currency of an EU country not participating in EMU would appear conceivable only as an exception and only for a limited period.

Avoidance of extensive intervention . . .

Past experience of the exchange rate mechanism of the EMS has demonstrated that extensive intervention commitments in support of agreed exchange rates may jeopardise the monetary policy of strong-currency countries, particularly that of the anchor country. According to prevailing opinion, this experience must be taken into account in the cooperation in the field of exchange rate policy between the euro area and the remaining EU countries. This is especially important as the ECB, as a newly created institution, will have to build up a reputation as a stability-oriented central bank from scratch. If its monetary policy efficiency were to be impaired in any way as a result of interventions or of adopting a deliberately accommodating monetary policy stance in response to exchange rate tensions, that would inevitably undermine public confidence in this institution and in the euro.

. . . requires sufficient flexibility

Any exchange rate arrangements between the euro currency area and the other EU countries must therefore be sufficiently flexible. As those countries which do not join the EMU initially will need to make good their convergence deficiencies in order to qualify for later entry into the monetary union, it follows that countries with weaker currencies should bear the brunt of the burden of achieving exchange rate stability (asymmetrical burden-sharing). This would merely serve to underline the fact that no exchange rate system, however conceived, can act as a substitute for internal stability efforts but that, conversely, sound economic conditions are the prime prerequisite of and basis for the desired aim of exchange rate stability. As a matter of principle, however, those countries which do not join the EMU at the start must be expected to subject themselves to the constraints resulting from the requirement of stable exchange rates, both with a view to their later entry into the euro currency area and in the interests of ensuring equal treatment for all EU countries. Another argument in favour of such a demand is the fact that the Maastricht Treaty stipulates as a condition of EMU entry a two-year period of participation in the exchange rate mechanism which must be largely free of tension.

Timely adjustment of parities must be ensured

The goal of securing a high degree of intra-European exchange rate stability is only justifiable, however, subject to the proviso that the agreed central rates reflect the fundamentals. Thus the aim of exchange rate cooperation cannot be to defend exchange rates, once fixed, at any price. Weak-currency countries and strong-currency countries alike would have nothing but disadvantages from such a scheme – as past experience has amply demonstrated. If a non-participant in EMU fails to secure a sufficient degree of internal stabilisation, the system must therefore be equipped with reliable procedures for making rapid exchange rate adjustments with the aim of minimising distortions in the real terms of trade. In the interests of ensuring the ECB's ability to act in the field of monetary policy, it should be assigned an appropriate role, which would also help to depoliticise the adjustment of parities.

Differentiated forms of cooperation probable

The precise form which future cooperation in the field of exchange rate policy will take cannot be determined in detail prior to the involvement of the ECB Governing Council (which will comprise the ECB's Executive Board and the governors of the participating national central banks) and before the respective composition of the two groups of countries has been established. It is to be expected that those countries which do not join the euro currency area immediately will display relatively heterogeneous levels of convergence. That will be particularly true if the EU is enlarged. This disparate starting situation must be taken into account by means of sufficiently differentiated forms of exchange rate cooperation and, if need be, through a graduated approach (for example, with different fluctuation bands) so as not to endanger the stability of the entire system right from the start. Agreements are conceivable according to which cooperation is differentiated by country and becomes progressively closer as further progress towards convergence is made.

Agreement between EC central banks would provide the necessary flexibility

The Maastricht Treaty offers no more than very limited starting points for tackling not only the material issues of intra-Community exchange rate cooperation but also the legal underpinning which should be provided for that cooperation. It would be advisable to base the system on the procedure which was adopted for the EMS. At that time, the EC central banks, on the basis of a resolution of the European Council, concluded an agreement covering the details of cooperation in the field of monetary policy. A parallel arrangement for monetary policy cooperation between the euro currency zone and the remaining EU countries would provide the necessary flexibility in structuring these relationships.

3. The IMF confronted with new challenges

(a) Monetary policy responses by the IMF to changes in the global economic environment

Lending trebled

In 1995 the International Monetary Fund more than trebled its lending against the preceding year. All in all, drawings on the IMF in 1995 reached an unprecedented order of magnitude of SDR 18.4 billion. By contrast, in the three previous years the total amount of IMF disbursements had been below SDR 6 billion in each case. The strong rise is due mainly to loans to Mexico and Russia. These two countries accounted for more than two-thirds of all IMF resources granted in 1995. Mexico, for example, received an IMF loan totalling SDR 12.1 billion, or 690 % of the Mexican quota, to overcome its financial crisis. This exceptionally sizeable commitment – the highest which the IMF has ever agreed with a single member country since its establishment – should definitely remain an exception, however. In addition, the Fund extended a short-term credit totalling SDR 4.3 billion – which was relatively high in absolute terms – to Russia which completely exhausted the annual access limit for drawings under the so-called stand-by arrangements of 100 % of a country's quota.

New procedure for financial assistance in cases of extreme crisis

As a result of a review commissioned by the World Economic Summit of 1995, the Interim Committee agreed in autumn last year to establish an "Emergency Financing Mechanism" (EFM). The objective of this "mechanism" is to provide the member countries concerned with particularly fast assistance in severe external

Disbursements, repurchases and repayments under IMF credit facilities and loans

Table 12

SDR billion

Item	1991	1992	1993	1994	1995
Disbursements					
Credit tranches	2.6	3.3	1.1	1.8	14.4
Extended Fund Facility	1.9	0.9	1.9	0.9	2.0
Compensatory and Contingency Financing Facility 1	3.0	0.6	0.7	0.3	0.0
Structural Adjustment Facility 2	0.8	0.5	0.3	0.9	1.4
Systemic Transformation Facility 3	–	–	1.4	1.9	0.6
Total disbursements	8.2	5.3	5.3	5.9	18.4
Repurchases and repayments	4.8	4.2	3.9	4.8	7.1
Net disbursements	3.4	1.1	1.4	1.1	11.3

Source: IMF. — **1** Comprising only the Compensatory Financing Facility up to August 1988; in 1991 it was temporarily extended to include a so-called oil import element. — **2** Including both the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF); both facilities are financed out of special IMF accounts and are available only to countries whose per capita income is particularly low. — **3** Temporary facility for countries in transition; purchases were possible until the end of 1995.

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crisis situations in order to contribute to calming the financial markets and thus to counteract any repercussions which might jeopardise the international monetary and financial system ("systemic risks"). In these circumstances an accelerated decision-making procedure in the IMF Executive Board is envisaged for credit applications under which financial aid would be granted within the existing Fund facilities and subject to the usual conditionality. As measured by the regular disbursement profile, the country concerned can, furthermore, draw a large part of the loan amount immediately ("front loading"). In addition, current access limits can be exceeded in exceptional cases. In return, the beneficiary countries are expected to adopt a programme of profound economic adjustment measures and to repay the loan as soon as possible after the crisis has been overcome. It is agreed in the IMF that this special procedure may be applied in extreme cases only. Nevertheless, given the possibility of such prompt assistance by the Fund, there is the danger that investors in the international financial markets, when making their decisions, may rely on being able ultimately to pass on to the IMF the risks arising from their exposures (problem of "moral hazard"). This would imply that the financial markets would no longer have the disciplining effect expected of them and would thus encourage a misallocation of capital. For these reasons the Deutsche Bundesbank had objected to the establishment of the EFM. It is to be hoped that recourse to this procedure will in fact take place very restrictively, as envisaged, and will be subject to stringent adjustment conditions.

Support for currency stabilisation funds

In future, the Fund may, moreover, provide financial assistance for the establishment of currency stabilisation funds in countries which adopt accelerated adjustment measures to reduce high rates of inflation and employ the exchange rate as a monetary anchor of their disinflation strategy. The IMF resources are made available as part of a stand-by arrangement in the higher credit tranches, taking account of the current access limits. A precondition for the Fund's support is that the exchange rate is fixed at a realistic level.

Concessional assistance for countries devastated by war

Since 1962 the IMF has been able to grant loans with low conditionality to its member countries in the case of natural disaster. Following a further suggestion of the World Economic Summit in Halifax, the Executive Board decided last year to extend this possibility to countries which have overcome serious internal or international conflicts ("post-conflict countries"). In doing so, the Fund wishes to take account of the fact that the administrative capacities of such countries are sharply reduced in most cases. The credit line fixed for this is limited to 25 % of the quota; it may, however, be exceeded in exceptional cases. The Republic of Bosnia and Herzegovina became the first country to resort to this newly established financing facility in December 1995.

Continuation of ESAF

Furthermore, in the autumn of 1995 a majority of the Interim Committee recommended the continuation of the Enhanced Structural Adjustment Facility (ESAF) which initially had been set up for a temporary period in 1987. The Fund uses this facility, which has clear development policy characteristics, to grant longer-term structural adjustment assistance on particularly favourable terms to developing countries with a low per capita income. So far the facility has been funded predominantly through direct loans from financially strong IMF members to the ESAF Trust. On this basis funding is ensured at least up to the end of 1999. From 2005 at the latest the ESAF is to be permanently funded by the resources of an IMF special account which will be released then. The way in which funds will be provided in the interim is still open. In order to bridge this interim period, the IMF staff has submitted various proposals which are to be discussed by the Interim Committee in the spring of 1996. Most of these proposals envisage financing these ESAF loans, up to the time they become self-financing, not out of the aforementioned loans to the ESAF Trust but from regular IMF resources (quota subscription payments). As the latter are, as a rule, provided by the central banks of the member countries and are made available mostly in the form of credits in the respective national currencies, this would amount to financing longer-term development-related tasks by creating money. For reasons of principle, such concepts must definitely be warned against. They are on a par with the demands, which are no less problematical, to create new special drawing rights for the purposes of development assistance.

Monetary character of the IMF should be preserved without qualification

In the Bundesbank's opinion, the IMF should primarily focus on its proper monetary mandate in future, and thus on the surveillance of the monetary and economic policies of its member countries, in particular, and on temporary balance of payments financing. The important task of the Fund to ensure an open and stable international monetary system should not be impaired by assuming functions for which it has no mandate and for which it lacks the suitable means. The Bundesbank takes an equally critical view of financing facilities which are subject to reduced conditionality as of attempts to finance payments redolent of development assistance by monetary means.

Problematic plans to reduce the debt burden on poor countries

The efforts to include multilateral financial institutions (World Bank, regional development banks and IMF) together with bilateral creditors in an action programme encouraged by the World Economic Summit in Halifax are most problematic as well; this programme is designed to assist heavily indebted poor developing countries to achieve a debt level that is sustainable over the long run. Under this programme far-reaching debt relief is to be granted to these countries once they have pursued a convincing economic policy for several years. Depending on the terms and conditions on which the multilateral institutions are included, it is to be feared that the hitherto undisputed preferred creditor status of the multilateral financial institutions would be undermined. Any impairment of this status would adversely affect both the financial standing of the multilateral development banks which fund themselves in the international capital markets and the revolving nature of the IMF's monetary resources. It is to be hoped that the action programme (the details of which have not yet been clarified) takes equal account of these concerns and of the circumstance that the structural character of the debt problems mentioned calls for a solution using development aid funds.

(b) Negotiations on strengthening the IMF's financial base

Discussions on parallel arrangements to the GAB

Following recommendations by the World Economic Summit of 1995, and with a view to the growing challenges facing the Fund, ways and means are being sought at present to essentially enlarge its lines of credit from member countries. In the light of the discussions so far a concept is evolving according to which the IMF might conclude complementary "new arrangements to borrow" with financially strong countries parallel to the General Arrangements to Borrow (GAB) which have existed since 1962. These additional refinancing lines, by means of which the present volume is to be doubled overall, would be provided both by GAB participants (G-10 countries and Saudi Arabia) and by those other member countries of the IMF which are able and willing to assume responsibility for a satisfactory functioning of the international monetary system. The GAB would be continued unchanged. It remains to be seen to what extent the current negotiations with potential new participants yield concrete results.

Increase in quotas in preparation

The establishment of additional credit lines for the IMF from member countries in a strong reserve position, however, is justifiable only as a supplementary safeguard for exceptional financing tasks. Irrespective of this, the Fund should, in principle, have sufficient resources of its own to be able to adequately assist its members to cope with balance of payments problems. Against this background, the need for an increase in quotas in the context of the current Eleventh General Review of Quotas is largely undisputed. Since the IMF quotas should approximately correspond to the relative importance of the individual member countries in the world economy, it would be sensible to take account, during the forthcoming review, of changes in the economic weights of member countries. Apart from an across-the-board increase in quotas, the Bundesbank therefore also supports selective quota adjustments. When deciding on the future size of the Fund, however, the ample supply of credit in the international markets must be considered as well, which argues against an excessive general increase in quotas.

(c) Improvement in crisis prevention

Strengthening of surveillance through the improved provision of data

The unexpected outbreak of the Mexico crisis showed clearly that the Fund's policy should increasingly be geared to crisis prevention. The IMF therefore plans to improve its surveillance of member countries' economic policies by requesting them to supply more comprehensive and more up-to-date economic and financial data. For this purpose, the reporting requirements for twelve core data categories were laid down in detail. In the context of the annual Article IV consultations, it is, furthermore, to be examined to what extent member countries comply with the defined information requirements vis-à-vis the Fund.

Two-tier standards for data publication

To facilitate correct risk assessment by the markets, the IMF has also adopted minimum requirements for the publication of data. These standards cover 17 economic data categories and should, in principle, be complied with by all countries. Furthermore, it is recommended that countries which have borrowed in the international financial markets or seek access to them meet additional quality requirements when publishing their data. However, for the time being only a few countries will be able to comply with these recommendations owing to numerous technical statistical problems. The Fund will nevertheless publish as soon as possible a "positive list" of those countries which meet the more demanding standards.

Strengthening the resilience of the international banking and financial system

Crisis prevention in the widest sense includes strengthening the resilience of the international banking and financial system to disruptions which may emanate from payment crises of major players. At the World Economic Summit of June 1995 the G-7 countries therefore urged closer cooperation between the relevant international institutions responsible for supervising banks and investment firms. The Basle Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) have meanwhile taken further common steps designed to limit the risks arising from derivatives transactions. The objective is to prompt market participants to improve their own risk controls and the disclosure of the positions they have incurred. On the other hand, cooperation in the field of capital provisioning for market risks is more difficult. On the recommendation of the Basle Committee on Banking Supervision, the G-10 central bank governors decided in December 1995 that uniform criteria are to be used in future for the capital backing of market risks arising from trading and derivatives positions. By virtue of the EC Capital Adequacy Directive, this regulation likewise applies to investment firms in the Community (see the comments on the Bundesbank's participation in banking supervision on page 134 ff.). Agreement in the IOSCO on the introduction of comparable regulations for non-European investment firms and hence the elimination of the present regulatory differential is, however, still outstanding. The financial problems encountered mainly by Mexican banks after the outbreak of Mexico's latest debt crisis, furthermore, focused interest on the special significance of the resilience of debtor countries' financial systems, too. The relevant international institutions should pay greater attention to the opportunities for improvements which exist in this area.

(d) Future management of debt crises

Growth of securitised debt requires adjustments in crisis management

As a complementary strategy to strengthening financing facilities and to promote crisis prevention, the G-7 countries, moreover, envisaged at their summit meeting in Halifax fundamentally reconsidering the management of debt crises. This concern has been prompted by the sharp growth in securitised debt of many developing countries since the beginning of the nineties. It is reflected in a much broader creditor structure which may render the resolution of international debt problems more difficult. However, the answer to this more complex situation must not lead, in the event of crisis, to international balance of payments assistance rewarding, so to speak, and thus encouraging risky behaviour in the international borrowing and lending of capital. The Heads of State or Government of the Group of Seven therefore requested the Group of Ten to examine how such debt crises can be coped with in future.

Agreement in the Group of Ten on the priority of market solutions

The Group of Ten has now begun this review in close contact with the representatives of investors. It came to the conclusion that mechanisms designed on the lines of national bankruptcy and composition proceedings would be unsuitable for facilitating the necessary sharing of burdens between debtors, creditors and international agencies in the event of crisis. Apart from manifold legal problems, there is the concern that such instruments might, in particular, encourage moral hazard by debtor countries. In the opinion of the G-10 countries, it is therefore important to make clear to market participants (both creditors and debtors) that no bail-out by official agencies can be expected and that payment problems must primarily be dealt with through market solutions. What can be considered at most is that the IMF implicitly accepts the temporarily unavoidable suspension of payments by a country by agreeing, under exceptional circumstances, to an adjustment programme backed by limited financial resources before the debtor country has reached a sustainable settlement of existing liabilities with all its creditors. The expediency of such an approach, which might help to build up confidence and thus facilitate reschedulings, requires further thorough examination, however. In addition, the Group of Ten considers it useful if market participants were to make future bond issues subject to clauses which could facilitate joint action by securities creditors in cases of crisis (this would mainly entail convening creditor meetings and appointing creditor representatives as well as allowing majority decisions). Even if, in purely legal terms, such clauses, which would have to be elaborated by the market participants themselves, could contribute to improving the starting conditions for crisis management only over the long term, they are likely to be suitable as guiding principles for crisis management even today.

Operations of the Deutsche Bundesbank

I. Processing cash payments and cashless payments

1. Cash payments

Banknotes and coins in circulation

The value of banknotes in circulation on December 31, 1995, at DM 248.4 billion, was DM 12.2 billion (or 5.2 %) higher than at the end of 1994. The value of coins in circulation, by contrast, rose by only 2.7 %. At the end of 1995 94.3 % of all currency in circulation consisted of banknotes, and 5.7 % of coins.

Currency in circulation

Table 13

Trends over time

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
1991	194,615	181,300	13,315
1992	227,285	213,355	13,930
1993	238,641	224,341	14,300
1994	250,907	236,165	14,742
1995	263,510	248,363	15,147

Pattern at the end of 1995

Banknotes in circulation			Coins in circulation		
Notes of DM	DM million	Percentage of total	Coins of DM	DM million	Percentage of total
1,000	81,162	32.7	10.00	2,347	15.5
500	26,098	10.5	5.00	5,625	37.1
200	10,752	4.3	2.00	2,193	14.5
100	95,872	38.6	1.00	2,273	15.0
50	21,100	8.5	0.50	1,095	7.2
20	8,111	3.3	0.10	996	6.6
10	4,958	2.0	0.05	311	2.1
5	310	0.1	0.02	144	0.9
			0.01	163	1.1
Total	248,363	100	Total	15,147	100

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At the end of the period under review, more than 2.5 billion notes were in circulation. Of these, 130 million were notes of the old series. In the denominations between DM 10 and DM 100 which are significant in payments, these old notes only accounted for shares of between 2 % (DM 100) and 8 % (DM 10) of the respective denominations in circulation. The notes of the old series ceased to be legal tender on July 1, 1995. However, the Bank will continue to replace them at their face value.

Destruction of banknotes

The following banknotes were destroyed as they were no longer fit for circulation or had been called in:

	1991	1992	1993	1994	1995
Number (million)	1,099	1,697	914	516	739
Value (DM billion)	62.6	97.5	120.0	28.2	50.6

The rise in the number of banknotes destroyed is essentially due to the increase in the age of the banknotes in circulation and to the fact that the sorting-out of banknotes no longer usable has been extended as a result of automated banknote processing.

Coins

The stock of German coins held by the Bank at the end of 1995 amounted to DM 2,091 million (end-1994: DM 2,126 million). In 1995 about DM 430 million was credited to the Federal Government in respect of coins received from the mints and about DM 61 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1995 the Bank – acting on behalf of the Federal Government – received coins amounting to DM 19,212 million and redeemed coins which were no longer fit for circulation or which had been called in, equivalent to DM 1,975 million. At the end of 1995 coins totalling DM 15,147 million were in circulation, equivalent (given 81.6 million inhabitants) to DM 186 per head of the population. The DM 10 commemorative coins "Frauenkirche Dresden", "Wilhelm Conrad Röntgen" and "Heinrich der Löwe" were put into circulation in 1995.

Counterfeits detained in payments, as recorded by the Bundesbank

Table 14

Year	Banknotes		Coins	
	Number	DM thousand	Number	DM thousand
1991	6,632	754	4,412	16
1992	14,057	2,520	21,257	103
1993	41,838	5,732	8,086	39
1994	23,028	3,317	15,561	77
1995	31,148	4,919	24,201	111

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Counterfeits

The number of counterfeit banknotes and coins detained in payments and appraised by the Bank increased, compared with the previous year.

Forgeries of the DM 100 note and DM 200 note accounted for 94 % of the total. The DM 5 coin accounted for 90 %.

2. Cashless payments

Number of payments submitted declining

In 1995 the number of credit transfer orders and collection orders channelled through the Bank declined. Altogether, 2.3 billion payments, totalling DM 194,107 billion, were submitted; this represented a decline of 18.6 % in the number of payments, compared with the previous year. The comparatively sharp decline is mainly attributable to the change in the method of statistical recording in respect of "conventional clearing". In order to underline the fact – for the purposes of international comparison – that this system is a large-value payment system, only the settled delivery envelopes, instead of the individual payments to be exchanged, are counted here. This also takes account of the more recent trend according to which the credit institutions increasingly use the clearing facilities at the major banking centres only for settling the total amounts in a cost-effective and liquidity-saving manner, irrespective of whether the individual payments – which are now mostly stored on data media – are exchanged at the Bank's branch offices or at another agency, for example, on a bilateral basis.

Retail payments

Particularly in respect of retail payments, it emerged that the reason for the declining volume of payment inputs was an increase in the bilateral exchange of payments between the credit institutions and in the number of transmissions in their own networks. In the Bank's seven computer centres and in its two payment units, the number of payments processed continued to decline, therefore. A new technical concept was implemented in the payment units, which provides for the separation of data input and output from the processing of payments. Both the credit institutions and the Bank are endeavouring to apply efficient and cost-effective paperless procedures; the possibility agreed with the banking industry of converting paper-based payments into data records and passing them on in a paperless form is therefore being used increasingly. Since November 1993 there has been a general obligation to convert all direct debits into data records and collect them by the electronic funds transfer system (EZL obligation). In addition, the EZÜ obligation (concerning the conversion of paper-

The Bank's cashless payments

Table 15

Item	1994 Number (million)	1994 DM billion	1995 Number (million)	1995 Change in %	1995 DM billion	1995 Change in %
Retail payments						
MAOBE transactions [1]						
Collection items	86.0	2,203	26.7	- 69.0	240	- 89.1
Credit transfers	162.0	104	88.6	- 45.3	27	- 74.1
Total	248.0	2,307	115.3	- 53.5	267	- 88.4
DTA transactions [2]						
Collection items	1,496.9	1,314	1,499.1	0.1	3,277	149.4
of which: Conversions	(60.8)	(285)	(105.1)	(72.8)	(2,263)	(695.3)
Credit transfers	610.2	1,067	657.8	7.8	1,155	8.2
of which: Conversions	(18.1)	(3)	(11.5)	(- 36.3)	(19)	(447.0)
Total	2,107.1	2,381	2,156.9	2.4	4,433	86.1
Grand total	2,355.1	4,689	2,272.2	- 3.5	4,699	0.2
Large-value payments						
Gross settlement procedures						
EIL-ZV	4.0	22,772	5.5	37.4	27,007	18.6
Local credit transfers	30.3	7,570	8.1	- 73.3	5,190	- 31.4
Other [3]	2.9	1,736	2.1	- 27.4	1,440	- 17.0
Total	37.2	32,079	15.7	- 57.8	33,638	4.9
Net settlement procedures						
Daily local clearing system						
Collection items [4] (conventional)	150.8	800	0.7	- 99.5	670	- 16.3
Local credit transfers [4] (conventional)	279.8	28,610	1.0	- 99.6	6,712	- 76.5
EAF	12.7	144,903	17.8	39.3	148,387	2.4
Total	443.4	174,313	19.5	- 95.6	155,770	- 10.6
Grand total	480.6	206,392	35.2	- 92.7	189,407	- 8.2
Cashless payments	2,835.7	211,081	2,307.3	- 18.6	194,107	- 8.0

1 Excluding payments submitted in a paper-based form which were converted and passed on in a paperless form by the Bank's units (EZÜ/GSE cheques and EPC/BZÜ credit transfers). — **2** Including payments submitted in a paper-based form which were converted and passed on in a paperless form by the Bank's units (BSE/GSE cheques and EZÜ/BZÜ credit transfers). — **3** E.g. conventional collections and credit transfers, special procedures for public authorities. — **4** Statistical recording method changed in 1995: settled delivery envelopes (clearing items) instead of individual payments.

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based credit transfers into data records), which was lowered to DM 1,000 in September 1994 and extended to cover local credit transfers as well, made itself felt in 1995 for the first time over the whole of a year. In anticipation of the general conversion obligation agreed for 1997, many credit institutions are now also submitting credit transfers below this amount limit as paperless payments. On a voluntary basis, the credit institutions are also converting and processing cheques for amounts below DM 5,000 under the paperless cheque collection procedure (BSE procedure) and converting and processing credit transfers particularly earmarked for this purpose under the paperless cash inpayment credit transfer procedure (BZÜ procedure). The Bank converted more than 11 million credit transfers and 49 million cheques on the basis of the above-mentioned agreements.

Reduction of the float owing to the GSE procedure

In addition, the Bank converted 56 million cheques, each amounting to DM 5,000 or more, under the large-value cheque collection procedure (GSE procedure), which has been introduced progressively since November 1994. This new procedure speeds up the collection of the countervalues of the cheques (which are frequently made out in very large amounts) by means of paperless clearing and separate transmission of the original cheques; the time required is now generally reduced to 24 hours. Thus, if operations proceed smoothly, the debiting of these cheques is now made on the day the amount is credited to the accounts of the presenters, with the result that the float previously associated with the collection (granting of interest-free loans to the banking industry) virtually ceases to exist.

Transfers made increasingly in paperless form

Owing to the above-mentioned measures, it has been possible to increase the share of credit transfers executed on a paperless basis in the retail payment system to 88 %, and the share of cheques and direct debits to 98 %.

Greater use of the Eiliger Zahlungsverkehr (EIL-ZV) system

The *Eiliger Zahlungsverkehr* (EIL-ZV) system (express electronic credit transfer system) recorded considerable rates of increase, as this procedure is being used increasingly by the branch offices of credit institutions to concentrate their liquidity holdings, among other things. Thus, in the year under review, 3.7 million "telegraphic" credit transfers were generally executed on a same-day basis, and approximately 1.8 million "urgent" credit transfers (large-value credit transfers amounting to DM 50,000 and more) were executed on a same-day basis where technically possible. In the case of "urgent" credit transfers, same-day settlement – not supported by default regulations – could be achieved for no less than 99 % of the orders. Under this large-value payment system, too, the banking industry increasingly used the possibility of paperless submission; thus, more than two-thirds of all orders were placed under the electronic counter procedure (ELS) via data telecommunication or diskette. The Bank intends to stop executing *Eiliger Zahlungsverkehr* payments via the decentralised computer systems installed at the branch offices and interlinked via data telecommunication. The first step towards the introduction of a new EIL system, which can be used, as before, through the giro accounts at the branch offices via two special high-availability computer centres, is planned for the autumn of 1996.

Further development of electronic clearing (EAF)

Apart from the work on the new EIL system, the further development of the EAF net settlement procedure to generate a new procedure, EAF 2, in the Frankfurt am Main banking centre was continued in the year under review. The new liquidity-saving EAF 2 procedure, which was developed in cooperation with the banking industry and whose risk situation will be comparable to that of a gross settlement procedure, started operations on March 8, 1996. About 18 million paperless credit transfers worth DM 148,387 billion (more than DM 590 billion, on a daily average) were exchanged fully automatically between the participants in the Frankfurt am Main banking centre, the major money market in Germany and the most important interface with other countries, under the EAF procedure. In all, the turnover share of electronic clearing in the execution of all cashless payments of the Bank was thus about 76 %.

3. Special trends in cross-border payments

Cooperation at EU level

As part of the technical and organisational preparation of the third stage of monetary union, the Bank, together with the other EU central banks, has developed, in working groups attached to the European Monetary Institute (EMI), a system for executing large-value payments in the EMU (Trans-European Automated Real-Time Gross Settlement Express Transfer = TARGET). This payment system will support the European System of Central Banks (ESCB) in respect of the implementation of a common monetary policy. The TARGET system has been established on the basis of the national real-time gross settlement (RTGS) systems, which either already exist or are planned and which are to be linked to each other by means of an Interlinking System. In principle, the national RTGS systems will retain their specific features. Only in the areas of the provision of intra-day liquidity, opening hours and pricing policy is there still a need for harmonisation between the participating central banks. The TARGET system will be available both to the ESCB and to the private banking sector for executing payments; but the use of the system will be mandatory only for payments executed in the context of the common monetary policy. A crucial performance feature of the TARGET system will be the rapid and secure execution of cross-border large-value payments. The payment orders will be charged irrevocably to the account of the principal, provided that its credit balance is sufficient (or provided that there are free credit lines), and then passed on via the interlinking system to the central bank of the recipient country for immediate and final crediting to the account of the recipient bank. The material and technical specifications for the Interlinking System, which will be available from January 1, 1999, are now being prepared.

Conversion systems

Irrevocable conversion rates between the currencies of the participating countries and vis-à-vis the single European currency, the euro, will apply from the first day of the third stage. At the same time, the accounting systems of the central banks will be converted to the new currency. In a transitional phase of about three years the use of the euro, in addition to the national currencies, will be optional for private economic agents in respect of cashless payments. The associated parallel use of several currencies makes it necessary to introduce conversion systems, which are able to convert the amounts denominated in the national currency concerned into euro, and vice versa. The Bank is now coordinating the necessary measures with the central associations of the banking industry. It will offer such conversion services in respect of cashless payments to those institutions which do not have the necessary facilities up to the end of the transitional phase.

Opening the electronic counter procedure to foreign payments

In the spring of 1995, as an additional contribution to the simplification of cross-border payments, the Bank extended its electronic counter procedure (ELS) to cover the paperless submission of foreign payment orders, too. Since March 16, 1995, it has been accepting foreign exchange payment orders and DM payment orders destined for other countries and delivering the settlement tickets for foreign exchange orders in a paperless form under the ELS procedure. Since that time domestic SWIFT follow-up payments and domestic payments in the SWIFT format can also be executed via the ELS procedure (provided that the recipient institution has declared that it is prepared to accept them).

Execution of retail payments

In order to provide a common basis for cross-border retail payments, the EU central banks agreed to follow the developments in the private sector towards an efficient EU payment system (oversight) and, if need be, support them actively (for example, by settlement). The central banks consider it their primary task to ensure the smooth operation and the satisfactory functioning of the large-value payment systems, which are important for monetary policy. Nevertheless, they will also see to it in future that cross-border retail payments are executed reliably and efficiently.

Electronic money

Regarding developments in the field of electronic money, the Bank, besides taking part in the relevant activities undertaken within the EMI, is also involved in the discussions held by the G-10 countries at the Bank for International

Settlements. Electronic money – which is frequently called electronic cash in other countries – is generally provided by the banks against prepayment in the form of digital value units either on the chip of a payment card (card money) or on the hard disc of a PC for potential use in the Internet (network money). In 1995 the Committee on Payment and Settlement Systems (CPSS), which is the responsible committee of the central banks of the Group of Ten, submitted proposals, which included the ongoing observation of new developments, cross-border monitoring and the examination of security aspects.

Minimisation of risks

In March 1996 the Steering Group on Settlement Risk in Foreign Exchange Transactions, established by the CPSS in 1994, published its findings, which, apart from an analysis, also contain recommendations for minimising risks. The individual central banks, together with the banking supervisors in the country concerned, should encourage the private banking sector to make risk-reducing efforts of its own.

II. The Bank's international transactions

Foreign exchange spot deals

The Bank's turnover in foreign exchange spot deals (foreign currency against Deutsche Mark) increased in the year under review by just under 50 % compared with the previous year. The key factor for this was the sharp increase in customer business, with foreign exchange purchases increasing by more than five times the previous amount. By contrast, the volume of foreign exchange sales remained virtually unchanged. Sales and purchases were as follows:

	1995	1994
		DM billion
Sales	14.0	2.7
Purchases	20.4	20.8
Turnover	34.4	23.5

Other foreign exchange deals

The volume of cross deals (foreign currency against another foreign currency) was almost halved to DM 3.1 billion, compared with DM 5.6 billion a year before. In addition, US dollar inter-centre switch transactions totalling US$ 111 million were entered into (against US$ 105 million in 1994).

Foreign bill of exchange and cheque deals

In the context of refinancing operations, the Bank bought foreign bills of exchange worth DM 44 billion (see page 127). Moreover, it sold 31,754 foreign cheques payable to order amounting to DM 116 million (compared with 29,933 cheques totalling DM 166 million a year before). Another 36,323 cheques, to the value of DM 51 million, were presented in 1995 under the simplified collection procedure for foreign cheques; in 1994, 44,543 cheques worth DM 125 million had been so presented. For the rest, the Bank accepted 12,627 items bought on a commission basis (mainly bills and cheques) for realisation in foreign commission business; a year earlier, 13,997 such items had been bought. Transactions in foreign notes and coins hardly changed at all compared with the previous year.

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

Discount credit

In 1995 the Bank granted credit institutions basic refinancing of approximately one-third of its active central bank money provision by supplying central bank money through the discount credit facility.[1] As in the previous year, the volume of rediscount quotas fixed (not counting the special rediscount facility to finance export orders) amounted to DM 65.6 billion at December 31, 1995. As usual, the quotas were recalculated on November 2, 1995 to take account of the increase in the liable capital which had occurred in the meantime and of the changes in the business structure and bill operations of the individual credit institutions. In the course of the final structural adjustment to the refinancing facilities, the Central Bank Council lowered the special rediscount facility for the financing of export orders, the so-called ceiling B of the *AKA Ausfuhrkredit-Gesellschaft mbH,* from DM 2,250 million to DM 1,250 million with effect from June 1, 1995; at midnight on May 31, 1996, it will be eliminated entirely, and existing funding will be gradually phased out.

Purchases of domestic bills of exchange

The utilisation of the rediscount quotas ran at a high level throughout most of 1995 and reached its peak, at just under 97 %, at the beginning of November. However, towards the end of November and in the course of December, banks

1 The monetary policy regulations currently in force are being published by the Bank in a brochure that is appearing simultaneously with the Annual Report: Deutsche Bundesbank, Monetary policy regulations, Banking regulations 3, April 1996. This publication is available free of charge upon written request.

expected a lowering of the discount rate and temporarily submitted fewer bills, with the result that the utilisation of the quotas lagged behind the normal degree of utilisation (about 95 %) for a time. Overall, just under 1.3 million domestic bills totalling DM 280 billion were purchased under the rediscount quotas or the special rediscount facility (ceiling B) granted to the *AKA Ausfuhrkredit-Gesellschaft mbH* (in 1994: 1.3 million of such domestic bills had been purchased, amounting to DM 283 billion). In the absence of payment, 6,686 bills totalling DM 193 million (in 1994: 7,560 bills amounting to DM 229 million) were returned and charged to the parties presenting them for discount.

Purchases of foreign bills of exchange

Purchases of foreign bills of exchange, which are counted towards the rediscount quotas, numbered 79,828 in 1995, and totalled DM 44 billion (in 1994: 89,938 bills totalling DM 51 billion). The share of foreign bills denominated in foreign currencies came to 1.7 % (in 1994: 1.6 %).

Securities repurchase agreements

The weekly open market transactions under repurchase agreements in securities ("securities repurchase agreements"), which are part of money market management, continued to be the most important means of regularly providing funds. As in the previous year, 53 such transactions were concluded in all, 17 of which were in the form of fixed-rate tenders announced in advance. The Bank initially abided by its policy of "steady as she goes" and used fixed-rate tenders during the first quarter, but from April 12, 1995 it switched over to variable-rate tenders for the rest of the year. Following the reduction of the discount and lombard rates in mid-December, the market was again given guidance through the use of fixed-rate tenders around the turn of the year. The standard maturity of the transactions has been two weeks. The volume of securities repurchase agreements outstanding at the end of 1995 was DM 145.8 billion and thus only slightly lower than at the end of 1994.

Operational safe custody accounts

All debt securities eligible as collateral for lombard loans that are officially listed or traded in the Regulated Market (Treasury discount paper is included even if unlisted) may be purchased. At the end of 1995, securities amounting to DM 471 billion (in 1994: DM 449 billion) were lodged by credit institutions in operational safe custody accounts at Land Central Banks for securities repurchase agreements (and therefore for lombard purposes, too). In addition, securities totalling DM 4 billion were pledged in such safe custody accounts, exclusively for lombard purposes.

Fine-tuning operations

Last year the number of fine-tuning operations in the money market was again fairly limited. In 1995 such measures were used only twice (in 1994: four times). This also reflects the fact that, since the introduction of the float-reducing large-value cheque collection procedure in November 1994, the float[1] in the Bundesbank system has been running at a comparatively steady level. Moreover, the small number of fine-tuning operations also indicates that following the third and final step towards the restructuring of the minimum reserve regulations with effect from August 1, 1995 the stabilisation and buffer function of this instrument has been maintained.

Quick tenders

The two fine-tuning operations were two quick tenders in the form of a fixed-rate tender and a variable-rate tender. These are securities repurchase agreements whose aim is to provide liquidity at short notice and which, in contrast to standard transactions, are effected within about one hour and to which only a few dozen banks operating in the money market are invited to submit tenders. The amounts involved in such quick tenders were about DM 8 billion and DM 4 billion, respectively, and their maturities were two and three days.

Foreign exchange dealings

As in the previous year, no foreign exchange swap and repurchase transactions for stabilising the money market were concluded during the period under review.

Dealings in money market paper

In 1995 the Bank did not sell Treasury bills on the basis of section 42 of the Bundesbank Act to mop up liquidity. The regular auction of Bundesbank liquidity paper ("Bulis") had already been discontinued with the issue of the last scheduled tranche in September 1994; in mid-March the "Bulis" which were outstanding and which totalled DM 4.9 billion became due for redemption.

Lombard loans

Throughout the year, recourse to lombard loans was available to banks to meet their short-term liquidity needs. On a daily average, utilisation of the lombard loan facility decreased from DM 1.6 billion in 1994 to DM 0.7 billion in 1995. This was due, among other things, to the fact that the banks, in view of the

1 Since the abolition of the central and regional public authorities' obligation to deposit their funds at the Bundesbank as far back as 1994, liquidity requirements throughout the month are mainly influenced by both the trend in the demand for currency, which, for years, has followed a largely unchanged seasonal and working-day pattern, and by the float in the Bundesbank system.

now reduced minimum reserve requirements, had generally geared their liquidity management operations more closely to their liquidity requirements. At DM 13.6 billion, the highest recourse to lombard loans was reached on January 31, 1995.

IV. The Bank's participation in issues of Federal securities

Issuers

In 1995 the Bank was much less involved in the issuing of Federal securities than in previous years. This was mainly because the Treuhand agency and the Debt-Processing Fund were dissolved at the end of 1994 and therefore ceased to issue securities. Following the transformation of the Federal Post Office into public limited companies, the Bundesbank likewise ceased to issue securities on

Debt securities issued by the Federal Government in 1995 Table 16

	Amount issued or increased (DM billion)				Terms				
Issuer	Total	Syndicate amount	Amount allotted by tender procedure	Market management amount	Nominal interest rate (% p.a.)	Maturity (years / months)	Issue price or average allotment rate (%)	Yield on issue price or allotment rate (% p.a.)	Date of issue
Federal Government (WKN 113 496) – increase –	7.0	–	3.8	3.2	7.375	9 / 11	– / 100.10	– / 7.35	Feb. 8
Total volume	17.0								
Federal Government (WKN 113 497)	12.0	3.0	4.8	4.2	6.875	10 / 0	100.65 / 100.53	6.78 / 6.80	May 9 / May10
Federal Government (WKN 113 497) – increase –	6.0	–	3.5	2.5	6.875	9 / 10	– / 100.99	– / 6.73	July 12
Federal Government (WKN 113 497) – increase –	2.0	–	–	2.0	6.875	9 / 8	–	–	Sep. 21
Total volume	20.0								
Federal Government (WKN 113 498)	12.0	3.0	4.4	4.6	6.500	10 / 0	100.55 / 99.98	6.42 / 6.50	Oct. 17/ Oct. 18
Federal Government (WKN 113 498) – increase –	8.0	–	4.4	3.6	6.500	9 / 10	– / 103.42	– / 6.02	Dec. 6
Total volume	20.0								

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behalf of the former Federal Post Office Special Fund. The remaining Federal special funds (Redemption Fund for Inherited Liabilities, which has assumed the debts of the Treuhand agency and of the Debt-Processing Fund, "German Unity" Fund, Federal Railways Fund and ERP Special Fund) did not issue any securities in 1995, but raised funds only through borrowers' note loans.

Issues of debt securities

In 1995 the Bank participated in the floating of two new debt securities issues of the Federal Government and four increases in the volume of debt securities totalling DM 47.0 billion. These increases created large liquid issue volumes of up to DM 20.0 billion per issue. In 1994, twelve debt securities issues (including two increases) totalling DM 96.0 billion had been placed in the market.

Issuing procedures

The debt securities were again launched by a combined syndicate and tender procedure, with certain amounts being earmarked for sale on the stock exchanges for market-management purposes. Credit institutions participating in the Federal Bond Consortium underwrote debt securities totalling DM 6.0 billion. A further DM 20.9 billion was allotted to syndicate banks under the tender procedure. DM 20.1 billion was held back for gradual sale on the stock exchanges for the purposes of market management.

As the six tender procedures executed since the last recalculation of quotas in the Federal Bond Consortium in November 1994 seemed to be too small to serve as a basis for another recalculation, the quotas for 1995 remained unchanged. At the end of the year, after four members had withdrawn and one bank had joined, the Consortium consisted of 95 credit institutions, including 48 foreign ones.

New issuing strategy in the medium-term maturity category

In 1995 the Bank also took over the tendering and placing of four-year Federal Treasury notes. However, there were only two issues with a total volume of DM 9.0 billion. The issuing of these debt securities was discontinued in the middle of the year.

Five-year special Federal bonds

The five-year special Federal bonds were reorganised instead. Following the conclusion of sales on market terms of five-year special Federal bonds of a given series, another tranche of the series in question is being offered by tender to the credit institutions every three months (February, May, August, November). The Bank reserves the right to close a series temporarily by offering a tranche by

Issues of five-year special Federal bonds in 1995

Table 17

Designation	Amount issued (DM million)				Terms				Start of sales on market terms / date of stock exchange listing
					Sales on market terms		Tender procedure		
	Total	Sales on market terms	Amount allotted by tender	Market management amount	Issue price (%)	Yield (% p.a.)	Average allotment rate (%)	Average yield (% p.a.)	
6.75% series 112 of 1994 (1999)	1 4,099	1 349	–	3,750	98.00 – 98.95	7.00 – 7.24	–	–	Jan. 2 / Jan. 20
7% series 113 of 1995 (2000)	5,000	2,058	–	2,942	99.60 – 101.85	6.52 – 7.10	–	–	Jan. 13 / Mar. 30
6.50% series 114 of 1995 (2000)	7,000	1,199	–	5,801	100.00 – 102.00	6.00 – 6.50	–	–	Mar. 23 / May 17
5.875% series 115 of 1995 (2000)	10,000	1,092	3,025	5,883	100.00 – 101.40	5.54 – 5.88	100.68	5.69	May 10 / Aug. 28
5.75% series 116 of 1995 (2000)	7,000	1,543	2,199	3,258	100.75 – 103.05	5.00 – 5.57	102.82	5.05	Aug. 22 / Nov. 28
5.125% series 117 of 1995 (2000)	2 634	2 634	2 ...	2 ...	100.55 – 101.40	4.80 – 5.00	2 ...	2 ...	2 Nov. 21 /...

1 Sales of this series began on September 15, 1994; total amount sold on market terms: DM 2,250 million; total amount issued: DM 6,000 million. — **2** Sales were not completed at the end of the year.

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Issues of Treasury notes by the Federal Government in 1995

Table 18

Issuer	Amount issued (DM million)			Terms				
	Total	Amount allotted by tender	Market management amount	Nominal interest rate (% p.a.)	Maturity (years / months)	Average allotment rate (%)	Average yield (% p.a.)	Date of issue
Federal Government (WKN 113 673)	4,000	1,422	2,578	6.875	4 / 0	99.44	7.04	Feb. 22
Federal Government (WKN 113 674)	5,000	2,285	2,715	5.750	4 / 0	100.00	5.75	May 24

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Issues of Federal savings bonds in 1995

Table 19

Issue	Sales period 1995	Gross sales (DM million) Total	Federal savings bonds, type A	Federal savings bonds, type B	Nominal interest rate (% p.a.)	Final yield (% p.a.) Type A	Type B
1994 / 11 +12	1 Jan. 2 – Feb. 8	3,105	2,729	376	5.00 – 8.25	7.08	7.35
1995 / 1 + 2	Feb. 8 – Mar. 15	2,651	2,353	298	5.00 – 8.25	7.05	7.32
1995 / 3 + 4	Mar. 15 – Mar. 27	935	845	90	5.00 – 8.00	6.93	7.17
1995 / 5 + 6	Mar. 27 – May 3	2,305	2,096	209	4.75 – 8.00	6.68	6.96
1995 / 7 + 8	May 3 – May 23	1,560	1,440	120	4.75 – 8.00	6.51	6.82
1995 / 9 +10	May 23 – June 6	930	862	68	4.50 – 7.50	6.24	6.50
1995 / 11 +12	June 6 – Sep. 1	5,778	5,368	410	4.50 – 7.25	6.00	6.25
1995 / 13 +14	Sep. 1 – Oct. 26	3,894	3,633	261	4.00 – 7.25	6.01	6.28
1995 / 15 +16	Oct. 26 – Nov. 28	1,692	1,537	155	3.75 – 7.50	5.83	6.17
1995 / 17 +18	2 Nov. 28 – Dec. 29	1,411	1,290	121	3.75 – 7.25	5.54	5.88

1 Sales began on November 3, 1994; total sales issue 1994/11: DM 5,190 million, issue 1994/12: DM 745 million. — 2 Sales were not completed at the end of the year.

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Issues of Treasury discount paper by the Federal Government and its special funds in 1995

Table 20

DM million

Type of paper	1994 Outstanding at December 31	1995 Issued	Redeemed	Outstanding at December 31
Treasury discount paper of the Federal Republic of Germany, types "B" and "BN" 1	16,990	6,195	14,473	8,712
of which: "Treasury financing paper"	(15,601)	(5,765)	(13,084)	(8,282)
Treasury discount paper of the Debt-Processing Fund, type "KAF N" 1	4,137	–	4,137	–
Treasury discount paper of the Federal Republic of Germany, "Germany Unity" Fund, type "FDE N" 1	1,023	–	1,023	–
Total	22,150	6,195	19,633	8,712

1 The Bundesbank has not undertaken to buy securities distinguished by the letter "N" before maturity.

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tender. The fragmentation of the medium-term maturity category into five-year special Federal bonds and four-year Federal Treasury notes has thereby been eliminated. At the same time, higher issue volumes are being achieved in the individual series of five-year special Federal bonds, with the result that there is an increase in liquidity in this market segment and in the volume of the securities available in the Bobl future. In 1995 six series of five-year special Federal bonds were offered for sale. Of the total issue volume amounting to DM 33.7 billion, sales on market terms accounted for DM 6.9 billion and allocations by tender for DM 5.2 billion. DM 21.6 billion was set aside for market management operations.

Federal savings bonds and Treasury financing paper

The Bundesbank, acting for the account of the Federal Government, was also involved in the selling (through credit institutions and its own offices) of Federal savings bonds and Treasury financing paper issued on tap. In 1995 sales of these securities reached a total volume of DM 30.0 billion (previous year: DM 29.0 billion), with Federal savings bonds, at DM 24.3 billion, again accounting for the bigger share.

Market management operations

Of the amounts set aside for market management operations when listed Federal securities (debt securities, Treasury notes and five-year special Federal bonds) are issued, the Bank gradually sold DM 53.7 billion on the stock exchanges on behalf of and for the account of the Federal Government and its special funds in 1995.

Price support operations

As in previous years, the Bank conducted (for the account of the issuers) price support operations on the German stock exchanges for officially listed securities issued by the Federal Government, its special funds and the Treuhand agency, as well as for securities issued by the Reconstruction Loan Corporation and the German Equalisation Bank. The Bank also conducts price support operations with respect to the debt securities issued by the Land of Lower Saxony, as listed on the stock exchanges in Frankfurt and Hanover.

V. The Bank's participation in banking supervision and the changes in banking supervision legislation

1. International harmonisation of banking supervision

In the year under review the Bank once again participated in the major committees engaged in projects concerning the international harmonisation of banking supervision.

(a) Activities in the context of the Basle Committee on Banking Supervision

Capital requirements for market risks

In 1995, following another consultation period, the Basle Committee completed its work on arrangements to incorporate market risks in the trading book of internationally operating banks, and at the beginning of 1996, after approval by the central bank governors, it proposed an Amendment to the Capital Accord of 1988. Under the new arrangements, capital charges must be applied to risks pertaining to interest-rate-related instruments and equities in the trading book and to foreign exchange risk and commodities risk throughout the bank. The resultant capital requirements may be met not only by core capital (tier 1 capital) and supplementary capital (tier 2 capital), but to some extent also by short-term subordinated debt ("tier 3 capital").

The recommendations, which must be implemented by the G-10 countries not later than the end of 1997, permit the use of internal risk management models for the calculation of capital requirements as an alternative to the prescribed, relatively simple standardised measurement method. Credit institutions domiciled in the European Union may – with the approval of the European Commission – use internal models for prudential purposes, subject to certain conditions, as early as the implementation of the EC Capital Adequacy Directive. However, the internal risk management models may be used for the calculation of capital only after the explicit approval of the Federal Banking Supervisory Office. In order to ensure a minimum of uniformity of capital requirements among banks, strict qualitative and quantitative provisions governing risk management must be complied with. Mixed authorisation teams consisting of representatives of the Federal Banking Supervisory Office, the Central Office of the Deutsche Bundesbank and the Land Central Banks will satisfy themselves that these requirements have been met. Moreover, the predictive quality of the models must regularly be checked by what is known as back-testing, and the effects of extreme market price fluctuations must be taken into account by means of special stress tests. The capital to be maintained on a daily basis to cover the market price risks posed by the trading book of a bank using its internal model is derived from the higher of the following two sums: the previous day's risk potential (value at risk), and the average of the daily value-at-risk figures on the preceding 60 business days, multiplied by three. The multiplication factor serves to offset any flaws in the model. These may reside in the fact that actual market movements differ from the simplified model assumptions and the historical data used. Moreover, it is intended to cover other risks not captured by the internal models (such as legal and performance risks). It is planned to review the parameters as soon as sufficient experience of the market risk rules has been gained.

Transparency of derivatives activities

In the year under review efforts were continued to enhance the transparency of derivatives activities; specifically, in annual accounts, in the general statistical area and in the field of supervision. The discussion paper endorsed by the Basle Committee on "Public Disclosure of Market and Credit Risks by Financial Intermediaries" (Fisher Report) released by the Euro-currency Standing Committee of the G-10 central banks in September 1994, which contains proposals for improving the public disclosure of banks' derivatives activities in their annual accounts, was the subject of a detailed exchange of views between the Federal Banking Supervisory Office, the Bundesbank, the associations representing the banking industry, the Institute of Auditors and various Federal ministries in May last year. The banks' voluntary efforts in this field were welcomed as steps in the right direction. At the same time, it was agreed that the Fisher Report, which, incidentally, is also addressed to non-banks with significant involvement in derivatives activities, contains valuable suggestions for further improvements in public disclosure.

An evaluation conducted by the Basle Committee and the Euro-currency Standing Committee of the annual accounts for 1994 of selected banks regarding the information included on derivatives activities revealed very wide differences in national and international public disclosure standards. The Basle Committee and the Technical Committee of IOSCO (the International Organization of Securities Commissions) published a joint report on the subject in November 1995, which contains recommendations on the further improvement of disclosure practices. The two committees emphasise, in line with the recommendations of the Fisher Report, that banks and securities firms should rely on their internal risk measurement systems to provide at regular intervals meaningful quantitative and qualitative summary information on the major risks – in particular, market price risk, credit risk and liquidity risk – associated with their derivatives and other trading activities; they should also report on their performance in managing those risks. The Accounting Committee of the Federal Association of German Banks has followed these recommendations recently by taking a further step. It recommends that its member institutions should in future disclose the maximum market price risk (value at risk) existing on the balance sheet date, as estimated by statistical methods. If uniform basic parameters that have been devised by the banking supervisory authorities are used, the figures calculated in this way also facilitate interbank comparison.

In connection with the efforts to enhance the transparency of derivatives activities in the general statistical area, the Euro-currency Standing Committee has for the first time included (as of April 1995) derivatives in its international survey of foreign exchange transactions, which it carries out at three-yearly intervals. Based on the survey concept used, a model for internationally harmonised statistics on derivatives is now being developed. With a view to enhancing the transparency of derivatives activities for the supervisory authorities, in May 1995 the Basle Committee on Banking Supervision and the Technical Committee of IOSCO jointly issued a "Framework for supervisory information about the derivatives activities of banks and securities firms". Both the proposals for enhancing transparency in annual accounts and the drafts of derivatives statistics are based on this framework, with the result that a comprehensive and desirable standardisation of the relevant information can now be achieved.

Financial conglomerates

The "Tripartite Group", an informal grouping of representatives of banking, securities and insurance supervisors, continued to address the issue of the supervision of financial conglomerates in the year under review. In July 1995 the Tripartite Group presented an extensive discussion paper entitled "The Supervision of Financial Conglomerates", which covers a number of major issues, solutions to which have been proposed in only a few cases in view of their complex nature.

Cooperation between supervisory authorities

The Basle Committee on Banking Supervision, the Technical Committee of IOSCO (international securities supervisors) and IAIS (international insurance supervisors) welcomed the report and made it available to interested specialists. In order to promote work in this area, the bodies mentioned have agreed officially to set up a common forum in which arrangements for practical cooperation between the individual supervisory authorities are to be worked out. The new group, known as the "Joint Forum", will be made up of a limited number of representatives of the three supervisory areas.

(b) Harmonisation in the European Union

Constitutive codification of the banking directives

At the end of 1994 the European Commission started combining the regulations applying in the field of banking into a single legally binding text, so as to make Community legislation more transparent, more precise and more easily understandable. No material changes to the provisions, which so far have been dispersed among a host of Council Directives, are envisaged. The work on such a constitutive codification of banking directives is expected to be completed in 1996.

"Memoranda of understanding"

Under the Second Banking Coordination Directive, banks authorised in the EU may establish branches in any other EU member state without requiring authorisation by the host country authorities; responsibility for banking supervision rests largely with the home country authorities. For the practical implementation of this provision, the Federal Banking Supervisory Office has meanwhile signed agreements, known as "Memoranda of understanding", with almost all EU member states, and also with Norway (which is a member of the European Economic Area). These memoranda regulate in detail the nature of the bilateral cooperation between banking supervisory authorities, with particular reference to the reciprocal information and consultation obligations. While the Bundesbank has not signed these agreements, it nonetheless participates in the ongoing consultations and in the exchange of information.

Financial conglomerates again

At EU level, too, a mixed group of experts in which the Bundesbank is represented has been addressing the subject of "financial conglomerates" since 1994, and in mid-1995 it produced a report which has not yet been published. The structure of the report and the topics it deals with are essentially identical with those of the Tripartite Group report. The Commission intends to publish this report, too, and has already indicated that it plans to resume work on a corresponding Draft Council Directive in the near future, so as to ensure consistency in respect of timing and subject matter with the work of the "Joint Forum".

Industrial mortgage lending

In January 1996 the European Commission adopted a proposal to amend the EC Solvency Ratio Directive, providing for a prolongation until January 1, 2001 of the transitional arrangements (expiring on December 31, 1995) for the 50 % risk weighting for industrial mortgage lending. This exception, which has hitherto applied only to Austria, Denmark, Germany and Greece, is to be granted to all EU member states in future, subject to certain conditions. In anticipation of the prolongation of the special regulations governing industrial mortgage lending, the Federal Banking Supervisory Office has authorised the continuation of the current exception for the time being. The mortgage-backed securities issued by non-bank borrowers are to be given equal treatment.

2. Amendments of national banking supervision legislation

Fifth Act Amending the Banking Act

The Fifth Act Amending the Banking Act came into force on December 31, 1995. It translated the Second EC Consolidation Directive and the EC Large Exposures Directive into German law. The large exposures provisions of the Banking Act are supplemented by the Large Exposures Regulation issued by the Federal Banking Supervisory Office, in agreement with the Bundesbank, and essentially prescribing the weights to be applied to the risk assets to be included in the large exposures computation. The broadened concept of exposures in the EC Large Exposures Directive, which also covers derivatives, likewise applies to the procedure for reporting loans of three million Deutsche Mark or more. Along with the Large Exposures Regulation, the First Regulation Amending the Reports Regulation was adopted – likewise in agreement with the Bundesbank – thus bringing the reporting procedure into line with the amended provisions governing consolidation, large exposures and loans of three million Deutsche Mark or more.

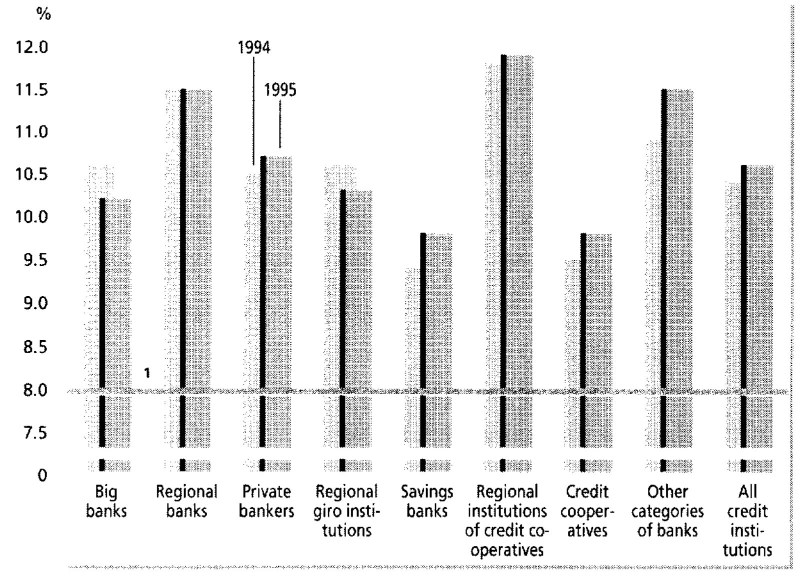
Sixth Act Amending the Banking Act

Considerable headway was made in the year under review on work on the Sixth Act Amending the Banking Act, which is to translate the EC Investment Services Directive, the EC Capital Adequacy Directive and what is known as the BCCI Directive into national law. The EC Investment Services Directive provides, among other things, that securities firms must be subject to a supervision which is comparable to that of credit institutions. Under the EC Capital Adequacy Directive, market risks essentially arising from trading book business and derivatives must be covered by adequate own funds; for large exposures in respect of these transactions which exceed the limits laid down in the EC Large Exposures Directive, procedures for computation and capital backing which diverge from those set forth in the Capital Adequacy Directive are to be used. The BCCI Directive contains regulations which are designed to close the loopholes in the supervision of the financial services sector which emerged when the Bank of Credit and Commerce International (BCCI) was closed. For example, it will no longer be permissible for a credit institution to establish close ties with other enterprises if this impedes the supervision of the credit institution.

Capital ratio of credit institutions filing Principle I reports

Chart 20

End of year



1 The Principle I minimum capital ratio is 8%.

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Principles Concerning the Capital and Liquidity of Credit Institutions

The implementation of the Second EC Consolidation Directive under the Fifth Act Amending the Banking Act has meant that Principle I has to be brought into line with the new consolidation requirements. In addition, three points of Principle I relating to the weighting of risk assets had to be changed in keeping with EC legislation, and in order to exercise an option in favour of credit institutions included in the EC Solvency Ratio Directive which had not hitherto been taken advantage of. The technical definition of the "Zone A" countries was modified so as to exclude OECD countries rescheduling their external debt from Zone A for a period of five years, with the result that the risk weighting increases accordingly. In future, a zero weighting is to apply to risk asset items constituting claims carrying the explicit guarantee of the European Communities. A 20 % weighting is envisaged for asset items constituting claims on, or carrying the explicit guarantee of, specified foreign Zone A authorities, provided that the national banking supervisory authorities put them on an equal footing with central or regional governments or local authorities. These changes will come into force on May 1, 1996.

Principle I

Principle I provides that a minimum 8 % capital charge is to be applied to the weighted risk assets both of an individual credit institution and of a group of credit institutions. The average capital ratio for all individual credit institutions was 10.6 % at December 31, 1995 and thus increased only marginally compared with the level at the end of 1994 (10.4 %). On a consolidated basis, the capital base of German banks at the end of December 1995 came to no more than 9.8 % (previous year: 9.7 %). The chart on the previous page shows the average capital ratios of the various sectors of the banking industry.

Principle Ia

Principle Ia limits the market price risks of a credit institution to 21 % of its foreign currency positions, 14 % of interest-rate-related derivatives and 7 % of the other derivatives positions. At the end of December 1995 the average ratios of all credit institutions were 3.5 %, 2.4 % and 1.1 %, respectively, and thus well below the prescribed ceilings.

Principles II and III

1995 saw no changes in the liquidity principles. As at December 31, 1995 the average ratios were 88.8 % for Principle II and 69.6 % for Principle III.

Minimum requirements for trading activities

On October 23, 1995 the Federal Banking Supervisory Office announced "Minimum requirements for the trading activities of credit institutions", which were drawn up by the Bundesbank together with the Supervisory Office. These minimum requirements apply to all credit institutions in Germany, including their legally dependent branches abroad, and cover the provisions which have governed foreign exchange and securities transactions for years past. They have now been extended to include all trading transactions of credit institutions, i.e. they also apply, in particular, to derivatives activities. The new minimum requirements at the same time implement the risk management guidelines for derivatives issued by the Basle Banking Supervisory Committee, and take due account of the general qualitative standards it has set for the admission of internal risk management models for prudential purposes.

3. Ongoing banking supervision operations

Further decline in the number of credit institutions supervised

At the end of 1995, 3,831 credit institutions were covered by banking supervision; specifically, 3,540 institutions in the old Länder and 291 in the new ones. On balance, this was 81 institutions fewer than in the preceding year, with this figure including mergers effected retroactively as from December 31, 1994. Once again, most of this fall in the number of credit institutions was due to mergers. In the year under review, there were 69 mergers in the cooperative bank sector (including 11 in the new Länder) and 18 in the savings bank sector (all of them in the new Länder). Altogether, a decline of 99 was accompanied by an increase of 18, recorded above all among regional banks and other commercial banks (6), the branches of foreign banks (6) and mortgage banks (3).

Land Central Banks' participation

The scale of Land Central Banks' participation in banking supervision is shown in the table below.

Ongoing banking supervision operations Table 21

Number of operations conducted

Item	1992	1993	1994	1995
Individual reports pursuant to section 13 of the Banking Act	72,267	68,542	65,908	66,714
Borrowers included in the lists submitted pursuant to section 13 of the Banking Act	82,626	75,996	76,987	77,317
Reports on loans of DM 1 million[1] or more pursuant to section 14 of the Banking Act	2,116,425	2,001,923	1,109,990	1,184,719
Reports pursuant to section 16 of the Banking Act	24,503	14,376	14,887	13,795
Reports pursuant to section 24 of the Banking Act	16,781	19,828	49,312	51,245
Monthly returns pursuant to section 25 of the Banking Act	54,776	49,514	48,914	46,900
Reports on the volume of external lending	973	998	407	302
Annual accounts of credit institutions	4,837	4,338	4,147	4,008
Auditor's reports on annual accounts	2,454	2,294	2,450	2,429
Reports on the auditing of safe custody accounts	527	407	534	412
Routine, special and deposit guarantee fund auditor's reports	489	463	647	683
Audits commissioned by the Federal Banking Supervisory Office pursuant to				
section 44 (1) of the Banking Act	27	33	32	34
section 44 (2) of the Banking Act	128	122	141	103
Reports under the Capital Accord of the Basle Committee on Banking Supervision	104	102	96	97

1 DM 3 million as from July 1, 1993.
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Credit register for "Millionenkredite"

The number of loans of DM 3 million or more to be reported quarterly under section 14 of the Banking Act increased by just over 8 % to around 308,000 within the year from the September 30, 1994 to the September 30, 1995 reporting date (see the table overleaf). The total volume of loans of DM 3 million or more reported went up by 6.8 % to DM 2,791 billion during that period. On the September 30, 1995 reporting date, 2,883 credit institutions and insurance enterprises participated in the reporting system for loans of DM 3 million or more; the number of lenders therefore rose marginally against the previous year. On the basis of the reports submitted, the credit register establishes the borrowers' overall debt, and discloses it to the lending institutions in

Credit register for "Millionenkredite"

Table 22

3rd quarter	Volume of loans of DM 1 million[1] or more: DM billion	Change (%)	Number of loans of DM 1 million[1] or more reported: Number	Change (%)	Number of reporting: credit institutions	insurance enterprises
1991	2,414	+ 27.8	494,950	+ 12.6	3,654	537
1992	2,593	+ 7.4	547,486	+ 10.6	3,608	518
1993[1]	2,444	− 5.8	275,691	− 49.6	2,403	403
1994	2,613	+ 6.9	284,568	+ 3.2	2,429	398
1995	2,791	+ 6.8	307,544	+ 8.1	2,500	383

1 Reporting threshold raised from DM 1 million to DM 3 million as from the reporting date September 30, 1993.

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its notifications. The number of borrowers notified to those institutions has risen again by 33,000 to 233,000 since the raising of the reporting threshold to DM 3 million; this was 22,000 borrowers more than in the previous year. Two-thirds of the borrowers were amalgamated into 51,000 borrower units as defined in section 19 (2) of the Banking Act. At the end of September 1995 71 borrower units' debt pursuant to section 14 of the Banking Act exceeded DM 2 billion; the total indebtedness of these borrowers amounted to DM 312 billion, thus accounting for just over 11 % of the total volume of lending reported. Lending to domestic borrowers, at DM 1,934 billion, made up almost 70 % of the total volume of lending reported. The above table shows the changes since 1991.

Insolvencies

In 1995 the credit register recorded a total of 1,113 insolvencies of enterprises and individuals, for whom, at the date when the insolvency became known, loans of DM 3 million or more had been reported. That was 160 more insolvencies than a year before (+ 16.8 %). Even so, the volume of loans of DM 3 million or more reported for insolvent borrowers declined by about DM 5 billion to just over DM 10 billion; DM 2.3 billion of this sum was accounted for by 331 borrowers domiciled in the new Länder.

International cooperation between European credit registers

In 1995 international cooperation between the credit registers operated in Europe by Belgium, France, Germany, Italy and Spain intensified further. Austria and Portugal, which likewise have credit registers, plan to take part in the agreed exchange of information as soon as the statutory requirements have been met.

VI. Authorisations under monetary law

Value guarantee clauses

Decisions on the authorisation of value guarantee clauses are taken by the Bank 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)".[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.

Applications for authorisations pursuant to section 3 sentence 2 of the Currency Act, and the decisions taken Table 23

Year	Applications	Authorisations	Certificate of non-applicability of authorisation requirement	Applications rejected
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
1993	57,155	44,949	8,231	3,975
1994	68,698	54,490	9,886	4,322
1995	71,881	57,643	9,767	4,471

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The general authorisations and authorisation principles under section 3 of the Currency Act were put into effect in the new Länder by Notice No. 1006/90.[2]

1 Deutsche Bundesbank Notice No. 1015/78 of June 9, 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 25 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 January 5, 1990, page 54.
2 Deutsche Bundesbank Notice No. 1006/90 of June 13, 1990, published in Federal Gazette No. 114 of June 23, 1990, page 3,215.

VII. UN embargo measures: recent developments in the field of financial sanctions

*Serbia/
Montenegro*

The outstanding event in 1995 in the field of UN financial sanctions was the suspension of the measures against Serbia/Montenegro. In connection with the peace negotiations in Dayton (USA), the Security Council suspended the financial sanctions with immediate effect by UN Resolution 1022 (1995) of November 22, 1995. From then onwards, no authorisation was required for payment and financial transactions with Serbia/Montenegro. Consequently, the Federal Ministry of Economics informed the associations accordingly on November 23, 1995. Later on, by virtue of the 38th Regulation of December 12, 1995 Amending the Foreign Trade and Payments Regulation (Federal Gazette, page 12,797), the Federal Minister of Economics amended section 69 k of the Foreign Trade and Payments Regulation by adding a fifth paragraph providing that the provision is not to be applied during the suspension, retroactively from November 22, 1995. In section 3 of UN Resolution 1022 (1995) the UN Security Council reserved the right to terminate the suspension at five days' notice if serious disturbances of the peace occurred. In that event, the Federal Ministry of Economics will issue an announcement on the reactivation of the sanctions.

During the suspension, no authorisations under the foreign trade and payments legislation are required. However, in a circular letter the Federal Ministry of Economics and the Bank have drawn the associations' attention to the fact that the suspension does not affect claims of the successor states arising from assets of the former Socialist Federal Republic of Yugoslavia. Moreover, it goes without saying that contractual or judicial restrictions or restrictions under bankruptcy legislation have to be complied with. Furthermore, the ban on meeting claims of Serbia/Montenegro deriving from the embargo remains in effect (EC Regulation No. 1733/94, Official Journal L 182/1).

*Bosnia-
Herzegovina*

The sanctions against the areas of Bosnia-Herzegovina that are controlled by Serbs (EC Regulation No. 2471/94, Official Journal L 266/1) were not suspended until February 27, 1996.

Iraq, Libya

In the other embargo areas (Iraq, Libya) no major changes took place.

Overview

To sum up, the following provisions concerning UN financial sanctions applied at the end of 1995:

Iraq:	sections 52 and 69 e of the Foreign Trade and Payments Regulation
Serbia/Montenegro:	section 69 k of the Foreign Trade and Payments Regulation (suspended, see section 69 k (5))
Libya:	section 69 n of the Foreign Trade and Payments Regulation
Bosnia/Herzegovina (where controlled by Serbs):	Articles 6 and 7 of EC Regulation 2471/94 (suspended since February 27, 1996).

VIII. Technical central bank cooperation by the Bank

Sustained heavy demand for technical cooperation

For several years, the Bank has been cooperating closely with a number of central banks in various countries in transition and developing nations in the areas of advice and training assistance. Like the central banks of other major industrial countries, the Bank regards Technical Central Bank Cooperation as being an important task in the context of international relations. The main objective of its efforts is actively to contribute to the setting-up and extension of market-oriented central bank systems, thus fostering the process of monetary reform and economic stabilisation in the countries concerned. Technical co-operation is tailored to the needs of the recipient central banks and thus to the respective conditions prevailing. It is therefore essentially geared to demand, and largely customised. In addition to bilateral activities, which are in the forefront, the Bank also participates in the multilateral advisory services offered by the International Monetary Fund and the European Community. Such technical central bank cooperation was continued in 1995, with the assistance granted by the Bank to the countries in transition being brought into line with the changes in demand.

Training measures for over 1,100 foreign central bankers

Instruction and advice is offered to the executives and staff members of foreign central banks in various ways: in the form of visits abroad by experts, training visits by foreign central bank staff to the Central Office of the Bank and the Land Central Banks, and the organisation of special seminars at the central banks receiving advice or at the Bundesbank. The activities are coordinated by the "Technical Central Bank Cooperation" Division of the Central Office of the Bundesbank, and carried out by specialists from all areas of the Bank. In line with the increase in demand, the number of training measures went up from 108 in 1994 to 126 in 1995 and the number of foreign participants from 866 to 1,110. Since 1993 almost 2,400 foreign central bank staff members have participated in such measures.

Transfer of seminars abroad

More recently, seminars with large numbers of participants have increasingly been held abroad. This has made it possible not only to reduce the costs but also to have a large number of applicants attending the seminars. In Germany, on the other hand, a greater number of training visits for individuals or small groups has been arranged. Accordingly, 707 staff members of foreign central banks attended seminars arranged by the Bundesbank abroad in 1995 and 111 foreign guests participated in seminars held in Germany. 292 foreign executives were offered an opportunity of further training in the context of training visits to the Central Office of the Bundesbank and the Land Central Banks. The average age of the participants in training measures has fallen distinctly.

Successful standardised seminars of the Bank

The latter is true in particular of the "standardised" seminars that were held for the first time last year. These are designed to address more basic and general aspects of modern central banking. They are open to a broad range of interested central banks from transitional and developing countries, and are conducted in German. Last year four seminars of this type, with a total number of 60 participants from the central banks of various countries, were organised; they have proved to be quite a success, and are to be continued in the current year.

Demand-induced shifts in the technical and regional focal points

In 1995 the largely bilateral demand for training increasingly focused on special areas of banking, with questions of banking supervision, payments, accounting and internal monitoring (as well as technical aspects of monetary policy) being in the forefront. The regional focus of demand, which hitherto had been primarily on central and eastern European countries in transition, shifted further to the east, and now increasingly also includes countries from the Transcaucasian and central Asian areas. In 1995 more than one-quarter of the participants in training measures of the Bundesbank came from the Russian Federation, followed by the Ukraine, Belarus, Poland, the Czech Republic and China. Altogether, 35 countries were granted assistance last year.

Advisory activities of the Bundesbank in the countries in transition considered very valuable

The Bundesbank's cooperation with the central banks receiving advice helps underpin their calls for independence and compliance with the stability requirements in the partner countries. Moreover, the persistently strong demand for technical assistance shows that the Bundesbank's advisory services are considered useful and effective. Some countries in transition have meanwhile made conspicuous progress on the road to developing a modern central bank system. In addition, some of these countries are passing on the experience they have gained in this way by organising advisory and training programmes of their own for less developed central banks abroad.

Demand for technical cooperation will persist

However, in some countries the transformation process is taking place in an extremely difficult economic and political environment, and sometimes results in standstill or even a setback. Even so, the economic and institutional reorientation towards free-market structures would appear to be virtually irreversible. Recent progress in overcoming macroeconomic imbalances, especially in the major transitional countries, strengthens hopes that the preconditions for successful transition will durably improve. At all events, the demand for technical assistance in setting up an efficient and up-to-date central bank system in these countries is unlikely to slacken in the near future.

IX. Changes in organisational structure, staff levels

Further streamlining of the branch office network

The process of rationalisation and concentration which started some years ago among private banks has resulted in a continuous decline in the demand for central banking services from the Bundesbank's nation-wide branch network. As a consequence, the Bank continued to streamline its branch office network in 1995, reducing the number of its branch offices by five to 177.

Trends in staff levels

Table 24

Beginning of 1995

Employed persons	Central Office of the Bank	Land Central Banks	Total 1	Male	Female
Civil servants	1,020	5,895	6,915	5,980	935
Other salaried staff	1,466	7,633	9,099	4,174	4,925
Wage earners	209	841	1,050	218	832
Total	2,695	14,369	17,064	10,372	6,692

Beginning of 1996

Employed persons	Central Office of the Bank	Land Central Banks	Total 1	Male	Female
Civil servants	1,022	5,776	6,798	5,865	933
Other salaried staff	1,402	7,178	8,580	3,911	4,669
Wage earners	191	804	995	212	783
Total	2,615	13,758	16,373	9,988	6,385

1 of whom

	Beginning of 1995	Beginning of 1996
Trainee civil servants, civil servants undergoing training programmes and other trainees	581	405
Part-time employees:		
Civil servants and other salaried staff	1,093	1,146
Wage earners	683	649
The following are not included in the staff figures:		
persons seconded to work for 12 months or more for other public employers, international organisations or otherwise abroad	78	75
members of the Bank's staff released without pay	627	694

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Staff levels again reduced

The decline in the volume of business at the branch offices, which entailed rationalisation measures in all areas of the Bank, was also reflected in the movements in staff levels. Altogether, the number of persons employed declined by 691, or 4 %, to 16,373 during the year under review. At 611, the major part of the decrease was accounted for by Land Central Banks. The total number of persons employed at the beginning of 1995 (see the above table) differs slightly from the previous year's figure because – for the sake of greater clarity – staff seconded to work outside the Bundesbank for twelve months or more (for other public employers, international organisations or otherwise abroad) have been shown separately for the first time.

Promotion of part-time employment

Although overall staff levels were declining, the number of persons working part-time increased to 1,795; this constitutes a part-time-working ratio of 11 %.

The Bundesbank's policy is to create part-time posts unless there are operational reasons that argue against it; that goes for executive positions, too.

New emphases in training and further training

Owing to changes in the demands made on staff, our training and further training schemes must continually alter their emphases. In the first place, the further training programmes for executives were made more individual and more goal-oriented last year. In addition, the curriculum for training for the Upper Intermediate Service at the Training College of the Bundesbank in Hachenburg was updated, above all with respect to recent developments in the money and capital markets. In this connection, topics relating to Europe and international issues continued to be highlighted.

Annual accounts of the Deutsche Bundesbank for 1995

I. Balance sheet of the Deutsche Bundesbank as at December 31, 1995

Assets

				DM	31. 12. 1994 DM million
1	Gold			13,687,518,821.70	13,688
2	Reserve position in the International Monetary Fund and special drawing rights				
	2.1 Drawing rights within the reserve tranche		7,468,707,428.79		(6,241)
	2.2 Loans under special borrowing arrangements		–		(–)
	2.3 Special drawing rights		2,868,619,765.95		(1,726)
				10,337,327,194.74	7,967
3	Claims on the European Monetary Institute				
	3.1 ECU balances	38,405,850,759.47			
	less: Difference between the ECU value and the book value of the contributed gold and dollar reserves	9,607,384,560.83			
			28,798,466,198.64		(31,742)
	3.2 Other claims		–		(–)
				28,798,466,198.64	31,742
4	Balances with foreign banks and money market investments abroad			68,463,925,549.45	60,188
5	Foreign notes and coins			19,730,763.24	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		1,750,000,000.–		(2,152)
	6.4 Other external assets		204,300,000.–		(208)
				1,954,300,000.–	2,360
7	Lending to domestic credit institutions				
	7.1 Securities bought in open market transactions under repurchase agreements		145,754,112,000.–		(146,285)
	7.2 Domestic bills of exchange		52,210,352,963.77		(52,108)
	7.3 Foreign bills of exchange		9,634,923,783.51		(9,546)
	7.4 Lombard loans		5,532,916,800.–		(9,753)
				213,132,305,547.28	217,692
8	Equalisation claims on the Federal Government and non-interest-bearing debt certificate in respect of Berlin			8,683,585,988.93	8,684
9	Securities			884,129,812.60	3,173
10	German coins			2,090,634,847.29	2,126
11	Balances on postal giro accounts			–	2,716
12	Land and buildings			3,559,378,262.82	3,364
13	Furniture and equipment			202,780,148.–	214
14	Other assets			2,571,648,255.35	2,439
15	Prepayments			61,738,544.31	110
				354,447,469,934.35	356,483

Liabilities

				31. 12. 1994
			DM	DM million
1	Banknotes in circulation		248,363,466,180.–	236,165
2	Deposits of credit institutions			
	2.1 Deposits on giro accounts	49,669,141,700.38		(56,154)
	2.2 Other	17,757,343.91		(28)
			49,686,899,044.29	56,182
3	Deposits of public authorities			
	3.1 Federal Government	40,225,527.39		(41)
	3.2 Federal special funds	7,359,047.75		(9)
	3.3 Länder Governments	78,526,158.–		(136)
	3.4 Other public depositors	37,992,974.46		(30)
			164,103,707.60	216
4	Deposits of other domestic depositors		707,386,216.49	711
5	Liabilities arising from liquidity paper sold		1,583,900,000.–	6,038
6	Liabilities arising from external transactions			
	6.1 Deposits of foreign depositors	14,798,820,718.64		(18,546)
	6.2 Other	7,490,264.13		(5)
			14,806,310,982.77	18,551
7	Counterpart of special drawing rights allocated		2,579,984,268.80	2,738
8	Provisions			
	8.1 for pensions	3,093,000,000.–		(2,753)
	8.2 for other purposes	6,992,435,965.89		(7,257)
			10,085,435,965.89	10,010
9	Items in course of settlement		2,252,622,784.60	1,955
10	Other liabilities		507,883,582.51	540
11	Accruals		393,262,844.90	722
12	Capital		290,000,000.–	290
13	Reserves			
	13.1 Legal reserves	11,808,300,000.–		(11,217)
	13.2 Other reserves	290,000,000.–		(290)
			12,098,300,000.–	11,507
14	Unappropriated profit		10,927,914,356.50	10,858
			354,447,469,934.35	356,483

II. Profit and loss account of the Deutsche Bundesbank for 1995

Expenditure

			DM	1994 DM million
1	Interest expenditure		796,361,121.96	2,198
2	Staff costs			
	2.1 Wages and salaries	1,074,163,149.63		(1,040)
	2.2 Social security contributions, spending on retirement pensions and on maintenance payments	705,908,359.85		(444)
			1,780,071,509.48	1,484
3	Other operating expenditure		368,353,133.56	359
4	Banknote printing		163,009,462.81	157
5	Depreciation			
	5.1 of land and buildings	234,064,490.44		(222)
	5.2 of furniture and equipment and of other assets	127,300,716.58		(155)
			361,365,207.02	377
6	Write-downs of monetary reserves and other foreign currency positions		1,149,214,050.32	2,804
7	Other expenditure		56,403,308.93	63
8	Profit for the year (= unappropriated profit)		10,927,914,356.50	10,858
			15,602,692,150.58	18,300

Receipts

		DM	1994 DM million
1	Interest	15,084,168,429.69	17,860
2	Fees	109,997,987.64	98
3	Other receipts	408,525,733.25	342
		15,602,692,150.58	18,300

Frankfurt am Main, February 14, 1996

Deutsche Bundesbank
The Directorate

Dr Dr h.c. Tietmeyer Gaddum
Häusler Hartmann Prof. Dr Dr h.c. Issing Meister Schieber Schmidhuber

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

Frankfurt am Main, March 20, 1996

C&L DEUTSCHE REVISION
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Windmöller
Certified Auditor

Langen
Certified Auditor

WOLLERT-ELMENDORFF
DEUTSCHE INDUSTRIE-TREUHAND GMBH
Wirtschaftsprüfungsgesellschaft

Thoennes
Certified Auditor

Flaig
Certified Auditor

III. Notes on the annual accounts for 1995

1. Legal basis and classification

Legal basis

Notwithstanding its public-law status, the Deutsche Bundesbank is a trader within the meaning of section 1 (2) 4 of the Commercial Code *(Handelsgesetzbuch – HGB)* because it conducts banking operations. Hence it, too, is subject to generally accepted accounting principles. In particular, the legal basis of its accounts is provided by section 26 and section 27 of the Bundesbank Act *(Gesetz über die Deutsche Bundesbank – BBankG)*. In accordance with those provisions, the layout of, and the notes on, the annual accounts must pay due regard to the Bundesbank's duties. Regarding valuation, the provisions of the Commercial Code relating to incorporated enterprises are to be applied as appropriate.

Specifically, the current assets (which include, first and foremost, the monetary reserves) are to be shown in the balance sheet strictly in accordance with the principle of the lower of cost or market (section 253 (3) of the Commercial Code). Furthermore, write-downs may be effected in order to obviate the need to change the valuation in the immediate future on account of fluctuations in value. Pursuant to section 26 (2) of the Bundesbank Act, the Bundesbank may retain such a lower valuation in the following years, too. Moreover, in the context of the ascertainment of the profit or loss, liability items may be created in respect of general hazards encountered in domestic and international operations.

In accordance with section 27 of the Bundesbank Act, 20 % of the net profit or DM 20 million, whichever is the higher, is to be transferred to the legal reserves until they reach 5 % of the total amount of banknotes in circulation. Up to 10 % of the remaining net profit may be used to form other reserves, which in the aggregate may not exceed the amount of the Bank's capital. The balance is to be paid over to the Federal Government. The final transfer to the Fund for the Purchase of Equalisation Claims was effected out of the net profit for 1994, since the Fund was wound up in December 1995.

Classification

Upon the restructuring of the Federal special funds, the designation of the balance sheet item Liabilities 3.2 "Equalisation of Burdens Fund, ERP Special Fund, "German Unity" Fund" was changed to "Federal special funds".

Auditing and approval of the annual accounts

The annual accounts of the Bundesbank for 1995 were audited by *C & L Deutsche Revision AG Wirtschaftsprüfungsgesellschaft* 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 (3) of the Bundesbank Act. In their certificate of audit, the auditors confirmed without qualification that the annual accounts for 1995 and the Bank's bookkeeping comply with German law, and present a true picture of the Bank's assets and liabilities, financial position and profitability. The Central Bank Council approved the annual accounts for 1995, together with the profit distribution, on April 18, 1996.

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 Institute (EMI) 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 13,688 million. As in the previous year, the gold is valued at its purchase price; the average value per ounce of fine gold 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 that result from the Federal Republic of 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, 1995 their level amounted to DM 7,469 million (= SDR 3,505 million), compared with DM 6,241 million (= SDR 2,760 million) at the end of 1994. They represent the difference between the German quota of SDR 8,242 million and the Deutsche Mark balances equivalent to DM 10,093 million (= SDR 4,737 million) at the disposal of the IMF at the end of the year. Mainly owing to Deutsche Mark drawings and Deutsche Mark repayments by other member countries, the holding of drawing rights increased by SDR 745 million on balance in 1995.

During the year under review, the Bank did not grant the IMF any new loans under special borrowing arrangements. At present an unchanged credit line in favour of the IMF amounting to SDR 2.4 billion is outstanding under the General Arrangements to Borrow (GAB), 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 free of charge to the extent of SDR 1,211 million. The counterpart thereof is shown on the liabilities side. The level of special drawing rights held at the end of 1995 amounted to DM 2,868 million (= SDR 1,346 million). Increases totalling SDR 603 million as a result of freely agreed SDR transactions and owing to interest receipts were accompanied by decreases amounting to SDR 20 million on account of sales and interest payments.

Claims on the European Monetary Institute

This item comprises the Bank's ECU balances and its claims denominated in ECUs which arise when other central banks avail themselves of the very short-term financing mechanism. The ECU balances amounting to DM 38,406 million derive mainly from the temporary contribution of 20 % of the Bank's gold and dollar reserves to the EMI. In addition, these balances include the reserve ECUs (DM 9,221 million) transferred to the Bank by other central banks participating in the EMS. The gold and dollar reserves contributed to the EMI under the terms of the EMS against the crediting of ECUs were transferred at market prices, and therefore at values higher than those shown in the balance sheet. The resulting difference of DM 9,608 million is deducted from the ECU balances. No other claims denominated in ECUs arising from lending under the very short-term financing mechanism were outstanding at the end of 1995.

Balances with foreign banks and money market investments abroad

The balances with foreign banks and money market investments abroad, the greater part of which are denominated in US dollars and bear interest, amounted to DM 68,464 million at the end of 1995, against DM 60,188 million at December 31, 1994 (not counting the dollar reserves contributed to the EMI). The assets and liabilities expressed in US dollars were valued at the balance sheet rate of US$ 1 = DM 1.3620, which represented (as at the balance sheet date) the all-time lowest level of the dollar recorded on April 19, 1995.

External loans and other external assets

The main constituents of this item are loans to the World Bank, which were 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 on December 31, 1995. The other external assets represent limited investments with foreign institutions. Because of their lesser liquidity, external loans and other external assets are not counted among the monetary reserves.

Lending to domestic credit institutions

This item reflects the volume and pattern of domestic credit institutions' refinancing. Most of it is made up of the securities repurchase operations used as part of the Bank's flexible money market management. In that context, the Bank buys securities eligible as collateral for lombard loans on condition that the sellers repurchase them forward. At the end of the year, the claims deriving from such transactions amounted to DM 145,754 million (1994: DM 146,285 million). The portfolio of domestic and foreign bills of exchange which the Bank purchases at the discount rate under the rediscount quotas increased only slightly compared with December 31, 1994. Lombard loans, by means of which the Bank supplies central bank money against the collateral of certain securities and Debt Register claims, serve to meet transitional short-term liquidity needs on the part of credit institutions. On the balance sheet date lombard loans amounted to DM 5,533 million.

Equalisation claims

Equalisation claims on the Federal Government and the non-interest-bearing debt certificate in respect of Berlin both date back to the currency reform of 1948. They form the balance sheet counterpart of the amounts paid out at that time in cash per capita and per enterprise, and of the initial provision of credit institutions and public corporations with central bank money. Equalisation claims yield interest at the rate of 1 % per annum. In connection with Article 104 of the Maastricht Treaty, it has been laid down that equalisation claims are to be redeemed in ten annual instalments, starting in the year 2024.

Securities

During the year under review the Bank's portfolio of securities, which chiefly comprises debt securities issued by the Federal Government, was further reduced, decreasing from DM 3,173 million to DM 884 million.

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 mints at face value. At the end of 1995 the amount of coins in the Bank's portfolio was equivalent to 13.8 % of the volume of coins outstanding; under the supplementary provisions of Article 104 of the Maastricht Treaty, the portfolio is subject to a ceiling of 10 %; for a transitional period, a ceiling of 15 % applies until the end of 1996 (as in the Coinage Act).

Balances on postal giro accounts

As a result of the conclusion of the Bank's special arrangements for the Postbank, the last postal giro accounts were closed in spring 1995. The item "Balances on postal giro accounts" is therefore appearing in the annual accounts for the last time.

Land and buildings

In 1995 the balance sheet value of the Bank's land, offices and residential buildings increased by DM 195 million. Additions of DM 429 million were accompanied by depreciation amounting to DM 234 million.

Furniture and equipment

In the year under review the value of the furniture and equipment of the Bank fell by DM 11 million, after additions of DM 107 million and depreciation totalling DM 118 million.

Other assets

"Other assets" primarily comprise interest income from external assets and securities repurchase transactions which is not due until 1996 but is assignable to the profit and loss account for 1995. This item also includes participating interests in the European Monetary Institute, Frankfurt am Main, the Bank for International Settlements, Basle, the cooperative society S.W.I.F.T., La Hulpe (Belgium), and *Liquiditäts-Konsortialbank GmbH,* Frankfurt am Main. The capital interest in the European Monetary Institute amounts to DM 255 million (= ECU 139 million), or 22.55 % of the aggregate capital. The 30 % interest in *Liquiditäts-Konsortialbank* entails for the Bank a maximum commitment of DM 558 million.

Prepayments

The prepayments consist mainly of payments booked in the year under review, but relating to 1996, for salaries and pensions, and for interest expenditure on liquidity paper sold.

3. Liabilities

Banknotes in circulation

Compared with the end of 1994, the volume of banknotes in circulation rose by DM 12,198 million to DM 248,363 million, representing an increase of 5.2 %. In the preceding year the increase had amounted to 5.3 %.

Compared with the previous year, the amount of currency in circulation went up by DM 12,603 million to DM 263,510 million; DM 15,147 million of this sum was accounted for by coins.

Deposits of credit institutions

Credit institutions' deposits on giro accounts totalled DM 49,669 million at the end of 1995, against DM 56,154 million on December 31, 1994; the decline was mainly due to the lowering of the minimum reserves from August 1, 1995. The sub-item "Other" (DM 18 million) contains the deposits of domestic credit institutions and of the branches of foreign banks on US dollar accounts.

Deposits of public authorities

This item encompasses the balances of the Federal Government, its special funds, the Länder Governments and other public depositors. The special funds comprise the Equalisation of Burdens Fund, the ERP Special Fund, the Redemption Fund for Inherited Liabilities and the "German Unity" Fund. The deposits of other public depositors constitute the balances of social security funds and local authorities. At December 31, 1995 such deposits amounted to DM 164 million in all (1994: DM 216 million).

Deposits of other domestic depositors

This balance sheet item contains the deposits of enterprises and individuals. At the end of 1995 such deposits totalled DM 707 million, against DM 711 million in the previous year.

Liabilities arising from liquidity paper sold

"Liabilities arising from liquidity paper sold" amounted to DM 1,584 million at the end of 1995 (1994: DM 6,038 million). The decline is due to the maturity, on March 15, 1995, of the final issue of Bundesbank liquidity paper ("Bulis") of September 1994, in the nominal value of DM 4,909 million. In the year under review only Federal Treasury bills were sold to public authorities, foreign monetary authorities and international organisations, which used these instruments inter alia for investing in an interest-bearing manner the balances they did not need for payment purposes. In 1995 no Treasury bills were sold to credit institutions to mop up short-term liquidity in the context of money market management.

Liabilities arising from external transactions

This balance sheet item, totalling DM 14,806 million (1994: DM 18,551 million), consists primarily of the Deutsche Mark deposits of foreign monetary authorities. Specifically, DM 14,694 million (1994: DM 17,622 million) was accounted for by the balances of foreign banks and DM 112 million by other deposits.

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 of the balance sheet, corresponds to the allocations of SDRs to the Federal Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,211 million.

Provisions for pensions

After an increase of DM 340 million, the provisions for pensions amount to DM 3,093 million; they are in line with the actuarially computed requirements.

Provisions for other purposes

The provisions for other purposes, which serve principally to cover general risks inherent in domestic and international operations and doubtful liabilities, declined by DM 265 million net on December 31, 1995. They now amount to DM 6,992 million (see also the notes below on the item "Write-downs of monetary reserves and other foreign currency positions").

Items in course of settlement

The "Items in course of settlement", the volume of which is affected, in particular, by return-date influences in payments, mainly consist of the credit transfers, cheques and direct debits in transit within the Bank at the end of the year. Following the introduction of the large-value cheque collection procedure in November 1994, the assets-side ratio of the items in course of settlement declined to such an extent that the liabilities-side ratio generally predominates. At December 31, 1995 there was an adverse balance which, at DM 2,253 million, exceeded that of 1994 by DM 298 million.

Other liabilities

The other liabilities, amounting to DM 508 million (1994: DM 540 million), constitute amounts not yet passed on and interest expenditure falling due in 1996 but relating to 1995.

Accruals

Accruals totalled DM 393 million at December 31, 1995 (1994: DM 722 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 bills.

Reserves

In accordance with the decision taken by the Central Bank Council on April 20, 1995, the legal reserves were increased by DM 591 million out of the unappropriated profit for 1994. Thereafter, the legal reserves totalled DM 11,808 million; they thus reached the maximum level permissible by law of 5 % of the amount of banknotes in circulation, which came to DM 236,165 million at the end of 1994. The other reserves had reached the statutory ceiling of DM 290 million as long ago as the end of 1980.

Unappropriated profit

See the notes on "6. Profit for the year" below.

4. Expenditure

Interest expenditure

Interest expenditure declined by DM 1,401 million in the year under review. Interest expenditure on both international and domestic operations decreased.

Staff costs

Staff costs went up by DM 296 million in 1995, to a total of DM 1,780 million. This increase was mainly due to the raising of the provisions for pensions. Excluding the transfer to such provisions, staff costs went up by 2.2 % against the previous year, mainly owing to the general pay rises and the upward trend of incomes in the new Länder. On the other hand, the number of persons employed at the Bundesbank decreased on average by 3.4 % against the preceding year.

DM 548 million (1994: DM 289 million) of the staff costs was accounted for by retirement pensions. This sum includes the increase of DM 340 million in provisions for pensions, as well as the payments made to staff members of the former Deutsche Reichsbank and to other persons to whom the Act concerning Article 131 of the Basic Law applies, for whom the Bank is required to provide in accordance with section 41 of the Bundesbank Act.

Payments to serving members of the Central Bank Council amounted to DM 10,201,608.30 in the year under review. Former members of that Council and of the Board of Directors and Board of Managers of the Bank deutscher Länder, and of the Executive Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 14,397,140.92.

Other operating expenditure

The other (non-staff) operating expenditure of the Bank increased by DM 9 million (2.5 %) compared with 1994, and amounted to DM 368 million; this increase was mainly attributable to higher spending on office buildings.

Banknote printing

In the year under review expenditure on banknote printing went up slightly (by DM 6 million) to DM 163 million.

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 and other foreign currency positions

This item comprises the outcome of the valuation of the monetary reserves and other foreign currency positions; it also includes the profits and losses resulting from purchases and sales of foreign currencies and changes in the provisions likewise affecting the external position. Altogether, losses of DM 1,149 million were incurred, mainly owing to write-downs of the dollar reserves.

5. Receipts

Interest

In the year under review the interest received, at DM 15,084 million, was DM 2,776 million lower than in 1994. The crucial factor here was the interest received from lending to domestic credit institutions; it declined by DM 2,334 million owing to further cuts in central bank rates and the lower average refinancing volume. Interest income from securities, at DM 183 million, had little impact on aggregate interest receipts. Interest income from international operations decreased by DM 332 million against the previous year, to a total of DM 6,439 million; among other things, the interest received from US dollar investments diminished on account of lower average exchange rates.

Fees

Receipts from fees, which accrue first and foremost in connection with payments, went up by DM 12 million to DM 110 million, mainly because of the increased use of the electronic window *(ELS)* for orders submitted for processing by the express electronic credit transfer system *(EIL-ZV)*.

6. Profit for the year

The profit and loss account for 1995 records a profit for the year of DM 10,927,914,356.50, which is shown in the balance sheet as unappropriated profit (net profit). In accordance with section 27 of the Bundesbank Act, DM 609,900,000.00 of this sum will be transferred to the legal reserves. The balance, amounting to DM 10,318,014,356.50, will be paid over to the Federal Government. After this appropriation, the legal reserves will total DM 12,418,200,000.00; they will thus come up to the statutory ceiling of 5 % of the amount of banknotes in circulation.

IV. Fund for the Purchase of Equalisation Claims

Operations of the Fund in the year under review

The operations of the Fund ceased in 1995.

During the year under review the Fund once more received DM 30 million from the profit of the Bundesbank for the preceding year. In addition, interest and redemption payments by the debtors of equalisation claims for the first half of 1995 in the amount of DM 238 million accrued to the Fund; in the second half of that year no interest and redemption payments had to be effected. Moreover, the Fund received interest payments totalling DM 11 million from the temporary investment of available resources. Together with DM 245 million carried forward from the financial year 1994, DM 524 million was at the Fund's disposal.

A total of DM 195 million was spent in 1995 on the purchase and equal-percentage acquisition of the residual amount of equalisation claims arising from the currency reform of 1948 in the hands of credit institutions, insurance enterprises and building and loan associations, in accordance with section 9 of the Act on the Redemption of Equalisation Claims *(Gesetz über die Tilgung von Ausgleichsforderungen)*. Altogether, DM 8 million of that sum was accounted for by purchases and the acquisition of "minor" equalisation claims pursuant to section 9 (2) 2 and section 9 (3) of the Redemption Act, and DM 187 million by the equal-percentage acquisition of all remaining equalisation claims on the Federal Government and ten Länder Governments pursuant to section 9 (3) of the Redemption Act. No emergency purchases of equalisation claims in accordance with section 9 (1) of the Redemption Act were effected.

Winding-up of the Fund

Upon the conclusion of the 22nd equal-percentage acquisition round on June 30, 1995, all outstanding equalisation claims – other than those of the Deutsche Bundesbank and the former German Federal Post Office – were in the hands of the Fund.

Then, in accordance with section 10 (1) of the Redemption Act, the Fund had to meet obligations to particular Länder Governments which derived from the full redemption of equalisation claims from budget resources in the years prior to 1960. Thereafter, the Central Bank Council's decision of December 14, 1995 to wind up the Fund in accordance with section 10 (2) of the Redemption Act came into force.

Prior to the decision to wind up the Fund, its assets totalled DM 2,873 million. DM 28 million of that sum was transferred to seven Länder Governments on December 15, 1995 to discharge the above-mentioned obligations.

The equalisation claims in the hands of the Fund, with a total residual capital value of DM 2,544 million, had been extinguished from the accounts in the Federal and Länder Debt Registers by December 31, 1995.

The Fund's "residual other resources" at the time of winding-up, in addition to the equalisation claims, and after discharging the said obligations, in the amount of DM 301 million were paid over to the Federal Government on December 15, 1995 in accordance with section 10 (3) of the Redemption Act; that authority likewise took over the Fund's liabilities, as published since 1982.

The Fund's functions were thereby fulfilled. It had bought from creditors of equalisation claims that were in difficulties low-yielding assets which were hard to liquidate, had mitigated the burdens borne by individual creditors as a result of unduly heavy allotments of equalisation claims, had reduced the administrative cost, in terms of time and effort, associated with equalisation claims for all concerned, and had shortened the life of equalisation claims compared with the redemption schedules. The winding-up of the Fund closed one of the final chapters of the currency reform of 1948.

Auditing and approval of the annual accounts

The Fund for the Purchase of Equalisation Claims was audited, as at December 31, 1995, by *C & L Deutsche Revision AG Wirtschaftsprüfungsgesellschaft* of Frankfurt am Main and *Wollert-Elmendorff Deutsche Industrie-Treuhand GmbH Wirtschaftsprüfungsgesellschaft* of Düsseldorf. In their certificate of audit the auditors confirmed without qualification that the Fund was properly managed, wound up and liquidated. The Central Bank Council duly approved the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1995 on April 18, 1996.

Trend in equalisation claims in the Fund in 1995

Deutsche Mark

Interest rate (%)	Initial capital 1			Remaining capital 2	Holding at Dec. 31, 1995 (initial and remaining capital) 3
	Holding at Dec. 31, 1994	Additions due to purchases and equal-percentage acquisition	Holding at Dec. 15, 1995	Holding at Dec. 15, 1995	
3	5,877,142,476.42	488,287,472.64	6,365,429,949.06	1,608,263,423.12	–
3 ½	5,372,675,467.08	448,346,030.26	5,821,021,497.34	935,544,724.72	–
Total	11,249,817,943.50	936,633,502.90	12,186,451,446.40	2,543,808,147.84	–

1 Amounts entered in the Debt Registers of the Federal and Länder Governments. — 2 Initial capital less the redemptions effected by debtors since 1956. — 3 By December 31, 1995 the equalisation claims had been extinguished from the Debt Registers.

Fund for the Purchase of Equalisation Claims in 1995

Deutsche Mark

	Equalisation claims (remaining capital)	Available resources	Liabilities	Fund assets, total
Holding at December 31, 1994	2,546,198,487.22	245,254,324.55	63,942.49	2,791,388,869.28
Transfer from the profit of the Deutsche Bundesbank for 1994	–	30,000,000.–	–	30,000,000.–
Purchases and equal-percentage acquisition of equalisation claims	195,439,077.88	– 195,439,077.88	–	–
Redemptions	– 197,829,417.26	197,829,417.26	–	–
Interest income from equalisation claims	–	40,613,032.44	–	40,613,032.44
temporary investment of the Fund's cash resources	–	10,590,293.61	–	10,590,293.61
Holding at December 15, 1995	2,543,808,147.84	328,847,989.98	63,942.49	2,872,592,195.33
Discharge of obligations to individual Länder Governments	–	– 27,922,707.66	–	– 27,922,707.66
Residual amount to be transferred to the Federal Government	–	– 300,925,282.32	–	– 300,925,282.32
Extinction of equalisation claims by the Debt Register authorities	– 2,543,808,147.84	–	–	– 2,543,808,147.84
Assumption of liabilities by the Federal Ministry of Finance	–	–	– 63,942.49	63,942.49
Holding at December 31, 1995	–	–	–	–

Frankfurt am Main, February 14, 1996

Deutsche Bundesbank
The Directorate

Dr Dr h.c. Tietmeyer Gaddum

Häusler Hartmann Prof. Dr Dr h.c. Issing Meister Schieber Schmidhuber