Deutsche Bundesbank Annual Report 1994

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on April 15, 1995

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Contents

Records of policy measures

Tables

Tables (cont'd)

Charts

Note

The current monetary policy regulations and the Principles Concerning the Capital and Liquidity of Credit Institutions are included in the following special publications, which are available to interested parties free of charge:
Deutsche Bundesbank, Monetary policy regulations, Frankfurt am Main, April 1995;
Deutsche Bundesbank, Banking Act, Frankfurt am Main, 1994.

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	Figure unknown, not to be published or not meaningful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

Economic conditions in Germany improved perceptibly in 1994. The west German economy left the trough of the business cycle and moved on to a growth path. The east German economy expanded strongly again and made further substantial headway in the adjustment process. At the same time, the pace of price rises slackened distinctly and the decline in employment came to a halt. The upswing was sparked off primarily by the expansion of foreign demand, although it also owed something to marked progress in the improvement of supply-side conditions, such as the moderate wage settlements of 1993 and 1994 and the vigorous corporate efforts to rationalise production. However, the global competitiveness of west German industry, and thus the jobs concerned, cannot be safeguarded by a one-off tour de force, but remain an ongoing challenge to economic policy makers, the business community, management and the trade unions. The recent tendency for the Deutsche Mark to appreciate and the comparatively high wage settlements agreed in 1995 once more imply major challenges and heavy burdens. In eastern Germany it is essential to bring more and more enterprises up to west German productivity levels, so that they can stand on their own feet. Not least on account of the rapid pace of privatisation by the Treuhand agency, growth was quick to spread throughout the new Länder. Yet the standard of living and domestic output continue to be disconnected. Happily, this gap (which is being filled by transfer payments) has narrowed.

The greatest challenge facing all those involved in economic activity currently consists in combating unemployment. In 1994 3.7 million people in Germany were out of work – that is to say, far more than is acceptable in the long run. The reasons for the unemployment are predominantly of a structural nature. In many cases, excessive regulation, unduly high labour costs and inadequate wage differentiation stand in the way of a fundamental improvement in the employment situation. The requisite reform measures lie in the area of wage rate, tax and structural policy; an expansionary monetary policy, by contrast, would not be an appropriate means of seeking to resolve the problems posed by the labour market. Germany's quality as an industrial location could benefit considerably not only from moderation in the field of wage rate policy but also from a reduction in the burden of government levies and taxes imposed on employees and enterprises. To create the financial leeway necessary for this, the continuation of the consolidation of the expenditure side of the public budgets will be a matter of paramount importance in the years ahead.

The policy of the Bundesbank in the course of last year was poised between progress in the area of price stability and disruptive influences stemming from the financial sphere. While inflationary pressures eased distinctly, the movement of the money stock long gave cause for concern. Around the turn of 1993-4 there was a liquidity surge in the financial markets as a result of changes in tax legislation, and it developed into a liquidity log-jam under the impact of the global increase in capital market rates and the associated interest volatility. In these circumstances, the Bundesbank adhered unwaveringly to its stability-oriented policy stance. In the first half of 1994 it abided by its policy of progressively lowering interest rates, and from the summer onwards it acted to steady interest rate movements. This strategy contributed to a widening of the interest rate gap between long and short-term financial assets and helped to reassure the financial markets, thus fostering a normalisation of monetary trends. Upon the attainment of the monetary target for 1994, the monetary targeting strategy passed the acid test, and maintained its key role in German monetary policy.

1994 was an important year in the evolution of European integration. The enlargement of the Community by the accession of Finland, Sweden and Austria gives the European Union even greater weight in both economic and political terms. What is more, on January 1, 1994 stage two of the Economic and Monetary Union entered into force. At the same time, the most significant institutional innovation was that the European Monetary Institute was established, and started operation in Frankfurt am Main in the course of the year. Its principal function is to perform preparatory work for the transition to stage three. The essential precondition for that transition is the fulfilment of the contractually agreed convergence criteria. Considerable deficiencies continue to be manifest in that regard, especially in the area of public finance, and are reflected in part in the movement of exchange rates. Given the serious implications of substantial convergence in the field of anti-inflation policy for the success of Monetary Union, it would be wrong to make compromises when interpreting the convergence criteria. The turmoil in the international foreign exchange markets in the first few months of this year once again graphically highlighted the connection between convergence in national economic policies and stable monetary relationships. In a world of closely interrelated financial markets and highly volatile investment capital, movements in exchange rates and interest rates increasingly hinge on the credibility of national economic policy. Uncertainties and speculative exaggerations in the financial markets have given rise to some considerable tensions world-wide. However, this changed environment also offers opportunities, if it is understood as an obligation to pursue a stability-oriented policy.

The Bundesbank has taken this obligation very seriously for a long time. The present Annual Report provides an outline of monetary policy and economic developments during the last year, as well as an analysis of major issues of domestic and international monetary policy. At the same time, the Bank presents its annual accounts for 1994, which were audited by two firms of auditors and approved by the Central Bank Council on April 20, 1995. As in previous years, the Bundesbank had numerous tasks to perform in 1994 in the context of its statutory functions – for instance, with respect to the provision of currency, the settlement of payments, the issue of Federal securities, in foreign exchange trading, and in the fields of currency legislation and national and international banking supervision.

Acting also on behalf of the Central Bank Council, I should like to take the opportunity of thanking all the staff members of the Bank for the dependable and responsible manner in which they discharged their duties in 1994. I also wish to thank the staff representative bodies for cooperating in a spirit of mutual trust.

Frankfurt am Main, April 1995

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

The currency and the economy

I. International economic fundamentals

Perceptible upturn in global economic activity

Underlying economic conditions underwent a change for the better in 1994. Expansionary forces gained in strength world-wide and spread to almost all western industrial nations. The US economy had already been in full swing for some considerable time. In Europe, too, the process of recovery picked up more quickly than had occasionally been expected. Even the Japanese economy, whose competitiveness had suffered as a result of the sharp appreciation of the yen, appears to have pulled out of the cyclical trough. On balance, the real gross domestic product of the industrial countries rose by nearly 3 % in 1994 and hence more than twice as much as in the year before. Sustained strong stimuli to growth were also generated by the newly industrialising countries of south-east Asia and of Latin America. The low point of output appears to have been overcome in the majority of countries in transition in central and eastern Europe, too. This applies principally to those countries in which the necessary reforms were tackled resolutely and quickly; the downward economic trend in Russia, by contrast, continued unabated. Overall, world trade increased last year at an estimated rate of 9 %.

Continued growth in the US economy

The increasing breadth of the upturn smoothed out the economic differential between the industrial countries appreciably, without totally obscuring the differing cyclical positions of the individual economies. Thus, the cyclical upswing continued with undiminished force in the Anglo-Saxon countries which, following long-standing structural problems, had overcome the recession as early as in 1993. The US economy, in particular, gathered pace so strongly that capacity bottlenecks were already perceptible on occasion in 1994. At a good 4 %, the real gross domestic product increased more sharply than it had in 1993 (just over 3 %), and the utilisation of production capacity in industry was now above its previous cyclical peak. The first signs of strain were detectable on the US labour market, too. The upturn was led mainly by a buoyant demand for capital goods and by private consumption, after weaknesses in enterprises' and households' financial and assets structures had been overcome. Much the same applies to the UK economy: its most powerful stimuli had likewise come at first from the revival in domestic demand and, as economic activity picked up in continental Europe, it then began to benefit to a greater extent from the competitive advantages resulting from the pound's depreciation.

Export-led upswing in continental Europe...

Although the stimuli to demand in other west European countries were mainly external last year, domestic demand, following the deep slump of 1993, once

Key macroeconomic variables in selected industrial countries

Table 1

Country	Real gross domestic product		Consumer prices 1		Unemployment rate 2		Balance on current account	
	1993	1994 p	1993	1994 p	1993	1994 p	1993	1994 p
	Change from previous year in %				%		US$ billion	
Industrial countries	+ 1.1	+ 2.8	+ 3.1	+ 2.6	7.8	7.8	+ 20.2	– 18.2
of which								
European Community 3	– 0.4	+ 2.6	+ 3.2	+ 3.1	10.7	11.4	+ 12.3	+ 27.8
of which								
France	– 1.0	+ 2.5	+ 2.1	+ 1.7	11.7	12.5	– 10.3	– 9.9
Germany 4	– 1.1	+ 2.9	+ 4.2	+ 3.0	6.1	6.9	– 15.5	– 21.1
Italy	– 0.7	+ 2.3	+ 4.5	+ 4.0	10.2	12.0	+ 11.2	+ 13.8
United Kingdom	+ 2.1	+ 3.8	+ 1.6	+ 2.4	10.3	9.5	– 16.8	– 0.2
United States	+ 3.1	+ 4.1	+ 3.0	+ 2.6	6.7	6.0	– 104.0	– 155.7
Japan	– 0.2	+ 0.6	+ 1.3	+ 0.7	2.5	2.9	+ 130.4	+ 129.3
Canada	+ 2.2	+ 4.5	+ 1.8	+ 0.2	11.2	10.3	– 23.9	– 18.2

Sources: EC Commission, IMF, OECD and national statistics. — **1** Cost-of-living index. — **2** Standardised unemployment rate according to OECD calculations; excluding the OECD countries Denmark, Austria, Greece, Luxemburg, Mexico and Turkey. — **3** Excluding the countries which joined on January 1, 1995. — **4** Germany as a whole; the growth of west German real GDP amounted to –1.7 % in 1993 and to +2.3 % in 1994. Consumer prices and unemployment rate for western Germany only.

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again made a positive contribution to growth. As a result, through the simultaneous increase in demand for imports, there was a mutual reinforcement of the stimuli to growth.

. . . but unsatisfactory employment situation persists

Nevertheless, with unemployment at a rate of 11 ½ % on a European Community average, the employment situation in Europe remained unsatisfactory, particularly as it will not improve fundamentally even with a continuation of the economic recovery process. Selective course adjustments are essential in order to improve the flexibility of the labour markets, to relax rigidities in the wage-bargaining process and to facilitate the necessary differentiation in wage and salary structures.

Burgeoning fears of inflation, despite success in terms of stability

This brightening-up of the international scenario was, on the whole, gratifying but was clouded by new fears of inflation – despite the notable successes in terms of stability which the western industrial nations are able to look back on. At an average of 2 ½ %, inflation rates thus reached a low which had not been recorded for decades. This figure should also be seen in the context of the preceding phase of recession, however. The "acid test" for anti-inflation policy is still to come in many cases. At any rate, concerns regarding anti-inflation policy grew increasingly in those countries where the cyclical upswing was already far advanced, particularly when they were faced with looming capacity bottlenecks. Sharply rising prices in the world raw material markets in the first half of 1994 were, in part, a reflection of these expectations and reinforced the fears associated with this. The US central bank reacted to the deteriorating price climate as early as the start of 1994 by changing its course in interest rate policy. This led to serious setbacks in the US capital market, although the interest rate trend had admittedly already gone up in autumn 1993. These upheavals spread almost simultaneously to the major international financial centres and occasioned a world-wide fundamental reassessment of interest rate prospects. Over the ensuing course of the year the US central bank tightened its monetary policy stance in several stages. In some European countries, too, the responsible monetary authorities were impelled to tighten the reins of monetary policy, not only because of the looming risks of inflation but also in order to support their domestic currency.

Marked rise in capital market yields

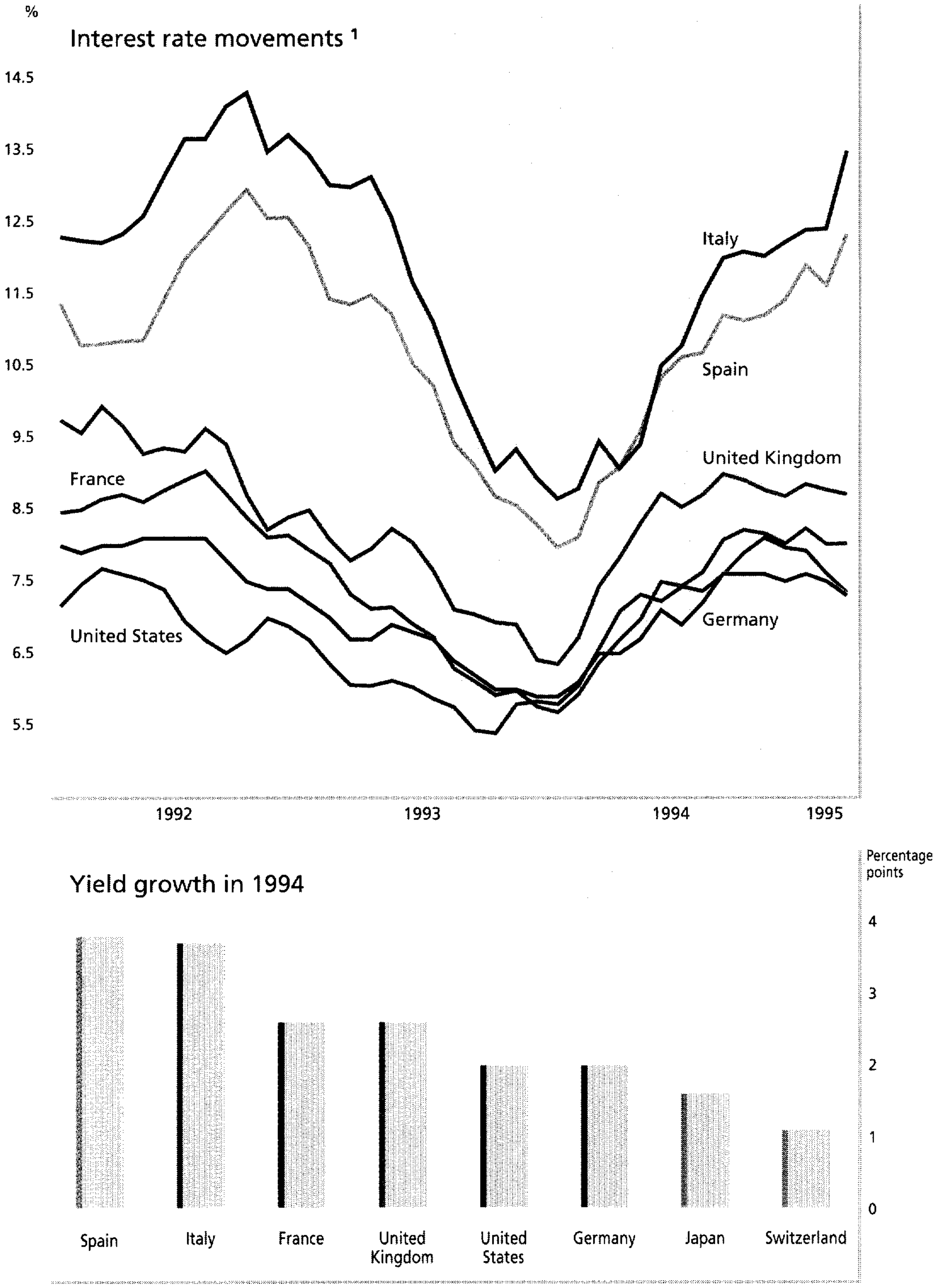
In the wake of developments in the United States and the associated reorientation in the international financial markets, capital market yields rose perceptibly in all industrial countries, although to a varying extent. Marked increases in interest rates, some reaching almost 4 percentage points, were recorded in the capital market in 1994, especially by countries whose currency is associated in the markets with comparatively high inflationary risks. Even countries with traditionally low inflation premiums in the capital market rate, however, had to accept yield increases of 1 to 2 percentage points. Growing uncertainty regarding further interest rate movements as well as the resulting greater volatility of the financial markets, which was perhaps further intensified by the increased use of derivatives, was evidently reflected world-wide in higher "risk premiums" for long-term investments. Furthermore, the sustained improvement in the economic outlook was probably reflected in the market by the rise in long-term interest rates.

"Global saving gap"?

Beyond this more or less normal cyclical "breathing" of long-term interest rates, structural factors, too, may have pushed up the interest rate level. Particular reference is frequently made in this connection to the sharp world-wide growth in capital requirements and the declining long-term trend in the propensity to save in the industrial countries. Households' saving ratios have indeed decreased over the past few years in many countries and, according to the forecasts of international organisations, they appear to be continuing to fall. It is just as true

Capital market rates in selected industrial countries

Chart 1



1 Government bonds with maturities of approximately ten years.

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that the process of economic growth, which is gaining in momentum, will be accompanied by a rise in private demand for capital. Moreover, in view of the high structural public sector deficits of most industrial countries, a large part of private saving is being absorbed – more than in comparable phases in earlier years – by the government's demand for financial resources, which is insensitive to interest rate fluctuations. Viewed in these terms, the "global saving gap", which would result from the interplay of all these factors with an unchanged long-term interest rate level, probably explains part of the comparatively sharp rise in interest rates which – in contrast to previous periods of recovery – now already affected a large number of industrial countries, especially in Europe, at an early stage of the cyclical upswing. To that extent the world-wide weakness of the capital markets last year indicates a potential risk for the continuation of the growth process, although this risk should not be overestimated. Even following its rise on a long-term comparison, the level of long-term interest rates cannot by any means be described as exceptionally high. In addition, the situation in the world capital markets has become distinctly calmer since autumn 1994. Nevertheless, shortcomings of fiscal policy since the end of the eighties have to be corrected world-wide, and a determined effort must be made to consolidate public finance so that sufficient capital is provided for investment that promotes growth. This will depend principally on public expenditure being cut effectively; covering public sector deficits by increasing the burden of taxes and social security contributions on households would not be very helpful as it would probably largely be to the detriment of private savings.

Budget deficits still high . . .

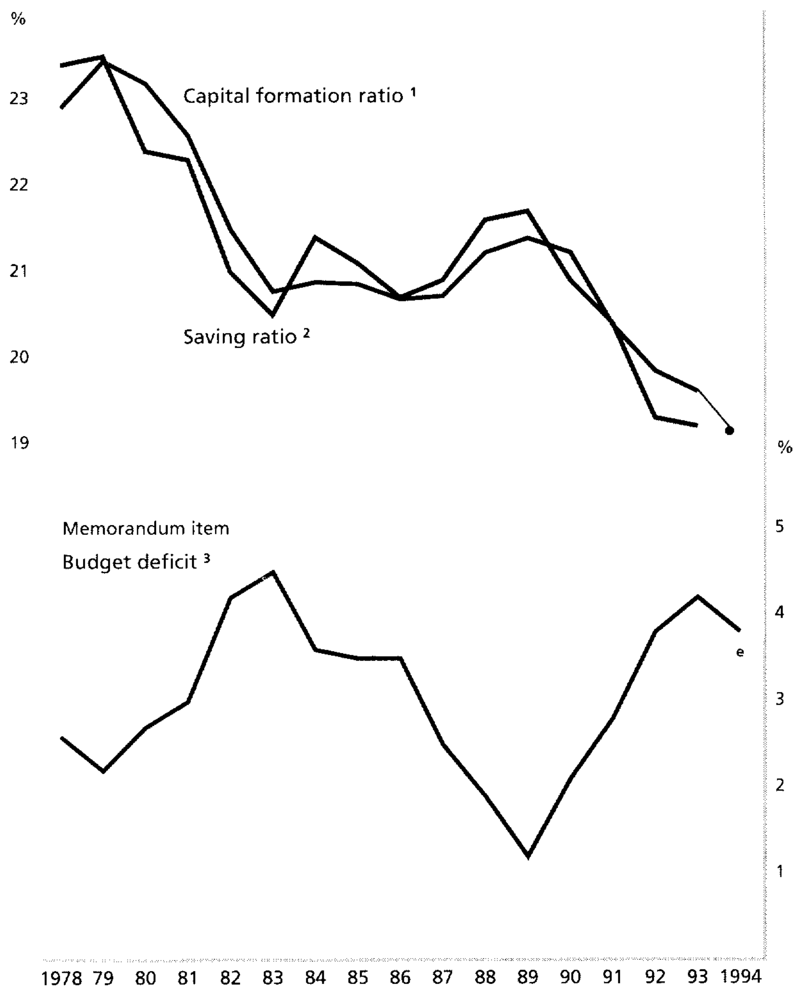
The budget deficits in 1994, on an average of all industrial countries, amounted to just under 4 % of the gross domestic product. Although this was admittedly somewhat lower than in 1993 (4 1/2 %), this slight improvement in the budgetary situation was attributable mainly to higher tax revenue due to cyclical factors and a slight decline in cyclically sensitive expenditure. In general, the structural budget deficits scarcely fell at all.

. . . and increasing debt ratios

The levels of public debt rose once again in relation to the nominal gross domestic product which, along with the higher interest rate level in the capital markets, will additionally narrow the scope available for budgetary action. Consolidation of public finance in the majority of industrial countries is imperative for that reason alone. This would, moreover, take pressure off the capital markets and ultimately create new confidence in public finance.

Saving and capital formation ratios *

Chart 2



* Average of the OECD countries: levels as % of GDP: — 1 Gross fixed capital formation. — 2 Gross saving. — 3 Excluding Iceland, Luxemburg, Mexico, New Zealand, Switzerland, Turkey. — ● = Latest position: 1st half of 1994.

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Undesirable political developments influence financial markets

The latest developments in the international financial markets have made it abundantly clear how sensitively internationally operating investors can react to actual or presumed misalignments in the political or economic sphere. Countries whose fiscal policy soundness or monetary policy resoluteness was called into question were affected by sharp increases in interest rates, and the currencies concerned came under pressure. Conversely, it has once again been demonstrated that a reliable political environment and a credible anti-inflation policy are the best guarantees of low interest rates measured by international standards.

US dollar under pressure

Notable shifts in the international monetary structure occurred as early as at the beginning of 1994. The US dollar, in particular, which had been conceded a considerable price potential in many quarters at the start of 1994, suffered a marked decline in value against the Deutsche Mark, following its distinct appreciation in 1993 in response to the divergent underlying cyclical tendencies in the United States and Germany. Increasing fears of inflation for the US economy and the improving cyclical prospects for Germany and Europe led to a situation – felt by many to be surprising – where the US currency weakened considerably, despite the simultaneous interest rate advantage in favour of dollar assets. Furthermore, it was probably the sharp rise in the US current account deficit as well as the concern arising over future fiscal developments in the United States which adversely affected the US currency; in view of the trade dispute with Japan which drew a great deal of attention in the first half of last year, this applies particularly to exchange rate movements against the Japanese yen. At the turn of 1994-5, on the other hand, the Mexico crisis and its potential adverse consequences for US financial institutions operating there were more in prominence.

Reform proposals on the occasion of the 50th anniversary of the IMF and the World Bank

In many cases, these marked shifts in exchange rate relationships between the major international currencies cannot be explained solely in terms of corresponding changes in the macroeconomic fundamentals; they have an additional function as a "barometer" which accurately reflects the confidence of the international financial markets. In view of this, it may appear to be the obvious thing to ask questions concerning possible reforms of the international monetary system. These and associated institutional questions were again raised for discussion in connection with the 50th anniversary of the International Monetary Fund and the World Bank. The importance of economic policy convergence was rightly stressed in this context as the essential prerequisite for more stable exchange rates. Other proposals, such as the creation of formal exchange rate target zones for the major currencies, however, would not be appropriate for strengthening the indispensable confidence of the markets. Such a monetary system would lack a "nominal anchor" if monetary stability were not safeguarded in those countries which have major international currencies. Gearing monetary policy solely to the aim of nominal exchange rate stabilisation would then involve considerable potential risks for the inherent stability of the currencies linked to each other.

Some European currencies under political strain

The importance of a credible anti-inflation policy is in certain respects confirmed by experience in the European exchange markets. In view of the greater convergence of economic policies and economic developments in the European

Community's member states, the easing which could be discerned since autumn 1993 continued at first in 1994, and the changes in the exchange rates of the currencies participating in the European exchange rate mechanism remained within fairly narrow bounds for by far the greatest part of the year. Around the turn of the year, however, individual member currencies lost considerable ground after political uncertainty in the partner countries concerned had placed market participants' confidence under strain. This applies principally to the Italian lira which is not participating in the exchange rate mechanism and which depreciated considerably in 1994. The Spanish peseta, too, came under pressure in the past few months which increased perceptibly as a result of the currency turbulence at the beginning of March. As a result, the Spanish currency depreciated by 7 % within the EMS. At the same time, the central rate of the Portuguese escudo was reduced by 3 ½ %. The trend of the French franc was also weak at times. Tension in the European exchange markets, moreover, increased appreciably in connection with the downward slide of the US dollar. These violent exchange rate variations remained, however, within the widened fluctuation bands, and interventions in the foreign exchange market – in contrast to previous currency crises – were kept within limits. To that extent, the widening of the fluctuation margins in the European exchange rate mechanism proved to be effective; there is no alternative to them for the time being.

Second stage of economic and monetary union

1994 was, in many respects, an important year for the advancement of the European Community. The transition to the second stage of economic and monetary union at the start of the year brought with it a wide range of changes in the fields of monetary, fiscal and economic policy, which are commented on in greater detail elsewhere in this Report (page 100). In this preparatory phase for entry into the third stage of economic and monetary union, the main aim is to promote a stability-oriented convergence of the member states, and thus to create the indispensable conditions for a single monetary policy which is committed, above all, to the target of stability with permanently fixed exchange rates between the member states. Furthermore, a number of elements of the legal, institutional and organisational framework of the third stage are to be prepared. The most noticeable change upon entry into the second stage was the setting-up of the European Monetary Institute which started work at the beginning of 1994.

The task of bringing eastern Europe closer to the Community

The European Union is likely to gain even greater weight as an economic factor in the world as a result of the Community now being enlarged by the accession of Austria, Finland and Sweden on January 1, 1995. Measured in terms of the domestic product, the economic potential of the enlarged Community is 10% higher than that of the United States and, as measured by the population, it is more than 40% larger. In future it will be necessary to ensure that protectionist tendencies do not prevail in this larger economic area. The newly founded World Trade Organisation (WTO) will in future have particular responsibility in this respect. In addition to its general effects in increasing prosperity, a free trading and economic system is likely to make it easier for the states of central and eastern Europe to integrate into the world economy. Besides the necessary domestic reforms, open markets are of crucial importance for the successful continuation of the process of transformation in these countries. They will offer the countries in transition the opportunity of finding their due place, to everyone's advantage, in the international economic process based on the division of labour.

II. Economic trends in Germany and central bank policy

1. Strong growth in both western and eastern Germany

German economy back on the path of growth

In 1994 the German economy generally moved into growth again. At approximately 3 %, the increase in the real gross domestic product was unexpectedly high. In the old Länder the economy finally overcame the recession, and a powerful upswing started to develop in the course of last year. The east German economy again recorded a high level of growth and advanced further in its adjustment process. In the wake of the overall economic expansion, there were first signs of an improvement on the labour market in Germany, but unemployment is still high and remains a paramount problem for economic policy makers. By contrast, clear successes were recorded in 1994 on the road to more price level stability.

(a) Western Germany: rapid economic recovery

Unexpectedly sharp expansion of output

The strength of the upswing, which started in the old Länder after the beginning of 1994, can be seen from the fact that the real gross domestic product rose by 2 ½ % and thus much more sharply than had generally been expected in spring. The primary reason for the cyclical turnaround was the improvement of the situation in the manufacturing sector, which expanded its output considerably. In the course of last year industrial enterprises utilised their capacity, which many had reduced in an effort to achieve more efficient production conditions, to an ever-increasing extent; at the end of the year capacity utilisation was distinctly higher than on a multi-year average. The cyclical recovery in the manufacturing sector spread to the private services sector, where the value added in 1994 consequently rose more sharply than in the recession year 1993. In the construction industry, too, which had largely been unaffected by the recession, output was generally raised substantially in 1994, and capacity was used to a greater extent than a year earlier. On the whole, unutilised production reserves have decreased noticeably in the west German economy in the wake of the cyclical upswing. In retrospect, moreover, it is becoming more apparent that the decline in economic activity in 1993, which, according to more recent calculations, was less pronounced than initially assumed, was by no means the severest recession of the post-war period. Capacity utilisation, in particular, remained far higher than in earlier comparable periods of cyclical weakness.

Sustained expansion of export demand

The upswing was initiated and later strengthened first and foremost by the expansion of foreign demand. The revival of export business had started as early as the beginning of 1993 and continued throughout last year. At the global economic level expansionary forces increasingly gained the upper hand, and demand for west German industrial products rose again as a result. In 1994 foreign orders received by the manufacturing sector in the old Länder were 14 ½ % higher than a year earlier, while export sales were 8 ½ % up on the year. However, the flourishing foreign business also owed something to west German industry's increased export efforts, including, in particular, wide-ranging rationalisation measures by firms designed to improve their efficiency and hence competitive position. However, the strong appreciation of the Deutsche Mark is likely to make it harder to sell German products abroad. Safeguarding the international competitiveness of German industry, and thus jobs, remains a permanent task for economic policy makers, enterprises, management and labour. It cannot be achieved by a one-off mighty "heave".

Marked improvement in supply-side conditions

Last year considerable progress was made in improving supply-side conditions. This imparted crucial stimuli to domestic demand. Cost pressures were again reduced substantially following the excessive wage increases in the wake of the unification boom. For one thing, manufacturing enterprises cut their staff levels in the past few years; towards the end of 1994 the peak level of spring 1991 was undercut by 16 ½ %. For another, the moderate pay settlements reached in 1993 and 1994 strengthened competitiveness. Taking account of "zero months" and the reduction in Christmas bonuses in some sectors, for instance, negotiated wages and salaries (on a monthly basis) were raised by only 1 ½ % in 1994 on an average of the west German economy. Actual earnings rose by 2 % in 1994. Calculated per unit of the real gross domestic product, labour costs fell by 1 %, and in the manufacturing sector unit labour costs dropped much more sharply still.

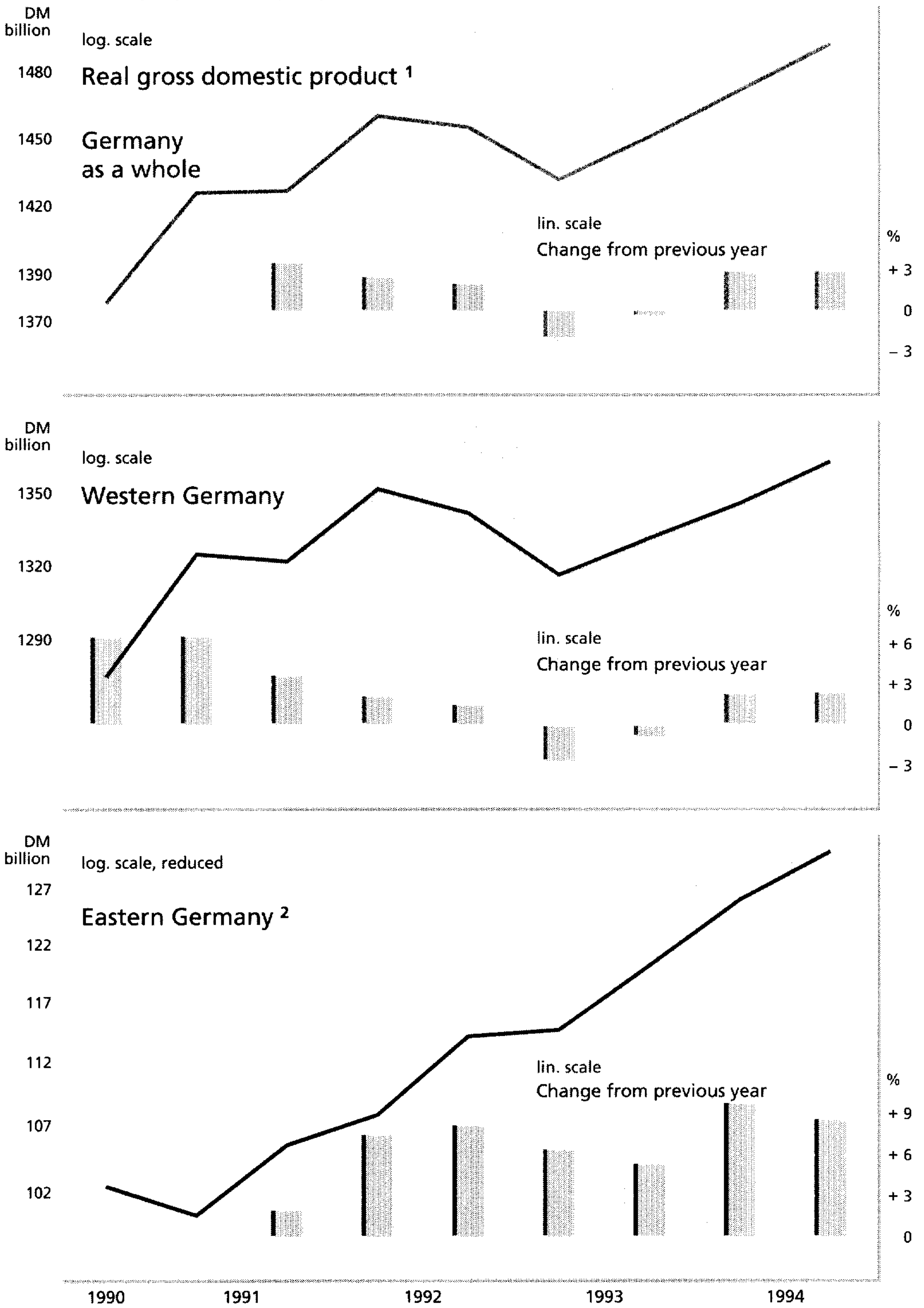
Rise in corporate profits

Together with the ever-more buoyant foreign business, the improved supply-side conditions contributed much to the gradual recovery of enterprises' profitability in the wake of the upswing, following the sharp slump in the recession year 1993. According to a calculation based on the national accounts, producing enterprises' gross income went up by 10 % in 1994. However, the level of profits was still lower than in 1992 and 1991. Individual areas, particularly the manufacturing sector, which was especially hard hit by the recession, are, moreover, probably lagging behind the average, so that the setback of 1993 has not yet been made good, despite a sharp increase in profits in 1994. Nevertheless, the improvement in the earnings situation was apparently accompanied by a more

Economic growth in Germany

Chart 3

Seasonally adjusted, half-yearly



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

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favourable assessment of profit prospects, which was not significantly affected by the higher longer-term interest rates.

Revival of the propensity to invest

The more positive profit expectations are likely to have been a major factor in the distinct revival in the course of last year of producing enterprises' propensity to invest. For example, capital goods producers (excluding vehicle manufacturers) in the west German manufacturing sector registered a nominal increase of 3 ½ % in domestic orders on an annual average in 1994 compared with a year earlier. The inflow of orders accelerated in the course of the year; at the end of the year the growth over twelve months amounted to 11 %. In the last quarter of 1994 expenditure on machinery and equipment, which follows orders with a time-lag and includes imports, for the first time exceeded its comparable previous year's level again. The surveys of the ifo institute show that in 1994, too, spending on rationalisation measures still took clear priority over investment in capacity extensions. Investment in industrial construction (which is usually accompanied by an expansion of production capacities) declined once more last year. On the whole, producing enterprises' gross fixed capital formation in 1994 was 2 ½ % lower in nominal terms, and 3 % lower in real terms, than in the recession year 1993 (owing to the slow start to the year); its share in the real gross domestic product, which had amounted to 12 ½ % in the boom period of 1990-1, decreased again to 10 %. However, the investment climate improved distinctly in the course of the year.

Sharp increase in capital spending on housing construction

Capital spending on housing construction proved to be a mainstay of business activity last year. The number of completed new housing units rose again by 17 % to 505,000. However, demand for housing construction work which – as measured by the orders received by the construction industry – rose by 15 % in value and by 13 % in volume on an annual average in 1994, compared with 1993, basically tended to decrease in the second half of last year. The main reason for this is probably to be found in the moderating effect, particularly on the construction of owner-occupied homes, emanating from mortgage rates, which had risen in the wake of the increase in capital market rates, and from the expiry at the end of 1994 of the temporary deduction facility for debtor interest for owner-occupied residential property (this tax concession applied only to projects completed by the end of 1994). Judging by the trend in building permits, the retarding effect of the higher interest rates on apartment house construction was, by contrast, very limited. In 1994 modernisation and extension work on existing dwellings was again of great significance for the level of construction

Key economic variables in western Germany

Table 2

Item	Unit	1993	1994	1993	1994
				Change from previous year in %	
Demand (real)					
Private consumption	DM billion	1,483.0	1,495.4	+ 0.2	+ 0.8
Fixed capital formation	DM billion	518.0	524.2	− 8.3	+ 1.2
Machinery and equipment	DM billion	208.3	201.9	− 17.6	− 3.1
Construction	DM billion	309.7	322.3	− 0.8	+ 4.1
Domestic demand	DM billion	2,473.8	2,517.1	− 2.2	+ 1.7
Exports	DM billion	893.0	961.7	− 3.2	+ 7.7
Aggregate demand	DM billion	3,366.8	3,478.7	− 2.5	+ 3.3
Memorandum item					
Foreign balance [1]	DM billion	174.8	192.5	.	.
Imports	DM billion	718.2	769.1	− 5.3	+ 7.1
Orders received (volume)					
by the manufacturing sector	1985=100	108.9	117.0	− 7.5	+ 7.4
by the construction sector	1985=100	138.0	142.6	− 0.6	+ 3.3
Distribution of income					
Compensation of employees	DM billion	1,535.9	1,555.6	+ 1.5	+ 1.3
do. as % of national income	%	72.1	70.8	.	.
Gross income of producing enterprises	DM billion	423.6	465.1	− 9.7	+ 9.8
do. as % of national income	%	19.9	21.2	.	.
National income	DM billion	2,129.2	2,197.1	− 0.5	+ 3.2
Output					
in the producing sector (excluding construction) [2]	1985=100	109.7	113.3	− 7.3	+ 3.3
in the construction sector [2]	1985=100	132.4	138.0	− 2.4	+ 4.2
Gross domestic product at 1991 prices	DM billion	2,648.6	2,709.6	− 1.7	+ 2.3
Employment					
Employed in western Germany	Millions	29.0	28.6	− 1.6	− 1.3
Unemployed	Thousands	2,270.3	2,556.0	+25.6	+12.6
do. as % of the total labour force	%	7.3	8.2	.	.
Prices and wages					
Cost-of-living index	1985=100	119.9	123.5	+ 4.2	+ 3.0
Producer prices of industrial products [3]	1991=100	101.4	102.0	p 0.0	+ 0.6
Overall construction price level	1991=100	109.6	111.5	+ 4.1	+ 1.7
Index of import prices	1985=100	78.5	79.1	− 2.0	+ 0.8
Gross income per employee (in western Germany)	Deutsche Mark	59,800	61,400	+ 3.3	+ 2.7
Unit labour costs in the economy as a whole [4]	Deutsche Mark	0.65	0.65	.	.
do. in terms of 1991 prices	1991=100	108.5	107.5	+ 3.5	− 0.9
Productivity [5]	1991=100	100.7	104.4	− 0.1	+ 3.6
do. in absolute figures [6]	Deutsche Mark	91,300	94,700	.	.
Overall negotiated wage and salary level (on a monthly basis)	1991=100	138.2	140.5	+ 3.6	+ 1.7

1 Balance of transactions in goods and services with the rest of the world; in contrast to the balance of payments statistics, deliveries to and supplies from eastern Germany (including direct purchases by households in western or eastern Germany) are included in exports or imports. — **2** Results for kinds of activity units. — **3** Domestic sales. — **4** Index of gross compensation per employee generated in western Germany divided by index of GDP per employed person calculated at 1991 prices. — **5** GDP per employed person at 1991 prices. — **6** Relative to GDP at 1991 prices. — The data from the national accounts and the figures on employed persons are provisional.

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activity. Total capital spending on housing construction increased by 9 % in real terms and by 11 % in nominal terms.

Relatively low level of consumption

In an upswing private consumption usually plays the part of the straggler. Last year, too, it failed to impart any special stimuli to growth; in addition, at the beginning of the year – as in 1993, although on a somewhat smaller scale – increases in indirect taxes and other levies became effective which reduced households' purchasing power. In 1994 private consumption expanded by 3 ½ % in value and by only 1 % in volume and thus at a slower pace than the real gross domestic product. But compared with the depressed expectations at the start of 1994, the level of consumption held up fairly well. In contrast to 1993, real consumption per inhabitant increased slightly.

Growing weight of services in the context of private consumption

The popular conception of the level of consumption is predominantly determined by the trend in retail sales, which declined in real terms in 1994. However, retail purchases make up only just over two-fifths of overall private consumption. A major part of consumer spending is accounted for by services, whose weight in households' budgets continued to increase in 1994. The most prominent item is holiday travel abroad, on which west and east German consumers spent 7 % more than in 1993. The higher expenditure on rents is likewise a major factor.

Narrow income scope of households

On the income side, the latitude for an expansion of consumer spending was very limited in 1994. Total gross wages and salaries increased by ½ %, but decreased by 1 ½ % after deduction of wage tax and social security contributions. By contrast, current transfers to households from public cash offices grew by 3 ½ %, inter alia because of the sharp expansion of payments in the context of unemployment and social assistance. Including property income and the withdrawals of self-employed persons, which increased sharply, private disposable income was 2 ½ % higher in nominal terms than a year earlier, which amounted to a slight decrease in real terms, i. e. after taking account of inflation.

Decline in saving

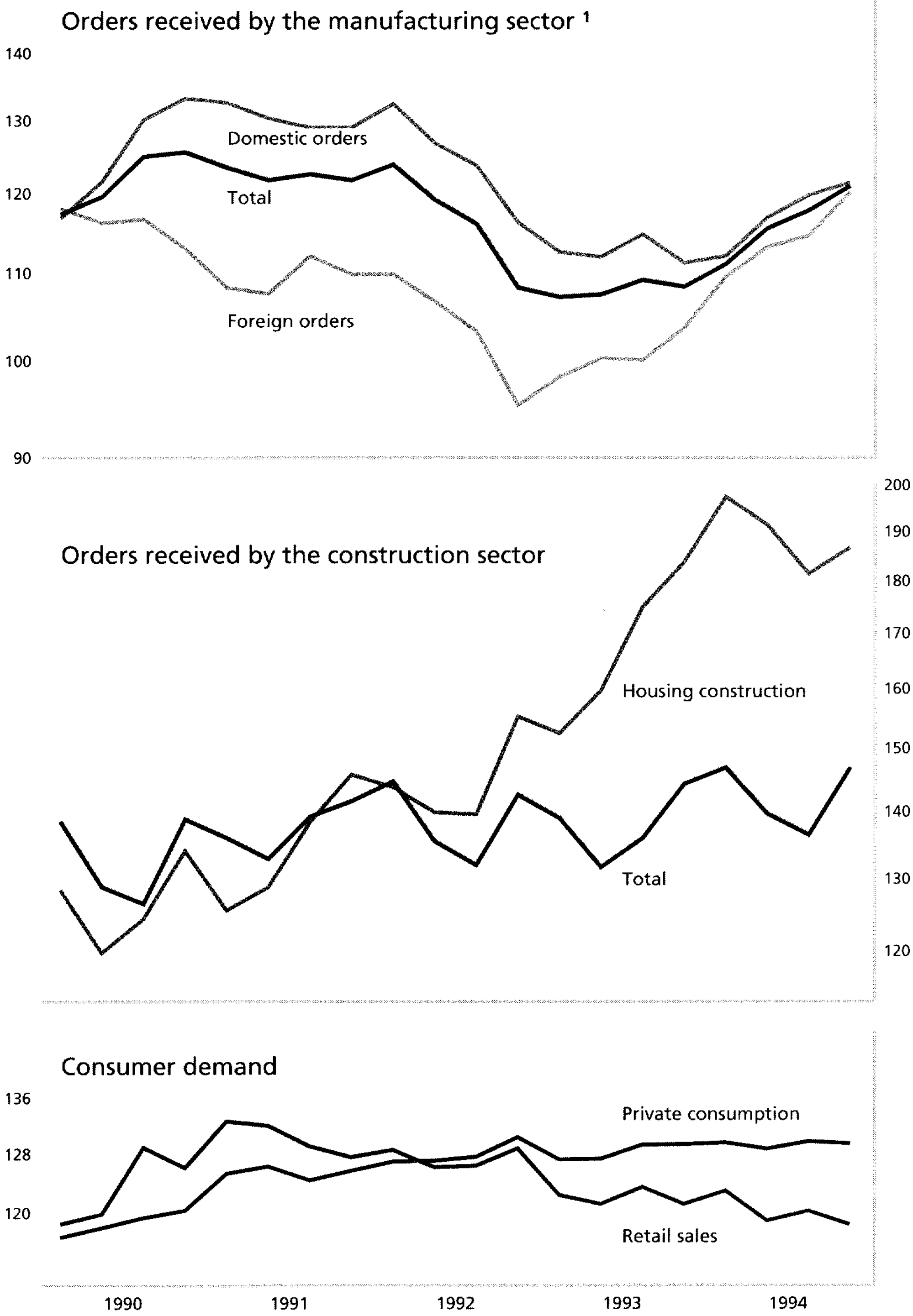
In 1994 the expansion of consumption expenditure was again at the expense of private saving. Households' saving actually decreased once more even in absolute terms; at 12 ¼ %, the private saving ratio was 1 percentage point lower than in 1993. As the interest rate pattern returned to normal, the focal points of investment within private financial asset acquisition shifted distinctly away from shorter-term and towards longer-term forms of investment, which mostly

Trends in demand

Chart 4

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

Western Germany



1 Excluding food, drink and tobacco industry.

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bear more attractive interest rates. In 1994, as in the previous year, the actual amount of saving, the saving ratio and the volume of disposable income are likely to be understated. For example, the figures for households' saving and income, on which our calculation is based, have so far not included the earnings (and their reinvestment) from private financial assets which were shifted abroad for tax reasons in the past few years.

Slower rise in consumer prices

Considerable progress was made in 1994 on the road to greater price level stability. The rate of increase in consumer prices, which had amounted to 4.2 % in 1993, declined to 3.0 % [1] on an annual average in 1994 and to 2.7 % up to the end of the year. At the beginning of 1995 the effect of administrative measures, particularly the rise in indirect taxes, on the year-on-year rate of increase lapsed; in the two preceding years this effect had contributed to the reduction in purchasing power to a similar extent (roughly ½ percentage point in both years). By March 1995 the rate of price increases had declined further to 2.3 %. The moderation of inflation must be regarded not least as a success of monetary policy makers who unwaveringly pursued their anti-inflation policy stance. However, the declining rate of price increases can be attributed to a great extent also to the moderate wage trend in 1994. Not least under its impact the prices of industrially produced consumer durables and consumer goods went up by much less last year than in 1993. Moreover, the fact that the rise in the prices of services was much lower, even though charges, contributions and other prices for public services were raised sharply again, is likewise due in part to the moderate wage increases. For the same reason the overall construction price level went up by only 1 ½ % and thus less than in 1993.

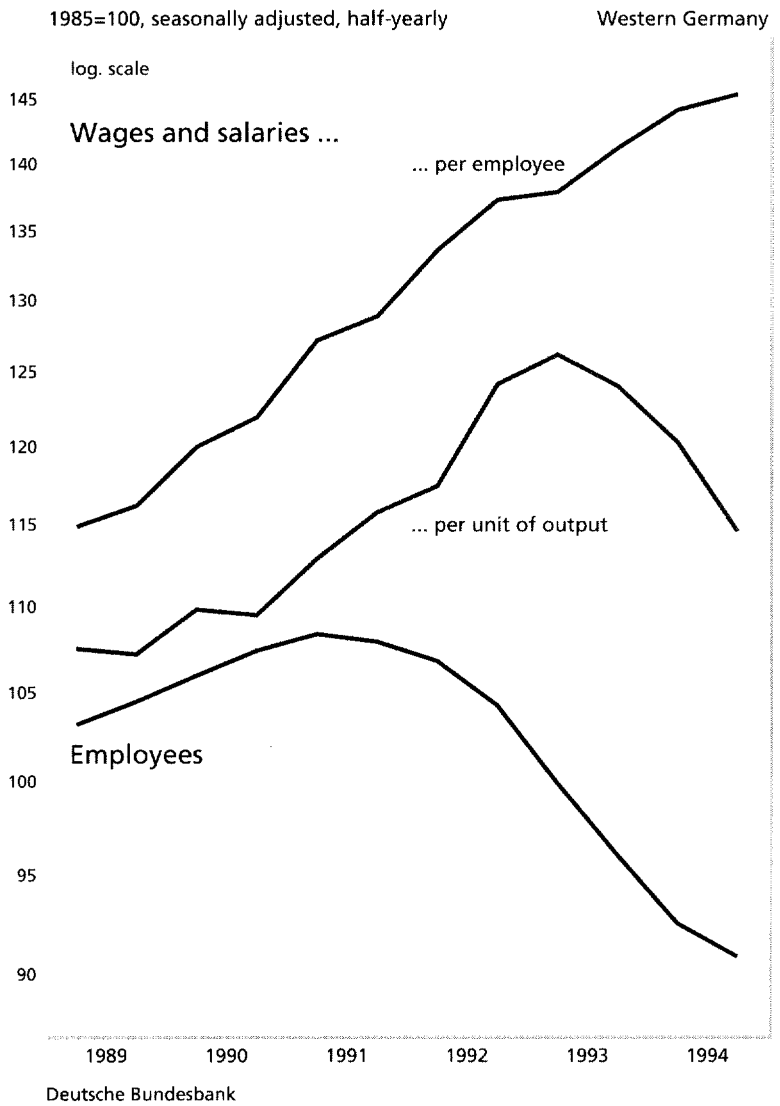
Do high wage increases stimulate economic activity?

The positive influence which the low wage rises had on the trend in consumer prices in 1994 refutes complaints alleging that the moderate pay settlements of last year's wage round would have a retarding effect on private consumption and thus on the cyclical upswing. Quite apart from the fact that this criticism overlooks the function of the private saving ratio as a temporary buffer, it must be said that wage increases that are unwarranted in macroeconomic terms lead to a higher rate of price increases – in some cases over the short term, but at all

1 In 1994, too, some west German consumers responded to the diverging increases in prices by changing their pattern of consumption accordingly. This is shown, inter alia, by the fact that the index for private consumption, in which – in contrast to the consumer price index – such changes are reflected, rose by a smaller margin, namely by 2 ½ %.

Wages and employment in the producing sector

Chart 5



events over the longer term – and in this way adversely affect private consumption as well as other components of aggregate demand. A faster rate of price increases invalidates the purchasing power created by accelerated wage rises, so to speak; it also affects the recipients of other income. Furthermore, high wage increases jeopardise the international competitiveness of German industry and consequently both employment and income. In other words: the cyclical effect aimed at by large wage rises, i. e. the stimulation of private consumption, is cancelled out by higher rates of price increases, leading to growth losses.

Future price risks, but relief afforded by currency appreciation

Notwithstanding the successes achieved in stabilising the price level, the risks for future price trends which began to loom last year must not be overlooked. These stemmed notably from the sharp increases in the prices of raw materials, whose dollar quotations (according to the HWWA) were 17 % higher in the last quarter of 1994 than a year earlier; the depreciation of the US dollar against the Deutsche Mark slowed down the upward movement of prices for German importers to 7 ½ %, however. Under the impact of the price boom for raw materials, import prices went up perceptibly towards the end of last year. On an annual average in 1994 imported goods were 1 % dearer than a year before, whereas their prices had declined considerably in the preceding years. At the end of 1994 the increase in import prices against the previous year amounted to 2 ½ %. At the industrial producer stage, too, the price level was largely stable on an annual average in 1994 (+ ½ %); however, in the autumn of last year it rose distinctly, despite declining unit labour costs in the manufacturing sector.

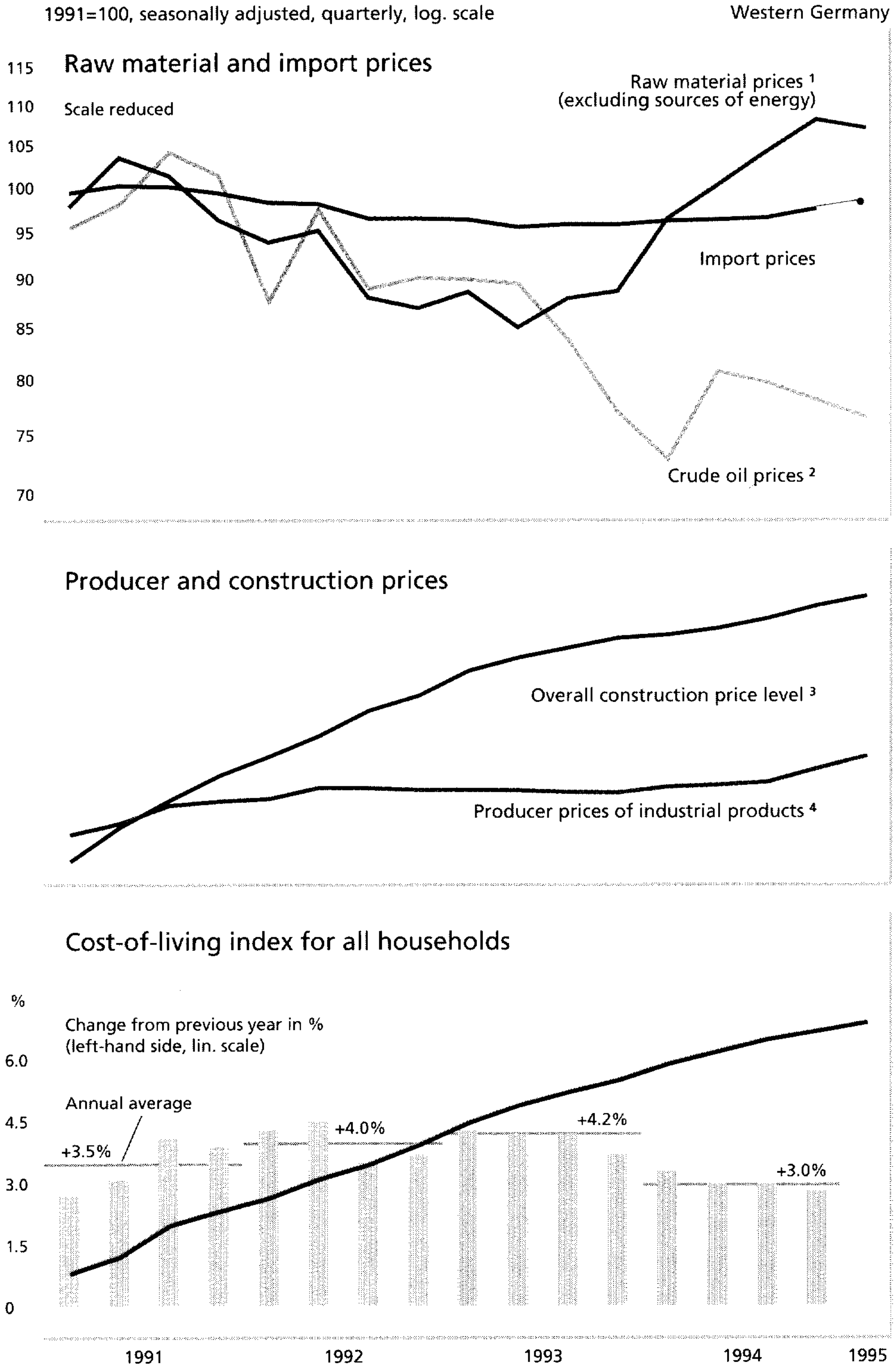
The recent sharp appreciation of the Deutsche Mark has reduced the aforementioned price risks and has afforded some relief to the price climate in Germany. As a result of exchange rate movements, the seasonally adjusted Deutsche Mark prices of raw materials declined against the previous month already in February, which was reflected at the same time in a decrease in the import price level. In March raw materials, calculated in Deutsche Mark, continued to cheapen considerably – presumably with corresponding consequences for import prices. The reduced cost of imported intermediate goods is having a moderating effect on price movements for industrial products.

Reversal in trend on the labour market

The strong upswing was reflected unexpectedly quickly in a reversal in trend on the labour market. The reduction in employment, which, calculated over the year, affected a further 375,000 members of the labour force, or 1.3 % of jobs, largely came to a stop in the second half of 1994. The continued reduction in personnel levels in the manufacturing sector in the same period was all but offset by an increase in staff numbers in other areas. Unemployment, which usually lags behind a cyclical trough, reached its peak as early as spring 1994, from which point it has declined, in seasonally adjusted terms, until recently. On an annual average in 1994 the number of unemployed came to 2.56 million (or 8.2 % of the total labour force); that was around 300,000 more than a year earlier. By the end of March 1995 seasonally adjusted unemployment had declined to a total of 2.53 million persons (8.2 % of the total labour force).

Prices

Chart 6



1 HWWA index of raw material prices; DM basis. — 2 Not seasonally adjusted. — 3 Calculated by the Bundesbank. — 4 Domestic sales. — • = Latest position: January-February 1995.

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(b) Eastern Germany: accelerated growth

Steep increase in overall output

In the new Länder the buoyant growth, which had started as early as the second half of 1991, accelerated in 1994, with the real gross domestic product climbing by 9 %. Since 1991 overall output in eastern Germany has risen by 7 ½ % per year. The strength of this growth process can be rated as a sign of the considerable advances made by the east German economy on its road towards adjusting to market conditions. In terms of the gross domestic product per inhabitant, the level of economic activity is, however, still rather low, at least compared with west German conditions. As far as the standard of living of east German residents is concerned, by contrast, the adjustment to western conditions has advanced much farther. As a result of west German transfer payments, there is still a considerable discrepancy in eastern Germany between the standard of living and output. Thus in 1994 the nominal gross domestic product came to only 60 ½ % of domestic demand, even though the gap has narrowed of late. Calculated per inhabitant, domestic demand reached 87 ½ % of the west German level, however (compared with only 47 ½ % in the second half of 1990). On the one hand, private consumption per inhabitant drew closer to the west German level (to 67 ½ % in nominal terms and to 60 % in real terms, compared with 48 % and 52 %, respectively, in the second half of 1990). On the other hand, investment in the new Länder rose dramatically. Gross fixed capital formation in eastern Germany in 1994, calculated per inhabitant, was one-third higher in value and one-quarter higher in volume than in western Germany. The renewal of the capital stock was accompanied by an extension of the infrastructure, so that the reconstruction of the east German economy is being less and less hampered on that count – in contrast to the immediate post-unification period.

Progress through privatisation

The progress achieved since unification owes much to the Treuhand agency's successful, speedy privatisation activities, which have now virtually been concluded. Within roughly 4 ½ years the Treuhand agency privatised, transferred to local authorities or liquidated over 12,000 formerly state-owned enterprises. Through privatisation and the ensuing modernisation and market orientation of enterprises, the Treuhand agency has, inter alia, prepared the ground for the east German manufacturing sector, which (as the manufacturer of goods exposed to international competition) was subjected to the strongest adjustment pressures in the transformation process, registering more and more successes not only on the German domestic market but gradually also on the export markets.

Key economic variables in eastern Germany

Table 3

Item	Unit	1993	1994	1993	1994
				Change from previous year in %	
Demand (real)					
Private consumption	DM billion	202.3	211.4	+ 2.7	+ 4.5
Fixed capital formation	DM billion	134.2	156.3	+ 14.1	+ 16.5
Machinery and equipment	DM billion	48.8	52.4	+ 7.0	+ 7.4
Construction	DM billion	85.4	103.9	+ 18.5	+ 21.6
Domestic demand	DM billion	434.2	467.6	+ 5.4	+ 7.7
Exports	DM billion	54.6	66.9	+ 5.5	+ 22.6
Aggregate demand	DM billion	488.8	534.4	+ 5.4	+ 9.3
Memorandum item					
Foreign balance 1	DM billion	– 199.2	– 210.9	.	.
Imports	DM billion	253.8	277.7	+ 5.0	+ 9.4
Orders received					
by the manufacturing sector	2nd hf of 1990=100	82.6	97.3	+ 13.1	+ 17.9
by the construction sector	2nd hf of 1990=100	275.2	345.1	+ 29.7	+ 25.4
Income					
Compensation of employees	DM billion	241.2	261.8	+ 8.2	+ 8.5
Households' disposable income	DM billion	277.6	291.9	+ 10.7	+ 5.1
of which					
Current transfers received	DM billion	107.1	115.4	+ 12.6	+ 7.7
Households' saving ratio 2	%	12.4	10.3	.	.
Output					
in the producing sector (excluding construction) 3	2nd hf of 1990=100	71.6	82.7	+ 5.8	+ 15.5
in the construction sector 3	2nd hf of 1990=100	156.4	197.7	+ 21.5	+ 26.4
Gross domestic product at 1991 prices	DM billion	235.0	256.7	+ 5.8	+ 9.2
Employment					
Employed in eastern Germany	Millions	6.2	6.3	– 3.0	+ 1.1
Unemployed	Thousands	1,149	1,142	– 1.8	– 0.6
do. as % of the total labour force	%	15.1	15.2	.	.
Prices and wages					
Cost-of-living index for all employee households	2nd hf of 1990/ 1st hf of 1991=100	131.0	135.4	+ 8.8	+ 3.4
Producer prices of industrial products 4	1991=100	104.2	105.5	+ 1.9	+ 1.2
Overall construction price level	1991=100	116.8	120.2	+ 5.9	+ 2.9
Gross income per employee (in eastern Germany)	Deutsche Mark	39,300	42,400	+ 13.2	+ 7.9
Unit labour costs in the economy as a whole 5	Deutsche Mark	1.04	1.03	+ 3.8	– 0.1
Productivity 6	Deutsche Mark	37,900	41,000	+ 8.9	+ 8.2

1 Balance of transactions in goods and services with the rest of the world; in contrast to the balance of payments statistics, deliveries to and supplies from western Germany are included in exports or imports. — **2** Saving as % of disposable income. — **3** Results for kinds of activity units. — **4** Domestic sales. — **5** Index of gross compensation per employee generated in eastern Germany divided by index of GDP per employed person calculated at 1991 prices. — **6** GDP per employed person at 1991 prices. — The data from the national accounts and the figures on employed persons are provisional.

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In this way the growth process in the new Länder is increasingly developing a momentum of its own.

Rapid wage adjustment and trend in employment

It is not yet possible to tell to what extent the continuation of the growth process will be accompanied by an increase in employment to a distinctly higher level on a lasting basis. The rapid adjustment of east German pay to the west German wage level, which has resulted in the input of labour in the new Länder being rather expensive compared with its output, i. e. in unit labour costs being relatively high, could prove a major impediment. Last year, for the first time since unification, the rise in gross income per employed person, at 8 %, did not outpace that of productivity. However, gross income came to 69 % of the level obtaining in the old Länder, whereas the nominal gross domestic product per employed person amounted to only 52 ½ % of the west German figure. Calculated per unit of the nominal gross domestic product, labour costs in the new Länder were 31 % higher than in western Germany; in the producing sector, which adjusted to wage cost pressures by cutting back jobs particularly sharply, the difference was much smaller, however, at 11 ½ %.

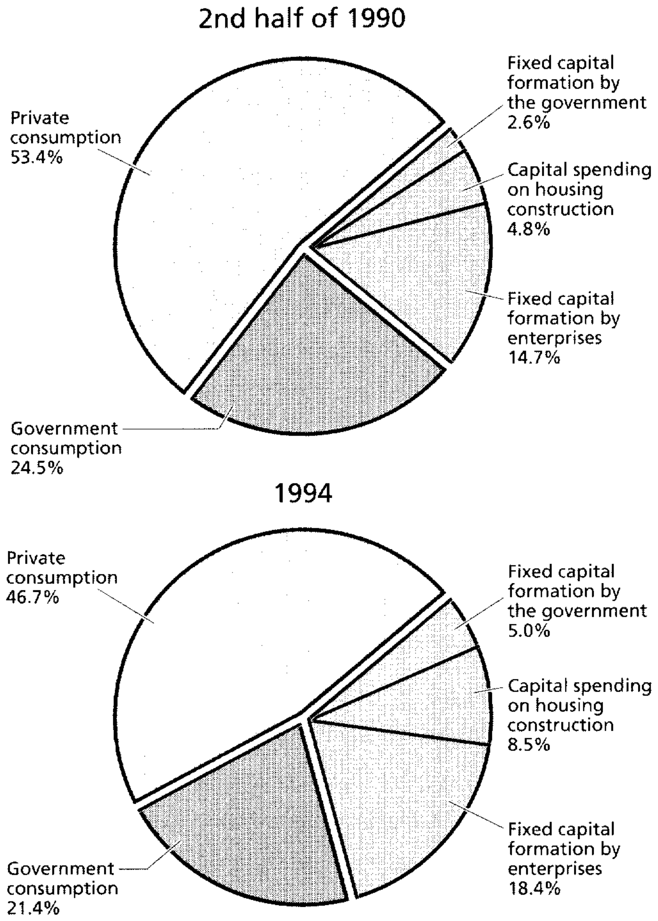
First successes in foreign business in the manufacturing sector

Demand for east German industrial products increased at an accelerated pace last year along with output and turnover. Manufacturing enterprises received 18 % more orders than a year earlier, in which orders had already expanded by 13 %. According to the statistical data, however, it was only domestic orders which increased, namely by no less than one-quarter, whereas export orders declined again. This picture is evidently misleading, however. The reality would seem to be that industrial enterprises from the new Länder succeeded in offering many more goods on the German market both in the east and the west and in selling them to German consumers and investors than in 1993. However, the statistics on domestic orders include the demand for goods which are first supplied to west German enterprises and then exported by the latter. The turnover figures appear to reflect foreign business more accurately than does the movement of foreign orders or the trend in goods exports as shown in the balance of payments statistics. Foreign turnover, which had declined by 7 % in 1993, increased by 9 ½ % in 1994, which suggests that east German products are starting to hold their own on the world markets. In line with the strong expansion of demand both at home and abroad, east German industrial enterprises raised their output by no less than one-fifth in 1994 and thus made a major contribution to the accelerated growth of overall output.

Structure of domestic demand in eastern Germany

Chart 7

as % of nominal domestic expenditure, excluding stocks



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Increased activity in the construction sector

In the construction sector, too, demand and output soared again in 1994 in all areas. Above all, housing construction activity rose substantially; new residential construction, in particular, increased in weight. One of the other mainstays of growth last year was again the services sector, whose overall economic significance is nevertheless still lagging considerably behind west German conditions.

First signs of an upturn on the labour market

In 1994 the strong growth, which had persisted for three years, led for the first time to the reduction in employment being superseded by an (albeit slight) increase in the number of employed persons and to a decline in unemployment in the course of the year. Despite the sharp expansion of output, the manufacturing sector again reduced its personnel levels. In other areas, above all in the services sector and in the construction industry, additional labour was recruited, however, so that employment rose by 1 % on balance. On an average of last year the number of unemployed was only close on 10,000 lower than in 1993, but at the end of the year it was 160,000, and at the end of March 1995 as much as 200,000, below the comparable previous year's level. The unemployment rate averaged 15.2 % in 1994. Women in the new Länder continue to be disproportionately affected by unemployment; the male unemployment rate averaged 10.9 % of the dependent labour force last year (compared with 21.5 % in the case of women). To some extent the decline in unemployment since spring last year is, admittedly, associated with the fact that at the end of the period under review 100,000 more persons, on balance, than a year earlier were participating in job-creation schemes or were attending further training courses.

Approximation of price movements to west German conditions

With the progressive adjustment of the economic structure in eastern Germany to market conditions, relative prices on the goods markets and the price level are now increasingly in line with supply and demand conditions; price changes, too, are drawing closer to west German conditions, but are still by no means completely congruent. At the consumer level, the upward price trend in 1994, at 3.4 %, was similar to that in the old Länder (3 %). A closer examination reveals distinct differences, however, whose main causes are to be found, firstly, in the field of rents (which are still strictly regulated) and, secondly, in wage trends. At the beginning of 1994 rent surcharges in eastern Germany were raised sharply. As a result, average rents were 10.4 % higher last year than in 1993. Excluding rents, the cost of living in eastern Germany increased by 2.2 % and thus slightly less than in the west, where the prices of food and industrially produced consumer goods and consumer durables went up more sharply. Not least on account of the further appreciable wage increases, the upward price trend for services was very much steeper, however. The different level of price increases for particularly labour-intensive construction work (3 % in the new Länder, 1½ % in the old Länder) is probably also due, inter alia, to this factor.

Moderate rise in consumer prices at the beginning of 1995

Since the turn of 1994-5 the year-on-year rate of increase in east German consumer prices – at 1.9 % in the first quarter – has been lower than in western Germany. The main reason for this is that the impact of the aforementioned increase in rents last year on that rate has now ceased to be effective. In the middle of 1995 a scheme similar to the system of west German comparative rents is to be introduced in the new Länder. The rise in the level of rents to be expected on that count is likely to accelerate the rate of increase in consumer prices.

(c) Outlook

Sustained strong growth of world trade

According to all forecasts by international institutions, sustained strong economic growth is to be expected in the current year in the western industrial countries as a whole and with it a renewed sharp increase in the volume of world trade. In Germany's continental European partner countries, which absorb the major part of German exports, the upswing is likely to gain further momentum; in particular, a marked revival of investment activity is to be expected. This is suggested, inter alia, by a survey conducted in the twelve "old" EC member countries on behalf of the EC Commission. According to that survey, industrial enterprises in those countries (excluding the Federal Republic of Germany) plan to expand capital formation by 10 ½ % in the current year against last year. Given their supply pattern, this opens up additional sales opportunities for German exporters, which customarily boost enterprises' propensity to invest. Because of the retarding influence emanating from the additional burdens, particularly the solidarity surcharge, which were imposed at the beginning of the year, the level of consumption will probably remain subdued in 1995.

Moderating effect of high pay settlements and of the sharp appreciation of the Deutsche Mark

The favourable economic outlook for the current year afforded by the growth of world trade has recently been clouded somewhat, however. From the end of last year until this Report went to press the Deutsche Mark appreciated by about 5 % against the currencies of 18 major trading partners. Furthermore, in the 1995 wage round rates of increase of around 4 % have been agreed to date for the current year. In some sectors prior burdens resulting from earlier pay agreements must be added. This applies, in particular, to the two-year agreement reached in the metal-working industry; taking account of the computed effect of the reduction in weekly working hours to 35 hours from October 1 this year, agreed hourly wages in the industry will rise by 4 ¾ % in 1995 and by 5 % in 1996. The resulting increase in costs will only partly be offset by the expected concurrent rise in productivity. For the other sectors of private industry the duration of the agreements is generally shorter than in the metal-working industry, so that new negotiations are due at the beginning of next year. The combination of high wage increases and a sharp appreciation of the Deutsche Mark is likely to have retarding effects on economic growth and ultimately on employment, though without fundamentally calling into question the further continuation of the upswing in the old Länder.

Such dampening influences will probably manifest themselves first in export demand and the propensity to invest. In the new Länder, where in large areas of the economy the pay settlements for western Germany take direct effect on account of adjustment clauses, the coincidence of these wage rises (on top of the additionally agreed adjustment steps) with the sharp increase in the value of the Deutsche Mark implies a considerable extra burden, particularly for industry, above all in its attempt to enter new export markets.

2. Entrenched unemployment

In 1994 roughly 3.7 million persons were unemployed in Germany; that represented 9.6 % of the total labour force. Unemployment has thus reached a level that cannot be tolerated over the long run. Apart from the manifold consequences for those affected, it results in a heavy fiscal burden, which has ultimately to be borne by the employed and which threatens to jeopardise the basis for economic growth and higher employment.

Increase in unemployment, despite expanding employment

Over the past three decades unemployment, which often reaches its peak only with a time-lag after a recession, was higher in western Germany at the beginning of each upswing than at the beginning of the preceding period of cyclical recovery. The increasing trend in unemployment, at least in the eighties, must be seen against the background of a sharp expansion of the labour potential, which came to just over 31 million persons in 1994, compared with only 28 million in 1980. This increase was initially due to the fact that persons born in years with a high birth rate reached working age. At the same time, the participation of women in the labour force has increased distinctly. At the end of the last decade, moreover, a large number of east Germans from the former GDR and of ethnic Germans from eastern Europe migrated to western Germany. To these were added up to ½ million commuters who worked in western Germany but retained their domicile in the new Länder. After the previous recession had been overcome at the beginning of the eighties, the considerable enlargement of the labour potential was accompanied by a substantial expansion of employment. Despite the decline in the wake of the recent recession, the number of persons employed in the old Länder in 1994, at 28.6 million, was still some 2 ½ million higher than at the beginning of the eighties. In the last few years an increase in employment started at a very much lower rate of economic growth than in the seventies, let alone the sixties; what is known as the employment threshold has thus fallen perceptibly.

Rising hard core of unemployment

In the course of the upswing in western Germany an increase in employment and a further decrease in unemployment can be expected again. It is to be feared, however, that, in line with the trend in the past two decades, a considerable hard core of unemployment will remain, which will not contract even if economic activity should continue to pick up. This means that – as in other European countries – a large part of unemployment is of a structural nature. In the past few years recessions were, above all, periods of intensive rationalisation; unemployment arising in this context is caused by cyclical factors, but a large portion of it remains permanent as rationalisation measures are not reversed in the ensuing economic upswing. Unemployment becomes entrenched unless additional employment opportunities become profitable at an adequate pace – once the economy picks up; among other things, the unemployed lose some of their skills over time, and some of them become long-term unemployed as a result.

Causes of structural unemployment

The causes of the sustained high structural unemployment are varied and in part closely interlinked. One of the foremost causes is the considerable imbalance between supply and demand on the labour market in the old Länder in several respects. One indication of this lack of coincidence is that, according to rough estimates made by the Federal Labour Office, alongside an average number of 2 million unemployed in the past few years, between ½ and 1 million jobs were unfilled, depending on the cyclical situation. This relation between unemployment and unsatisfied demand for labour reveals great difficulties in balancing the labour market. Compared with the average of employed persons, the unemployed are undoubtedly older and in many cases less well trained. According to surveys conducted among enterprises as to jobs on offer, about two-thirds of vacancies are to be filled by qualified employees or workers; on the other hand, only half of the unemployed have such qualifications. However, as much as one-quarter of the jobs on offer were open to unskilled workers and almost one-tenth to employees without any particular skills. It would therefore be wrong to assume that there are hardly any jobs for less qualified labour. However, these are not always filled by the appropriate candidates as a filtering process has been taking place among employees for some years now: better-trained individuals are frequently employed in positions which do not actually require their qualifications, while owing to the ample supply of labour employees who are less productive are dismissed sooner. Apart from a lack of qualifications, rising unemployment often also points to an inadequate degree of mobility. At all events, the labour market is unable to achieve a balance.

Growing duration of unemployment

In general, employees with a restricted deployment range find a new job only after a prolonged search. Whereas – according to data from the Federal Labour Office – other unemployed are on average jobless for less than five months, unemployed persons whose placement potential is handicapped in several respects have to look three times as long. On the whole, the average duration of unemployment has risen considerably in the past three decades. Today it is more than seven months; at the beginning of the sixties it was approximately four weeks. The share of long-term unemployed has gone up to 30 %. Compared with the sixties and seventies, it has almost trebled. This, too, is an indication that the unemployment arising in periods of cyclical disruption often becomes entrenched.

Disincentives through the social welfare system

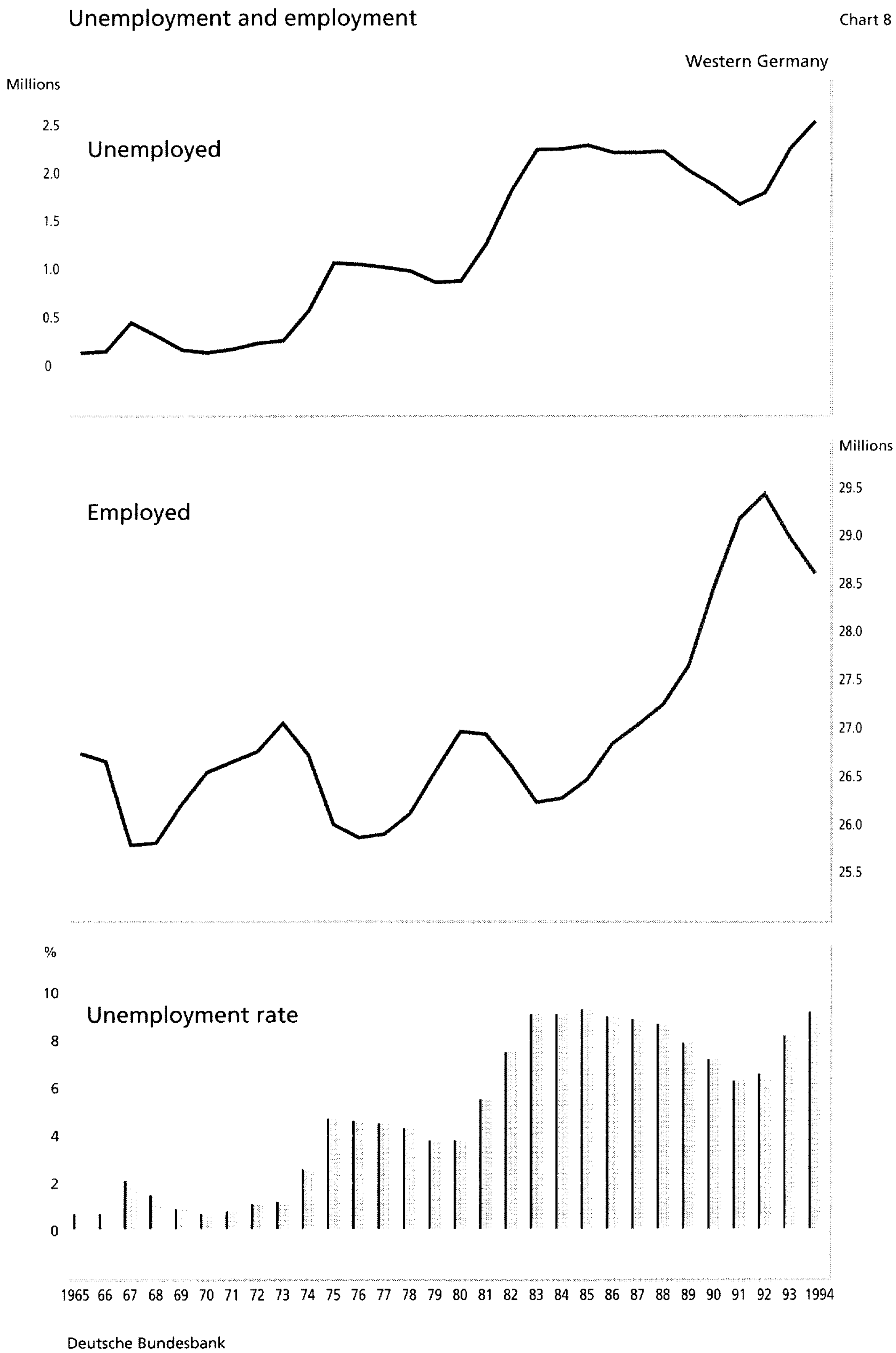
The financial burden of unemployment is reduced for the unemployed individual by social benefits. Unemployed persons receive unemployment benefits for up to 32 months and subsequently – in case of need – unemployment assistance for an unlimited period. The fact that benefits are paid on this scale is largely in line with the sense of justice of the general public: those who pay the price for structural change in the form of temporary unemployment and possibly permanent income losses deserve some compensation. However, care must be taken to ensure that the compensation paid for the loss of the job does not impair overall economic efficiency. The amount and duration of wage substitutes must also be oriented to maintaining adequate incentives for an active job search. Wherever this principle is infringed, the social welfare network needs to be adjusted. In addition, the abuse of social benefits must be combated.

Labour legislation . . .

Enterprises create new jobs only if this is profitable for them. A crucial consideration in many cases are numerous institutional conditions which, along with direct income claims, determine labour costs. With the objective of strengthening the position of employees vis-à-vis enterprises, manifold legal regulations have been adopted and frequently extended by judicial decisions which are geared solely to the protection of job-holders, but largely disregard job-seekers and their interests. Examples are protection provisions against dismissal and social plan regulations. These are doubtless justified in individual cases, but on the other hand they can only reduce the willingness of an employer to enlarge his staff and in extreme cases prevent recruitment.

. . . and institutional conditions

In many cases new jobs are not created because regulations of all kinds hamper developments on the goods markets. Limitations of opening hours in trade or laborious planning procedures for allocating industrial sites and connecting


Unemployment and employment
Chart 8
Western Germany
Millions
2.5
2.0
1.5
1.0
0.5
0
Unemployed
Employed
Millions
29.5
29.0
28.5
28.0
27.5
27.0
26.5
26.0
25.5
%
10
8
6
4
2
0
Unemployment rate
1965 66 67 68 69 70 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 1994
Deutsche Bundesbank

them to the traffic network are examples of how market access can be made more difficult and competition can be restricted. Comprehensive trade regulations can hamper the development of new products, while production processes must comply with far-reaching regulations. Taxes and other public levies likewise adversely affect profitability calculations.

Wages do not clear the market

Under the given circumstances, however, wages and salaries of potential staff members and expectations as to the future trend in labour costs are of outstanding significance for enterprises' personnel planning. It is difficult to determine empirically by what margin the growth of real wages would have to lag behind the increase in labour productivity in the next few years if employment is to expand strongly again. One thing, however, is certain: wages, as a decisive component in the cost of the production factor labour, are part of the reason why the labour market is "cleared" only inadequately. The alternative explanation of unemployment often given, namely that wages are not actually too high but that fixed capital is lacking, is hardly convincing because the size and structure of the capital stock itself are essentially determined by relative factor prices. On the other hand, real capital can be used flexibly enough over the medium term to employ many more people. The profitability of fixed capital – a decisive prerequisite for more investment – depends on demand but, above all, on costs, and particularly wage costs.

Heavy burden owing to additional wage components and levies

Additional wage components have continuously increased in significance in the last few years as an autonomous cost factor. As measured by the difference between gross compensation of employees and average gross earnings (ascertained in the national accounts), as much as roughly one-fifth of wage costs in 1993 was accounted for by ancillary costs. At the beginning of the last decade this share was close on 18 ½ %, and in 1970 only 14 ½ %. The discrepancy is much larger still if employees' contributions to the social security funds and taxes are taken into account. It then becomes clear that, on the one hand, the price of labour has increased appreciably for enterprises but that, on the other, the rises in the income of employees and their purchasing power have been much smaller.

Existing wage differentiation inadequate

Structural unemployment can be enlarged not only by the amount of labour costs but also by the lack of adequate wage differentiation. Today wages differ fairly greatly depending on qualifications, age, experience, industry and region, but the question remains of whether the existing differences satisfy the requirements of labour market balance. According to calculations by the OECD, the

Structural features of unemployment

Table 4

Percentages — Western Germany

Item		Unemployed 1	Vacancies 1	Employed 2
Occupational fields	Manufacturing	40	41	29
	Technical	5	3	6
	Services	49	43	58
	Crop growers, stockbreeders and miners	3	12	4
	Other occupations	2	–	3
Regions	Schleswig-Holstein, Hamburg	7	6	7
	Lower Saxony, Bremen, Berlin (west)	20	13	16
	North Rhine-Westphalia	31	22	25
	Hesse	8	8	9
	Rhineland-Palatinate, Saarland	7	11	7
	Baden-Württemberg	13	15	16
	Bavaria	14	25	20
Training	In-plant occupational training	42	54	54
	Specialised vocational school, technical college	5	5	8
	Specialised technical college	2	} 4	4
	University	4		7
	No completed occupational training	47	37	28
Age	under 25 years	14	–	14
	25 to 35 years	28	–	27
	35 to 45 years	20	–	25
	45 to 55 years	18	–	23
	55 to 65 years	20	–	11

1 Results of the structural survey of September 1993. — 2 Results of the microcensus of April 1993, in the case of occupational fields and training data of April 1991.

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balance of the labour market has been most successful in those countries which have registered an extension of wage spreads. In Germany, too, additional jobs could probably be created by greater wage differentiation.

Wage policy for less qualified labour

Many proposed therapies aim at a greater downward flexibility of wages, in particular. Such considerations are based on the fact that persons who are badly trained or little productive for other reasons are over-represented in the total number of unemployed; they probably make up the major part of the long-term unemployed, too. A step on the road towards greater wage flexibility in the lower range was taken by management and labour in the chemical industry who introduced lower initial pay rates for individuals taken on following a fairly long period of unemployment. With the exception of the west German paper industry, no other industry has been prepared so far to conclude similar agreements. Yet such arrangements would undoubtedly generate some employment opportunities for employees of lower productivity. The many simple personal and production-related services spring to mind. However, the spread of the wage pattern in Germany is limited by social benefits. Everybody is entitled to a cultural subsistence income, and wages must be above the subsistence level so as to make it attractive to take up work. Depending on how high it is, this cultural subsistence income can have either an unfavourable or a favourable influence on the trend in employment.

Wage differentiation undergoing structural change

In order to foster employment in periods of structural change, flexible sectoral differentiation of wages is important above all. The wage pattern existing between the individual industries today has grown historically and is not very flexible. This is probably due not least to the wage-bargaining process customary in Germany. The first agreement concluded in a wage round in one of the major wage-bargaining sectors is frequently assigned a signal function, and subsequent agreements are largely guided by it. This leaves insufficient room for sector-specific agreements which take account of the sometimes massive differences in cost and earnings conditions and in productivity trends. However, too large a spread of wages in line with the productivity differential is not unproblematical. The expansion of flourishing sectors would be hampered by high labour cost rises.

Wage trend conducive to more employment needed

All in all, there is a need for moderate real wage rises for the next few years which would remain distinctly below the trend in productivity growth. This applies particularly to eastern Germany, where unit labour costs continue to be considerably above the comparable figures for western Germany. Past experience has shown that there is a close link between the increase in real wages and rises in employment.[1] At the same time wage policy would contribute to safeguarding the degree of price stability reached. It follows that the scope for nominal wage rises is not very large. Ultimately, however, it is the improvement in real standards of living which is important and not the nominal increases which are absorbed by higher prices and, moreover, reduce employment opportunities – owing to the associated cost burdens.

Active role of monetary policy?

Some commentators recommend expansionary fiscal or monetary policy measures to combat unemployment. In view of the ever-increasing degree of capacity utilisation, such a policy would soon come up against its limits, however, and achieve nothing more than price increases, without being able to influence employment in the desired direction. It is the root causes of the predominantly structural unemployment which must be tackled. Artificial stimulation of demand

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1 See Deutsche Bundesbank, The trend in agreed pay rates and actual earnings since the mid-eighties, Monthly Report, August 1994, page 29 ff.

would be unable to solve the labour market problems but would pose new difficulties. The field of monetary policy action is short-term interest rates; these play a subordinate role in enterprises' investment decisions, however. According to Bundesbank investigations, more than four-fifths of all bank loans, by far the most important source of external finance for business enterprises, are of a long-term nature. The terms of these loans are oriented primarily to the capital market, which is largely outside the sphere of direct influence of monetary policy makers. As the experience of 1994 again showed, there is no automatic link between interest rates at the short and the long end of the market. On the contrary, a policy of accelerated interest rate reductions in the money market would increase the risk of inflationary expectations deteriorating and of long-term interest rates starting to move upwards. Monetary policy makers can make a greater indirect contribution to reducing unemployment by seeking to ensure monetary stability and fostering sound financial structures.

Necessary challenges for management, labour and the government

The prerequisites for achieving more satisfactory trends in employment must essentially be created by wage and tax policy makers. Management and labour, in particular, are called upon to contribute to a sustained rise in employment by agreeing on appropriate increases in nominal wages, which are not geared solely to the interests of the employed but, above all, to those of the unemployed, and on structural reforms of general pay rate conditions. The pay settlements reached in 1993 and 1994 were steps in the right direction. Mould-breaking arrangements were, in particular, the possibility provided for in the pay agreement for the chemical industry – which was initially limited to one year – of paying wages below the agreed pay rates to persons previously unemployed for some time and, in the metal-working industry, the option (limited to two years) of reducing working hours without compensation of earnings in periods when the order inflow is low. The pay agreements concluded in the 1995 wage round up to the time this Report went to press do not contain any further structural improvements. In this year's agreement for the chemical industry the duration of the arrangement for the long-term unemployed was merely extended by a further year. Legislators are likewise called upon to introduce reforms conducive to creating additional jobs and a better labour market balance. The recent authorisation of private employment agencies is an important step towards deregulation in this field. Major stimuli to a reduction of unemployment are likely to be imparted by lowering the burden of government levies on employees and enterprises. This would create considerable incentives and substantially improve Germany's locational qualities as an industrial base.

3. Appreciation of the Deutsche Mark

Deutsche Mark firm against the US dollar...

The Deutsche Mark performed particularly strongly in the foreign exchange markets in 1994. The increase in stability, which had begun to emerge clearly at the beginning of last year, and the noticeable improvement in the economic prospects for the German economy led to a radical change in sentiment in the international financial markets in favour of the Deutsche Mark. On the other hand, the US dollar tended to weaken on the whole as a result of both the mounting uncertainty about the continuation of the growth process in the United States, which had been relatively free of strain, and the consequent tightening of interest rate policy by US monetary policy makers. The smouldering trade conflict with Japan, particularly during the first few months of last year, also had a detrimental effect on the US dollar. The Deutsche Mark gained ground right into the autumn, even though the differences in international interest rates had been continually shifting in favour of the dollar. The US currency was able to extricate itself from this persistent period of weakness for only a short time when the US central bank put its determination to fight inflation to the test by further increasing interest rates. Towards the end of last year, however, the dollar came under renewed pressure as a result of the currency crisis in neighbouring Mexico; at the beginning of April 1995 the dollar fell to historic lows against the yen and the Deutsche Mark. The outcome was that in the first quarter of 1995 the Deutsche Mark was 16 ½ % higher against the dollar, compared with the same time a year earlier.

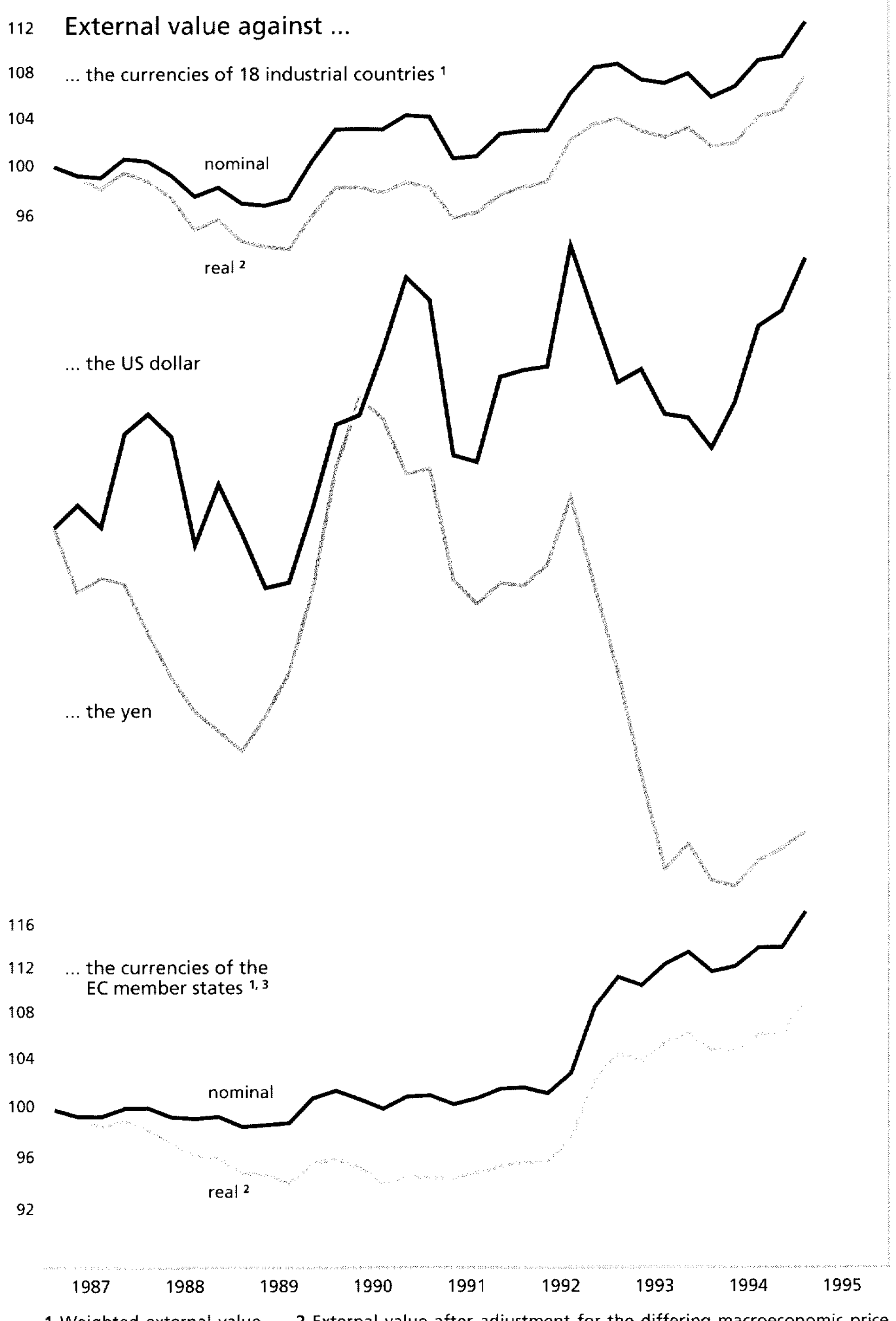
. . . and major EC currencies

Despite the movements described in the Deutsche Mark-dollar area, changes in exchange rates against most European currencies were fairly small at first. One important exception was the British pound. As in the case of the dollar, this is probably to be seen mainly in the light of the advanced stage already reached in the United Kingdom's cyclical upswing and, from the point of view of the market participants, of the inflationary risks associated with this. Later in the year other currencies, particularly those of Italy and Spain, were also to sustain significant losses. However, the French franc, too, tended to be weak for a time. In the wake of the currency turbulence which spread rapidly at the beginning of March, almost all European partner currencies came under renewed pressure against the Deutsche Mark. In the EMS the Spanish peseta and the Portuguese escudo were devalued by 7 % and 3 ½ %, respectively. The Deutsche Mark was being quoted 5 % higher against all other EC currencies during the first quarter of 1995 than it had been at the same time a year earlier. Such a noticeable appreciation of the Deutsche Mark, which did not get fully under way until a few months ago, cannot be explained by economic fundamentals as these changed very little last year.

External value of the Deutsche Mark

Chart 9

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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Instead, it was largely due to political uncertainty in a number of countries and the consequent reassessment of currencies in the international financial markets.

Weighted external value of the Deutsche Mark

In terms of the weighted average of the currencies of the 18 most important trading partners, the Deutsche Mark appreciated by 6 ½ % between the first quarter of 1994 and the first quarter of 1995. Given Germany's relatively small stability lead, the real rate of appreciation was of a similar magnitude, at 6 % (in terms of the deflator of total expenditure), after elimination of divergent price trends at home and abroad. This means that the real external value of the Deutsche Mark is now considerably above the long-term average.

Competitiveness in price terms worsens

There is no doubt that the real appreciation of the Deutsche Mark represents a particular challenge to Germany's ability to check costs and prices if the degree of competitiveness regained in terms of prices as a result of a variety of rationalisation efforts and restructuring measures on the part of enterprises and the moderate wage agreements in 1993 and 1994 is not to be jeopardised. The appreciation of the Deutsche Mark against the US dollar is giving considerable cost relief to the economy as a whole because imports of intermediate goods invoiced in dollars, including raw materials and energy in particular, have become cheaper. By increasing the regional diversification of their manufacturing locations and by resorting to competitive foreign suppliers, enterprises will probably continue to try to avoid domestic cost pressures. There is also a challenge here for wage policy makers if jobs which are exposed to international competition are to be safeguarded. Judging by what has taken place so far, however, management and labour in major industrial sectors are not yet sufficiently aware of the changed circumstances. At any rate, the pay settlements already reached for 1995 have taken no account of the most recent dramatic appreciation of the Deutsche Mark, with the result that Germany's overall competitive position has worsened.

Dynamic growth in exports

Foreign trade received considerable growth stimuli last year, particularly from the recovery process in the world economy. Overall, German exports picked up much more quickly than some observers had thought possible at the beginning of last year. In 1994 exports of goods exceeded those of the previous year by 9 %. The growth rate of real exports was somewhat higher as the corresponding unit values in this sector declined slightly. The preconditions which enabled German exporters to participate in the equally dynamic growth in world trade in this way had already been created through a number of radical measures to improve supply-side conditions. Not least in view of the difficulties in maintaining competitiveness as a result of the recent exchange rate trends, there must be no let-up in this in the future either. German exporters were particularly successful in overseas industrial countries, notably in Japan, which absorbed about 14 % more German goods in 1994 than a year before. There is no doubt that the considerable purchasing power of the yen, which has been extremely strong for two years now, also played a role here. Significant increases in sales were also registered in the countries in transition in central and eastern Europe, where in many cases the losses of output due to restructuring have now been overcome, and in the dynamic economies of south-east Asia and Latin America. In the course of the year, however, the traditional export markets in western Europe in particular, which on average account for about two-thirds of Germany's total export demand, proved to be increasingly absorptive again.

Imports revive in the wake of the cyclical recovery

The reciprocal strengthening effects of growth and foreign trade, both at home and abroad, can be seen not only in Germany's exports but also in the sharp rise in its imports at the same time. The value of these exceeded the level of the previous year by approximately 8 %. In real terms, however, the growth rate was somewhat lower as unit import values rose by 1 ½ %. During the year it was particularly the European industrial countries and the United States that benefited from the increased German demand for imports. If measured in terms of growth rates, however, it was mainly the countries in transition in central and eastern Europe as well as enterprises in east Asia – including China – which strengthened their foothold in the German market.

Current account deficit rises somewhat . . .

The export surplus increased again last year. When measured in f.o.b. / f.o.b. terms, it rose by almost DM 17 billion to DM 82 ½ billion, compared with 1993. Nevertheless, Germany's current account deficit in 1994 grew by DM 7 ½ billion to DM 33 ½ billion.[1] Large deficits on foreign travel and lower receipts from the troops stationed in Germany, both of which were reflected in a rise of almost DM 10 ½ billion to DM 62 ½ billion in the deficits on services account, were important reasons for this. The significant reduction in factor income from abroad, however, which fell by DM 10 billion (to a net DM 8 billion) in 1994, had an equally strong impact here.[2] This is principally due to the decline in Germany's net

1 A detailed account of the trend in Germany's current account was given in Deutsche Bundesbank, Germany's balance of payments in 1994, Monthly Report, March 1995, page 45 ff. The same Monthly Report also contained detailed explanations of the balance of payments concept now in use. See Deutsche Bundesbank, Changes in the methodology of the balance of payments, Monthly Report, March 1995, page 33 ff.

2 See Deutsche Bundesbank, Recent developments in service transactions with non-residents, Monthly Report, January 1995, page 51 ff.

external assets owing to the current account deficits of the past few years. Despite its current account deficits since 1991, however, Germany, with external assets of approximately DM 340 billion (in mid-1994), which is just over one-tenth of its gross domestic product, is still at the top of the league of industrial countries, together with Japan.

... but is no reason for concern

Seen in this light, the current account deficit is not a reason for concern, especially as it is running at a fairly modest level (1 % of the gross domestic product). It is essentially a reflection of Germany's special economic situation after unification in 1990, which ultimately led to a considerable demand for resources to finance the restructuring and reconstruction of eastern Germany. However, as overall saving is likely to increase again in future, Germany will probably not have to draw on foreign resources to this extent again. The consolidation of the sharply increased budget deficits resulting from unification is significant here, and this should not be underestimated. Important decisions for the inevitable change in the fiscal policy stance were taken last year (see page 54 ff.).

Smooth "financing" of the current account deficit

The smooth and tension-free "financing" of the external deficits by large inflows of capital through the markets as a result of the increased confidence in the Deutsche Mark is consistent with this evaluation of Germany's current account situation, namely that it is nothing more than a reasonable reaction to a greater demand for resources. Net inflows of capital from abroad amounted to DM 57 billion. However, in line with developments in the international financial markets, there were considerable structural changes in financial operations with non-residents. Essentially, these concerned changes in the maturity structure of international portfolios, which were observed after the radical reassessment of international interest rate prospects in all major capital markets.

Structural shifts prompted by interest rates...

Most obvious of all were the changes in the maturities preferred by internationally operating investors in securities, transactions in which resulted in capital outflows of DM 44 ½ billion in 1994, compared with record inflows of DM 177 billion in 1993. In view of the widely held expectation that interest rates would rise, non-residents preferred to sell, particularly bonds and notes, during the first half of the year; it was not until July, when a yield level which investors evidently found more satisfactory had been reached, that interest rose again. However, to a large extent these purchases really amounted to financial investment by Luxemburg investment companies, which in the second half of 1994 placed the funds they received from selling money market fund and other investment certificates in the German market, notably in floating-rate bank debt securities. Moreover,

Balance of payments

Table 5

DM billion

Item	1991	1992	1993[8]	1994[8]
I. Current account	– 31.9	– 33.7	– 25.8	– 33.4
1. Goods	+ 29.9	+ 41.4	+ 65.7	+ 82.4
Exports (f.o.b.)[1]	667.6	671.6	632.6	690.2
Imports (f.o.b.)[1]	637.7	630.2	566.9	607.8
2. Services	– 28.9	– 42.6	– 52.2	– 62.7
of which				
Foreign travel	– 34.2	– 39.9	– 44.7	– 50.0
3. Factor income	+ 29.7	+ 22.5	+ 18.2	+ 8.0
of which				
Investment income	+ 32.2	+ 26.4	+ 23.1	+ 12.8
4. Current transfers	– 62.6	– 55.1	– 57.5	– 61.2
of which				
Net contributions to the EC budget[2]	– 21.3	– 24.7	– 26.7	– 31.0
Other official current transfers to non-residents (net)	– 26.2	– 13.8	– 14.3	– 13.4
II. Capital transfers	– 1.0	+ 1.1	+ 0.9	+ 1.2
III. Financial account (capital exports: –)	+ 20.9	+ 90.3	+ 6.2	+ 57.1
1. Direct investment	– 32.5	– 26.8	– 23.7	– 28.7
2. Portfolio investment[3]	+ 41.3	+ 45.3	+ 177.3	– 44.6
Equities	+ 1.0	– 5.7	+ 0.2	– 10.6
Investment fund certificates	– 12.4	– 61.0	– 14.7	– 23.9
Bonds and notes	+ 46.2	+ 112.4	+ 195.1	– 8.5
German investment abroad (increase: –)	– 12.6	– 7.8	– 13.1	– 27.1
Foreign investment in Germany (increase: +)	+ 58.8	+ 120.2	+ 208.1	+ 18.6
Other portfolio investment[4]	+ 6.5	– 0.4	– 3.3	– 1.5
3. Credit transactions[3]	+ 15.3	+ 74.6	– 144.8	+ 133.2
Credit institutions	+ 12.7	+ 81.0	– 87.6	+ 141.6
Long-term	– 27.7	+ 13.9	+ 12.0	+ 15.8
Short-term	+ 40.5	+ 67.1	– 99.7	+ 125.8
Enterprises and individuals	+ 12.0	+ 6.2	– 51.8	– 17.1
Public authorities	– 9.4	– 12.6	– 5.4	+ 8.8
4. Other investment	– 3.3	– 2.8	– 2.6	– 2.8
IV. Balance of unclassifiable transactions (balancing item)	+ 12.3	+ 11.1	– 17.0	– 12.7
V. Change in the Bundesbank's net external assets at transaction values (increase: +)[5, 6]	+ 0.3	+ 68.7	– 35.8	+ 12.2
Memorandum item				
Change in the Bundesbank's net external assets at balance sheet rates (increase: +)[6, 7]	+ 0.8	+ 62.4	– 34.2	+ 8.6

1 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. — **2** Excluding collection expenses, EAGGF (Guidance Fund) and Regional Fund. — **3** Excluding direct investment. — **4** Money market instruments, warrants and the balance of other payments in financial derivatives. — **5** Excluding SDR allocations and changes due to valuation adjustments. — **6** Including the Treasury discount paper (liquidity paper) issued since March 1993 and sold to non-residents. — **7** Including SDR allocations and changes due to the end-of-year revaluation. — **8** Figures subject to major uncertainty owing to changes in the method of data collection in foreign trade.

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improvements in the interest rate advantage of foreign currency bonds and the expectation of exchange rate profits again accelerated the trend towards internationalising investment which has been observed for years and has prompted German residents to invest more abroad. Capital inflows through all domestic sectors also declined in long-term credit transactions outside the securities markets in 1994.

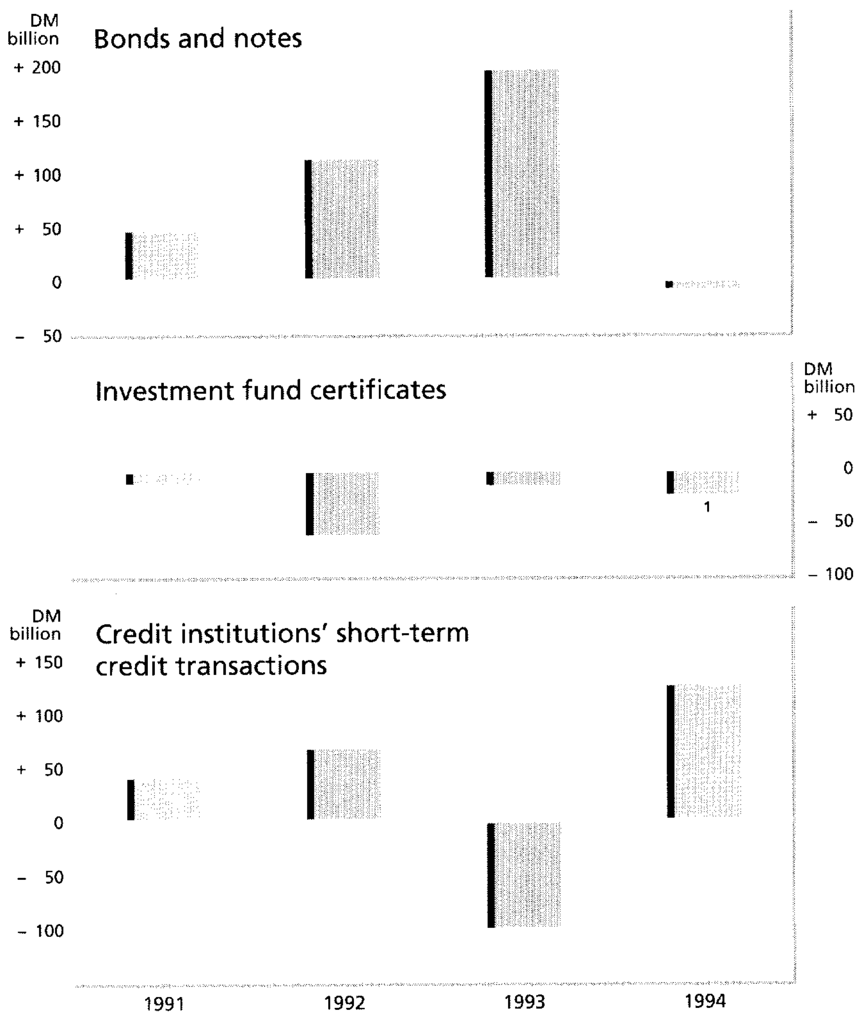
. . . in favour of large short-term capital imports

Conversely to the remarkable reversal in investors' interest in the bond market at the beginning of last year, foreign investors quickly built up their short-term Deutsche Mark positions. The latter trend is becoming apparent, particularly in a dramatic decline in the net external assets of domestic credit institutions which took place mainly in the first half of 1994 and reached an annual level of DM 126 billion, compared with a corresponding increase of just under DM 100 billion in the banks' net short-term external assets a year earlier. The substantial capital flows reflected in these significant shifts in the international structures of funding from one year to another emphasise yet again the high degree of sensitivity and mobility of international capital. However, in view of the flexible compensatory function through which highly developed financial markets effectively support the real adjustment processes in a system of free capital transfers, the considerable sources of potential disturbances which may be feared in the case of shortcomings in the system and losses of confidence therefore become apparent at the same time. The level of the current account deficits which are to be "funded" in purely "mechanical" terms ultimately becomes insignificant.

Monetary reserves of the Bundesbank largely unchanged

The firmness of the Deutsche Mark in the foreign exchange markets throughout last year is also reflected to some extent in the monetary reserves of the Bundesbank. Apart from the repayments of the remaining outstanding ECU liabilities which European partner central banks had vis-à-vis the Bundesbank as a result of intervention in connection with the EMS crisis 1992-3, the monetary reserves of the Bundesbank were practically unchanged. However, the external liabilities of the Bundesbank declined significantly, especially in the second half of the year, because the liquidity Treasury discount paper ("Bulis") which were mostly held by foreign central banks as part of their Deutsche Mark monetary reserves were reduced on maturity after the issue of this paper had ceased. Mainly as a result of this, the net external assets of the Bundesbank rose in 1994 (at transaction values) by DM 12 billion.

Trend in financial transactions * Chart 10



* Balances; capital imports: +. — 1 Including money market fund certificates (– DM 15.1 billion).

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Revaluation of the external position

As a result of the revaluation of the Bundesbank's external position, there were fairly small changes in the external assets which are mainly due to market-price-related valuation adjustments to dollar assets; on the other hand, exchange-rate-related valuation changes were relatively insignificant. The US dollar holdings were again valued at DM 1.3870 per dollar; the ECU holdings likewise remained unchanged at DM 1.89636 per ECU. On the other hand, the value of SDR holdings declined to DM 2.26102 per SDR. These factors together resulted in a net external position of DM 92 billion on the balance sheet date, which was December 31, 1994.

Changes in the net external position of the Deutsche Bundesbank *

Table 6

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)
1994 Jan.	- 2.8	–	–	–	- 2.8	+ 1.2	+ 0.2	- 2.8	- 1.4
Feb.	- 1.4	–	–	–	- 1.4	+ 1.7	- 0.8	- 0.4	- 1.8
Mar.	+ 5.3	–	–	–	+ 5.3	+ 1.1	- 0.5	+ 1.2	+ 3.5
Apr.	- 3.5	–	–	–	- 3.5	+ 1.2	- 0.5	+ 0.1	- 4.2
May	+ 3.7	+ 1.1	+ 1.1	–	+ 2.6	+ 1.4	- 0.4	+ 1.0	+ 0.6
June	+ 4.4	+ 0.8	+ 0.8	–	+ 3.7	+ 1.2	- 0.6	+ 2.3	+ 0.7
July	+ 1.0	–	–	–	+ 1.0	+ 1.0	- 1.3	+ 1.8	- 0.6
Aug.	+ 0.9	–	–	–	+ 0.9	+ 1.6	- 0.7	+ 0.3	- 0.3
Sep.	+ 6.3	–	–	–	+ 6.3	+ 1.2	+ 1.0	- 2.2	+ 6.4
Oct.	- 1.2	–	–	–	- 1.2	+ 1.0	- 0.6	- 1.2	- 0.3
Nov.	- 1.8	+ 0.8	+ 0.8	–	- 2.5	+ 1.6	- 1.7	- 2.7	+ 0.3
Dec.	+ 1.4	–	–	–	+ 1.4	+ 1.2	+ 0.2	- 8.8	+ 8.8
Total	+ 12.2	+ 2.6	+ 2.6	–	+ 9.7	+ 15.2	- 5.7	- 11.4	+ 11.7
1995 Jan.	+ 1,0	–	–	–	+ 1.0	+ 0.9	+ 1.1	- 0.9	- 0.1
Feb.	+ 0.5	–	–	–	+ 0.5	+ 1.3	- 0.1	- 1.1	+ 0.3
Mar.	+ 6.4	+ 0.7	+ 0.7	–	+ 5.7	+ 1.0	- 0.6	+ 1.0	+ 4.3

* 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.

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Deutsche Mark maintains its position

Overall, the Deutsche Mark was able to consolidate and strengthen its position as an international investment and reserve currency last year. With a 16 % share in the monetary reserves held by all central banks throughout the world, it is still the second most important world currency after the US dollar. The popularity of the Deutsche Mark as an international investment currency has also remained unchanged. A precondition for this has been the confidence in the reliability of Germany's anti-inflation policy which has been built up over decades. In view of future challenges, it is necessary to maintain and to strengthen this trust.

4. Public finance adopts a course of consolidation

(a) Trends in 1994

Budget situation of the central, regional and local authorities improved

Last year the financial position of the public authorities changed for the better; for the first time since German unification, the overall deficit decreased again. This owed much to the enhanced retrenchment efforts of the central, regional and local authorities at all levels of government. The basic necessity of curbing the growth of expenditure in view of the tight state of public finance was increasingly given due consideration, whereas, in the initial period after unification, retrenchment measures to offset the additional burdens had not been taken on a sufficiently large scale. At the same time, the incipient economic upswing mitigated the pressure exerted by the labour-market-related expenditure. The improvement in the economic situation was reflected only partly in tax revenue. However, relatively high other receipts (for example, from privatisations and sales of real estate, as well as from the Bundesbank's profit) accrued, although this cannot be expected to continue on the same scale over the longer term. Altogether, the deficit of the central, regional and local authorities decreased by DM 27 billion in 1994, compared with the previous year, and totalled DM 106 billion; hence it also remained distinctly below the figure provided for in the budgets.

Overall picture, including social security funds and Treuhand agency

The contribution rate to the pension insurance scheme was raised at the beginning of 1994 in order to stabilise the financial situation; as a result, the deficit decreased in this area, too. On the other hand, the surplus recorded by the health insurance scheme in 1993, in the wake of the Act on the Structure of the Health Sector, contracted sharply. As a consequence, the social security funds, taken as a whole, failed to run a surplus. The deficit incurred by all public authorities, according to the financial statistics, came to DM 108 billion, and was thus equivalent to 3 ¼ % of the gross domestic product (compared with just over 4 % in 1993). However, this figure does not include the deficit of the Treuhand agency, which amounted to DM 37 billion. Inclusive of the Treuhand agency, the public sector deficit reached just over 4 ¼ % of GDP (against 5 ¼ % in 1993).

Deficit criterion of the Maastricht Treaty

As defined in the national accounts, on which the deficit criterion of the Maastricht Treaty is based, the public sector deficit (which, by definition, excludes the Treuhand agency) came to 2 ½ % of GDP, so that the 3 % convergence criterion provided for in the Treaty was undershot, contrary to the original expectations. However, the 3 % benchmark was not to be regarded as a financial policy target, but rather as a minimum requirement. The need for structural consolidation faced by public finance would not nearly be complied with if in future the 3 % limit were but barely achieved. The Economic Advisory Council at the Federal Ministry of Finance has recommended that, under normal cyclical circumstances, the public sector deficit should not exceed 1 % to 1 ½ % of the gross domestic product. This can be considered an appropriate guideline. Medium-term financial planning is already geared to reducing the deficit much further.

Retrenchment efforts of the central, regional and local authorities

Statutory restrictions (particularly in the context of the Retrenchment, Consolidation and Growth Programme adopted towards the end of 1993), restraint in budget planning and expenditure cuts effected in the implementation of the budget helped to moderate the growth of the spending of the central, regional and local authorities last year. It was not least the moderate pay settlements in the public service which afforded relief. In all, the expansion of the expenditure of the central, regional and local authorities in 1994 slowed down to a rate of 3 % (compared with 5 % a year previously, and as much as 9 ½ % in 1992). A significant factor in 1994 was that, owing to the railway reform, expenditure hitherto effected by the railways was transferred to the Federal Railways Fund, a new subsidiary budget of the Federal Government; this led to an increase of 1 ½ percentage points in public sector spending.

Expenditure at the individual levels of government

Federal expenditure fell DM 9 billion short of the amount envisaged, and was only 3 % higher than in 1993. At the Länder and local authority levels, too, the growth of expenditure moderated. Owing to the retrenchment efforts, the expenditure of the west German Länder rose by little more than 1 % in 1994 (compared with 4 ½ % a year previously). In the west German local authorities, the pace of expenditure growth likewise slackened to just over 1 %. Owing to the pressure exerted by the budget situation (and not least in view of the social assistance burdens, which continued to mushroom), cuts in municipal capital spending, too, were unavoidable. By contrast, the modernisation of the infrastructure continued to enjoy priority in eastern Germany; capital spending remained at a high level. In this context, the retrenchment efforts were directed mainly towards the reduction of staff levels, which in some areas were still fairly high. Overall, expenditure in the new Länder increased by 4 % last year; municipal spending decreased somewhat, owing partly to the fact that some tasks were transferred to private sector enterprises.

Social security spending

In the area of social security, however, expenditure growth, at 5 ½ %, continued to be faster than in the case of the central, regional and local authorities. Trends differed, admittedly, in the individual branches of insurance. Pension insurance (particularly in the new Länder) once again recorded a sharp increase in spending. In addition, the expenditure of the health insurance scheme again rose much more rapidly than a year before, although this rise also has to be seen against the background of a period of relatively low spending (owing to special factors) after the entry into force of the reform at the beginning of 1993. By contrast, the expenditure of the Federal Labour Office decreased by almost one-tenth as a result of retrenchment measures and the gradual stabilisation of the labour market situation.

Public sector finance *

Table 7

Item	1992 pe	1993 pe	1994 pe	1992 pe	1993 pe	1994 pe
	DM billion			Change from previous year in %		
Central, regional and local authorities						
Expenditure						
Personnel expenditure	321.5	336	349.5	+ 9	+ 4.5	+ 4
Other operating expenditure	155	157.5	159	+ 8	+ 1.5	+ 1
Transfers 1	302	338	346.5	+ 2.5	+ 12	+ 2.5
Interest paid	101	102.5	114.5	+ 30.5	+ 2	+ 12
Fixed capital expenditure	103.5	101	97	+ 14	– 2.5	– 4
Financial aid 2	83	83	81.5	+ 17	– 0	– 1.5
Total expenditure 3	1,066	1,117.5	1,148.5	+ 9.5	+ 5	+ 3
of which						
Federal Government 4	431	462	478.5	+ 6.5	+ 7	+ 3.5
West German Länder Governments 5	349.5	366	370.5	+ 5.5	+ 4.5	+ 1
East German Länder Governments	88	95.5	99.5	+ 12.5	+ 8.5	+ 4
West German local authorities	250.5	261	265	+ 9.5	+ 4.5	+ 1.5
East German local authorities	64.5	67	66	+ 33.5	+ 3.5	– 1
EC 6	35.5	38	42	+ 8	+ 6.5	+ 10.5
Receipts						
Tax revenue	731.7	749.1	786	+ 10.5	+ 2.5	+ 5
Other receipts	224.5	234	252	+ 17	+ 4	+ 8
Total receipts 3	956	984.5	1,042.5	+ 12.5	+ 3	+ 6
of which						
Federal Government 4, 7	399.5	401	439	+ 12.5	+ 0.5	+ 9.5
West German Länder Governments 5	331	340	343.5	+ 6	+ 2	+ 1
East German Länder Governments	75	79.5	83	+ 10	+ 6	+ 3.5
West German local authorities	240.5	252	259.5	+ 8	+ 5	+ 3
East German local authorities	56.5	62	60	+ 13	+ 9.5	– 3
EC	35.5	38	42	+ 8	+ 6.5	+ 10.5
Deficit (–)	– 110	– 133	– 106.5	.	.	.
of which						
Federal Government	– 32	– 61	– 39.5	.	.	.
West German Länder Governments 5	– 18.5	– 26	– 27	.	.	.
East German Länder Governments	– 13	– 16	– 16.5	.	.	.
West German local authorities	– 10	– 9	– 5.5	.	.	.
East German local authorities	– 8	– 5	– 6	.	.	.
"German Unity" Fund	– 22.5	– 13.5	– 3	.	.	.
Debt-Processing Fund	+ 0.5	– 0	+ 0	.	.	.
ERP Special Fund	– 6.5	– 1.5	– 2	.	.	.
Federal Railways Fund	.	.	– 5.5	.	.	.
Social security funds						
Expenditure	628	668.5	706.5	+ 14.5	+ 6.5	+ 5.5
Receipts	621	672.5	705	+ 10.5	+ 8.5	+ 5
Surplus (+) or deficit (–)	– 7	+ 4	– 2	.	.	.
Public sector, total						
Expenditure	1,616.5	1,688	1,761	+ 11.5	+ 4.5	+ 4.5
Receipts	1,499.5	1,558.5	1,653	+ 11.5	+ 4	+ 6
Deficit (–)	– 117	– 129.5	– 108	.	.	.
Memorandum item						
Deficit of the Treuhand agency	– 30	– 38	8 – 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 enterprise 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 net basis. — **5** Including Berlin. — **6** EC expenditure financed out of EC revenue in Germany. — **7** The Bundesbank's profit transfer is included in full in this figure as Federal Government revenue. — **8** Including the transfers to the Debt-Processing Fund which are not provided for in the budget.

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Public sector spending ratio

Altogether, the ratio of government expenditure to the gross domestic product fell slightly in 1994, for the first time after four years of increase; according to the definitions used in the national accounts, it amounted to 50 %. (According to the classifications of the financial statistics, the level would be a little higher.) However, the difference from the ratio in the old Länder in 1989 (just under 46 %) suggests that there is a considerable need for adjustment and correction, which will have to be attended to in future. Thus the financial policy makers cannot simply rest content with initial successes in curbing public expenditure.

Moderate growth of tax revenue

The economic upswing affected tax revenue with a time-lag. Although corporate profits rose steeply, receipts from corporation tax and assessed income tax diminished sharply for a while. This reflected the unfavourable assessment outcome of previous years. In addition, the tax cuts and transitional regulations for distributing profits which came into force at the beginning of 1994 reduced revenue. In view of the subdued growth of wages and the lower average level of employment during the year, wage tax saw a moderate increase only. Turnover tax was the mainstay of revenue growth, not least owing to the increased investment in residential construction. Moreover, additional receipts were recorded as a result of the increase in mineral oil tax, which is intended to help finance the railway reform. Overall, tax revenue grew by 4.9 % in 1994. Thus it did not greatly exceed the expectations entertained at the end of 1993, which formed the basis of the budget plans, although economic activity developed perceptibly better than was suggested by the forecasts of that time. Compared with the previous year, the overall tax ratio remained almost unchanged. Even so, the overall government levy ratio continued to rise as a result of the increase in the contribution rate to the pension insurance scheme, viz. to 43.7 % of GDP (as defined in the national accounts); it was thus just over three percentage points higher than after the tax reform in the old Länder in 1990.

Financial positions of the individual levels of government

Among the individual levels of the central, regional and local authorities, it was particularly the financial position of the Federal Government that improved last year. The deficit of the Federal Government decreased from DM 67 billion in 1993 to just over DM 50 billion. Hence the Federal budget developed much more favourably than had been envisaged; the plan had provided for a deficit of almost DM 70 billion. If one includes in revenue that part of the Bundesbank's profit transfer which exceeds the "basic amount" of DM 7 billion entered in the budget, the deficit decreased from DM 61 billion to DM 39 billion. In spite of their retrenchment efforts, the old Länder registered a further increase of DM 1 billion in the deficit, to DM 27 billion (including Berlin), since their revenue hardly grew at all, owing to sluggish receipts of assessed taxes and the additional transfers of resources to the "German Unity" Fund. In the new Länder (although tax receipts grew sharply there, in contrast with the west), the deficit likewise rose somewhat, viz. to DM 16 ½ billion. Thus the deficit was considerably lower than had been provided for; however, calculated per head of the population, it was almost three times as large as in the west German Länder. The deficit of the local authorities in the old Länder, at DM 5 ½ billion, was DM 3 ½ billion below the very high level reached in 1993. By contrast, the large deficit incurred in eastern Germany increased by DM 1 billion (to DM 6 billion). In the case of the subsidiary budgets, the deficit of the "German Unity" Fund decreased by just over DM 10 billion to no more than DM 3 billion in the course of the systematic reduction in borrowing from year to year. On the other hand, the deficit of the Federal Railways Fund, totalling about DM 5 ½ billion, now had to be newly included in these figures.

Borrowing and total debt

In 1994 the central, regional and local authorities drew on the credit markets to the tune of DM 78 billion, which was far less than a year before (almost DM 160 billion). Besides the decrease in the deficits, credit needs were lessened by the fact that the Federal Government was able to fall back on considerable cash resources which it had accumulated on the basis of loans raised "as a precaution" at the end of 1993. The total debt of the central, regional and local authorities reached DM 1,655 billion (or 50 % of the gross domestic product) at the end of 1994. Its growth owed much to the fact that, under the railway reform, old debt amounting to DM 66 billion was transferred to the Federal Railways Fund. The Treuhand agency (after deduction of the redemption of old debt) took up just under DM 40 billion. Its liabilities have been counted as part of public sector debt only since they were transferred to the Redemption Fund for Inherited Liabilities at the beginning of 1995; at that time they amounted to DM 205 billion.

(b) Outlook for 1995 and further prospects

Regulations to cope with the financial consequences of unification

In 1995 the reduction of the public sector deficit, which is necessary both in budgetary terms and in the light of macro-economic conditions, will presumably make further headway. In view of the expiry of the transitional arrangements, the Federal Consolidation Programme already paved the way for that in important respects. From 1995 onwards, the Federal revenue-sharing scheme was restructured in order to provide east German regional and local authorities on a long-term basis with appropriate revenue for performing their tasks. This yet again increases the transfers from the west to the east. This will enable the new Länder to reduce their deficits considerably. The liabilities of the Treuhand agency and the Debt-Processing Fund (the latter is already included in the public sector figures) as well as, from mid-1995 onwards, some of the debt of the east German housing sector, will be assumed by the newly established Redemption Fund for Inherited Liabilities. For servicing this debt, the Federal Government supplies budget resources for an annual repayment of 7.5 % of the liabilities taken over by the Fund; in addition, that part of the Bundesbank's profit which exceeds DM 7 billion will be transferred to the Fund; so far that part has been used, in accordance with budgetary law, for additional redemptions of Federal debt. The Federal Government also assumes the costs arising in connection with the successor organisations of the Treuhand agency. Thus the burdens ensuing from German unification are now fully reflected in public sector budgets (particularly the Federal Government's budget), which was not the case hitherto, since the Treuhand agency was formally included in the enterprise sector. In view of the additional budgetary burdens, another tax package was approved for the beginning of 1995 under the Federal Consolidation Programme. It involves, in particular, the levying of a new solidarity surcharge on income tax; in addition, insurance tax and property tax on private assets have been raised. These tax increases – together with the containment of expenditure growth, which continues to be part of the plans, and the favourable impact of the economic upswing – warrant the expectation that the deficit of the central, regional and local authorities will continue to decline in the current year, and drop below the level of DM 100 billion. Moreover, if it is taken into account that the deficit of the Treuhand agency (which in fact exhibited many of the features of a subsidiary public sector budget) is no longer included, then the public sector deficit, in a comprehensive view, might decrease by about DM 50 billion, compared with the previous year – a fact which would afford much relief to the credit market.

Individual levels of government

In 1995 the improvement in the budget position of the central, regional and local authorities will focus on the new Länder. The Federal Government, which will assume the bulk of the additional burdens in the wake of the restructuring of the revenue-sharing scheme, nevertheless plans to reduce its deficit somewhat more in the current year. In the draft budget presented in November 1994, the 1995 deficit was estimated at DM 59 billion, which was already DM 10 billion lower than in the first draft of July 1994, mainly because of increases in non-tax receipts. After the out-turn in 1994 had improved significantly over the expectations entertained as late as last autumn, the planned expenditure volume was reduced by DM 6½ billion in the deliberations of the Bundestag; in particular, expenditure on the labour market and on interest was now put at a lower level. In addition, estimates of tax receipts were raised by almost DM 2 billion

Indebtedness of the central, regional and local authorities

Table 8

DM billion

Item	1993	1994 pe	1993	1994 pe
	Level at end of year		Change from previous year	
Borrowers' note loans	603.6	668.5	+ 39.3	+ 65
Securities	817.7	897	+ 120.3	+ 79.5
Other debt	87.9	89	+ 4.3	+ 1
Total indebtedness	1,509.1	1,654.5	5 + 163.9	5 + 145.5
Federal Government	685.3	712.5	+ 74.2	+ 27
West German Länder Governments	393.6	414.5	+ 27.0	+ 20.5
East German Länder Governments	40.3	55.5	+ 17.7	+ 15
West German local authorities 1	153.9	158	+ 12.5	+ 4.5
East German local authorities	19.0	23.5	+ 5.7	+ 4.5
"German Unity" Fund	87.7	89	+ 13.3	+ 1.5
Debt-Processing Fund 2	101.2	102.5	+ 9.5	+ 1
ERP Special Fund	28.3	28	+ 4.0	– 0
Federal Railways Fund	.	71	.	+ 71
Memorandum items				
Treuhand agency 3	168.3	204.5	+ 61.5	+ 36.5
Federal Railways/East German Railways 4	66.0	.	+ 12.5	.
Federal Post Office	104.5	124	+ 7.9	+ 19.5

1 Including municipal special-purpose associations. — 2 Including the hitherto assumed liabilities to the Currency Conversion Equalisation Fund, which amounted to DM 73.9 billion at the end of 1993, and to DM 75.2 billion at the end of 1994. — 3 Including assumption of old loans and liabilities arising from equalisation claims of enterprises. — 4 After adjustment for the borrowing of the East German Railways from the Federal Railways. — 5 The figure for net borrowing given in the text on page 59 is lower than the increase in indebtedness, which also includes the assumption of the debt of the railways and of old debt.

Deutsche Bundesbank

(owing to the lower expected transfers to the EC), and estimates of other revenue were also increased somewhat. The deficit is now expected to come to DM 49 ½ billion. However, when assessing the financial position of the Federal Government, it should be borne in mind that the large amount of special revenue expected in 1995 from privatisations and capital withdrawals will afford only temporary relief to the budget. However, particularly in view of the necessity of lowering taxes again as soon as possible, the recent budget trends do not imply that the expenditure curbs can soon be eased. In the old Länder, too, the financial situation remains very tight in view of their additional transfers to eastern Germany; not counting the payments effected within the framework of the revenue-sharing scheme, the increase in spending, according to the budgets, is to be restricted to an average rate of just over 2 ½ %.

Public sector spending ratio and government levy ratio

However, in spite of the retrenchment efforts, it seems unlikely that progress will already be made in 1995 in the field of reducing the public sector spending ratio, in view of the assumption of the burdens hitherto borne by the Treuhand agency and of the introduction of the nursing care insurance scheme. Judging by the current state of budget planning, this will result in an increase in overall expenditure by the central, regional and local authorities of about 4½%, approximately half of which is attributable to the rise in interest expenditure. According to the official tax estimate of March 1995, this will be accompanied by a growth in tax revenue of just over 8%. The overall tax ratio will thus rise perceptibly. In addition, in the field of social security, a contribution amounting to 1% of eligible incomes has to be paid in respect of the nursing care insurance scheme. On the other hand, the contribution rate to the pension insurance scheme could be reduced again by 0.6 percentage point, mainly because of increased contribution payments in respect of wage substitutes, to the debit of the Federal Labour Office or the Federal Government. In all, the burden of levies and taxes will probably rise to about 44½% of the gross domestic product in the current year. However, the increase in levies which has occurred since 1991 can be no more than a temporary makeshift intended to stabilise the budget position.

Indebtedness

The level of public sector debt will once again increase sharply, particularly as a result of the inclusion of the liabilities of the Treuhand agency. At the end of 1995 it will probably reach an order of magnitude of DM 2,000 billion and thus, in absolute terms, be more than twice as high as at the end of 1989; as a percentage of the gross domestic product, it will rise to an estimated level of about 57%. Although, contrary to the original expectations, this would not violate the debt level criterion laid down in the Maastricht Treaty (60% of the gross domestic product), interest expenditure, which in the case of the Federal Government alone will rise to the equivalent of one-fifth of spending, will constitute a heavy burden. It is imperative to cut the deficits, if only in order to be able to lessen the high debt ratio in future.

Medium-term requirements

Over the medium term, the fiscal policy makers are faced with a difficult balancing act in view of the necessity of continuing the consolidation of the budget and gradually reducing the heavy burden of levies, which is massive by international standards, too. This two-fold task can be performed all the better, the more the public authorities succeed in curbing the growth of spending at all levels of government. Expenditure policy thus plays the key role. Cyclically-induced extra spending must not lead to any relaxation of the expenditure policy stance. The reduction of the public sector spending ratio over the medium term to its level prior to German unification, as aimed at by the Federal Government, should be given absolute priority in financial policy. In this context, it is advisable to gauge tax relief, as part of a phased approach, in such a way as to ensure that a renewed increase in the deficits – even if perhaps for a limited period only – is out of the question. It would be desirable to run down the deficits at times of favourable economic conditions to such an extent that a "reserve" to cope with the risk of a downturn in economic activity is created. There must be no room for doubt concerning the continuation of the consolidation process, since the prospect of a stabilisation of public finance is an important element of the expectations that are relevant to economic decisions. This applies not least with regard to the capital and foreign exchange markets, where expectations as to future developments materially affect sentiment. From a macro-economic point of view, the state cannot in the long run lay claim for its own purposes to such a large part of private savings as it has done in the last few years without jeopardising the potential for further economic growth and for an increase in employment. At the same time, an economy's tax performance must not be consistently overstrained; a reduction in the burden of levies is required in order to safeguard and strengthen Germany's position as an industrial location.

Tax policy

The perception that consolidation and tax relief must go hand in hand, and that undue haste with respect to massive tax cuts must be ruled out, is widespread in the political arena. Like the Federal Government, the Länder Governments and local authorities have to face up to the fact that the financial leeway for tax relief still remains to be generated. In the course of 1995, major decisions affecting tax legislation in the ensuing period will have to be taken. The exemption of subsistance incomes from income tax will have to be regulated not later than the beginning of 1996, in accordance with a ruling by the Federal Constitutional Court. To this end, the 1996 Annual Tax Bill suggests a solution, in the light of the budget situation, which limits revenue shortfalls to the order of magnitude of roughly DM 16 billion. In addition, improvements in the equalisation of family burdens (children's allowances or child benefits) are envisaged (DM 6 billion). In order to continue the reform of corporate taxation, too, trading capital tax is to be abolished, and trade earnings tax is to be reduced, to the benefit of small and medium-sized enterprises, from the beginning of 1996; however, diminishing-balance depreciation is to be restricted at the same time, in order to prevent tax losses. Investment promotion in the new Länder is to be prolonged and streamlined. The question of whether it is possible to reduce the solidarity surcharge is to be reconsidered annually. The still unresolved financial policy problems include the further financing of the railway reform. Only until the end of 1995 is the Federal Railways Fund allowed to finance some of its expenditure by borrowing; in this case, too, consolidation will be necessary in the end. Finally, following the abolition of the "coal pfennig" (a special levy to subsidise the generation of electricity from German coal), the burden associated with the other assistance measures will have to be offset in the Federal budget.

Record of domestic and external monetary policy measures

January 1, 1994

Stage two of European Economic and Monetary Union (EMU) enters into force. The European Monetary Institute is established; it is domiciled in Frankfurt am Main. Its principal duties comprise coordinating monetary policies in stage two, with the aim of bringing about the convergence in the field of price stability that is necessary for transition to the final stage of EMU, and laying the legal, institutional and organisational foundations for a uniform European monetary policy stance in the final stage. In line with the regulations governing stage two, cash advances by the Bundesbank to the public sector (under section 20 of the Bundesbank Act) are prohibited; at the same time, the central and regional authorities are effectively released from the requirement to deposit their liquid funds with the Bundesbank (under section 17 of the Bundesbank Act).

January 11, 1994

The Council of the European Monetary Institute assembles for its constituent meeting in Frankfurt am Main.

January 20, 1994

The Central Bank Council approves the restructuring and lowering of the minumum reserves with effect from March 1, 1994. The reserve ratio for the sight deposits of both residents and non-residents is lowered to a uniform 5%. The deductibility of credit institutions' cash in hand when complying with the minimum reserve requirements is limited to 25% (rather than 50%) of the required reserves. This measure is designed to reduce the incentive to try to circumvent the minimum reserve regulations, and to lessen the competitive drawbacks of Germany as a financial centre.

February 17, 1994

The Central Bank Council lowers the discount rate from 5 ¾ % to 5 ¼ % with effect from February 18. In this way, the Bundesbank takes due account of the sustained decline in the inflation rate and the further strengthening of confidence in the Deutsche Mark.

April 14, 1994

Given the further improvement in price prospects, the Central Bank Council lowers the discount rate from 5 ¼ % to 5% and the lombard rate from 6 ¾ % to 6 ½ % with effect from April 15. At the same time, it approves the annual accounts for the financial year 1993. DM 18.26 billion of the net profit is paid over to the Federal Government.

May 11, 1994

The Central Bank Council lowers the discount and lombard rates further by ½ percentage point each. With effect from May 13 the discount rate is set at 4 ½ % and the lombard rate at 6%. This measure is primarily intended to widen the interest rate gap between short and long-term financial assets, thus contributing to a gradual dissolution of the liquidity log-jam in the financial markets, which is inhibiting monetary growth.

June 24, 1994

The Deutsche Bundesbank calls in, as of June 30, 1995, the banknotes of the old type issued since the start of the sixties. At the close of that day, those notes will cease to be legal tender, although they will continue to be exchanged at their face value by the Bundesbank free of charge for notes of the new series, which have been in circulation since October 1990.

July 16, 1994

The Fifth Act Amending the Bundesbank Act enters into force. The old section 17 (deposit policy) is repealed; in its new wording, section 20 of the Act no longer provides for cash advances to the public sector.

July 21, 1994

The Central Bank Council reviews and reaffirms the monetary target for 1994, which provides for an expansion of 4 % to 6 % in the money stock M3 between the fourth quarter of 1993 and the fourth quarter of 1994, and emphasises that, despite persistent disruptive influences and short-term distortions, it continues to regard the money stock as its key benchmark variable for monetary policy. At the same time, the Bundesbank switches from variable-rate tenders to fixed-rate tenders with a rate of 4.85 %. It abides by this rate until the end of March 1995.

July 27, 1994

The Deutsche Bundesbank sets aside its previous reservations with regard to DM money market funds, and no longer objects to the issue of certificates of such funds. On the other hand, it retains its misgivings about the advance of short-term public sector debt securities.

August 1, 1994

Major parts of the Second Financial Market Promotion Act enter into force. The key points are, firstly, the adjustment of underlying conditions in the German financial markets to international standards in the field of securities trading supervision through the framing of statutory provisions governing insider trading offences and the setting-up of a central public supervisory authority (the Federal Supervisory Office for Securities Trading); secondly, German investment companies may now establish pure money market funds as well.

August 18, 1994

The Central Bank Council decides to discontinue regular auctions of Bundesbank liquidity paper ("Bulis"). By this decision, the Bundesbank takes account of the fact that the original monetary policy intention of putting open market operations on a broader footing by means of "Bulis" cannot be realised in this way. Moreover, it does not wish to offer investment outlets for money market funds.

December 22, 1994

The Central Bank Council sets the monetary target for 1995. It provides that the Bundesbank will conduct its monetary policy in 1995 in such a way as to ensure that inflation continues to slacken and, at the same time, that the monetary conditions for lasting economic growth remain in place. To this end, the Bank regards it as appropriate for the money stock M3 to expand by 4 % to 6 % between the fourth quarter of 1994 and the fourth quarter of 1995. When analysing monetary developments, the Bank will pay greater attention in future to the "extended money stock M3", which, in addition, includes domestic non-banks' domestic and foreign money market fund certificates.

January 1, 1995

The Federal Supervisory Office for Securities Trading, which is domiciled in Frankfurt am Main, commences operation.

January 9, 1995

Austria joins the exchange rate mechanism of the European Monetary System (EMS) with fluctuation margins of ± 15 %.

March 6, 1995

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

March 16, 1995

The Central Bank Council decides to discontinue the last remaining special rediscount facility in two steps. With effect from June 1, 1995 it will be reduced by DM 1 billion to DM 1.25 billion, and at the close of May 31, 1996 it will be discontinued altogether.

March 30, 1995

The Central Bank Council lowers the discount rate by ½ percentage point to 4 % with effect from March 31. At the same time, it decides to offer the first repurchase transaction in April in the form of a fixed-rate tender with a rate of 4.50 % (i. e. 0.35 percentage point lower than the preceding transactions), and to launch the two subsequent repurchase transactions in the form of variable-rate tenders. By this decision, the Bundesbank takes account of the persistent weakness of monetary growth and the changes in the monetary policy setting.

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.

Record of general economic and fiscal policy measures

April 29, 1994

The Bundesrat adopts the Act Implementing the Social Security Scheme to Finance Nursing Care of the Aged and Handicapped, which creates a new branch of social security in the shape of a statutory nursing care scheme. The benefits of this insurance scheme are to be introduced in stages (for nursing care at home, by April 1, 1995; for in-patient nursing care, by mid-1996). They will be financed through contributions, which initially will amount to 1% of eligible earnings (from the beginning of 1995) and then be raised to 1.7% in mid-1996. In the first stage, the burden imposed on enterprises by the pro rata contribution payments is to be offset by the abolition of a public holiday; in the second stage, the need for compensation is to be the subject of an expert opinion by the Council of Economic Experts.

June 9, 1994

The Financial Planning Council declares that it is essential to transform the incipient upswing into durable growth by the systematic improvement of the underlying economic conditions. It asserts that, besides moderate wage settlements, this calls for a fiscal policy which distinctly reduces the overall public sector deficit by means of the consistent consolidation of government expenditure, while taking due account of future-oriented key areas. An additional objective, it says, remains the containment of the burden of taxes and social security contributions. For the next few years, the Financial Planning Council again recommends limiting the rise in the expenditure of the central, regional and local authorities to an average rate of 3%.

July 15, 1994

The Federal Cabinet approves the draft Federal budget for 1995 – envisaging an expenditure volume of almost DM 485 billion and a deficit of just over DM 69 billion – and the new medium-range financial plan. The plan provides for the annual increase in expenditure being limited to ½% to 1½% until 1998, and for the deficit being lowered progressively to DM 27½ billion; given the expected economic growth, this reduction will be facilitated by a marked decline in labour-market-related spending.

September 23, 1994

Following lengthy disagreements, and after the Mediation Committee has been called upon twice, the Bundestag approves the Indemnification and Compensation Act. If property expropriated in eastern Germany is not returned, the former owners are entitled under that Act to certain compensation rights which are fulfilled by the transfer of negotiable (and, from the year 2004, interest-bearing) debt securities, which are redeemable in five annual tranches. Persons expelled and persecuted by the National Socialists receive one-off payments. These benefits are financed through a new fund, whose resources derive mainly from the Federal budget.

November 21, 1994

The Council of Economic Experts expects the upswing in Germany to continue in 1995. Much as in 1994, the real gross domestic product might grow by 3%, with the increase in western Germany, at 2½%, being slightly stronger than before, and that in eastern Germany, at 9%, being somewhat lower than in 1994.

Hence the rise in aggregate output will hardly exceed that in production potential, but the period of declining inflation rates will draw to an end as the increase in demand will open up scope for enterprises to raise prices. The rise in the cost-of-living index in the old Länder in 1995, at 2½%, will thus probably be just as high as in 1994; in the new Länder, at 3%, it may be slightly greater than in western Germany owing to the planned introduction of the comparative rent system.

December 1, 1994

The Federal Cabinet, as reconstituted after the general election, approves an updated draft Federal budget for 1995. Compared with the previous draft, it provides for a deficit (of about DM 59 billion) reduced by just over DM 10 billion, with the improvement resulting almost entirely from higher receipts (of taxes, and from the sale of Deutsche Kreditbank AG). However, at DM 484 billion, the expenditure volume differs only marginally from that of the first draft.

January 1, 1995

Numerous fiscal policy measures enter into force, including in particular the major elements of the Federal Consolidation Programme, which was approved by Parliament as long ago as 1993. This legislative package comprises, on the one hand, the restructuring of the Federal revenue-sharing scheme and the assumption by the public authorities of "inherited" debts, most of which used to be borne by the Treuhand agency; on the other hand, it involves tax increases amounting to approximately DM 30 billion (as a result of the reintroduction of a "solidarity surcharge" on income and corporation tax, and the raising of insurance tax and property tax).

February 2, 1995

In its Annual Economic Report for 1995, the Federal Cabinet expects aggregate output to grow by about 3%. For the old Länder, a growth rate of 2½% seems likely, whereas in eastern Germany the rate might come to between 8% and 10%. With respect to conditions in the labour market, this implies an increase in employment and a faster decrease in unemployment. Even so, the situation still gives cause for concern.

March 31, 1995

The Bundestag approves the 1995 Federal budget. On balance, the deficit is reduced by DM 10 billion (to a total of DM 49½ billion) compared with the Federal Cabinet's original draft; this owes something not only to additional revenue totalling just over DM 3 billion, but also to cuts of DM 6½ billion in the expenditure appropriations.

Long-term problems for the future

The financial burdens deriving from German unification will have to be shouldered by the public authorities for a long time to come. In addition, the major changes in the population structure foreseeable in the decades ahead are casting their shadows before. It is important to forestall as early as possible the danger of social security benefits overtaxing the nation's financial capacity. In addition, civil service pensions threaten to become a heavy burden, particularly on the Länder Government budgets. The reform measures already adopted will have to be followed by further steps. Ultimately, it will probably be indispensable in future to grant higher priority to private pension schemes.

5. Monetary policy marked by progress on inflation and uncertainties in the financial sector

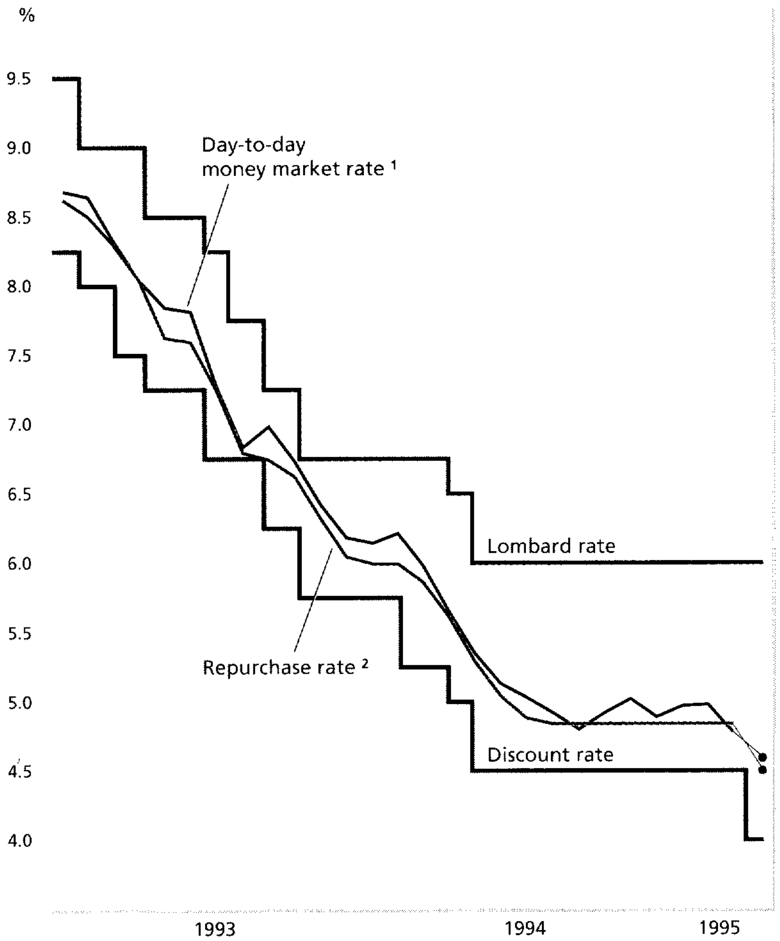
(a) Interest rate policy geared to lowering interest rates until the spring of 1994; thereafter, until March 1995, to steadying interest rate movements

Interest rate cuts in the spring of 1994

Last year the Bundesbank's monetary policy continued to be geared to the objectives of further reducing domestic inflation and, at the same time, maintaining the monetary conditions permitting sustained economic growth. The Bank pursued these objectives against the background of growing signs of progress on inflation, accompanied by developments in the financial sector which called for caution. On the one hand, inflationary pressures were easing distinctly, and the outlook for stability brightened. On the other hand, monetary expansion accelerated considerably around the turn of 1993-4 owing to special factors. In the ensuing period, this surge in liquidity resulted in a liquidity log-jam, under the impact of the global rise in interest rates and investors' consequent reluctance to lock in funds at longer term. In these exceptional circumstances, it was essential to give the financial markets clear guidance, to encourage the acquisition of longer-term financial assets by increasing the interest rate gap between short and long-term assets, and thus to contribute to dampening monetary growth and the associated fears of inflation. In the spring, when the Deutsche Mark had recovered from its temporary weakness in the exchange markets, the Bank therefore resumed its gradual interest-rate-cutting strategy, after having suspended it for several months. Between February and May the discount rate was lowered in three steps from 5 ¾ % to 4 ½ %, and the lombard rate was reduced from 6 ¾ % to 6 %. Moreover, at the beginning of March last year the Bundesbank switched from fixed-rate to variable-rate tenders, whose allocation rates declined successively. These Bundesbank moves implied no new interest rate policy strategy,

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 20, 1995.

Deutsche Bundesbank

in particular no neglect of the strategy of potential-oriented monetary targeting, but were rather the appropriate response to a specific situation in the financial markets which was marked by special factors.

Steadying of interest rate movements in the second half of the year

After the slightly more pronounced interest rate cut in May had cleared the horizon as far as the discount and lombard rates were concerned, the Bank sought to steady and stabilise money market rates. It restrained the fall in the rate applied to the weekly securities repurchase agreements (which initially continued to be offered in the form of variable-rate tenders), whose marginal allotment rate went down to slightly below 5 % in mid-July. At the end of July 1994 the Bank switched from variable-rate tenders to fixed-rate tenders, at a rate which remained unchanged (at 4.85 %) until the end of March 1995. At the same time, the Central Bank Council announced, immediately after each meeting, the terms of the securities repurchase agreements to be concluded until its next meeting. By this steady-as-she-goes approach, the Bank intended to exercise a steadying influence on market perceptions and prices in the bond market in the light of the volatility of the financial markets, and in particular to prevent its actions from having undesirable signal effects. In the prevailing monetary policy setting, which for a long time was marked by uncertainty, a change-over to variable-rate tenders, which in principle are considered preferable, would have involved the risk of even minor interest rate fluctuations which are unavoidable, and in the final analysis irrelevant to monetary policy, being interpreted as indicating a relaxation or tightening of monetary policy.

Dissolution of the liquidity blockage

Besides the rise in long-term yields, the Bundesbank's interest rate policy stance was a crucial factor in facilitating the dissolution of the liquidity blockage in the financial markets and the return of monetary growth to the target corridor by the end of 1994. Another factor arguing in favour of a steady-as-she-goes interest rate policy was that the level of short-term interest rates reached in the summer seemed consistent with overall economic conditions. On the one hand, the upward pressure on raw material and industrial product prices increased in the further course of the year, many enterprises were approaching their capacity limits as the economic recovery progressed, and, despite the normalisation of monetary growth, liquidity in the economy initially remained ample. On the other hand, inflationary pressure at the consumer level eased, labour unit costs declined, and the Deutsche Mark strengthened.

Interest rate cuts at the end of March 1995

At the beginning of 1995 the monetary policy setting changed. The money stock M3 dropped distinctly against the level in the autumn of 1994, and fell below both the target range adopted for 1995 and that for 1994, if the latter is imagined to extend into the beginning of 1995. The sluggish trend of monetary expansion reversed the ballooning of the money stock which had been caused by special factors around the turn of 1993-4, and the liquidity overhangs that had accumulated in the past disappeared. Monetary conditions in Germany also changed under the influence of the strong external value of the Deutsche Mark. The appreciation of the Deutsche Mark was expected to restrain further monetary growth. Moreover, it provided a considerable counterweight to the domestic cost increases and the rise in the world market prices of the raw materials and industrial products imported by Germany. Against this backdrop, the Bundesbank lowered the discount rate from 4 ½ % to 4 % at the end of March. It also reduced the fixed-rate-tender rate for securities repurchase agreements in the first week of April from 4.85 % to 4.50 %. Thereafter, it switched to variable-rate tenders, which, in principle, are considered preferable, for securities repurchase transactions. The interest rate cuts, which seemed advisable in the light of the monetary targeting strategy and monetary developments, and which were buttressed by exchange rate trends, did not signify the "all-clear" on the inflation front. On the contrary, the Bundesbank made it plain that, especially in the light of the latest wage settlements and the resultant price risks, it will not be deflected from its counter-inflationary policy stance.

German interest rates low by international standards

While the Bundesbank left the central bank rates unchanged between the summer of 1994 and the spring of 1995, and then lowered them again, a number of other central banks – including those in the United States, the United Kingdom, Italy, Spain and Sweden – have since raised their interest rates appreciably, partly to avert home-grown inflationary dangers, partly to counteract a depreciation of their own currencies. Thanks to the progress made on inflation in Germany, the Bundesbank was able to dissociate itself from this trend. Overall, Germany's money market rates are now at the lower edge of the international interest rate range. The same applies to capital market rates, even though these went up rapidly last year – in contrast to the movement of interest rates in the German money market – under the impact of the global rise in interest rates. Against the background of the growing globalisation of the financial markets, Germany was unable to disengage itself from the international interest rate trend, it is true, but, given the credible anti-inflationary thrust of monetary policy, interest rates in Germany rose less than in most other countries. As always, comparatively low market rates must be "earned" by a consistent policy stance which successfully seeks to ensure monetary stability and sound public finance. On the other hand, an aggressive interest-rate-cutting strategy on the part of the central bank, aimed at detaching capital market rates more strongly from the international interest rate trend, would have been doomed to failure. It would have risked causing mistrust in the future movement of the domestic and external value of the currency, and in the final analysis would probably have led to higher, rather than lower, capital market rates.

Money market management under changed underlying conditions . . .

The framework for ongoing money market management changed in several respects last year. In connection with the move to the second stage of European economic and monetary union, the central and regional public cash offices'

. . . abolition of public authorities' deposit requirement . . .

obligation to deposit their liquid funds with the Bundesbank was abolished de facto in January 1994 – i. e. by granting or increasing what were known as blanket quotas for investment elsewhere – and de jure, too, in July.[1] This terminated the traditional pattern of central bank balances in the course of a month, which was characterised by a large measure of advance compliance with the minimum reserve requirements in the first half of the month, and to which the Bundesbank's ongoing provision of funds during a reserve period has hitherto been geared. Forthwith, inflows and outflows of public funds were no longer reflected in major variations in the banks' central bank balances, but cancelled out in the money market, so that central bank balances fluctuated more closely around the level of the net reserve requirement. The minimum reserve cut of March 1, 1994, which reduced net reserve requirements by about DM 19 billion, operated in the same direction.[2] They continue to exceed the working balances held voluntarily by the banks at the Bundesbank. But since then, credit institutions have been trying to manage their central bank balances in such a way that they closely and as smoothly as possible follow the level of the current (net) required reserves over the greater part of the reserve period and avoid maintaining excess reserves in the initial weeks of each month. They ensure compliance with the reserve requirements primarily by means of end-of-month cash management operations. The Bank takes due account of this pattern of behaviour by offsetting the fluctuations in market factors which determine liquidity in the course of the month as timely as possible by gauging the amount of repurchase transactions accordingly. Even so, since March 1994 most credit institutions have been drawing to a greater extent on lombard loans from the Bank at the end of each month as part of their compliance with the minimum reserve requirements, which now tends to be more tail-heavy, i. e. focused on the end of the month.

. . . minimum reserve reduction . . .

. . . same-day processing of payments on pension payment dates . . .

Until September 1994 the lombard facility was also regularly used fairly heavily on pension payment dates (i. e. the dates of the processing of pension payments). On such dates the Postbank used to hold in its Bundesbank account the pensions remitted to it for onward transmission, thereby satisfying a major part of its minimum reserve requirements. To offset the associated drain on liquidity and prevent the central bank balances from falling below the level of the working balances, the other credit institutions used to resort to heavy lombard borrow-

1 See Deutsche Bundesbank, The second stage of European economic and monetary union, Monthly Report, January 1994, page 23 ff.

2 See Deutsche Bundesbank, The restructuring and lowering of the minimum reserves, Monthly Report, February 1994, page 13 ff.

Monetary developments

Table 9

Changes during year[1]

Item	1991	1992	1993	1994
	DM billion			
I. Central bank money requirements of banks and liquidity policy measures of the Bundesbank[2]				
1. Provision (+) or absorption (–) of central bank balances by:				
Changes in central bank money[3] (increase: –)	– 20.2	– 38.7	– 21.5	– 15.0
Foreign exchange movements (excluding foreign exchange swaps)	+ 1.1	+ 63.6	– 16.6	+ 6.3
Changes in domestic non-banks' net balances with the Bundesbank (including shifts of Federal balances under section 17 of the Bundesbank Act[4])	+ 9.2	+ 15.5	– 9.2	+ 6.4
Other factors	– 18.4	– 23.8	– 18.9	– 28.8
Total 1	– 28.4	+ 16.6	– 66.2	– 31.1
2. Lasting provision (+) or absorption (–) of funds:				
Change in minimum reserve ratios[5]	– 0.1	– 0.9	+ 32.6	+ 29.5
Change in refinancing facilities	– 7.6	– 15.5	+ 0.1	– 0.1
Recourse to unused refinancing facilities (reduction: +)	– 2.0	+ 2.0	– 4.2	+ 2.7
Open market operations in liquidity paper and in the bond market	+ 1.5	+ 3.3	– 26.5	+ 11.9
Transfer of the Bundesbank's profit to the Federal Government	+ 8.3	+ 14.5	+ 13.1	+ 18.3
Total 2	+ 0.1	+ 3.4	+ 15.0	+ 62.2
3. Change in the banks' short-term liquidity gap (total 1 plus 2, increase: –)	– 28.3	+ 20.0	– 51.2	+ 31.1
4. Meeting of remaining deficit (+) or absorption of surplus (–) by:				
Securities repurchase transactions	+ 29.8	– 16.0	+ 46.6	– 27.2
Very short-term assistance measures by the Bundesbank[6]	+ 0.8	– 2.6	+ 3.6	– 3.2
Changes in lombard loans (increase: +)	– 2.3	– 1.4	+ 1.1	– 0.7
	%			
II. Key monetary indicators				
Money stock M3[7]	+ 6.2	+ 8.5	+ 8.8	+ 3.9
Money stock M3 extended[8]	+ 7.1	+ 9.9	+ 11.9	+ 4.2
Lending by the banking system to domestic non-banks	+ 9.9	+ 9.4	+ 9.5	+ 8.3
	DM billion			
III. The money stock and its counterparts				
Money stock M3 (= 1 plus 2 less 3 less 4 less 5)	+ 95.7	+117.1	+186.2	+ 31.9
Counterparts in the balance sheet:				
1. Volume of credit[9]	+286.1	+299.9	+333.9	+318.9
of which				
Lending by credit institutions to domestic non-banks	+286.0	+294.3	+339.8	+320.5
– to enterprises and individuals[10]	+259.3	+247.9	+242.3	+256.1
– to public authorities	+ 26.7	+ 46.4	+ 97.5	+ 64.4
2. Net external assets[11]	– 7.4	– 40.7	– 6.7	–141.2
3. Monetary capital formation	+154.4	+101.5	+ 96.5	+166.8
of which				
Savings deposits at over three months' notice and bank savings bonds	+ 10.3	+ 12.3	+ 9.0	+ 1.5
Time deposits for four years and more	+ 32.1	+ 26.3	+ 32.9	+ 62.1
Bank debt securities outstanding[12]	+ 92.1	+ 41.0	+ 31.1	+ 73.5
4. Federal Government deposits in the banking system[13]	– 6.4	– 12.3	+ 13.1	– 10.0
5. Other factors	+ 35.1	+ 52.9	+ 31.4	– 11.1

1 Unless otherwise indicated, based on end-of-month figures. — **2** Based on daily averages of the last month of the period. — **3** Currency in circulation 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. — **4** Under section 17 of the Bundesbank Act as amended up to July 15, 1994. — **5** Including changes in minimum reserves due to the growth of reserve-carrying foreign liabilities. — **6** 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). — **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** Credit institutions and the Bundesbank; including lending against securities. — **10** Including housing loans. — **11** Credit institutions and the Bundesbank. — **12** Excluding banks' portfolios. — **13** Until December 1993 central bank deposits of domestic public authorities.

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ing. Since September 1994 the Postbank has been processing pension payments on a same-day basis on the pension payment dates; since then, the gridlock situations in the day-to-day money market which used to be caused by technical factors on those dates have not recurred.

. . . float reduction due to GSE procedure

The large-value cheque collection procedure (GSE procedure) that has been introduced in stages since the beginning of November likewise tends to contribute to steadying money market trends. The GSE procedure reduced the time needed for the collection of the proceeds of cheques under the supraregional collection procedure from two days to one day. Since then, the credits and debits have been posted on the same day, and the non-interest-bearing float in favour of credit institutions has largely been eliminated. In particular, it has proved possible to flatten float peaks, and to reduce the number of short-term float-induced outliers in the movement of credit institutions' central bank balances.

Distinct fall in needs of funds

Credit institutions' funding needs dropped considerably last year (see also the table on page 73). The abolition of the public authorities' deposit requirement generated inflows of funds to banks amounting to over DM 6 billion during 1994. It also resulted in the Federal Government immediately (on April 14, 1994) injecting all of its DM 18.3 billion share in the Bundesbank's profit, as transferred to it, into the money market, so that – in contrast to the situation in previous years – the full amount of profit transferred was instantly added to liquidity. The minimum reserve reduction in March 1994 increased bank liquidity – as mentioned above – by around DM 19 billion (net) more. Together with the minimum reserve cut in March 1993, the Bundesbank's moves released about DM 52 billion of funds; this release was likewise accompanied by considerable cost relief to banks. Finally, major inflows of liquidity to credit institutions resulted from the discontinuance of the revolving auctions (which had been introduced in the spring of 1993) of Bundesbank liquidity discount paper ("Bulis"). In March 1995 the last Bulis (of which a total of about DM 25 billion had been issued) matured. The main reason for the discontinuance of the Buli auctions was that this form of open market policy had failed to enable the Bank to influence domestic non-banks' cash-holding; in fact, Bulis were bought primarily by non-residents. Moreover, the Bundesbank did not wish to provide the money market funds newly authorised since August 1, 1994 with investment outlets; on the contrary, in principle it upholds its objections to money market funds and the advance of short-term financial instruments. The highly expansionary factors described above were accompanied by a much slower increase in credit institutions' central bank money requirements. The Bank therefore sharply reduced the total amount of securities repurchase agreements outstanding. Nevertheless, securities repurchase transactions remained by far the most important source of funds for credit institutions; they now account for about 70 % of the total amount of funds raised. Short-term fine-tuning operations were employed only on very rare occasions last year.

(b) Monetary target for 1994 met after all at the end of the year

1994 monetary target

In 1994 the Bank continued its policy, which it has been pursuing since 1975, of announcing monetary targets. According to the target set in December 1993, the money stock M3 was to grow by 4 % to 6 % between the fourth quarter of 1993 and the fourth quarter of 1994. The fact that the Bundesbank – unlike other major central banks – has been able to adhere to its monetary targeting strategy for the past 20 years is due to the continuity of the institutional framework and the longer-term stability of financial relationships in Germany. Following German reunification, it is true, monetary growth was temporarily distorted by various disruptive factors, some of which remained operative for some time. They included macro-economic shocks caused by unification – in output, prices, public finance and the current account – as well as the monetary crises in the European Monetary System, the yield curve (which was inverse for a long time) and the introduction of the withholding tax on interest income. As these factors hampered the implementation of a strategy of monetary targeting, there was a marked overshooting of the monetary target in 1992 and a slight overshooting in 1993. However, the progressive integration of the east German economy, the diminishing domestic risks to stability and the greater calm in the EMS warranted the hope that these problems would increasingly recede into the background, and that monetary targeting might move into calmer waters again in 1994.

Strong monetary growth in early 1994

However, at first these hopes were not fulfilled. At the beginning of 1994 actual monetary growth was much stronger than would have been consistent with the target. A prime reason for this was that some changes to major tax legislation were made at the end of 1993. The extension of the withholding tax on interest income to include income realised in Germany from foreign growth investment funds prompted the repatriation of funds on a considerable scale to domestic liquid bank accounts. At the same time, demand for housing loans soared, as the tax concessions granted on the acquisition of owner-occupied old buildings were reduced. The associated surge in liquidity developed into a liquidity blockage in the ensuing period, since the propensity to invest funds at long term decreased perceptibly in view of the global rise in interest rates and the greater volatility evident in the financial markets.

Reversal in the course of the year

After the strong "overshooting" at the beginning of the year, a reversal in monetary growth started in the late spring, accelerated noticeably towards the end of 1994 and persisted well into 1995. Initially, this was attributable to the resumption of monetary capital formation, which owed a great deal to the Bundesbank's interest-rate-cutting strategy in the spring, which widened the interest rate gap between long and short-term assets and thus helped to overcome investors' wait-and-see attitude. The rise in capital market rates operated in the same direction; particularly in the second half of the year, when capital market rates settled down at around 7 ½ %, the propensity to buy longer-term financial assets increased sharply. During that period – above all, towards the end of the year – monetary growth was also curbed by domestic non-banks' purchases of money market fund certificates, which are not included in the money stock M3.

Attainment of the target at the end of the year

Ultimately, the average level of the money stock M3 in the fourth quarter of 1994 was 5.7 % up on the level in the fourth quarter of 1993. The 1994 monetary target of 4 % to 6 %, which had been exceeded until October, was thus met. Despite the attainment of the target, liquidity in the economy remained plentiful. This was suggested not only by the persistently high level of money balances but also by the fact that some of their fall at the end of the year was ascribable to portfolio switching out of time deposits into money market funds. Although most of these investments are likely to constitute capital-market-related financial assets, they may also be held as a liquidity reserve that can be mobilised at any time.

Normalisation of the trend of the money stock components, too

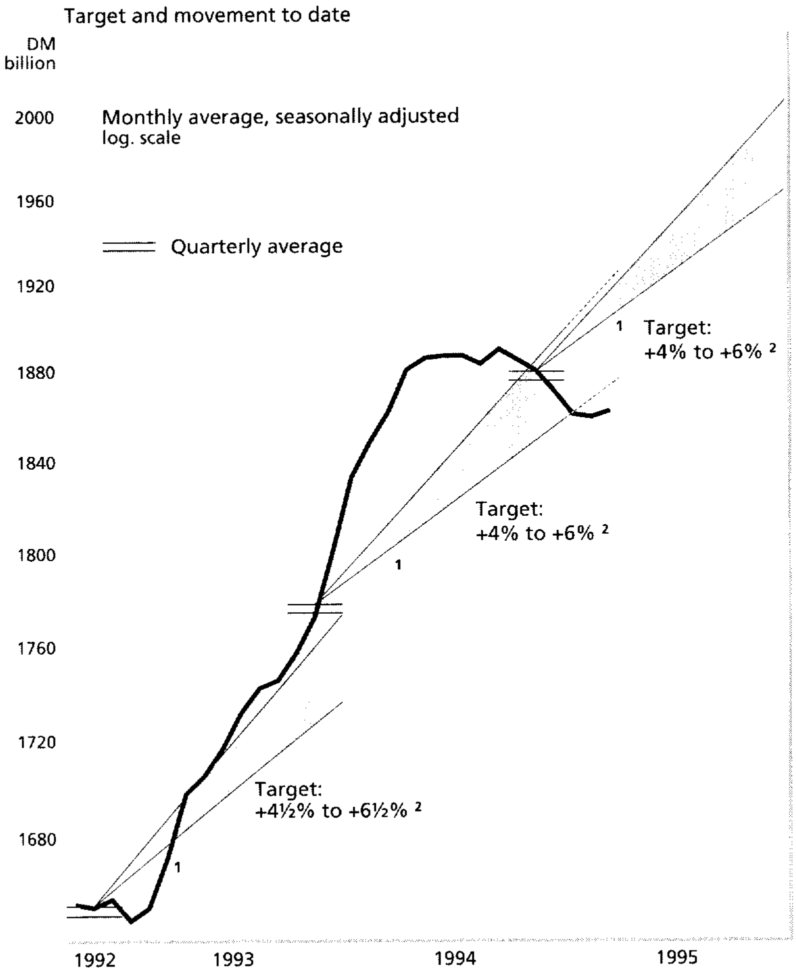
The trend towards a gradual normalisation of money-holding is underlined by the movement of the individual money stock components. The slowdown in monetary expansion was mainly caused by the reduction in time deposits which started in the spring, and which is typical of a transition to a positive slope of the yield curve. By contrast, the other components of the money stock M3 grew fairly vigorously. This, too, is in line with the experience gained in comparable interest rate periods in the past. The sharpest growth in 1994 was seen in savings deposits at three months' notice. During the period of rising money market rates, their significance had decreased. With the fall in time deposit rates and credit institutions' increased range of new, more attractive special savings facilities, demand for such deposits has been gathering fresh momentum since 1993, and has persisted during the past year, too.

Potential-oriented monetary targeting strategy not called into question

The lapsing of the special factors and attainment of the target confirmed that the Bundesbank can continue to rely on stable underlying relationships existing between the money stock, interest rates and prices. Bundesbank studies and the

Growth of the money stock M3 *

Chart 12



* 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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majority of external studies have shown that long-term monetary relationships, which are crucial to any potential-oriented strategy of monetary targeting, remained in place even after German unification. This does not rule out the possibility of shorter-term disruptions – in the future, too. Moreover, the distortions in monetary growth at the beginning of 1994 were due to clearly identifiable factors which were beyond the Bundesbank's control. On the occasion of the regular review of the monetary target at mid-year, the Central Bank Council therefore decided to abide by the target corridor set at the end of 1993, and to continue to use the money stock M3 as its key benchmark variable. This decision was underpinned by the fact that the Bank does not see any superior alternatives to monetary targeting. Other control procedures – such as direct inflation targeting – are, rather, second-best solutions if, as a result of fundamental structural changes in the financial markets, a stable relationship between the money stock and prices no longer obtains.

Newly defined M3 extended

On the other hand, the Bundesbank is well aware that the distinguishing power of the definition of the "relevant" money stock has decreased of late. Such definitional problems are nothing new, however. In the past, they were encountered in the context of Euro-deposits and short-term bank debt securities in the hands of non-banks, which the Bank has been including for a long time in the money stock M3 extended. Last year, the advance of the special savings facilities covered by M3, which in some respects are more closely related to long-term financial investments than are the old savings deposits at statutory notice, likewise contributed to blurring the demarcation line. Above all, however, from August onwards money market funds (whose monetary nature is likewise doubtful) were authorised. In terms of their degree of liquidity, they are certainly comparable to bank deposits, which are included in M3. In actual fact, however, a major part of them is likely to constitute interest-sensitive financial assets, which are not direct near-payment media, at least not primarily. Because of this "dual character" of money market funds, the Bundesbank does not include them in the intermediate target variable M3, but rather in the extended money stock M3. The latter thus now comprises, besides the money stock M3, German non-banks' deposits abroad and short-dated bank debt securities, as well as their certificates of domestic and foreign money market funds. This solution has the advantage that it does not additionally include capital-market-related financial assets in the money stock M3, and thus keeps it more informative. Moreover, this monetary aggregate can be controlled more effectively by interest rate policy measures than can a broader aggregate which would also include short-term financial instruments associated with M3 that carry market-related rates of interest. On the other hand, there is no denying the fact that, following the authorisation of money market funds, the uncertainties surrounding the assessment of monetary conditions have increased. The Bank will therefore in future attach greater importance to the extended money stock M3. Between August and December 1994 domestic non-banks bought DM 46 billion of money market fund certificates; DM 27 billion thereof was purchased in December alone, which evidently owed much to the fact that the property tax payable on investment fund certificates was lower than that payable on financial assets held direct. Between the end of 1993 and the end of 1994, M3 extended grew at about the same rate as M3 (just over 4 %). One reason for this was that purchases of money market fund certificates were accompanied by a decline in domestic non-banks' Euro-deposits.

1995 monetary target

In the light of the correction of monetary growth in the course of 1994 and the findings of empirical studies, which suggest that a strategy of monetary targeting is still vindicated in Germany, the Bundesbank set and announced a monetary target for 1995, too. It provides for the money stock M3 increasing by 4 % to 6 % between the fourth quarter of 1994 and the fourth quarter of 1995. This target is based, firstly, on an all-German production potential growth of 2 ¾ %, a normative medium-term inflation rate not exceeding 2 % and an increment of 1 percentage point to allow for the falling trend in the velocity of circulation of money. Secondly, when deriving the target, the rapid average pace of monetary growth in 1994 was also taken into account and a corresponding deduction made from the average target (of 5 ¾ %) derived from the macro-economic benchmarks. The fact that the four-quarter growth target will nonetheless not be lower than that for 1994 is attributable to the circumstance that, at the end of the year, the money stock M3 was actually below its average level during the year. This leaves scope for higher four-quarter growth. The target set implies a complete dissolution of the liquidity overhangs that had built up last year. The Central Bank Council thus set a clear counter-inflationary signal.

Target undershot at the beginning of 1995

At the beginning of 1995, the decline in the money stock M3 which was first observed in the autumn of 1994 continued. The large purchases of money market fund certificates by domestic non-banks in December played some part in this, it is true. They caused the money stock M3 to drop in December distinctly below its average level in the fourth quarter; this statistical "negative overhang" impeded the entry to the new target period. However, the underlying trend of monetary expansion also remained weak. The trend growth of both the money stock M3 and the money stock M3 extended, which includes investments in money market funds, was fairly moderate. In February, the money stock M3 was 1 % below its level in the fourth quarter of 1994. It exceeded the level of the fourth quarter of 1993 by an annualised rate of 3.7 %. Since 1995 the Bank has additionally been using the basis of the penultimate year's monetary target as a reference variable for assessing monetary growth in the first few months of a year, so as to alleviate the problems posed by switching from the old to the new monetary target base.

(c) Normalisation of the determinants of monetary growth, too, over the course of the year

Recovery of monetary capital formation makes monetary correction possible

The trend towards a normalisation of monetary growth, which was gathering pace during 1994, was also reflected in the balance sheet counterparts of the money stock, notably monetary capital formation. At the beginning of the year monetary capital formation was almost flat because non-banks preferred liquid funds, for the reasons mentioned. After a transitional period, during which it gradually picked up, funds were switched into long-term assets on a major scale towards the end of the year. Over the year as a whole, monetary capital increased by 8 % (or DM 167 billion), and thus much more rapidly than in 1992 and 1993 (around DM 100 billion each), when longer-term financial asset acquisition was adversely affected by the low level of capital market rates and tax-related special factors. The reversal in the trend of monetary capital formation was mainly attributable to domestic non-banks' purchases of bank debt securities. They amounted to almost DM 74 billion; three-fifths of this sum accrued in the second half of the year. Longer-term time deposits, which went up by DM 62 billion, and thus almost twice as fast as a year before, were one of the principal factors stimulating monetary capital formation. The amount of funds paid into longer-term savings accounts, by contrast, remained modest, and non-banks' resales of bank savings bonds continued to outweigh purchases on balance.

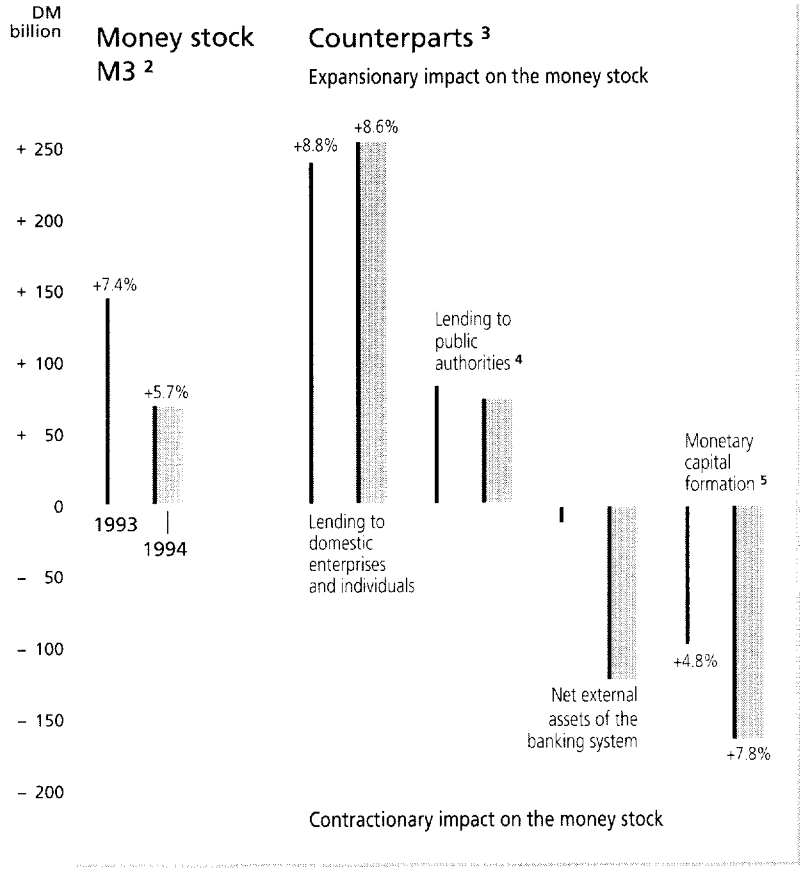
Private demand for credit remains at a relatively high level

Private demand for credit continued to impart strong stimuli to monetary expansion last year. Lending to enterprises and individuals increased by DM 256 billion; this represented a growth rate of 8 ½ %. However, credit expansion was no longer as buoyant as in the first few years following reunification, and it also slackened somewhat in the course of the year. Credit demand was once again fuelled primarily by housing construction, which received two-thirds of the direct credit. Lending to that sector expanded by 13 %. This vigorous growth owed something not only to the fact that long-term interest rates initially remained favourable, but also to the reduction or expiry of tax concessions granted on the purchase of owner-occupied housing at the end of 1993 and the end of 1994. In contrast to this, trade and industry borrowed on a minor scale only. Their debt to banks rose by no more than 3 ½ %. Experience has shown that, at the start of an upswing, enterprises are able to draw heavily on internally generated funds. But for the funds needed for reconstruction in eastern Germany, their borrowing requirements would have been even smaller. The associated credit expansion is reflected in particular in the high level of lending to the construction industry and the public utilities. East German demand for capital also had an impact on lending against

The money stock
and its principal counterparts

Chart 13

Change during year in DM billion or % 1



1 Growth rates of the money stock M3: change during 4th qtr of 1994 from 4th qtr of 1993; counterpart: change in December 1994 from December 1993. — 2 Calculated on the basis of monthly averages. — 3 Calculated on the basis of end-of-month levels. — 4 Less Federal Government deposits in the banking system. — 5 Monetary capital formation of domestic non-banks at domestic credit institutions.

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securities. Securitised credit, which was chiefly granted to Federal enterprises, including the Treuhand agency, increased by DM 48 ½ billion in 1994. Consumer credit expanded by 6 % last year. Given the depressed consumption climate, its pace of growth slackened slightly against the previous year.

Preference for long-term credit

Borrowers again showed a clear preference for long-term financing last year. Especially at the beginning of 1994, they sought to secure for themselves at long term the current lending rates, which were still relatively favourable. They were therefore intent on taking up loans at interest rates locked in for fairly long periods, and they consolidated some of their short-term debt. Given the ever-steeper slope of the yield curve, the stabilisation of capital market yields at the level of their long-term average, and trade and industry's rising needs of working funds in the light of the economic upswing, the demand for short-term credit, too, increased as the year progressed. Over the year as a whole, however, the latter grew much less (at 1 ½ %) than longer-term direct advances (8 ½ %).

Public sector credit demand moderates

Public sector demand for credit slackened perceptibly last year as a result of the declining budget deficits. Public sector bank debt rose by DM 64 billion, or 7 ½ %, in 1994. If the public enterprises railways, post office and Treuhand agency are included, public sector bank liabilities mounted by DM 92 billion, or 9 %. To some extent this does not reflect genuine new borrowing, but rather a shift from external credit to domestic borrowing. On the other hand, it must be borne in mind that in 1994 the Federal Government ran down its bank deposits, which are not counted towards the money stock, by DM 10 billion, and thereby also contributed to monetary growth.

Heavy outflows of funds generated by external payments

Domestic non-banks' external payments generated exceptionally heavy outflows of funds last year. The net external assets of the banking system, a fall in which reflects such outflows, dropped by DM 141 billion. One reason for this was the higher current account deficit. Large exports of capital also played a part. In the first half of the year, under the impact of the steep rise in dollar interest rates and the exhaustion of the upside potential in the Deutsche Mark bond markets, non-residents sold debt securities on a major scale, in particular public debt securities, which – given non-banks' reluctance to buy bonds at the time – were mostly taken up by credit institutions. Towards the end of the year it was primarily heavy purchases of money market fund certificates that led to outflows of funds abroad. To some extent, domestic investors bought certificates of foreign funds direct; to some extent domestic funds invested the funds accruing to them in the Euro-market. The outflows of funds abroad had only a limited impact on domestic monetary growth as their balance sheet counterparts also included – as mentioned above – an increase in lending to the public and private sectors.

6. Financial markets under the impact of the global interest rate increase

(a) Capital market rates in the international setting

Steep interest rate increase in the German debt securities market

German capital market yields increased steeply in 1994 in the course of the global upsurge in interest rates. The yield on domestic debt securities outstanding, which had fallen to 5 ½ % by the beginning of 1994 (thus nearly regaining its all-time low), increased to just over 7 ½ % at the beginning of October, with some marked fluctuations. Thereafter, capital market rates mostly oscillated within a range of 7 ¼ % to 7 ½ %, thus running at approximately their long-term average level. At the beginning of 1995 a decline in yields began, and continued even after the Bundesbank's interest rate reduction at the end of March; in mid-April 1995 domestic debt securities were yielding just over 6 ¾ %, thus once again running at the level of August 1994.

Normalisation of the interest rate pattern

Last year's interest rate increase emanated from the United States. There, sustained buoyant economic growth and the associated inflationary risks prompted the US central bank to raise money market rates in stages from the beginning of February onwards. The markets responded by fundamentally reassessing the outlook for interest rates and inflation, and that led overall to a pronounced increase in capital market rates world-wide. The global rise in demand for capital owing to the high level of business activity gave an additional boost to the international upsurge in interest rates, in conjunction with high public sector deficits, which were actually increasing in many countries. The yield curve in Germany, which had been flat at the beginning of 1994, fanned out noticeably in the course of the first half of the year on account of the interest rate increase at the long end of the market, which was accompanied by falling Deutsche Mark money market rates until the middle of the year. From mid-1994 to the spring of 1995, the yield gap between ten-year and one-year listed Federal securities was approximately 2 percentage points; in mid-April 1995 it was just under 2 ½ percentage points. Such yield curves are rather typical of periods when economic activity is picking up and monetary policy being eased.

German capital market in the international setting

The steep rise in capital market rates last year showed how highly interdependent the financial markets have now become. Against this background, the German debt securities market has up to now been able to detach itself only temporarily from international interest rate movements, in spite of the strength of the Deutsche Mark and the brightening of the domestic price situation. All in all, however, yields in Germany, as mentioned before, rose less than in many other countries with a less pronounced "stability culture" and less fiscal discipline. The interest rate increase was accompanied by high volatility in the capital markets, which did not abate until the autumn. For instance, between January and October 1994, in brisk trading, the yield on Federal securities outstanding changed on 22 days by more than ten basis points relative to the previous day, whereas since then this has happened only once. Periods of higher price volatility in the financial markets are not a new phenomenon, but the intensity and frequency of their occurrence are affected by the profound structural changes in the financial system which have been in progress for some time. Besides the liberalisation, globalisation and institutionalisation of the financial markets, one must mention in this context the growth of the markets for derivative financial instruments, which has been downright explosive in the past few years. Financial derivatives such as futures, options and swaps permit the cost-effective management of individual risk positions; they can be used with a strong leverage effect either for hedging or for speculative purposes. In addition, these instruments encourage trading and investment strategies which ultimately foster the integration of market segments that were previously separate, as well as fostering the cross-market diffusion of price movements. Financial derivatives basically serve to improve the price formation process, as their prices reflect the fundamentals underlying them more speedily and more reliably. However, price adjustments in individual markets may overshoot, particularly in periods of increased market uncertainty and abrupt changes in sentiment, and this overshooting may spread rapidly to other markets. In such a case, while financial derivatives are not the reason for such a development, they may accelerate and reinforce it. Owing to the financial markets' increasing dependency on expectations and their growing integration, not only interest rate trends but also short-term interest rate swings are transferred to a greater extent. The central bank has to take this into account when formulating and implementing monetary policy. The perception has gained greater acceptance at the international level, too, that monetary policy can successfully counteract the structural changes in its environment and financial markets' latent susceptibility to volatility only by means of a consistent and credible orientation towards the target of stability.[1]

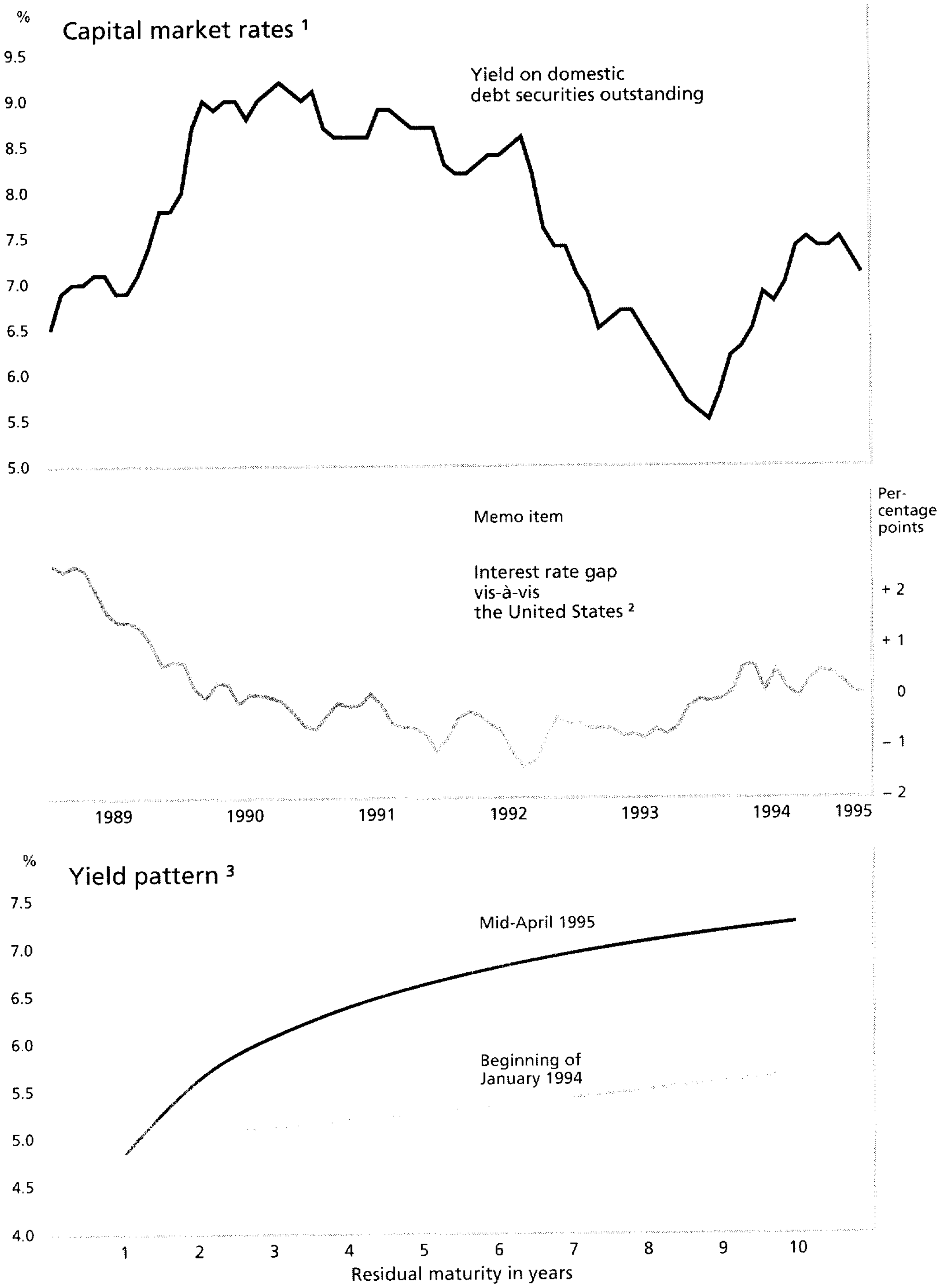
Interest rates and capital formation

Long-term capital formation and efficient capital input are major prerequisites of steady growth, accompanied by a high level of employment. Domestic savers'

1 See Bank for International Settlements, Macroeconomic and Monetary Policy Issues Raised by the Growth of Derivatives Markets, Basle, November 1994.

Interest rate movements in the debt securities market

Chart 14



1 Monthly averages. — **2** Yields on US Treasury paper with a maturity of approx. 10 years less yields on public debt securities with a residual maturity of over 9 up to and including 10 years. — **3** Regression figures for listed Federal securities.

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propensity to invest funds at longer term was noticeably enhanced by the increase in capital market rates and the waning of interest rate fluctuations from the autumn onwards. It was also fostered by the slowdown in price rises, which resulted in an increase in the long-term real rate of interest, as measured by capital market rates adjusted for current price movements at the consumer level. The increase in long-term nominal and real rates of interest (which in the meantime has been partly reversed) has not hitherto noticeably affected capital spending in the economy. Here, it is probably of some relevance that, during an upswing, the return on fixed capital also goes up, thus forming a counterweight to the higher cost of financing. In addition, owing to the higher cash flow, enterprises are less sensitive to increases in the cost of outside funds. In the eighties, when the real rate of interest long stood at over 5 %, economic growth was sustained and largely tension-free. However, a comparison with the cyclical upswing at that time also highlights how important a lasting consolidation of public finance and improvements in the supply-side situation (particularly in the form of a moderate wage rate policy) are for favourable capital market and investment conditions.

(b) Structural changes in the debt securities market

Debt securities market holds its ground with respect to overall financial flows

In spite of the interest rate increase and interest rate uncertainties, the German debt securities market was rather buoyant last year. Net sales of domestic and foreign debt securities came to DM 273 billion, with issuing activity being particularly vigorous during the second half of the year and with a high level of redemptions. This matches the volume reached at the beginning of the nineties; however, the amount raised lagged behind the record figure of 1993 by DM 114 billion.[1] In the market for foreign Deutsche Mark debt securities the amount raised, at DM 21 ½ billion (against DM 43 ½ billion in 1993), slackened rather more, in line with the subdued trends in the international financial markets; just under one-third of the securities was placed in Germany. At the same time, foreign currency debt securities totalling DM 20 ½ billion were sold in Germany in 1994. In terms of the overall financial flows, the debt securities market held its ground in 1994. At the end of last year, the ratio of bonded debt to total public sector

1 These figures do not include the allocations of debt securities by the Currency Conversion Equalisation Fund to the tune of DM 8.7 billion and DM 5.4 billion in 1993 and 1994, respectively, or the bonds totalling DM 21.3 billion arising from the conversion of loans and advances of the Postbank not evidenced by certificates to the German Federal Post Office in December 1994. These transactions did not involve direct recourse to the market. Gross sales in 1994 amounting to DM 621 ½ billion also include foreign currency issues by domestic issuers equivalent to DM 27 billion.

debt stood virtually unchanged at 53 %; at the end of the eighties the corresponding ratio had been 43 %. Among credit institutions, which by tradition are heavily involved in the financing of budget deficits and corporate capital spending by means of direct credit, the funding of lending by the issue of bank debt securities has slowly but surely increased in significance in recent years. At the end of 1994, credit institutions' liabilities evidenced by debt securities made up 20 % of their total liabilities, compared with 18 % at the end of the eighties. Since the beginning of the eighties, the ratio of debt securities to households' total financial assets has increased by 6 percentage points; at the end of 1994 it was 16 %.

Decline in amounts raised by the public sector

The public sector drew on the debt securities market to the tune of DM 128 ½ billion (net) in 1994, which is DM 93 billion less than a year before (not counting the transactions of the Currency Conversion Equalisation Fund and those of the Postbank, which do not have a direct impact on the market). Owing to the relatively favourable budgetary trend, the amount raised by the Federal Government in the debt securities market, at DM 48 billion, was only one-half as large as in 1993. The Federal Government launched four bond issues totalling DM 50 billion. For the first time since 1986, they included a 30-year issue, in the shape of the New Year's Eve issue, which was value-dated early January and increased to DM 20 billion in February 1994. Contrary to the issuer's original intentions, it has not drawn on this market segment again since. The Federal Government received DM 13 billion net from Federal savings bonds, which were launched in the form of a tap issue; the amount of special Federal bonds outstanding in the market declined by DM 7 billion in 1994. In the last year of its existence, the Treuhand agency sold own-debt instruments amounting to DM 58 ½ billion net. At the beginning of 1995 its liabilities evidenced by securities, to the extent of DM 155 ½ billion, were transferred to the Redemption Fund for Inherited Liabilities, which is serviced by the Federal budget. The other public issuers drew on the debt securities market to the total amount of DM 22 ½ billion net, including the post office, which accounted for DM 15 billion, and the Länder Governments, which took up DM 6 ½ billion.

Other bank debt securities in the forefront

Sales of bank debt securities in 1994 raised DM 117 billion net, against DM 152 billion a year earlier. As is customary in periods of economic upswing, other bank debt securities increased in significance in this context; net sales thereof, at DM 52 ½ billion, doubled compared with 1993. These flexibly deployable instruments also serve to fund short and medium-term loans to enterprises and public authorities at matching maturities. Sales of mortgage bonds, at

DM 18 ½ billion, ran at the same level as in 1993. By contrast, placements of communal bonds in 1994, at DM 54 ½ billion net, yielded less than half as much as in the previous year. The outstanding amount of debt securities issued by specialised credit institutions declined further (– DM 8 ½ billion). The main reason for this was again sizeable redemptions of securities which had been issued in connection with the restructuring of the east German banking system after monetary union.

Interest rate uncertainty encourages the issuing of floating-rate notes

Last year the issuing of Deutsche Mark floating-rate notes was stepped up; this is rather typical of periods of rising interest rates and pronounced interest rate uncertainty. Overall, such issues accounted for DM 82 billion, or 13 %, of gross sales in 1994. During the period of rising interest rates in 1990-1 this ratio had reached a similar order of magnitude. As a proportion of all securities outstanding, however, floating-rate notes, at a ratio of 8 ½ % at the end of 1994, continue to be of little importance, in contrast to the situation in many other countries. The significance of Deutsche Mark money market paper is even smaller. The amount of Deutsche Mark commercial paper outstanding, with maturities mostly running for less than one year, came to DM 13 ½ billion at the end of last year; just over one-half of this sum was accounted for by paper issued by non-residents. At the same time, securities issued by the public sector and running for less than one year amounting to DM 14 billion were in circulation. They consisted mostly of one-year Treasury discount paper and Treasury financing paper issued by the Federal Government and its special funds. Money market paper issued by credit institutions with an original maturity or maturity shortened by special agreement of up to and including one year was outstanding to the extent of DM 25 billion at the end of 1994. As a percentage of the total amount of debt securities outstanding (in which it is not included, except for banks' issues), money market paper accounted for a share of only 2 %.

Reservations about debt securities running for less than one year

Long-term financial relations are a major asset for an efficient economic system and a stability-oriented monetary policy. The greater the short-termism in the financial sector, the more planning uncertainties increase, and this tends to have an adverse effect on growth owing to failure to undertake projects which are viable in the long run or to higher hedging costs. Furthermore, there is a danger of conflicts of interest; a high percentage of interest rates locked in for short periods could seriously impede interest rate rises that are necessary in monetary policy terms as, in these circumstances, they have a direct and stronger impact on the real economy and the public sector. This is why the Bundesbank still has fundamental misgivings about the issue by the public sector of paper running for less than one year, even after the authorisation of Deutsche Mark money market funds.

Sales and purchases of debt securities

Table 10

DM billion

Period	Sales: Total	Domestic debt securities[1]: Total	of which: Bank debt securities	of which: 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	7.8
1993	395.6	382.6	151.8	230.6	13.1
1994	299.6	272.5	117.2	155.4	27.1
1994 1st qtr	67.9	61.0	27.3	34.1	6.9
2nd qtr	38.1	33.8	20.3	13.3	4.4
3rd qtr	81.1	74.2	34.3	39.9	6.8
4th qtr	112.4	103.4	35.3	68.1	9.0
	Purchases: Total	**Banks (incl. the Bundesbank)[3]**	**Non-banks[4]: Total**	**Non-banks[4]: 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	127.4	125.9	58.8
1992	291.8	133.5	38.2	46.3	120.2
1993	395.6	163.1	24.4	26.9	208.1
1994	299.6	125.3	155.8	135.0	18.6
1994 1st qtr	67.9	52.5	20.9	18.7	- 5.5
2nd qtr	38.1	28.2	32.2	28.4	- 22.3
3rd qtr	81.1	20.0	48.5	43.2	12.6
4th qtr	112.4	24.6	54.1	44.8	33.7

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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The launching of such securities involves the danger of paving the way for a general dissemination of short-term paper, thus encouraging a shift in financing structures towards shorter maturities.

Shifts of emphasis in purchases of debt securities

On the buyers' side of the German debt securities market, domestic investors dominated in 1994, contrary to the previous year. Non-banks' purchases were particularly noteworthy. Under the influence of the uncertain course of interest rate movements, they were slow to purchase debt securities during the first few months of last year. In the further course of the year, however, they increasingly converted liquid funds into debt securities, one-half of which were accounted for by bank debt securities. Overall, their purchases of domestic and foreign debt securities in 1994, at DM 156 billion, reached a record figure. During the first half of 1994, credit institutions strongly increased their bond portfolios, but they reduced their purchases during the second half of the year owing to the increased risk of write-downs. Excluding the above-mentioned allocation of debt securities of the Currency Conversion Equalisation Fund and the conversion of Postbank claims not evidenced by certificates into debt securities, their new purchases amounted to DM 98 ½ billion, against DM 154 ½ billion in 1993. At the end of 1994 banks' debt securities portfolios peaked, making up a ratio of 13 ½ % of the volume of business. Foreign investors showed varying degrees of interest in German debt securities in 1994. In the first half of the year they were on the selling side in the light of the turmoil in the global debt securities markets, in the second half they once again purchased bonds. On balance, new purchases predominated in 1994; however, at DM 18 ½ billion, they fell well short of the figures of previous years (1993: DM 208 billion, 1992: DM 120 billion).

Money market funds benefit from property taxation

Trends in the market for investment fund certificates in 1994 were determined by money market funds, which were authorised in August. One-half of the amount accruing to all German investment funds open to the general public, which came to DM 63 ½ billion, was accounted for by domestic money market funds. In December alone, they recorded an inflow of investible resources totalling DM 23 billion. This evidently owed a great deal to the preferential treatment of investment funds in the context of property tax. The 24 different money market funds in the market at the end of 1994 had at that time invested 53 % of their assets in bank deposits, two-thirds thereof in the Euro-market; 44 ½ % was accounted for by securities, just under 14 % thereof by money market paper. The foreign investment fund certificates sold in the German market in 1994 (in the amount of DM 28 billion) consisted mainly of the certificates of (Luxemburg) money market funds. The amount raised by specialised funds in 1994, at DM 45 ½ billion, matched the volume of the preceding year. The vast bulk of domestic and foreign investment fund certificates were bought by domestic non-banks. Of their new purchases, totalling an estimated DM 124 billion, DM 46 billion was attributable to money market fund certificates, most of which were presumably bought by private investors.

(c) Fluctuations in sentiment in the share market

Decline in share prices masked by sharp price fluctuations

Trends in the German share market were rather mixed in 1994. While the volume of issues reached a record level, prices declined overall, with some marked swings in sentiment. In the course of the year domestic equities lost just over 8 % of their value, as measured by the market-wide index of the Federal Statistical Office. Initially, prices dropped further in the first few months of 1995; in mid-April they were on average just over 2 % below their annual low of October 1994. After the tempestuous upward trend in share prices in 1993, as a result of globally falling capital market rates and the prospect of higher corporate profits, last year the share market was increasingly affected by the rising interest rate trend and the interest rate uncertainty in international capital markets. By contrast, improving economic conditions and the profitability of enterprises receded into the background. Share prices repeatedly reached all-time highs in the first half of 1994, but in the ensuing period the market twice moved into a period of pronounced price consolidation. The prices of banks' and insurance enterprises' shares, in particular, felt the adverse effects emanating from the debt securities market, and fell at above-average rates (approximately 18 % and 16 %, respectively) in the course of the year. Owing to the steep increase in interest rates, these enterprises, with their sizeable securities portfolios, were expected to have quite considerable write-down requirements.

Amounts raised at record levels

The volume of issues in the German share market last year, at just over DM 29 billion, reached a record level. However, this did not involve an all-round strengthening of the equity capital base of trade and industry, which would be desirable in macro-economic terms. The greater part of the amount raised was accounted for by capital increases by a limited number of large enterprises. One-half thereof accrued to financial services enterprises, which were bringing their equity capital base into line with their increased volume of business. The share issues launched by large enterprises outside the financial sector probably also owed something to the increasingly global orientation of these enterprises, as well as to the more favourable business conditions in Germany, which normally act as an incentive to expand a company's capital base. At ten, the number of new companies listed on German stock exchanges remained low.

Share purchases

On the buyers' side of the German share market, domestic non-banks dominated in 1994. They built up their portfolios of domestic equities by DM 26 ½ billion, compared with DM 8 ½ billion a year earlier. In addition, they bought foreign participatory instruments worth DM 22 ½ billion, with portfolio investments and direct investments accounting for roughly equal shares. Non-banks' indirect involvement in the share market through purchases of the certificates of share-based investment funds, at DM 10 ½ billion, was again fairly high. This form of investment affords smaller investors, in particular, access to professional portfolio management and a diversified portfolio, especially since direct purchases in the share market are often unattractive to private investors on account of the costs involved.

(d) Measures to develop Germany further as a financial centre

Second Financial Market Promotion Act

As in the previous years, a number of measures were introduced in 1994 in order to further develop the financial centre Germany. Notably the Securities Trading Act, which forms the centre-piece of the Second Financial Market Promotion Act, and the reform of trading supervision and surveillance are likely to contribute to enhancing Germany's international competitiveness and attractiveness as a financial centre. By reforming the supervision of securities trading and setting up the Federal Supervisory Office For Securities Trading, the legislature has given due consideration to the great importance of efficient and effective supervision for the international reputation of the financial centre Germany. Paving the way for preventing insider trading and for the criminal prosecution of the relevant offences is not only to be welcomed from the point of view of the foreign institutional investors who have been calling for such standards for quite a long time but also increases the protection of private savers. The enhancement of the transparency of participating interests and of the rules of conduct relating to securities services enterprises which set higher standards for the quality of portfolio counselling operate in the same direction. Lowering the minimum face value of shares from DM 50 to DM 5 and facilitating the exclusion of stock options involve the expectation that shares will be strengthened as an instrument of asset acquisition and corporate financing.

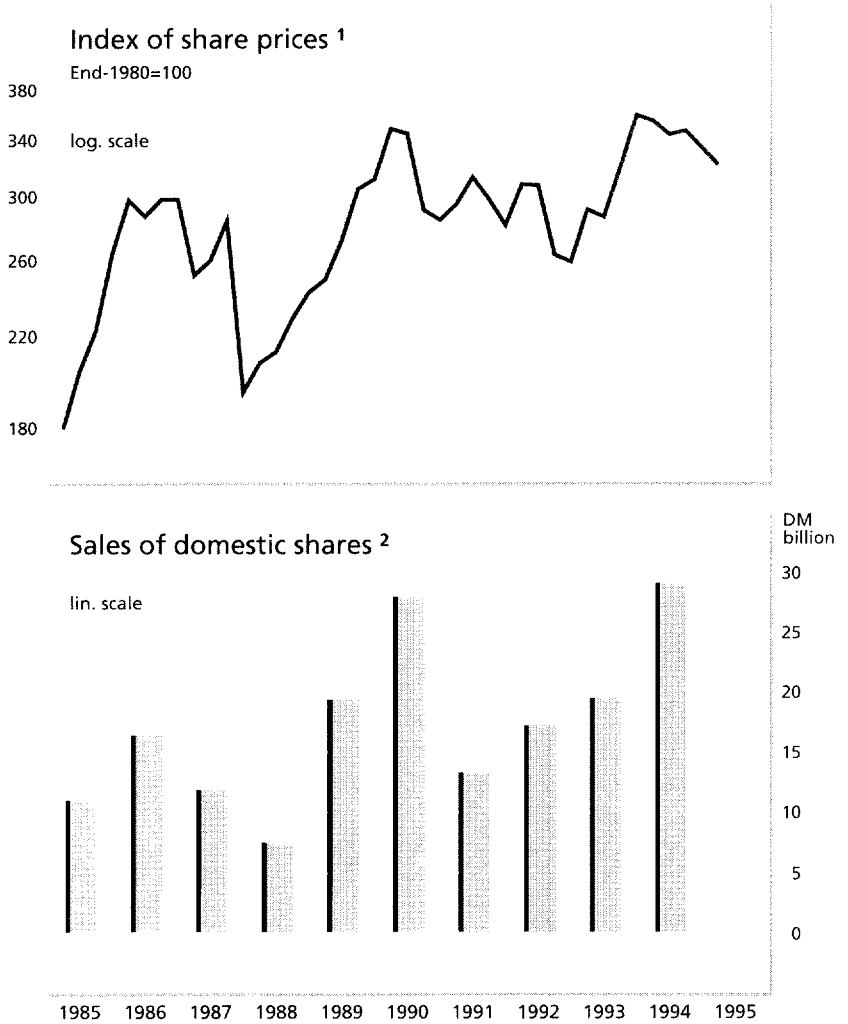
(e) Business trends in the banking sector

Mortgage banks, savings banks and credit cooperatives benefit from credit demand

Last year credit cooperatives, savings banks and mortgage banks captured market shares in lending operations with domestic non-banks. Their lending to domestic borrowers expanded by 12.9 % (credit cooperatives) and 11.8 % (savings banks and mortgage banks), and thus significantly faster than the average growth of all banks (8.4 %). These categories of banks continued to benefit from the strong demand for credit for residential construction. Furthermore, they also provided the public sector with substantial resources. On an average, regional banks increased

Conditions in the share market

Chart 15



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

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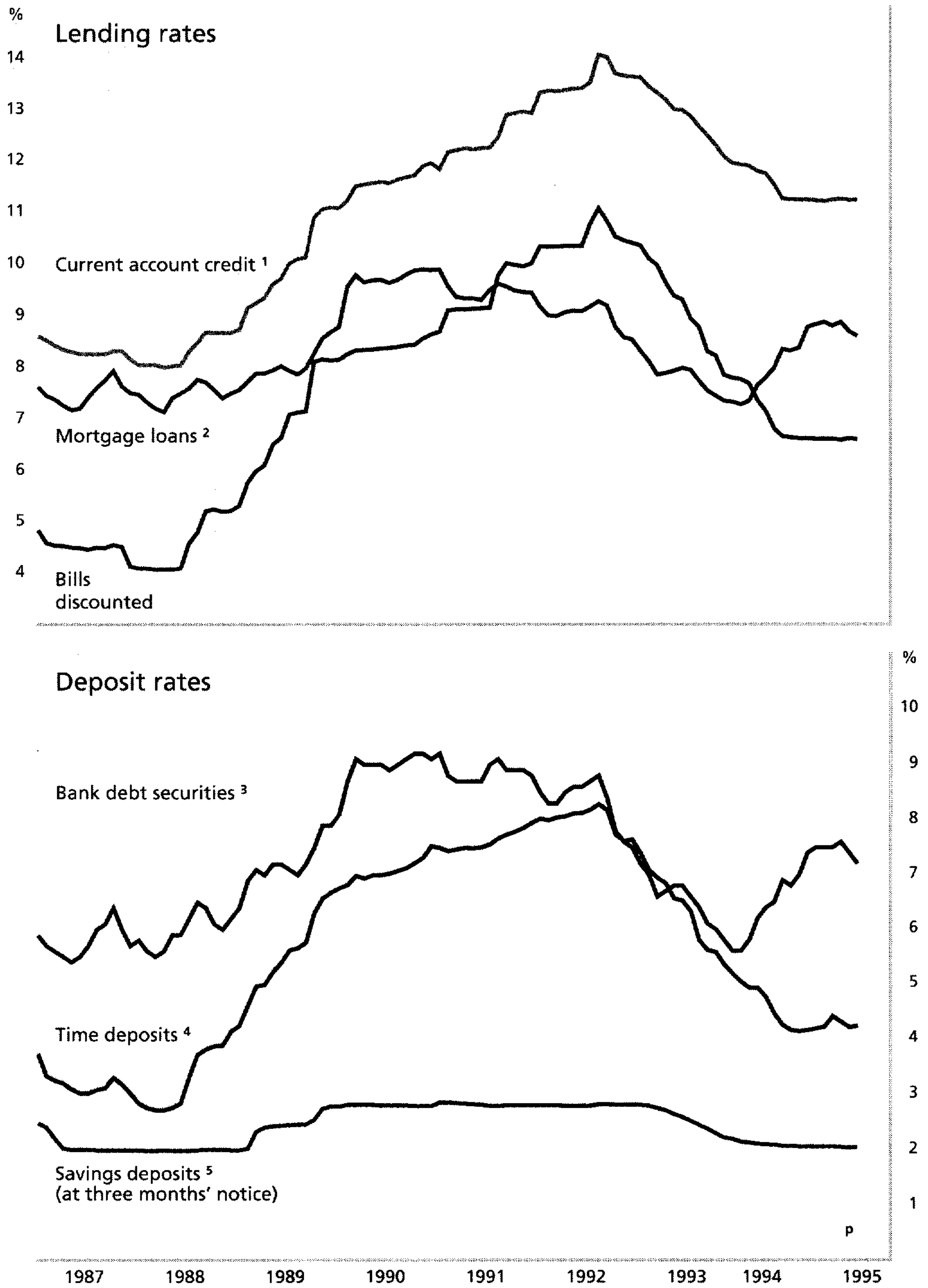
their credit volume, while it rose less among regional giro institutions (7.8 %), regional institutions of credit cooperatives (4.9 %) and big banks (3.1 %). This was mainly due to the muted trend in (short-term) lending to trade and industry. With regard to credit institutions' borrowing, the tendency towards the growth of debt evidenced by certificates, which has lasted for some time, continued. This applies above all to regional banks and mortgage banks, but also to the cooperative bank sector and to savings banks.

Movements in selected bank interest rates * Chart 16



* Since January 1991, including the rates in the new Länder. — 1 Under DM 1 million. — 2 Average effective rate for fixed-rate mortgage loans secured by residential real estate with interest locked in for 10 years. — 3 Yield on debt securities outstanding. — 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; excluding bonus-carrying savings deposits and special savings schemes.

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Likely profitability trends

According to the information available at present, the profitability of German credit institutions in the financial year 1994 was not quite as satisfactory as in 1993, at least for some categories of banks. The increase in long-term lending buttressed the net interest received, as did the earnings from term transformation, which are apparently rising; however, owing to the more unfavourable state of the domestic capital markets, we have to expect a decline in the net profit on financial operations. The fall in prices in the debt securities and share markets will probably lead to some considerable write-downs of market prices, which will be accompanied, on the other hand, in many cases by somewhat lower risk provisioning in lending business. The profitability of east German savings banks and credit cooperatives might again be characterised by an interest margin which is tending to decline (and thus to return more to normal), by relatively high administrative expenses and by sizeable, albeit gradually diminishing, counterparty risks.

III. International monetary policy cooperation

1. New tensions in the European foreign exchange markets

Renewed adjustment of central rates of peseta and escudo

Following the considerable exchange market turbulence within the EMS in 1992-3, which led to the widening of the fluctuation margins to ± 15 % in August 1993, the exchange rates between the currencies participating in the exchange rate mechanism remained fairly stable well into 1994. From December 1994, however, several partner currencies of the Deutsche Mark again came under pressure – the central rate of the worst affected currency, the Spanish peseta, was consequently devalued by 7 % within the European exchange rate mechanism at the beginning of March 1995. The latest weakening of the peseta came as something of a surprise as the Spanish currency had already been devalued three times in the course of the foreign exchange market turbulence of 1992-3, thereby depreciating by a total of 18 % against the Deutsche Mark. The Portuguese government followed suit to some extent by lowering the central rates of the escudo against the other currencies by 3.5 %. The Portuguese move was primarily a reflection of its close economic ties with Spain and of the fact that the escudo had in any case weakened in the markets. The value of the escudo had already been reduced by 12 % vis-à-vis the central rate of the Deutsche Mark. The latest adjustments mean that the cumulative realignments of the two currencies since 1992 came to 24 % and 15 %, respectively. By contrast, the currencies of the Netherlands and of Belgium remained firm despite the increased volatility in the foreign exchange markets. The Austrian schilling, too – which joined the European exchange rate mechanism at the start of 1995 – held very steady, as it has tended to do for a long time now. From August 1993 the French franc likewise kept mainly within its previous narrower fluctuation margins before its exchange rate dipped a little for a time from the end of 1994.

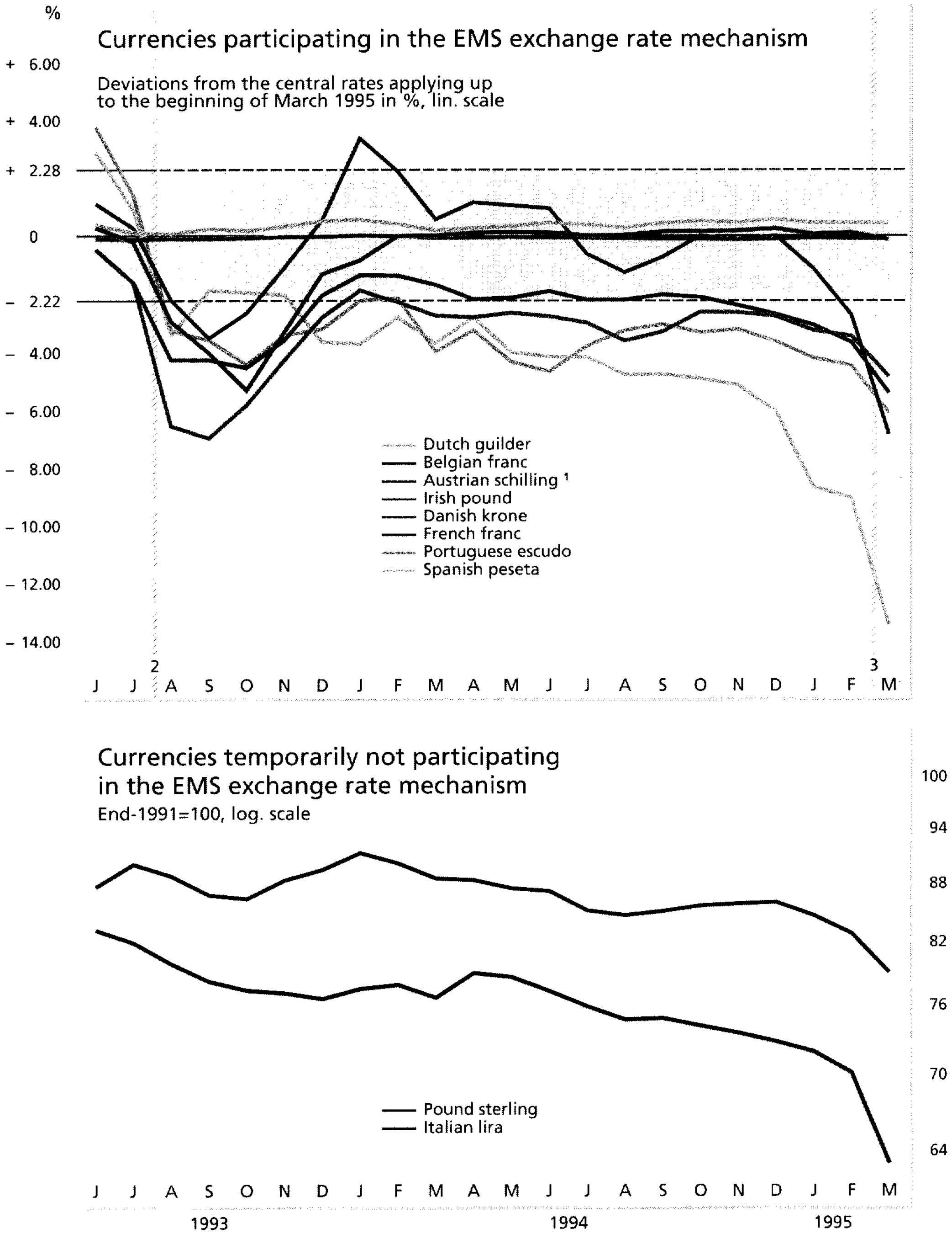
Further pronounced weakening of pound and lira

The currencies of the United Kingdom and Italy, which withdrew from the European exchange rate mechanism in 1992 when subjected to heavy downward pressure, have likewise weakened further. Although the pound was able from mid-1993 to regain some of the value it had lost in 1992, a further marked slide began at the start of 1994. By March 1995 the British currency had depreciated by 24 % on a monthly average vis-à-vis its previous central rate against the Deutsche Mark. The value of the lira, taking into account the realignment of September 1992, has declined from a corresponding perspective by no less than 38 %. These falls in value clearly exceed the level which the inflation-related decline in com-

Movements of selected EC currencies against the Deutsche Mark

Chart 17

Monthly averages



1 Joined the exchange rate mechanism at the start of 1995. — **2** Previous fluctuation margins of ± 2¼% and ± 6%, respectively, widened to a uniform ± 15%. Depiction of the narrow fluctuation margin (± 2¼%) for the period after July 1993 serves merely to facilitate assessment of exchange rate movements. — **3** Peseta and escudo devalued by 7% and 3½%, respectively, with the two currencies' central rates being largely adjusted to the market trend.

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petitiveness in previous years appears to warrant. Such substantial exchange rate changes could, in fact, bring the devaluing countries more problems than benefits in the longer run. The expected rise in import prices will hamper the fight against inflation, in particular, and possibly worsen on a lasting basis the underlying conditions for a satisfactory overall course of economic development.

Decreased interventions in the foreign exchange markets

After the fluctuation margins had been widened, the foreign exchange market interventions in the EMS declined perceptibly, as intended, especially in comparison with the very high level of interventions made during the EMS crisis of 1992 in support of the British and Italian currencies. Although further support operations were mounted during the initial period following the widening of the fluctuation margins, particularly in favour of the Belgian franc, the subsequent restoration of calm in the EMS largely obviated the need for such measures. In fact, some countries were now able gradually to repurchase a large part of the foreign currency reserves which they had deployed. Only from the beginning of 1995, when a number of partner currencies tended to weaken, was there a significant resumption of interventions in the foreign exchange markets. However, the scale of intervention was far smaller than before the widening of the fluctuation margins. Moreover, bank liquidity and the money stock in Germany were not affected as the support operations were financed without recourse to central bank lending.

Currency turmoil in Europe exacerbated by weakness of dollar

The renewed tensions between the EC currencies since December 1994 are probably due in the first instance to differences in the economic problems and prospects of the member countries. The markets' assessment of individual currencies appears to be based primarily on the extent of each country's budgetary problems and on the resoluteness with which the respective governments are seeking to deal with excessive budget deficits and the concomitant risks to growth and price stability. The stability of the underlying political conditions is evidently rated as being no less important than the degree of credibility which market participants attribute to current retrenchment efforts in the light of each country's track record in economic and monetary policy. All this would seem to imply that the Maastricht convergence criteria are increasingly being used as the gauge for evaluating currencies. The valuation differences between the European currencies have been accentuated of late by the weakness of the dollar which – apart from the yen and the Swiss franc – has been reflected primarily in the appreciation of the Deutsche Mark. The resulting additional exchange rate tensions in Europe have manifested themselves, in particular, in the initially unrelenting pressure on certain partner currencies, despite the realignment at the beginning of March 1995. In view of these developments the objective of greater cohesion between the European

Deutsche Mark interventions in the EMS *

Table 11

DM billion

Period		Compulsory	Intramarginal	Total	**Memorandum item** Effect on liquidity in Germany 1
1991	Purchases	–	6.4	6.4	–
	Sales	–	21.9	21.9	–
	Balance	–	– 15.5	– 15.5	–
1992	Purchases	–	75.1	75.1	– 51.3
	Sales	63.7	199.7	263.4	110.6
	Balance	– 63.7	– 124.6	– 188.3	59.4
1993	Purchases	–	92.0	92.0	– 63.7
	Sales r	25.1	168.0	191.1	59.8
	Balance r	– 25.1	– 74.0	– 99.1	– 4.8
1994	Purchases	–	52.6	52.6	–
	Sales	–	5.5	5.5	–
	Balance	–	47.1	47.1	–
Selected periods, net					
January 1, 1993 to July 7, 1993 r Deutsche Mark again firm within the EMS; devaluations of several partner currencies		– 0.4	22.1	21.8	– 25.0
July 8, 1993 to August 1, 1993 Further strengthening of the Deutsche Mark in the EMS, followed by widening of the fluctuation margins		– 24.7	– 82.4	– 107.0	58.6
August 2, 1993 to December 5, 1993 Initial weakening of several partner currencies gradually rectified		–	– 20.0	– 20.0	– 38.4
December 6, 1993 to December 5, 1994 Calm in the EMS		–	52.3	52.3	–
December 6, 1994 to January 9, 1995 Sustained strength of the Benelux currencies, but weakening of other currencies		–	1.9	1.9	–
January 10, 1995 to March 5, 1995 Growing tensions; devaluation of peseta and escudo		–	– 25.3	– 25.3	–
March 6, 1995 to March 31, 1995 Sustained strength of the Deutsche Mark		–	– 15.4	– 15.4	–

* Deutsche Mark interventions of other central banks participating in the exchange rate mechanism plus the EMS interventions of the Bundesbank (spot interventions); based on the transaction date. — **1** Shows to what extent Deutsche Mark interventions in the EMS plus the settlement of intervention debts influenced the Bundesbank's net external position and hence the supply of central bank money to the banks; + = expansionary liquidity effect through Deutsche Mark sales; – = contractionary liquidity effect through Deutsche Mark purchases.

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currencies, which is not least one of the basic prerequisites for the envisaged economic and monetary union, clearly requires the EC countries to redouble their efforts towards improving economic and fiscal policy stability. The substantial widening of the EMS fluctuation margins and even the floating of some currencies do not conflict with this objective. For one thing, real progress towards convergence, but critical divergences as well, can reveal themselves more clearly in a setting of significantly expanded exchange rate flexibility than in an exchange rate regime with narrow fluctuation margins. For another thing, the reduced prevalence of interventions in the foreign currency markets has lowered the risk that shortcomings of individual countries in terms of economic and monetary policy could have "knock-on effects" on other participants in the exchange rate system and hence lead to an undermining of the monetary integration process.

2. State of preparations for entry into the third stage of EMU

(a) Development of a "turn-key concept" for the ESCB

EMI entrusted with important tasks

The purpose of the second stage of economic and monetary union (EMU), which entered into force at the beginning of 1994, is to prepare extensively for entry into the final stage of EMU, which, according to the Maastricht Treaty, is scheduled for the start of 1999 at the latest. The most important institutional innovation ushered in by the second stage was the establishment of the European Monetary Institute (EMI). It replaced the Committee of EC Central Bank Governors which up to then had acted as the central monetary policy coordinating body. The Institute's brief is to help pave the way for transition to the third stage in two respects: firstly, by fostering monetary policy coordination, and, secondly, by preparing the regulatory, organisational and logistical framework which the European System of Central Banks (ESCB) will need in order to discharge its functions. Its field of responsibilities ranges from developing monetary policy instruments and harmonising the payment system to supervising the preliminary work on designing banknotes for the future single currency.

Elaboration of ESCB framework by the end of 1996

According to the EMI Statute, the technical preliminary work has to be completed by the end of 1996 so as to meet the earliest possible deadline prescribed by the Maastricht Treaty for launching EMU, namely the start of 1997. Although that early starting date is rated in many quarters as being not very realistic, the EMI is taking the ambitious deadline for its mandate very seriously. The EMI is aided in its task by the fact that it can make use of some groundwork carried out by the Committee of EC Central Bank Governors. In addition, the EMI is able to rely on smoothly functioning institutional structures in the form of subcommittees and working groups of the former Committee of EC Central Bank Governors, which have continued to meet under the EMI's aegis.

"Master plan" adopted

In order to be able to perform this preliminary work as fluently and speedily as possible, the EMI Council adopted a comprehensive working programme in November 1994. The object of this "master plan" is to coordinate and schedule these various activities and to ensure the consistency of the work. The plan is conceived at once as being a "blueprint", a "timetable" and a gauge by which the EMI Council will monitor and evaluate quarterly the progress made in the preparatory work.

Monetary targeting strategy and range of instruments under discussion

One of the EMI's important and pressing preparatory tasks is to develop a concept for the ESCB's monetary policy strategy. The Bundesbank continues to advocate the adoption of monetary targets as a medium-term benchmark. A basic orientation of monetary policy to monetary targets is, in the Bundesbank's experience, very important for winning credibility for central bank policy and so could prove a real boon to the ESCB, which must first build up its own stock of public confidence. What is more, no indisputably better alternatives are discernible. However, the question of whether it appears appropriate to use the money stock as an intermediate monetary target at the European level, too, depends ultimately on just how reliable the correspondence between monetary aggregates, overall demand and price movements actually turns out to be. The EMI Council has decided to continue the discussions on this issue in the course of 1996 in the light of the experience gathered up to that point. Preparatory work on devising the ESCB's range of monetary policy instruments likewise began some time ago. The Bundesbank is seeking to ensure that its own tried and tested set of instruments is adopted as far as possible.

Technical preparations under way

In addition to the elaboration of a monetary policy strategy and a suitable set of instruments, a single monetary policy also requires adjustments to the system of cross-border payments. The same-day transfer of funds throughout the area covered by EMU has to be ensured, at least for large-value payments, in order to safeguard an integrated money market and hence smooth liquidity management. For this reason the EMI and the Working Group on EU Payment Systems have been working for quite some time on the task, to which they have attached a high priority, of installing what is known as real-time gross settlement systems for large-value payments in all member countries and of interlinking these systems.

Other crucial preparatory work concerns the harmonisation of statistics, the creation of an internal information and communication system for the ESCB and the preparation of European banknotes and coins.

Clarification of the mode of transition to EMU of great importance

Another question now being examined is how the preparation and start of the third stage (and, subsequently, the introduction of the single currency) should be designed. The EMI Council is currently discussing alternative scenarios. They basically differ on whether the single currency (including the European banknotes and coins) should be introduced only after an ample period of preparation "in a big bang" or whether it should be introduced instead for the bulk of cashless transactions right at the beginning of the third stage and for the rest in stages. In considering these alternatives, the Bundesbank is guided primarily by the principle that laying sound technical foundations for the ESCB and the banking system, including the conversion of accounting systems, should be given priority over the desire for a rapid introduction of the single currency if the two goals should clash; for technical hitches would jeopardise the public acceptability of the single currency and the efficiency of monetary policy. Another key consideration is the desirability of achieving the maximum of transparency, predictability and legal certainty, which would probably be extremely difficult in the constantly changing setting of a gradual transition. A fact which militates not least against a gradual approach is the comparatively high conversion costs which would be incurred in the transitional phase even in the event of limited parallel use of the single currency and the national currencies.

Responsibilities of EMI and of EC Commission should not be blurred

Apart from its mandate to perform the multifarious preparatory tasks for the ESCB and its monetary policy, the EMI is given sole responsibility by the EC Treaty only in certain fields in the run-up to the final stage, such as supervising the preparation of banknotes, whereas the European Commission has the right to launch initiatives in other fields. As a result the Commission, too, is concerning itself intensively with matters relating to the transition to a single currency. In the interests of preparing the way for monetary union as efficiently as possible, it is urgently to be desired that all the parties involved cooperate closely but also respect each other's fields of responsibility.

(b) Unsatisfactory progress towards convergence

Essential convergence requirements

Among the essential prerequisites for building a stable and lasting monetary union, apart from the thorough preparation of the technical and institutional framework, is the need to meet the convergence criteria spelled out in the

Maastricht Treaty. The ceding of national monetary and exchange rate policy autonomy is acceptable for a stability-oriented country only if its fellow participants do not undermine the monetary stability of the union through their economic policies. Conversely, countries joining a monetary union without being adequately prepared would be able ultimately to tackle their economic problems only through real adjustments of prices and wages. Thus any convergence deficiencies could threaten the monetary union's stability orientation, if not its very survival.

Success in combating inflation

Most countries in the European Union have so far failed to achieve the stipulated convergence criteria. Further progress in the fight against inflation was made in 1994 – as in the previous year – mainly as a result of moderate wage settlements, marked productivity increases and, in some cases, underutilised production capacities. However, measured by the level of price stability of the best-performing country, only eight countries would have fulfilled the inflation criterion in 1994. The criterion for long-term interest rates would likewise not have been met by some countries.

Unsatisfactory trend in public finance

The convergence deficiencies in the fiscal policy field continue to be particularly serious. Although the budget deficits in many member countries declined marginally from the record levels of 1993, in general these successes were due primarily to the perceptible revival of business activity, whereas the problem of reducing the structural deficits remained largely unresolved. In many countries the intractability of the current deficits stems not least from the steep increase in public indebtedness and the resultant burden of interest imposed upon the public sector. In 1994 only two member countries would have fulfilled the Maastricht Treaty's criteria for the current budget deficit and the overall level of debt.

Problematic imprecision of convergence criteria

In the light of this overall unsatisfactory course of development, it is particularly problematic that the convergence criteria set out in the Treaty on European Union and in the pertinent Protocols display considerable imprecision and hence permit different interpretations. That applies to every single criterion. But since the criteria are not particularly demanding anyway, any attempt to water down the conditions for joining must be vigorously opposed in the interests of ensuring lasting success for the monetary union. This is all the more imperative as convergence performance will be measured largely at a single point in time, whereas lasting convergence success is needed if the monetary union is to function satisfactorily.

Reference value for inflation and interest rate criterion should be based on the best-performing country only

The Protocol on the convergence criteria stipulates that, as a condition for participating in EMU, the rate of inflation, measured by the index of consumer prices, may not exceed by more than 1.5 percentage points that of the – at most three – best-performing member states in terms of price stability. As the Bundesbank argued in its 1993 Annual Report, the inflation rate of the best-performing country alone should, if possible, be taken as the reference value. Similar considerations to those applying to the inflation criterion also apply to the convergence of long-term interest rates. The reference value stipulated in this case is the interest rates of the – at most three – best-performing countries. The significance of this criterion is that the level of capital market rates gives some indication of the credibility of each country's commitment to stability. In this way, progress in terms of the inflation criterion is subjected to a second, in part forward-looking, test.

Exchange rate stability remains an important measure of convergence

Regarding exchange rate movements the Protocol on the convergence criteria states that the "normal fluctuation margins" of the European Monetary System (EMS) must have been observed for at least the last two years before the review without the country in question having altered its currency's central rate and without severe tensions. However, following the widening of the exchange rate margins in August 1993 to a uniform ± 15 %, this criterion became open to interpretation. A country's participation in the exchange rate mechanism of the EMS, as required by the Treaty, should, however, continue to be viewed as a precondition for meeting the criterion. Nor should the importance of achieving a stable exchange rate over an extended period be called into question as this – unless produced by artificial means – provides a key pointer to the durability and credibility of the convergence process. Although the fluctuation band of ± 15 % cannot be regarded as constituting the "normal margin", it nevertheless appears expedient to refrain for the time being from explicitly defining how the term is to be interpreted and instead to defer the assessment of exchange rate movements until the time for the prescribed convergence review has come. This also accords with the approach adopted by the EMI Council. Thus while the latter, in a statement of October 1994, expressed its satisfaction about the smooth functioning of the EMS up to that date since the widening of the fluctuation margins, it emphasised at the same time that the member states should seek to avoid major exchange rate fluctuations through sound economic policies and contribute in this way to meeting the exchange rate criterion. The Council of Ministers explicitly reaffirmed this position in a public statement made by its chairman in December 1994.

Progress in convergence between the current EC members, as measured by the EMU criteria (disregarding the exchange rate criterion)

Table 12

EMU criterion fulfilled

Country	Change in consumer prices from previous year in %		Financial balance of the public sector as % of GDP 1	
	1993	1994	1993	1994
EMU threshold value 2	2.7	2.6	– 3	– 3
Austria	3.6	3.0	– 4.1	– 4.4
Belgium	2.8	2.4	– 6.6	– 5.5
Denmark	1.2	2.0	– 4.4	– 4.3
Finland	2.1	1.1	– 7.2	– 4.7
France	2.1	1.7	– 5.8	– 5.6
Germany	3 4.2	3 3.0	– 3.3	– 2.5
Greece	14.5	10.9	– 13.3	– 14.1
Ireland	1.4	2.3	– 2.5	– 2.4
Italy	4.5	4.0	– 9.5	– 9.6
Luxemburg	3.6	2.2	1.1	1.3
Netherlands	2.6	2.7	– 3.3	– 3.8
Portugal	6.5	5.3	– 7.2	– 6.2
Spain	4.6	4.8	– 7.5	– 7.0
Sweden	4.6	2.2	– 13.3	– 11.7
United Kingdom	1.6	2.4	– 7.8	– 6.3

Country	Yield on long-term public bonds in %		Gross indebtedness of the public sector as % of GDP 1	
	1993	1994	1993	1994
EMU threshold value 2	9.3	10.4	60	60
Austria	6.8	7.0	57.0	58.0
Belgium	7.2	7.8	138.9	140.1
Denmark	7.3	7.8	79.5	78.0
Finland	8.2	8.4	62.0	70.9
France	6.8	7.2	45.8	50.4
Germany	6.5	6.9	48.1	50.2
Greece	23.4	20.8	115.2	121.3
Ireland	7.8	8.1	96.1	89.0
Italy	11.3	10.6	118.6	123.7
Luxemburg	6.9	6.4	7.8	9.2
Netherlands	6.4	6.9	81.4	78.8
Portugal	12.4	10.8	66.9	70.4
Spain	10.2	10.0	59.8	63.5
Sweden	8.5	9.5	83.5	93.8
United Kingdom	7.5	8.2	48.3	50.4

Sources: European Commission, BIS, EMI and national statistics. — **1** In the definition of the national accounts (including social security funds). — **2** The rate of inflation must not exceed that of the – at most three – best-performing countries by more than 1.5 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 best-performing member country in terms of price stability (see text on page 104). Fulfilment of the criteria is measured in terms of these threshold values. — **3** Western Germany.

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Strict application of fiscal policy entry criteria required

The two fiscal policy requirements for joining the EMU are especially significant. According to the Treaty, the planned or actual government deficit of a member country in the year in which the convergence criteria are assessed may not exceed a ratio of 3 % of GDP unless the reference value is exceeded only exceptionally and temporarily or the deficit has declined substantially and continuously and has come close to the reference value. In addition, government debt may not exceed a ratio of 60 % of GDP unless the ratio is sufficiently diminishing and approaching the reference value at a rapid pace. These imprecise formulations of the Treaty leave substantial room for interpretation and assessment which is not reconcilable with the potential burdens that an unsatisfactory budgetary situation could impose on the monetary policy makers' room for manœuvre and effectiveness. Therefore both entry criteria must be applied as stringently as possible.

Tightening of ongoing budget surveillance urgently called for

To ensure that EMU is geared to stability on a lasting basis, the fiscal policy criteria are to apply not just in the second stage but also after the monetary union has been established. Compliance with the criteria will be regularly reviewed and urged as part of the budget surveillance procedure. However, this procedure will be able to exert its disciplining effect only if the reference values for the budget deficit and for government debt of 3 % and 60 % of GDP, respectively, are understood not as target figures but as absolute ceilings. Any overshooting should therefore be tolerated only in the most exceptional of circumstances. Hence it follows that, in phases of economic prosperity, the budget deficit would have to be distinctly below 3 % of GDP, for only in this way would some scope be available in the event of a subsequent cyclical downturn for the "automatic stabilisers" to take effect. In countries with accumulated debt of more than 60 % of GDP the deficit ratio should lie even further below the 3 % mark, and some countries would have to achieve substantial budget surpluses for several years running if their level of indebtedness is to come close to the 60 % ceiling in the foreseeable future. The unsatisfactory course of budget policy convergence to date gives rise to the question of how – in the second stage and, above all, in the third stage – the member countries could be urged with a sufficient degree of insistence to lastingly exercise greater fiscal policy discipline.

3. Problems and perspectives of the international monetary system

Debate on reform triggered by 50th anniversary of the Bretton Woods conference

The 50th anniversary of the Bretton Woods conference, at which the post-war monetary order with fixed exchange rates and the founding of the IMF and the World Bank were agreed, presented an opportunity for a broad international debate on problems and perspectives of the present global monetary system. The central theme of these discussions, which have by no means been concluded (and which have been given added topicality by the Mexican crisis), is concern about the stability of international economic and financial relations. There is a widespread sense of unease that, since the change-over from fixed to floating exchange rates and the extensive liberalisation of financial transactions, the volatility of capital movements and the fluctuations of real exchange rates have increased – in some cases substantially – with potentially detrimental consequences for the stability of the financial system and economic growth. Many observers are also worried about the high level of dependence of many developing and transitional countries on loans from international financial institutions. The question has been raised in this context of whether the existing financing problems could be solved by a new allocation of special drawing rights. There have also been many calls to improve the efficiency and coordination of the work of international financial institutions and, in particular, to reconsider the future role of the IMF and of the World Bank. These issues are not least the subject of a study which the Heads of State or Government of the G-7 countries will consider at the forthcoming global economic summit.

Retention of the IMF's monetary character

In the Bundesbank's opinion the IMF should continue to concentrate, as hitherto, on its proper monetary tasks, i. e. above all on monitoring the monetary and economic policies of its members, on advising its members and on providing financial assistance to bridge temporary balance of payments deficits. The principal objective must be to strive to achieve a stable international monetary system via stability-oriented monetary and economic policies on the part of the individual member countries and in this way to create a favourable basis for growth, employment and development. The IMF's extensive financial commitments in the form of long-term adjustment programmes that are strictly geared towards growth is, however, difficult to reconcile with this conception of what the role of the Fund should be. Apart from the IMF's contribution to meeting the financial requirements of the countries in transition, which in some cases are absolutely imperative, its persistently high volume of lending can be seen rather as an expression of the ineffectiveness of its surveillance and advisory functions. The Fund should therefore tighten up the terms of its financial aid by supporting only those programmes that are aimed at restoring an acceptable balance of payments position within an appropriate time-frame. Achieving a not-too-slow pace of adjustment is ultimately also in the enlightened self-interest of the borrower countries. Past experience shows that the postponement of necessary measures merely necessitates even harsher stabilisation efforts in the future and thus hampers the recovery process in the final analysis. Furthermore, strict conditionality is also necessary in order to ensure that the Fund's resources are repaid on time and hence to maintain the IMF as a community of solidarity.

Intensification of multilateral surveillance

The recent currency crisis in Mexico, too, is an indication of shortcomings on the part of the IMF in monitoring the economic policies of member countries. The Fund's staff and Executive Board are thus looking for ways to strengthen and improve the efficiency of the IMF's surveillance and advisory functions. The IMF must draw attention in good time and with sufficient clarity, in particular, to misalignments in the key areas of monetary, budgetary and balance of payments policies and call insistently for adequate countermeasures. In addition, closer attention should be paid to market reactions to the economic policy of a given country, which are reflected in financial transactions and the level of interest rates. This would facilitate the earlier detection and combating of looming currency crises. In its surveillance activities the Fund should focus, however, on observing macroeconomic aggregates and key structural factors instead of concerning itself overly with specific questions of detail that lie outside its monetary mandate.

No basis for exchange rate target zones

The more effective surveillance of the monetary and economic policies of the major industrial countries could also help to foster the stability of the foreign exchange markets. In contrast to developments in Europe, where the convergence of economic structures and advances in the political unification process are gradually improving the conditions for introducing a single currency, at least in some countries, a limited degree of convergence at most is discernible at the global level. But as long as major differences in economic structure, economic policy and economic development continue to exist between the world's leading industrial nations, those countries will be unable to dispense with flexible exchange rates as an instrument of adjustment and protection in their dealings with one another. Correspondingly, the basic prerequisites for establishing exchange rate target zones between the world's major currencies, as has been repeatedly proposed, will be lacking for the foreseeable future. No matter how such arrangements were to be devised, they would either be limited to "fair-weather" scenarios or they would pose the risk of problematic monetary policy coordination and excessive foreign exchange market interventions. The only way of moving closer to the

Development of international monetary reserves*

Table 13

US$ billion; end-of-year levels

Components/Groups of countries	1981 1	1990	1994 p	Average annual change since 1981 in %
I. Total reserves	424.6	947.1	1,227.0	8.5
II. Reserve components				
Gold 2	40.3	39.7	38.4	- 0.4
Special drawing rights	19.1	29.0	23.0	1.4
IMF reserve position	24.8	33.8	46.3	4.9
Balances in official ECUs	50.2	64.1	69.6	2.5
Foreign exchange 3	290.3	780.5	1,049.7	10.4
of which				
US dollar	205.5	429.1	639.4	9.1
Deutsche Mark	38.2	153.8	181.3	12.7
Japanese yen	12.5	72.9	97.9	17.2
Pound sterling	6.2	25.2	37.1	14.8
III. Groups of countries				
Industrial countries	251.4	622.7	665.7	7.8
Developing countries	173.2	324.4	561.3	9.5
Newly industrialising countries in Asia 4	23.6	139.0	236.9	19.4
Oil-exporting countries 5	80.8	62.2	64.9	- 1.7
Other developing countries	68.8	123.2	259.5	10.8

Sources: IMF, EMI (and EMCF and Committee of EC Central Bank Governors). — * Gross monetary reserves of all IMF member countries plus Taiwan. — 1 Year of the last allocation of special drawing rights. — 2 Valued at US$ 42.22 per ounce of fine gold. — 3 Including balances in private ECUs. — 4 Malaysia, Singapore, South Korea, Taiwan, Thailand. — 5 Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, United Arab Emirates, Venezuela.

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objective of greater exchange rate stability between the world's key currencies is therefore for the countries concerned to seek steadfastly to attain financial and economic soundness.

No need for special crisis facilities

Against the background of the sharp increase in volatility in the foreign exchange and capital markets, proposals have also been made in the context of the reform discussions which aim at establishing new short-term IMF financing facilities for countering sudden capital withdrawals. Such assistance could carry the risk of being counter-productive because it might end up undermining the discipline of the market participants, which is indispensable for the longer-term stability of the financial markets. Borrowers and lenders alike would probably tend to examine their international loan transactions less rigorously if, whenever the debtor country concerned were to encounter sudden balance of payments difficulties, comprehensive support mechanisms could be expected to be deployed at short notice. It would be unrealistic, moreover, to rely on the hope that such problems of moral hazard could be limited or even eliminated by means of restrictive access conditions. A rapid response would normally be required in balance of payments crises triggered by massive capital withdrawals, thus rendering it next to impossible to make an informed assessment as to whether the exchange rate in question were worth defending. In practice, therefore, the proposed facility would have to be capable of being drawn virtually automatically. For all these reasons the Federal Government and the Bundesbank oppose the introduction of a special IMF crisis facility. This rejection is based not least on the consideration that adequate means of granting effective help already exist. The IMF's General Arrangements to Borrow and the role of the BIS need, in particular, to be taken into account in this context.

New general SDR allocations not justifiable

Given the balance of payments difficulties of many developing and transitional countries, the idea of a fresh allocation of special drawing rights has aroused great interest in many quarters. Many IMF members, as well as the Managing Director of the IMF, have for some time been advocating a general fresh allocation amounting to at least SDR 36 billion. By contrast, some members of the Fund, including Germany – which together form a blocking minority on this issue within the IMF – reject such a global SDR allocation. These countries believe that the sole criterion specified in the IMF's Articles of Agreement for allocating new special drawing rights – the existence of a long-term global need for additional international liquidity – does not obtain. In fact, global monetary reserves have grown substantially since 1981, the year of the last allocation of special drawing rights, by an annual average of 8.5 %, compared with an average real expansion of world trade of 4.6 %. During this period the monetary reserves of the group of developing countries have actually expanded particularly sharply by 9.5 % per year. This shows that insufficient monetary reserves on the part of individual countries or groups of countries do not constitute proof of a global need for additional international liquidity. In view of the abundant supply of funds in the international financial markets today, it is, moreover, doubtful whether there is now any justification at all for speaking of global reserve requirements. Given a sound economic and fiscal policy, fluctuations in the balances of payments can be financed without difficulty via the markets. In any case SDR allocations are not suitable for fostering necessary adjustment processes. On the contrary, it is to be feared that unnecessary allocations will slacken the balance of payments discipline and incite inflationary expectations to the detriment of all countries.

One-off special SDR allocation to benefit particular countries justifiable

The opponents of general allocations have, however, expressed their willingness to agree to a one-off special allocation of SDRs not premised on any global need to those countries which did not participate at all or in full in previous allocations. This would ensure an appropriate involvement in the SDR system for this group of countries, which includes most of the countries in transformation. To facilitate a compromise, the Group of Seven major industrial countries further proposed at the Annual Meeting of the IMF in 1994 to couple the special allocation with a relatively small, likewise one-off allocation to the other members of the Fund. In the upshot the new members would receive a stock of SDRs roughly comparable to that of the old members. For Germany it is important that the proposed special allocation would require an amendment of the IMF's Articles of Agreement which would have to be ratified by the member countries. This would prevent a questionable precedent on which the proponents of general allocations could base future calls.

No agreement yet reached on a comprehensive compromise package

At the meeting in Madrid in 1994 the seven major industrial nations, in addition to their SDR proposal, sought to meet the proponents of a general SDR allocation half way by calling for the annual drawing limits under the regular IMF facilities to be raised and recommending that the Systemic Transformation Facility (STF) – which was originally set to expire at the end of 1994 – be extended and increased. The STF was created in 1993 in order to help countries with former planned economies that are now in transition towards a market economy if they encounter balance of payments problems that are associated with tensions arising from the systemic change. To date, however, no compromise package embracing all these proposals has been agreed. The Executive Board did, however, raise each country's annual drawing limits for regular IMF loans in October 1994 for a period of three years from 68 % to 100 % of their quota. In addition, the STF was prolonged up to the end of April 1995 with unchanged drawing ceilings.

Operations of the Deutsche Bundesbank

I. Processing cash payments and cashless payments

1. Cash payments

Banknotes and coins in circulation

The amount of banknotes in circulation at December 31, 1994, at DM 236.2 billion, was DM 11.9 billion (or 5.3 %) larger than at the end of 1993. The amount of coins in circulation, by contrast, rose by only 3.1 %. At the end of 1994 about 94 % of all currency in circulation consisted of banknotes, and 6 % of coins.

Currency in circulation

Table 14

Trends over time

DM million

End of	Currency in circulation	Banknotes in circulation	Coins in circulation
1990	179,690	166,909	12,781
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

Pattern at the end of 1994

Banknotes in circulation			Coins in circulation		
Notes of DM	DM million	Percentage of total	Coins of DM	DM million	Percentage of total
1,000	74,950	31.7	10.00	2,180	14.8
500	25,724	10.9	5.00	5,534	37.5
200	11,309	4.8	2.00	2,131	14.5
100	90,745	38.4	1.00	2,252	15.3
50	20,427	8.7	0.50	1,085	7.4
20	7,852	3.3	0.10	959	6.5
10	4,812	2.0	0.05	301	2.0
5	346	0.2	0.02	140	0.9
			0.01	160	1.1
Total	236,165	100	Total	14,742	100

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Of the more than 2.4 billion notes which were in circulation at the end of 1994, barely 0.2 billion were notes of the old series. In the denominations between DM 10 and DM 100 which are significant in payments, the old notes only accounted for shares of between 10 % (DM 10) and 4 % (DM 100) of the respective total amounts in circulation. All notes of the old series will cease to be legal tender after June 30, 1995. However, the Bank will go on replacing those notes at their face value even after they have been withdrawn from circulation.

Destruction of banknotes

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

	1990	1991	1992	1993	1994
Number (million)	506	1,099	1,697	914	516
Value (DM billion)	25.8	62.6	97.5	120.0	28.2

The sharp decline in the number of banknotes destroyed is due to the fact that, on the one hand, the volume of banknotes of the new series sorted out still falls far short of the multi-year average figures of the notes of the old series while, on the other hand, the number of banknotes of the old series which flowed back to the Bank from payment operations decreased considerably.

Coins

The stock of German coins held by the Bank at the end of 1994 amounted to DM 2,126 million (end-1993: DM 2,067 million). In 1994 DM 535 million was credited to the Federal Government in respect of coins received from the mints and DM 34 million was debited to it in respect of coins no longer fit for circulation. Between 1948 and 1994 the Bank – acting for account of the Federal Government – received coins amounting to DM 18,782 million and redeemed coins which were no longer fit for circulation or which had been called in equivalent to DM 1,914 million. At the end of 1994 coins totalling DM 14,742 million were in circulation, equivalent (given 81.4 million inhabitants) to DM 181 per head of the population. The DM 10 commemorative coins "Robert Koch", "50th anniversary of July 20, 1944" and "Johann Gottfried Herder" were put into circulation in 1994.

Counterfeits

With regard to the counterfeit DM banknotes detained in payments and appraised by the Bank, the sharp increases discernible in recent years came to a halt; compared with the previous year, in fact, there was a substantial decline.

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

	Banknotes		Coins	
Year	Number	DM thousand	Number	DM thousand
1990	4,120	327	12,132	49
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

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DM 100 note forgeries predominated, accounting for 76 % of the total. About 50 % of all counterfeits were colour photocopies. By contrast, the counterfeiting of Federal coins increased steeply, the DM 5 coin accounting for 96 % of the total.

2. Cashless payments

Number of payments submitted continues to decline

In 1994 the number of credit transfer orders and collection orders channelled through the Bank continued to decline. Altogether, 2.8 billion payments, totalling DM 211,081 billion, were submitted; this represented a decrease of 8.6 % in the number of payments, compared with the previous year. Thus, it is probable that, in the year under review, credit institutions again transmitted a larger number of payments within their own networks or exchanged them bilaterally, instead of channelling them through the Bank, as they did in earlier years.

Retail payments

The banking industry continues to endeavour to use efficient and cost-effective paperless procedures. This also had an impact on the execution of retail payments via the Bank. In the Bank's seven regional computer centres and two payment units (only processing of incoming and outgoing payments, data processing at a remote computer centre), the share of credit transfer orders and collection orders submitted for the paperless exchange of data media (DTA procedure) continued to increase. Besides the introduction of a general obligation (EZL obligation) for credit institutions to convert all direct debits into data records and to collect them by the electronic funds transfer system from November 18, 1993, the fact that the obligation to convert paper-based intercity transfers in force since the beginning of 1992 (EZÜ obligation) was lowered with effect from September 27, 1994 from DM 10,000 to DM 1,000, and extended to cover local credit transfers as well, also made itself felt in this context. In anticipation of this change, many credit institutions had started to transform credit transfers below this ceiling into paperless payments, without distinguishing between local and intercity transfers. On a voluntary basis, many credit institutions also convert cheques for amounts below DM 5,000 under the paperless cheque collection procedure (BSE procedure) and execute them in a paperless form; the same applies to credit transfers earmarked for this purpose, which are converted under the paperless cash inpayment credit transfer procedure (BZÜ procedure) and executed in a paperless form. In the year under review, the Bank's computer centres converted about 55 million cheques and 18 million credit transfers under the BSE/BZÜ procedures and passed them on in a paperless form. Hence 89 % of retail payments was executed in a paperless form in all.

The Bank's cashless payments

Table 16

Item	1993 Number (million)	1993 DM billion	1994 Number (million)	1994 Change in %	1994 DM billion	1994 Change in %
Retail payments						
MAOBE transactions [1]						
Collection items	155.5	2,667	86.0	-44.7	2,203	-17.4
Credit transfers	238.0	148	162.0	-31.9	104	-29.8
Total	393.5	2,814	248.0	-37.0	2,307	-18.0
DTA transactions [2]						
Collection items	1,702.2	1,064	1,496.9	-12.1	1,314	23.5
of which: Conversions	(65.9)	(53)	(60.8)	–	(285)	–
Credit transfers	517.8	944	610.2	17.8	1,067	13.1
of which: Conversions	(4.2)	(1)	(18.1)	–	(3)	–
Total	2,220.0	2,008	2,107.1	- 5.1	2,381	18.6
Grand total	2,613.5	4,822	2,355.1	- 9.9	4,689	- 2.8
Large-value payments						
Gross settlement procedures						
EIL-ZV	3.4	18,875	4.0	18.9	22,772	20.7
Local credit transfers	53.5	9,396	30.3	-43.4	7,570	-19.4
Other [3]	3.6	1,768	2.9	-17.2	1,736	- 1.8
Total	60.5	30,039	37.2	-38.4	32,079	6.8
Net settlement procedures						
Daily local clearing system						
Collection items (conventional)	95.4	828	150.8	58.2	800	- 3.3
Local credit transfers (conventional)	321.0	37,661	279.8	-12.9	28,610	-24.0
EAF	10.9	129,305	12.7	17.0	144,903	12.1
Total	427.3	167,793	443.4	3.8	174,313	3.9
Grand total	487.7	197,832	480.6	- 1.5	206,392	4.3
Cashless payments	3,101.3	202,654	2,835.7	- 8.6	211,081	4.2

1 Excluding payments submitted in a paper-based form which were converted and passed on in a paperless form by the Bank's regional computer centres/payment units (BSE/GSE cheques and 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 regional computer centres/payment units (BSE/GSE cheques and BZÜ credit transfers). — **3** E.g. conventional collections and credit transfers, special procedures for public authorities.

Deutsche Bundesbank

Reduction of the float owing to the GSE procedure

In addition, the Bank converted about 6 million cheques in the amount of DM 5,000 each and 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 collection period of these cheques is now consistent with the Bank's crediting condition, with the result that the previously associated float (granting of interest-free loans to the banking industry) virtually ceases to exist.

Large-value payments

In the year under review, only 17 % of the number of cashless payments of the Bank, but almost 98 % of the aggregate amount, was transmitted under the Bank's large-value payment procedures. Under the "Eiliger Zahlungsverkehr" procedure (express electronic intercity and local credit transfer system – EIL-ZV), about 2.9 million telegraphic transfers were executed, always on a same-day basis, and 1.1 million express credit transfers (express large-value credit transfers amounting to DM 50,000 and more) were executed on a same-day basis, as far as was technically feasible; with regard to the express credit transfers, same-day settlement (which was not supported by default regulations) was achieved in no less than 99 % of all cases. Under the EIL-ZV procedure, there were considerable increases in volumes and turnover, particularly during the last quarter, although they were concentrated on a few bank places owing to the increasing centralisation of payment settlement in the banking industry. Under this large-value procedure, too, the banking industry made greater use of the option of paperless submission; about one-half of the orders were placed in the context of the electronic counter (ELS) scheme via telecommunication or diskette.

Electronic clearing (EAF)

About 13 million paperless credit transfers worth DM 144,903 billion were exchanged fully automatically between participants in the Frankfurt/Main money market (the largest trading post in Germany and the most important interface with other countries) under the electronic clearing procedure (EAF). The share of EAF in the processing of the Bank's cashless payments thus amounted to almost 69 %. The further development of the existing EAF net settlement procedure (started in the context of the international discussion on risks posed by payment and settlement systems) to generate a new liquidity-conserving procedure, EAF 2, whose risk situation will approach that of a gross settlement procedure, was continued in cooperation with the banking industry. The introduction of the new procedure is envisaged for autumn 1995.

3. Special trends in cross-border payments

Cooperation at EU level

A common monetary policy by the European System of Central Banks in the third stage of Economic and Monetary Union (EMU) presupposes that an efficacious large-value payment system is able to distribute central bank money quickly and efficiently throughout the European money markets. In that third stage, the EC central banks therefore consider it to be one of their primary objectives to provide facilities for the processing of the cross-border large-value payments arising from interbank operations. Since the beginning of stage two of EMU, the EC central banks have continued their cooperation, which started in 1991 on the initiative of the EC central bank governors, under the auspices of the European Monetary Institute, in the "Working Group on EU Payment Systems (WGPS)" and its sub-groups.

Real-time gross settlement system (RTGS)

The prime objective of this work is to formulate concrete goals for stage three for the establishment of an EMU-wide real-time gross settlement system (RTGS), in which payments will be executed individually after cover is available. For the purposes of this new facility, the existing national RTGS systems (or those which are in the process of being developed) are to be linked to each other by means of a cross-border network. In accordance with the principle of subsidiarity, credit institutions' accounts are to continue to be carried decentrally at the central banks of member countries. In order to prepare for this cross-border link-up, the Bank has already opened up its electronic counter for processing outgoing and incoming cross-border payments.

In order to facilitate the interlinking of national RTGS systems and to pave the way for a smooth execution of cross-border large-value payments, the national systems are being harmonised – insofar as is necessary – by the EC central banks in technical, organisational and business policy terms (e. g. access conditions, provision of liquidity, pricing policy).[1]

"Oversight" of payment systems

The EC central banks have a particular interest in the smooth functioning of cross-border payments. For foreign credit institutions participating in cross-border payments and subject, under the Second Banking Coordination Directive, to the banking supervision of their home country, the EC central banks, irrespective of the prudential requirements, have therefore agreed on common principles for the "oversight" of payments and of their national systems. In order to handle the necessary exchange of information between central banks, an "observatory" has been set up at the EMI as a central information collection and exchange office.

1 The progress already made in this context, along with other developments in payments, are described in the report entitled "Developments in EU Payment Systems in 1994" published by the EMI in February 1995.

"Electronic purses"

Against the background of the increasing activities of banks – and non-banks – with respect to the issuing of multi-purpose prepaid cards ("electronic purses"), the Bank participated in the preparation of the "Report on Prepaid Cards" published by the EMI in May 1994. It strongly endorses the conclusion drawn in that report that, both in monetary policy terms and for the sake of preserving the integrity of payments, only credit institutions which are subject to banking supervision should be allowed to issue such cards.

Cooperation among the G-10 countries

In the group of G-10 countries at the Bank for International Settlements (BIS) in Basle, payment problems extending beyond the EU level were discussed in the "Committee on Payment and Settlement Systems" in 1994 as well. The joint examination of the extent to which the cross-border net settlement systems for the foreign exchange transactions of private banks which are being established in Europe, North America and Japan are consistent with the minimum requirements set in the report on interbank netting systems (Basle, 1990) still has to be continued in depth.

Risk analysis

The constantly growing trading volumes in the foreign exchange markets and the resulting risks posed by their cross-border settlement prompted the committee to set up a "Steering Group on Settlement Risk in Foreign Exchange Transactions". This group is to analyse the existing settlement practices in foreign exchange transactions and, if appropriate, to submit proposals for reducing the settlement risk involved in payments. In this connection, the Bank maintains close contacts with credit institutions from all areas of the German banking industry.

II. The Bank's international transactions

Foreign exchange spot deals

The Bank's turnover in foreign exchange spot deals (foreign currency against Deutsche Mark) diminished in the year under review. Foreign exchange purchases decreased to DM 2.7 billion, whereas they had reached DM 8.4 billion in 1993. Foreign exchange sales declined to DM 20.8 billion, compared with DM 32.3 billion a year before. The decrease in turnover is attributable to the stabilisation of exchange rates in the EMS after the widening of the fluctuation margins in August 1993. In 1994, unlike 1993, no support purchases of EMS currencies were effected. Similarly, in the year under review, in contrast with 1993, there were no sales of the foreign exchange which had accrued to the Bank in earlier years from repayments of foreign currency loans by European central banks.

Other foreign exchange deals

In the year under review the volume of cross deals (foreign currency against another foreign currency) increased to DM 5.6 billion, compared with DM 2.2 billion a year before. In addition, US dollar inter-centre switch transactions totalling US$ 105 million were entered into, against US$ 125 million in 1993.

Foreign bill of exchange and cheque deals

In the context of refinancing operations, the Bank bought foreign bills of exchange worth DM 51 billion in 1994 (see overleaf). Moreover, it sold 29,933 foreign cheques payable to order amounting to DM 166 million (compared with 28,892 cheques totalling DM 112 million a year before). Another 44,543 cheques, to the value of DM 125 million, were presented in 1994 under the simplified collection procedure for foreign cheques; in 1993, 58,055 cheques worth DM 145 million had been so presented. For the rest, the Bank accepted 13,997 items bought on a commission basis (mainly bills and cheques) for realisation in foreign commission business; a year earlier, 13,829 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 1994 the Bank again granted credit institutions basic refinancing by providing central bank money through the discount credit facility.[1] 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, 1994 (1993: DM 65.3 billion). On the occasion of the regular updating of the rediscount quotas at the beginning of November 1994, the manner of calculating interest in discount business was changed from the so-called "German" method (360/360) to the Euro-interest method (exact day/360). The aim of this modification is to avoid fluctuations in bill of exchange presentations, which were to be observed, under the impact of the calendar, particularly in the month of February. The Euro-interest method, which is used internationally for money

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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 1995. This publication is available free of charge upon written request.

market transactions, now underlies all money market and refinancing transactions of the Bank.

Purchases of domestic bills of exchange

After a rather sluggish pace of bill presentations at the beginning of 1994 (owing to pronounced expectations of falling interest rates), the utilisation of the rediscount quotas ran at a high level, particularly in the second half of the year. Altogether, 1.3 million domestic bills of exchange totalling DM 283 billion were purchased under the rediscount quotas or under the special rediscount facility (ceiling B) granted to the AKA Ausfuhrkredit-Gesellschaft mbH (in 1993 1.4 million such domestic bills had been purchased, amounting to DM 262 billion). In the absence of payment, 7,560 bills totalling DM 229 million (1993: 6,998 bills amounting to DM 196 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 89,938 in 1994, and totalled DM 51 billion (1993: 107,275 bills totalling DM 63 billion). The share of foreign bills denominated in foreign currencies came to 1.6 % (1993: 1.4 %).

Securities repurchase agreements

The most important instrument of central bank money provision continued to be open market transactions under repurchase agreements in securities ("securities repurchase agreements"). In 1994 53 such transactions were concluded in all, 31 of which were in the form of fixed-rate tenders. Such fixed-rate tenders were used, first, for bridging the previous end-of-year transactions and, again, from the middle of the year, in order to give the markets a clear interest rate benchmark. The Bank underlined its policy of "steady-as-she-goes" in the money market in the second half of the year by announcing the fixed-rate tenders in advance, immediately after the meetings of the Central Bank Council. The standard maturity of the transactions was two weeks. The volume of securities repurchase agreements outstanding at the end of 1994 was DM 146.3 billion, against DM 184.5 billion at the end of 1993.

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 1994, securities amounting to DM 449.3 billion were lodged by credit institutions in operational safe custody accounts at Land Central Banks for securities repurchase agreements or for lombard purposes (1993: DM 436.5 billion). In addition, securities totalling DM 6 billion were pledged in such safe custody accounts, exclusively for lombard purposes. About 40% of the securities lodged in operational safe custody accounts are public sector debt securities, while 60% are securities of private issuers, above all covered bank debt securities.

Fine-tuning operations

In 1994 the number of fine-tuning operations in the money market declined perceptibly. On the one hand, this is to be seen against the background of the fact that the abolition of the deposit requirement at the Bank for public authorities resulted in the waning of liquidity fluctuations in the banking system during a month. In addition, in September 1994 the monthly pension payment was changed to same-day settlement, and as a consequence previous difficulties due to the accrual of balances of up to DM 25 billion on the Bundesbank accounts of the Postbank were remedied. Finally, the external disruption potential decreased considerably after the transition to wider margins in the European Monetary System. Overall, in spite of the lowering of the minimum reserve ratios from March 1, 1994, it is apparent that credit institutions are complying with the reserve requirements with relatively few fluctuations over lengthy stretches of the reserve period.

Quick tenders

In order to provide liquidity at short notice, the Bank entered into two quick tenders in the form of fixed-rate tenders in 1994. These are securities repurchase agreements which, in contrast with 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 ranged between about DM 7 billion and DM 10 billion, and their maturities were seven and three days.

Foreign exchange deals and shifts under section 17 of the Bundesbank Act

No foreign exchange swap and repurchase transactions for stabilising the money market were concluded during the period under review. The option of shifting liquid resources under section 17 of the Bundesbank Act for monetary policy purposes no longer existed after the abolition of the deposit requirement for public authorities.

Dealings in money market paper

In order to mop up liquidity, the Bank sold short-term liquidity Treasury bills totalling DM 10.6 billion on two days in 1994, on the basis of section 42 of the Bundesbank Act. Their maturity was three days in each case. In addition, the Bank issued (likewise by virtue of section 42 of the Bundesbank Act) three tranches of Bundesbank liquidity discount paper ("Bulis") with maturities of about six months and a total volume of DM 26.5 billion. At its meeting on August 18, 1994 the Central Bank Council decided to discontinue the regular auction of

"Bulis" since the monetary policy objectives envisaged when this instrument was introduced could not be attained. Moreover, the Bank did not wish to offer investment outlets for the newly authorised money market funds itself, thus fostering trends towards structural shifts towards shorter maturities in the financial markets. The last regular issue of "Bulis" took place in September 1994; at the end of the year, DM 4.9 billion thereof was in circulation, and matured on March 15, 1995.

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 increased from DM 1.0 billion in 1993 to DM 1.6 billion last year. This owed much to special factors, such as transitional problems in connection with the lower minimum reserve requirements in force from March 1994. In this context, lombard loans were used increasingly to offset unforeseeable debit balances arising from payments, in the form of giro overdraft lombard loans. The peak level was reached on March 30, 1994, at DM 26.7 billion. As part of the fifth amendment of the Bundesbank Act, the safety discounts hitherto prescribed by law for lombard transactions have ceased to apply. With effect from August 1, 1994, the Bank extends loans against collateral up to the full amount of the loan value, i. e. in principle at the current market value. This increases the banks' lombard potential, which is significant, among other things, in the light of the mounting security requirements in the field of national and international payments.

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

Issues of bonds

In 1994 the Bank was again involved in the issuing and placing of securities launched by public borrowers at the Federal level. Altogether, the Bank participated in the floating of twelve bond issues totalling DM 96.0 billion. In the previous year, 19 bond issues amounting in all to DM 129.0 billion had been launched.

Of last year's twelve bond issues, six were attributable to the Federal Government. They included an increase in the 30-year New Year's Eve bond issue of 1993 and one floating-rate note issue. Three bond issues were floated by the Treuhand agency, which drew on the capital market to the extent of DM 26.0 billion in all in 1994 – i. e. distinctly less than the Federal Government (DM 52.0 billion). The German Federal Post Office likewise launched three bond issues (totalling DM 18.0 billion) in the last year of its existence as a special fund of the Federal

Government. The other issuers – viz. the "German Unity" Fund, the Federal Railways Fund (which administers the debt of the former German Federal Railways) and the ERP Special Fund – launched no bond issues in 1994.

Issuing procedures

The method of launching bonds by a combined syndicate and tender procedure proved to be effective again. In 1994 the credit institutions participating in the Federal Bond Consortium underwrote bonds totalling DM 32.0 billion. A further DM 36.6 billion was allotted to syndicate banks under the tender procedure, and DM 27.4 billion flowed progressively into the market via market-smoothing operations. In keeping with the annual pattern, the quotas in the Consortium were brought into line with the placement potential again in November 1994, taking due account of allotments under the tenders. After the withdrawal of eleven members, at the end of 1994 the Federal Bond Consortium consisted of a total of 98 credit institutions, including 51 foreign-owned banks.

More 30-year bond issues?

The market segment of 30-year bond issues, which was reopened at the end of 1993 and bolstered by a 30-year Bund futures contract, was not extended any further in 1994 – if one disregards the increase in the foregoing New Year's Eve bond issue in February. This owed much to the rise in capital market rates and the associated low absorptive capacity of the market for 30-year paper. In addition, notions of making such bonds more attractive by providing the option of "stripping" foundered on the tax problems posed by reconstituting the debt security from the previously separated capital and interest claims, which problems have long been unresolved.

Issues of other Federal securities

In 1994 the Bank also took over the tendering and placing of Treasury notes of the Federal Government and the Federal Railways Fund, as well as of Treuhand five-year special bonds. In all, eleven issues amounting to a total of DM 41.0 billion were launched, six of which, to the overall volume of DM 27.0 billion, were accounted for by the Treuhand agency. Furthermore, the Bank, acting for the account of the Federal Government, was involved in the selling (via credit institutions as well as through its own offices) of Treasury financing paper, Federal savings bonds and five-year special Federal bonds (which were issued on tap). These securities (in the case of five-year special Federal bonds, including sales from amounts set aside for market-regulation operations) were sold in 1994 to the tune of DM 42.4 billion. Federal savings bonds, with gross sales totalling DM 15.4 billion, were particularly successful compared with the preceding years. In December 1994 the Bank introduced, all told, 28 tranches of Deutsche Bundespost notes with a total volume of DM 21.4 billion into the Regulated Market

Bonds issued by the Federal Government, its special funds and the Treuhand agency in 1994

Table 17

Issuer	Amount issued (DM billion)				Terms				
		of which							
	Total	Syndicate amount	Amount allotted by tender procedure	Market regulation 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 - increase -	2.0	–	–	2.0	6.000	9/8	–	–	Feb. 2
Federal Government - increase -	10.0	3.0	2.5	4.5	6.250	29/11	98.90/ 96.92	6.33/ 6.48	Feb. 8
Treuhand agency	8.0	3.0	2.5	2.5	6.250	10/0	100.60/ 97.54	6.17/ 6.59	Mar. 1
Federal Post Office	6.0	2.5	1.3	2.2	6.750	10/0	100.50/ 98.72	6.68/ 6.93	Apr. 19
Treuhand agency	8.0	3.0	3.2	1.8	6.750	10/0	100.40/ 100.22	6.69/ 6.72	May 9
Federal Government	10.0	3.0	4.7	2.3	6.750	10/0	101.00/ 100.40	6.61/ 6.69	July 19
Federal Post Office	5.0	2.5	1.4	1.1	7.500	10/0	100.60/ 99.44	7.41/ 7.58	Aug. 23
Treuhand agency	10.0	3.0	4.2	2.8	7.500	10/0	100.95/ 99.91	7.36/ 7.51	Sep. 6
Federal Government	10.0	3.0	4.5	2.5	1 var.	10/0	99.35/ 99.12	– / –	Sep. 27
Federal Post Office	7.0	3.0	3.9	0.1	7.750	10/0	99.65/ 98.80	7.80/ 7.92	Oct. 25
Federal Government	10.0	3.0	4.0	3.0	7.500	10/0	99.75/ 99.84	7.54/ 7.52	Nov. 8
Federal Government	10.0	3.0	4.4	2.6	7.375	10/0	100.20/ 98.74	7.35/ 7.56	Dec. 28

1 Interest rate: 3-month Fibor less 0.25% p.a.

Deutsche Bundesbank

Issues of five-year special Federal bonds in 1994

Table 18

Designation of series	Start of sales	Amount issued (DM million) Sales 1	Market regulation amount	Total	Terms Nominal interest rate (% p.a.)	Issue price (%)	Yield (% p.a.)	Date of stock exchange listing
S. 109 of 1993 (1998)	2 Jan. 3	3 719	4,281	5,000	5.250	101.20	4.95	Mar. 21
S. 110 of 1994 (1999)	Mar. 14				5.375	99.90	5.39	
	Apr. 28					98.90	5.63	
	May 13					99.20	5.56	
	May 16					99.40	5.51	
	May 18	524	3,476	4,000		99.60	5.46	June 23
S. 111 of 1994 (1999)	June 16				6.125	100.00	6.12	
	July 13					100.60	5.97	
	July 19					101.10	5.85	
	Aug. 11					99.50	6.23	
	Aug. 19					98.40	6.51	
	Sep. 8	787	3,213	4,000		97.80	6.67	Sep. 22
S. 112 of 1994 (1999)	Sep. 15				6.750	99.70	6.82	
	Oct. 5					98.70	7.06	
	Oct. 14					99.50	6.86	
	Nov. 3					98.70	7.06	
	Nov. 9					98.95	7.00	
	Nov. 24					99.50	6.86	
	Dec. 12	1,901	4 ...	4 ...		98.95	7.00	4 ...

1 Cumulative from the first day of sale. — **2** Start of sales on November 15, 1993. — **3** Sales from November 15, 1993 to December 31, 1993 = DM 550 million. — **4** Sales were not completed on December 31, 1994.

Deutsche Bundesbank

Issues of Federal savings bonds in 1994

Table 19

Issue	Sales period 1994	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/ 1+ 2	1 Jan. 3 – Apr. 28	2 4,258	3,868	390	4.75 – 6.25	5.49	5.64
1994/ 3+ 4	Apr. 28 – June 16	1,876	1,686	190	4.75 – 7.50	6.12	6.39
1994/ 5+ 6	June 16 – Aug. 19	3,382	3,049	333	4.75 – 7.75	6.48	6.74
1994/ 7+ 8	Aug. 19 – Sep. 15	1,232	1,104	128	4.75 – 7.75	6.64	6.89
1994/ 9+10	Sep. 15 – Nov. 3	1,803	1,555	248	4.75 – 8.00	6.88	7.14
1994/11+12	Nov. 3 – 3	2,947	2,575	372	5.00 – 8.25	7.08	7.35

1 Start of sales on December 28, 1993. — **2** Sales from December 28, 1993 to December 31, 1993: DM 119 million, of which FSB/A DM 108 million and FSB/B DM 11 million. — **3** Sales were not completed on December 31, 1994.

Deutsche Bundesbank

Issues of Treasury notes by the Federal Government and its special funds and issues of Treuhand five-year special bonds in 1994

Table 20

Issuer	Amount issued (DM million)			Terms				
	Total	of which: Amount allotted by tender	of which: Market regulation amount	Nominal interest rate (% p.a.)	Maturity (years/ months)	Average allotment rate (%)	Average yield (% p.a.)	Date of issue
Treuhand agency	6,000	4,358	1,642	5.000	5/0	100.00	5.00	Jan. 12
Federal Government	4,000	2,154	1,846	5.250	4/0	99.46	5.40	Feb. 23
Federal Railways Fund	2,000	989	1,011	5.750	4/0	99.82	5.80	Apr. 6
Treuhand agency	5,000	2,933	2,067	5.750	5/0	99.56	5.85	Apr. 27
Federal Government 1	–	–	–	5.875	4/0	–	–	-
Treuhand agency	4,000	2,012	1,988	6.375	5/0	99.63	6.46	June 29
Treuhand agency	4,000	2,490	1,510	6.250	5/0	99.82	6.29	July 27
Treuhand agency - increase -	3,000	1,652	1,348	6.375	4/10	98.95	6.62	Aug. 17
Federal Government	4,000	2,037	1,963	6.375	4/0	99.14	6.62	Aug. 30
Treuhand agency	5,000	3,115	1,885	7.000	5/0	100.11	6.97	Nov. 23
Federal Government	4,000	2,130	1,870	6.875	4/0	99.83	6.93	Nov. 30

1 Owing to price bids inconsistent with market conditions and inadequate bid amounts, no allotment was effected on May 25.

Deutsche Bundesbank

Issues of Treasury discount paper by the Federal Government and its special funds in 1994

Table 21

DM million

Type of paper	1993: Outstanding at December 31	1994: Issued	1994: Redeemed	1994: Outstanding at December 31
Treasury discount paper of the Federal Republic of Germany types "B" and "BN" 1	25,992	14,601	23,603	16,990
of which: "Treasury financing paper"	(25,577)	(13,627)	(23,603)	(15,601)
Treasury discount paper of the Debt-Processing Fund, type "KAF N" 1	6,226	1,452	3,541	4,137
Treasury discount paper of the Federal Republic of Germany, "Germany Unity" Fund, type "FDE N" 1	2,073	–	1,050	1,023
Total	34,291	16,053	28,194	22,150

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

Deutsche Bundesbank

on the Frankfurt stock exchange. No recourse to the market was associated with these securities. Instead, only claims of the Postbank on the German Federal Post Office special fund were converted into fungible securities.

Market-smoothing operations

Of the amounts set aside for market-regulation operations, which are retained when listed Federal securities are issued, the Bank sold DM 52.8 billion on the stock exchanges on behalf and for the account of the issuers concerned last year. Market-smoothing operations thus proved to be effective as a "third pillar" in issuing Federal securities.

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, the German Equalisation Bank and the State Bank, Berlin. The Bank also conducts price support operations with respect to the bonds 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 changes in banking supervision legislation

1. International harmonisation of banking supervision

In the year under review the Bank again participated in the major bodies engaged in the international harmonisation of banking supervision.

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

Last year the Basle Committee on Banking Supervision was mainly concerned with the extension of the 1988 Basle Capital Accord and the supervisory treatment of financial derivatives and financial conglomerates. A focal point of the Committee's work in 1994 was the regulation governing the treatment of market risks arising from position-taking in the trading portfolio of internationally operative banks, which still has to be integrated in the Capital Accord. In this context, the Committee received comments from all over the world on its consultative paper issued in 1993. These comments suggested, in particular, admitting the internal risk management models already used by credit institutions for assessing the capital charges for market risks. The Committee has taken up this suggestion and is currently devising principles specifying the conditions on which these internal models can be recognised for banking supervision purposes. Initial simulations carried out among a number of international banks based on a standard specimen portfolio have shown that the use of the currently applied internal calculation models results in significant differences in global risk positions, and thus in the capital charges based on them. In the interests of competitive equality, it therefore seems necessary to standardise the parameters underlying the calculation models to a greater extent. Admission of the banks' internal models would for the first time introduce qualitative elements to German banking supervision on a major scale.

"Basle Capital Accord"

With the G-10 central bank governors' approval, the Basle Committee on Banking Supervision has amended two points of the Basle Capital Accord. The previous recognition of netting by novation for the purpose of calculating the counterparty risk of off-balance-sheet activities and hence for the computation of the capital requirement has been supplemented by other types of netting (such as close-out netting, which makes netting dependent on the occurrence of a particular event, such as the institution of bankruptcy proceedings). The Second Financial Market Promotion Act has now made such arrangements legally effective in Germany, too.

The Basle Committee also made the application of lower rates to specific claims on OECD countries for the purpose of calculating capital adequacy requirements subject to a particular condition. From 1995 the reduced risk weighting enjoyed by all OECD members and participants in the General Arrangements to Borrow will be applied only on condition that they have not rescheduled their external government debt within the preceding five years.

Counterparty risks

Hitherto, the methods of calculating the counterparty risk involved in derivatives operations have related to interest rate and currency contracts only. By virtue of another amendment to the Basle Capital Accord, equity, precious metal and commodity contracts are also to be included; to this extent, only the marking-to-market method will be authorised for assessing positions. At the same time, a new maturity category with separate weights is due to be introduced for calculating the potential future risk arising from such contracts with maturities of more than five years where hitherto a distinction has been drawn only between contracts running for one year or less and those running for more than one year.

The changes or proposals mentioned will be incorporated in due course in the relevant EC Directives and, in line with these, in the German supervisory regulations (Principle I); preliminary work thereon has already been started at EU level.

Derivatives business

As part of the ongoing discussion of derivatives business, the Basle Committee has also carefully addressed the question of whether such transactions are duly taken into account in banks' internal risk management. In July 1994 it issued "Risk management guidelines for derivatives", which were supposed to "provide guidance" to all banks for the time being. Supervisors were expected to find the guidelines useful in reassessing their own methods and procedures for monitoring how banks control the risks posed by transactions in derivatives. The Basle guidelines have already been reflected in Germany in draft "Minimum standards for banks' trading", which the Federal Banking Supervisory Office sent to the Institute of Auditors for its comments in December 1994.

Transparency of derivatives operations

Moreover, the Committee has examined the question of how to improve the internal and external transparency of derivatives operations. In this connection it supported the efforts of the Euro-currency Standing Committee, another committee of the G-10 central bank governors, which last year put forward proposals to enhance the hitherto inadequate transparency of derivatives transactions in banks' annual accounts ("Fisher report"). This report goes beyond other recommendations, especially as regards the presentation of the market risk, by encouraging all market participants to disclose, on the basis of their own risk management systems, not only figures on the credit risks assumed but also statistics on the market risks incurred. The paper follows what is known as the "value-at-risk" approach, which is also favoured by banking supervisors; it recommends disclosing information about the market risk and the risk management performance by juxtaposing expected changes in the value of a portfolio and the actual out-turn. As the methods of risk management used in practice change and are constantly becoming more sophisticated, as there is not yet any uniform standard for the disclosure of risks, and as the further evolution of the methods should not be hampered by prescribing a definite form of presentation, the paper allows reporting institutions the requisite scope for developing appropriate forms of reporting themselves, although they should be equivalent to the proposed disclosure of information. The limits to the comparability of disclosures among firms should be accepted for the time being. Even though the paper is primarily addressed to financial intermediaries, the proposed disclosure principles should also be applicable by other enterprises with significant derivatives operations.

Implementation

The paper was distributed in Germany to the associations representing the banking industry, other industrial associations and other public and private bodies dealing with accounting issues, with a request to take up the proposals contained therein and bear them in mind in their own deliberations. The Deutsche Bundesbank and the Federal Banking Supervisory Office intend to invite the associations representing the banking industry to an exchange of views on this subject in due course.

Brockmeijer Report

The global special survey of derivatives which is due to be carried out for the first time in April 1995 on the basis of a standard survey form drawn up by central bank experts (Brockmeijer Report) and which is designed to improve the transparency of the global derivatives markets can likewise be traced back to the Euro-Currency Standing Committee.

Supervision of financial conglomerates

The Basle Committee on Banking Supervision has been addressing the issue of supervising financial conglomerates for years past. It first organised several joint informal meetings with securities regulators in 1988, and since 1990 it has also arranged some with insurance regulators. At its instigation, what is known as a "Tripartite Group" was set up at the beginning of 1993, comprising representatives of banking, securities and insurance supervisory authorities. This group will shortly be publishing a report which will provide the basis for further deliberations in the relevant international bodies of banking, insurance and securities supervisors. A working group of the International Organisation of Securities Commissions (IOSCO) has been discussing the subject of the supervision of financial conglomerates for some time. The working group, in which the Bundesbank is also participating, will soon have to address itself to the findings of the Tripartite Group report.

(b) Harmonisation efforts at European Union level

In February last year a first joint meeting of the Advisory Banking and Insurance Committees was held in Brussels at EU level. At the time, it was agreed that the risks inherent in a conglomerate which are relevant for supervisory purposes should be analysed, and that proposals for solving the problem of handling these risks should be elaborated. For this purpose, a joint technical working group was set up with the objective of drawing up a recommendation. It remains to be seen whether such a recommendation will one day lead to a proposal for a directive.

Council Directive on deposit guarantee schemes

The Council Directive on deposit guarantee schemes was issued on May 30, 1994. It must be translated into national law by June 30, 1995 and calls for a basic minimum level of guarantee of ECU 20,000. All credit institutions must belong to a deposit guarantee scheme which covers the EU branches of these institutions as well (home country principle). However, these branches are not allowed to enjoy a higher level of deposit protection under a scheme of their home country than that in the host country (ban on exports of deposit protection). On the other hand, they have the right to join a host country deposit guarantee scheme in addition if it provides a higher level of protection than that in the home country. Germany was the only member state in the Council of the European Union to vote against the Directive and to file an action before the European Court of Justice. Under the action, the Court is being requested to declare the Directive as a whole – or at least the ban on exports of deposit protection, the additional coverage and the mandatory membership – null and void.

UCITS Directive

Despite considerable efforts under the German Presidency in the second half of 1994, the Council of the European Union failed to adopt the Directive Amending the UCITS Directive of 1985. The draft amendment provides for an extension of the range of investment facilities available to investment funds by adding money market funds, cash funds, funds of funds and master/feeder funds, and for a harmonisation of definitions (in particular, of the concept of security and the concept of money market instrument), and is intended to make the function of cross-border central securities depositories possible.

Further harmonisation efforts

For the rest, the Bank has been participating – as, indeed, for many years now – in the work of several committees at EU level whose mandate is to harmonise other legal areas or administrative practices, such as the Advisory Banking Committee, the Contact Group of the EC banking supervisory authorities and other working groups.

2. Amendments of national banking supervision legislation

Fifth Act Amending the Banking Act

The Fifth Act Amending the Banking Act, which was published in September 1994 and will come into force on December 31, 1995, translated the EC Consolidation Directive and the EC Large Exposures Directive into German law. This was a further major step towards harmonising European banking supervision rules.

EC Consolidation Directive

When implementing the EC Consolidation Directive, the German legislature decided to retain the German consolidation provisions, some of which are more stringent, and under which direct and indirect minority interests of 40 % of the capital shares or more in subordinated domestic and foreign credit institutions and factoring and leasing enterprises have to be included, and to add to these provisions the new regulations of the Directive. These require all other financial institutions and ancillary banking services enterprises (such as property management) to be consolidated, too. In addition to the above-mentioned minority interests, subsidiaries (majority interests or enterprises on which a dominant influence can be exercised), their subsidiaries, second-tier subsidiaries, etc., likewise have to be consolidated. As hitherto, credit institution groups are formed if the parent institution of the subordinated credit and financial institutions is a credit institution. If the parent institution of the group is a financial holding company, it will in future, together with the subordinated credit and financial institutions, form a financial holding company group. Minority interests are subject to pro rata consolidation, while other participating interests are fully consolidated.

EC Large Exposures Directive

Upon the implementation of the provisions of the EC Large Exposures Directive, the prudential concept of exposure is broadened by the inclusion of assets evidenced by certificates and of derivatives (options, futures, swaps). After a transitional period expiring at the end of 1998, in which the higher limits continue to apply, a large exposure obtains if an exposure to a single borrower exceeds 10 % of the liable capital of the lending institution; such an exposure must not exceed 25 % of the liable capital, and all large exposures combined must not amount to more than eight times the liable capital. The large exposure regulations must be complied with on a consolidated basis in future, too. The extended concept of exposure applying to large exposures must also be applied to the reporting requirement for loans of 3 million Deutsche Mark or more, except in the case of securities held in the trading portfolio and participating interests.

Preparation of the Sixth Act Amending the Banking Act

Work on the preparation of the Sixth Act Amending the Banking Act has already started. It will implement the EC Capital Adequacy Directive, which limits the market risks inherent in securities transactions and derivatives operations, and the EC Investment Services Directive.

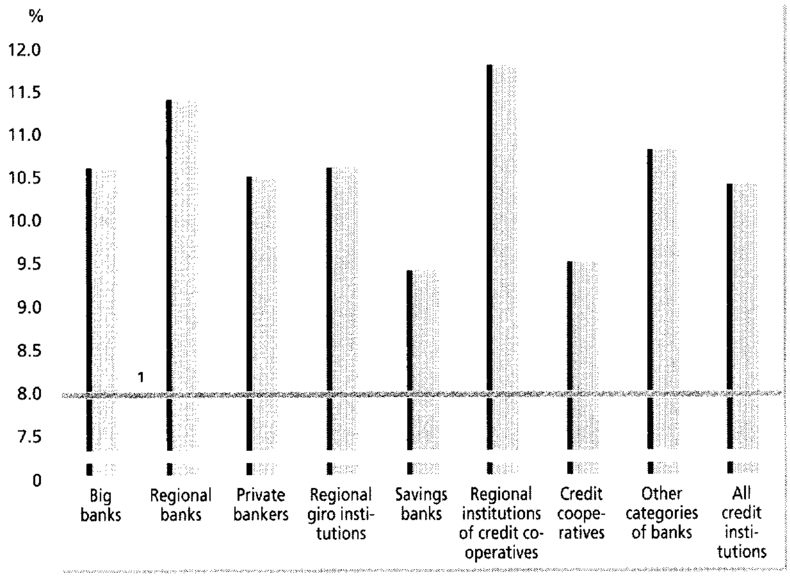
Principles Concerning the Capital and Liquidity of Credit Institutions

The content of the Principles Concerning the Capital and Liquidity of Credit Institutions pursuant to section 10 of the Banking Act has not been changed from last year. The average capital ratio of all credit institutions under Principle I, which provides that the risk assets must be backed by a minimum of 8 % of liable

Chart 18

Capital ratio of credit institutions filing Principle I reports

End of December 1994



1 The Principle I minimum capital ratio is 8%.

Deutsche Bundesbank

capital, increased from 9.9 % at December 31, 1993 to 10.4 % at the end of 1994. This slight strengthening of the capital base is discernible among all categories of credit institutions. Details of the average capital ratios of the various categories of banks are shown in the above chart.

The foreign currency risks, interest rate risks and other price risks involved in derivatives transactions are limited by Principle Ia. At 3.7 %, 1.5 % and 1.0 %, respectively, for the risk categories mentioned, the average Principle Ia ratios of all credit institutions were well below the prescribed ceilings of 21 %, 14 % and 7 %.

As of December 31, 1994, the average ratios for the Liquidity Principles were 89.1 % for Principle II and 68.4 % for Principle III.

Auditor's Report Regulation

After having consulted the Bank, the Federal Banking Supervisory Office issued, by virtue of section 29 (3) of the Banking Act, the Regulation concerning the Contents of Auditor's Reports on the Annual Accounts and Interim Accounts of Credit Institutions, dated July 21, 1994 (Federal Law Gazette I, 1994, page 1803). This regulation has to be applied for the first time to the report on the audit of annual accounts prepared for a financial year beginning after September 30, 1993, and it supersedes the audit guidelines issued by the Federal Banking Supervisory Office in 1968. The regulation ensures that the Federal Banking Supervisory Office is furnished with the information it needs for performing its functions. The auditor's report constitutes an important basis for the supervision of credit institutions. In future, a synopsis of data must be attached incorporating major report data, so as to facilitate their speedier EDP recording and analysis.

Country Exposure Regulation

Under section 25 (4) of the Banking Act, the Federal Banking Supervisory Office, in consultation with the Bank, issued the First Regulation Amending the Country Exposure Regulation of June 7, 1994 (Federal Law Gazette I, 1994, page 1216). Under the Country Exposure Regulation of 1985, credit institutions had to report, on a quarterly basis, their total external lending – if it exceeded DM 100 million – in order to enable the banking supervisory authorities to assess the country exposures incurred by those institutions. Under the Regulation Amending the Country Exposure Regulation, a half-yearly reporting pattern (March and September) has been introduced. The coverage of countries in the report forms was reduced, with due regard to risk aspects. In addition, the Regulation Amending the Country Exposure Regulation provides for the disclosure of some additional data (separate disclosure of trade credits, indication of secondary market deductions on the purchase of assets). In accordance with the home country principle applied to banking supervision in the EU, branches of enterprises domiciled in another member state of the European Economic Community (section 53 b (1) or (7) of the Banking Act) are no longer required to report.

3. Ongoing banking supervision operations

Fall in the number of reporting credit institutions

At the end of 1994, 3,924 credit institutions (3,597 institutions in the old Länder and 327 in the new ones) were covered by banking supervision. That was 156 institutions fewer than in the preceding year. In the period under review most of this reduction was due, once again, to mergers in the cooperative bank sector (117, including 23 east German institutions) and the savings bank sector (48 mergers, including 36 in the new Länder). Increases (24 in all) were recorded chiefly in the case of regional banks and the branches of foreign banks.

Land Central Banks' participation

The scale of the Land Central Banks' participation in banking supervision is shown in the table below. Major changes in the workload resulted chiefly from changes in reporting regulations. Thus, the considerable increase in the reports

Ongoing banking supervision operations

Table 22

Number of operations conducted

Item	1991	1992	1993	1994
Individual reports pursuant to section 13 of the Banking Act	69,593	72,267	68,542	65,908
Borrowers included in the lists submitted pursuant to section 13 of the Banking Act	73,012	82,626	75,996	76,987
Reports on loans of DM 1 million[1] or more pursuant to section 14 of the Banking Act	1,875,105	2,116,425	2,001,923	1,109,990
Reports pursuant to section 16 of the Banking Act	23,755	24,503	14,376	14,887
Reports pursuant to section 24 of the Banking Act	16,905	16,781	19,828	49,312
Monthly returns pursuant to section 25 of the Banking Act	53,147	54,776	49,514	48,914
Reports on the volume of external lending	983	973	998	407
Annual accounts of credit institutions	4,652	4,837	4,338	4,147
Auditor's reports on annual accounts	2,317	2,454	2,294	2,450
Reports on the auditing of safe custody accounts	393	527	407	534
Routine, special and deposit guarantee fund auditor's reports	738	489	463	647
Audits commissioned by the Federal Banking Supervisory Office pursuant to				
section 44 (1) of the Banking Act	33	27	33	32
section 44 (2) of the Banking Act	117	128	122	141
Reports under the Capital Accord of the Basle Committee on Banking Supervision	106	104	102	96

1 DM 3 million as from July 1, 1993

Deutsche Bundesbank

pursuant to section 24 of the Banking Act is attributable to the fact that the Fourth Act Amending the Banking Act introduced a reporting requirement for participating interests of credit institutions in other enterprises and other enterprises' participating interests in credit institutions. The reports on total external lending dropped to around 40 % of the previous year's figure after – as already mentioned in the section on the Country Exposure Regulation – the reporting frequency and the number of countries covered were reduced.

Credit register for "Millionenkredite"

The number of loans of DM 3 million or more reported under section 14 of the Banking Act increased by over 3 % to around 285,000 within the year from September 30, 1993, the first reporting date after the raising of the reporting threshold to DM 3 million, when the number of reports had dropped by almost one-half. The total volume of loans of DM 3 million or more reported went up by 8 % to DM 2,639 billion during that period. The table on page 138 shows the changes since 1990.

On the September 30, 1994 reporting date, 2,827 credit institutions and insurance enterprises reported loans of DM 3 million or more; the number of

Credit register for "Millionenkredite"

Table 23

3rd qtr	Volume of loans of DM 1 million[1] or more		Number of loans of DM 1 million[1] or more reported		Number of reporting	
	DM billion	Change (%)	Number	Change (%)	Credit institutions	Insurance enterprises
1990	1,889	+ 14.4	439,565	+ 8.7	3,264	520
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	2,639	+ 8.0	284,568	+ 3.2	2,429	398

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

Deutsche Bundesbank

lenders involved therefore changed but little from the previous year. The credit register establishes, on the basis of the reports submitted, the borrowers' overall debt and discloses it to the lending institutions in its notifications. The number of borrowers notified to the institutions has risen again by no less than almost 11,000 to 210,000 since the raising of the reporting threshold. Two-thirds of the borrowers were amalgamated into 44,000 borrower units as defined in section 19 (2) of the Banking Act. Of these borrowers, 36,000 had taken up loans from more than one lender, which is a share of around 25 %, whereas only 15 % of the borrowers not amalgamated into borrower units were indebted to several lenders. At the end of September, 70 borrower units' debt pursuant to section 14 of the Banking Act exceeded DM 2 billion; the total indebtedness of these borrowers amounted to DM 294 billion, and thus accounted for just over 11 % of the total volume of lending reported. Lending to domestic borrowers, at DM 1,807 billion, accounted for not quite 70 % of the total volume of lending reported.

Insolvencies

In 1994 the credit register recorded a total number of 953 insolvencies of enterprises and individuals who, at the date when the insolvency became known, had loans of DM 3 million or more outstanding. That was 588 fewer insolvencies than a year before (– 38.2 %). The sharp year-on-year decline in the number of insolvencies reported owes something to the fact that, in the wake of the raising of the reporting threshold, the number of reported loans fell by about one-half in 1994 against the previous year. Even so, the volume of loans of DM 3 million or more reported for insolvent borrowers went up by DM 5 billion to a total of DM 15 billion; DM 1.4 billion of this amount was accounted for by 230 borrowers domiciled in the new Länder.

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. 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]

Applications for authorisations pursuant to section 3 sentence 2 of the Currency Act, and the decisions taken Table 24

Year	Applications	Authorisations	Certificate of non-applicability of authorisation requirement	Applications rejected
1985	46,629	37,343	7,312	1,974
1986	40,064	30,998	7,367	1,699
1987	37,083	28,069	7,523	1,491
1988	37,812	29,899	6,313	1,600
1989	38,633	30,349	6,448	1,836
1990	42,552	33,232	7,123	2,197
1991	48,806	37,837	8,197	2,772
1992	54,129	41,689	8,840	3,600
1993	57,155	44,949	8,231	3,975
1994	68,698	54,490	9,886	4,322

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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 3215.

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

EC provisions

Following the report on the Bank's activities in the field of UN embargo measures in the 1993 Annual Report, it should initially be noted, regarding developments in 1994, that the "Council of the European Union" for the first time took advantage of its law-making powers with respect to financial sanctions under Article 73 g of the EC Treaty in force since January 1, 1994 in the shape of a regulation concerning the Bosnian Serbs. The EC Currency Committee participated in the preparations pursuant to section 109 c.

Embargo areas

In the individual embargo areas, the following developments took place:

Iraq

Regarding the Iraq embargo, the UN Sanctions Committee has been requiring a financing plan with each delivery application since 1994. Basically, however, no payments from Iraqi account balances can be authorised (as before) unless Iraq agrees to payment through a UN escrow account (UN Resolution 778 (1992)).

Serbia/ Montenegro

"For an initial period of 100 days" (which has meanwhile been extended) the UN suspended the restrictions on flights to and from Belgrade, provided that the Federal Republic of Yugoslavia (Serbia/Montenegro) complies with the embargo against the Bosnian Serbs (UN Resolution 943 (1994)) of September 23, 1994, implemented by EC Regulation 2472 of October 10, 1994 (Official Journal L 266/8 of October 15, 1994). In accordance with the guidelines of the UN Sanctions Committee, the Bank has granted the credit institutions concerned the necessary collective authorisations for the payments required in connection with the flights; these authorisations also include payments from blocked accounts of the Yugoslav airline to other EC states (payments to other countries require individual authorisation).

Haiti

Regarding the UN financial sanctions against Haiti (see below), which have meanwhile been lifted, the Council had issued on May 30, 1994, by virtue in particular of Article 228 a of the EC Treaty, EC Regulation No. 1263/94 "on the suspension of certain trade and financial relations with Haiti" (Official Journal L 139/1 of June 2, 1994). Notwithstanding this published title, however, in accordance with the will of the majority of the Council, the financial part was not adopted, because, it was claimed, implementation of the relevant new UN Resolution 917 (1994) of May 6, 1994 was not mandatory according to its wording (section 4). Hence section 69 o of the Foreign Trade and Payments Regulation continued to apply, which, in the unanimous view of the Federal Government and the Bank, also covered the new UN sanctions. The embargo against Haiti was terminated by UN Resolution 944 (1994) of September 29, 1994; accordingly, the Federal Ministry of Economics lifted Chapter VII e, i. e. section 69 o of the Foreign Trade and Payments Regulation, by the 35th Regulation Amending the Foreign Trade and Payments Regulation of October 27, 1994 (Federal Gazette of November 3, 1994, page 11162).

Libya

The Regulation prepared by the Commission on the basis of Article 73 g of the EC Treaty did not meet with the requisite majority among the member states. The principal reasons arguing against the adoption of the draft were that most member states had already implemented the UN sanctions effective since December 1, 1993 by passing legislation of their own, and that a new text drafted by the EC might have had an unsettling effect on trade and industry. Moreover, implementation by EC legislation pursuant to Article 73 g did not appear to be mandatory.

Bosnia/ Herzegovina

A new development is the UN embargo against the areas of the Republic of Bosnia-Herzegovina that are controlled by Bosnian-Serbian troops. The relevant UN Resolution 942 (1994) of September 23, 1994 was implemented by the EC not only in the field of merchandise and service transactions but also, by virtue of Articles 228 a and 73 g of the EC Treaty, with respect to financial relations (EC Regulation 2471/94 of October 10, 1994, Official Journal L 266/1). Pursuant to Article 6 – and contrary to previous practice under the Foreign Trade and Payments Regulation – "funds or other financial assets or resources" of individuals in the areas concerned, i. e. primarily of pensioners living there, are likewise frozen. The Bank granted the pension funds and credit institutions the requisite payment authorisations on request. Payments to areas of the Republic of Bosnia-Herzegovina not controlled by Serbs do not require special authorisation.

Overview

To sum up, the following provisions concerning UN financial sanctions applied at the end of 1994:

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

Libya:	section 69 n of the Foreign Trade and Payments Regulation
Bosnia/Herzegovina (if controlled by Serbs):	Articles 6 and 7 of EC Regulation 2471/94

VIII. Technical central bank assistance by the Bank

Increased demand for technical assistance

For several years, the Bank has been actively assisting central banks in countries in transition and developing countries in the establishment and extension of a central banking and banking system geared to market principles. Demand for such technical assistance has increased markedly of late, as the important role played by a well-functioning central bank in the transformation process has become ever-clearer in the countries in transition. The keen interest in advice and training assistance from the Bank probably also reflects the internationally high reputation of the Bank and the comparatively successful transformation process in the new Länder after German reunification. The Bank has taken due account of the higher demand and upgraded the previous coordination unit at the Central Office to form a "Technical Central Bank Assistance" Division, and has enlarged its staff.

Regional and technical focal points

As part of its technical central bank assistance, the Bank in principle supports central banks only. In designing and implementing such technical assistance, regional and technical priorities are set in the light of the heavy demand, on the one hand, and the limited staff resources, on the other. The regional focus is on countries in central and eastern Europe and the former Soviet Union and, of late, increasingly also on east Asian countries, such as the People's Republic of China and Viet Nam. Regarding the technical subjects, technical central bank assistance covers a broad spectrum, ranging from central bank legislation and questions of payments, accounting, organisation, data processing, statistics, lending, foreign exchange transactions and banking supervision to domestic and external monetary policy. Most recently, the emphasis has increasingly shifted to issues relating to payments and banking supervision.

Diverse range of training and instruction

In order to ensure the maximum efficiency of technical assistance, the Bank solely uses in-house experts (including retired staff) who have a thorough theoretical knowledge and, above all, many years of practical experience of central banking. The focus of assistance is on bilateral training, instruction and advisory services for staff members and executives of foreign central banks. This takes the form of expert advice proffered abroad, information visits to the Bank and special seminars held both abroad and at the Bank. In this connection, great importance is attached to the assistance being tailored to the specific situation and needs of the recipient central bank. In addition to such bilateral assistance, the Bank contributes to the multilateral assistance granted by the IMF and occasionally the World Bank by seconding Bundesbank experts.

Doubling of technical assistance activities

In 1994 the technical central bank assistance activities of the Bank, including the Land Central Banks, doubled against the previous year, both in terms of the number of activities and in terms of the number of participants. In the roughly 30 countries whose central banks were supported by the Bundesbank in 1994, about 100 missions were undertaken to provide advice. At the same time, around 400 staff members of foreign central banks attended seminars held by the Bundesbank abroad, and about 230 foreign guests attended seminars at the Bank. Finally, over 75 information visits for almost 250 participants were organised at the Bank.

New, standardised seminars

Of late, the requirements of the central bank assistance requested have shifted increasingly in favour of specific project-related advisory and training services. The Bundesbank has taken due account of this change and introduced new, standardised seminars for the residual demand for general training and instruction. These are designed to address themselves to more basic and general aspects of modern central banking. They will be held regularly at the Bank and be open to a broad range of interested central banks from transitional and developing countries.

Gratifying initial successes

Given that in many cases the transition process is taking place in a difficult economic environment, with serious macro-economic imbalances, it would be premature to seek finally to assess the effectiveness of technical central bank assistance in the recipient countries. Nevertheless, there are some heartening signs that the assistance is bearing fruit. For instance, there is growing recognition among central banks in the countries in transition that in the long run the best contribution to transformation is a monetary policy geared to stability, and that this should be supported by refraining from financing the public sector through the central bank and, if at all possible, also by ensuring the independence of the central bank. This perception owes a great deal to previous participants in technical assistance programmes, who have now moved up in a number of cases to senior positions in their respective central banks, and are there implementing and applying the knowledge and skills they acquired. Moreover, it is particularly gratifying to see that some central banks in central Europe are now for their part passing on this knowledge and their own experience to other countries through technical assistance programmes. Despite these initial successes, it will probably be some years before the need for advice and instruction as part of the Bank's technical and central bank assistance scheme will have been met.

IX. Changes in the organisational structure, staff levels

Closure of small bases; new branch offices in eastern Germany

The tendency towards streamlining the structure of the Bank continued at a faster pace in the year under review. In 1994 eight branch offices of the Bank were closed. New jobs were found for the employees concerned in other Bank offices. On the other hand, in order to extend the Bank's regional presence in the new Länder, one new branch office was set up in Bautzen and another in Dessau.

Staff adjustment measures approved

As a result of the agreed further reduction in the number of branch offices in the next few years, and of other expected organisational changes, the Central Bank Council approved a series of measures in December 1994 with the aim of keeping the staff members concerned in employment where possible – if need be, also by placing them with other employers – while, on the other hand, making necessary staff adjustments socially acceptable and adopting them in consultation with employees.

Staff levels continue to fall

On balance, the number of employees declined from 17,632 at the beginning of 1994 to 17,142 at the beginning of 1995, i. e. by 490 (– 2.8 %). A decrease of 404 employees was accounted for by the Land Central Banks.

Creation of part-time jobs

A further focal point of the Bank's personnel management policy in 1994 was the implementation of new legal provisions designed to foster the creation of part-time jobs. In the past, the Bank has been able – with a few exceptions – to comply with all wishes for part-time employment that its employees have expressed. Of the Bank's 17,142 employees, 1,776 were working part-time at the end of 1994; this constitutes a part-time ratio of about 10 %. Other possible ways of increasing the proportion of part-time employment are to be exploited.

Trends in staff levels

Table 25

Beginning of 1994

Employed persons	Central Office of the Bank	Land Central Banks	Total 1	Male	Female
Civil servants	1,060	5,960	7,020	6,108	912
Other salaried staff	1,551	7,976	9,527	4,377	5,150
Wage earners	217	868	1,085	221	864
Total	2,828	14,804	17,632	10,706	6,926

Beginning of 1995

Employed persons	Central Office of the Bank	Land Central Banks	Total 1	Male	Female
Civil servants	1,064	5,927	6,991	6,050	941
Other salaried staff	1,468	7,633	9,101	4,176	4,925
Wage earners	209	841	1,050	218	832
Total	2,741	14,401	17,142	10,444	6,698

1 of whom

	Beginning of 1995	Beginning of 1994
Trainee civil servants and other trainees	581	887
Part-time employees:		
Civil servants and other salaried staff	1,093	1,030
Wage earners	683	710
Persons seconded to work at international institutions or abroad	53	33
The following are not included in the staff figures: members of the Bank's staff released without pay	623	546

Deutsche Bundesbank

International focus of training and further training

In 1994, too, the Bank's training and further training programmes focused on the preparation of staff members for assignments in the international, and primarily European, field. The Bank made full use of the scope for seconding staff members to EC central banks, under the terms of existing agreements on the exchange of staff, and to various international organisations.

Annual accounts of the Deutsche Bundesbank for 1994

I. Balance sheet of the Deutsche Bundesbank as at December 31, 1994

Assets

			DM	31. 12. 1993 DM million
1 Gold			13,687,518,821.70	13,687
2 Reserve position in the International Monetary Fund and special drawing rights				
2.1 Drawing rights within the reserve tranche		6,241,554,017.34		(6,833)
2.2 Loans under special borrowing arrangements		–		(–)
2.3 Special drawing rights		1,725,870,745.83		(1,663)
			7,967,424,763.17	8,496
3 Claims on the European Monetary Institute				
3.1 ECU balances	44,433,342,617.61			
less: Difference between the ECU value and the book value of the contributed gold and dollar reserves	12,691,665,843.42			
		31,741,676,774.19		(31,876)
3.2 Other claims		–		(4,300)
			31,741,676,774.19	36,176
4 Balances with foreign banks and money market investments abroad			60,188,385,432.76	61,762
5 Foreign notes and coins			20,374,011.41	22
6 External loans and other external assets				
6.1 Loans in connection with EC medium-term balance of payments assistance		–		(–)
6.2 Other loans to foreign monetary authorities		–		(–)
6.3 Loans to the World Bank		2,151,800,000.–		(2,412)
6.4 Other external assets		208,050,000.–		(208)
			2,359,850,000.–	2,620
7 Lending to domestic credit institutions				
7.1 Securities bought in open market transactions under repurchase agreements		146,285,230,000.–		(184,531)
7.2 Domestic bills of exchange		52,108,308,067.62		(47,586)
7.3 Foreign bills of exchange		9,545,539,028.43		(10,549)
7.4 Lombard loans		9,753,182,300.–		(14,836)
			217,692,259,396.05	257,502
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			3,173,075,260.22	4,729
10 German coins			2,126,366,759.51	2,067
11 Balances on postal giro accounts			2,715,897,195.23	451
12 Land and buildings			3,364,299,967.75	3,176
13 Furniture and equipment			213,838,982.96	238
14 Items in course of settlement			–	2,963
15 Other assets			2,438,549,441.11	2,506
16 Prepayments			109,880,078.02	488
			356,482,982,873.01	405,567

Liabilities

		DM	31. 12. 1993 DM million
1 Banknotes in circulation		236,165,302,300.–	224,341
2 Deposits of credit institutions			
2.1 Deposits on giro accounts	56,153,923,361.20		(73,345)
2.2 Other	27,700,771.08		(33)
		56,181,624,132.28	73,378
3 Deposits of public authorities			
3.1 Federal Government	41,514,156.99		(13,025)
3.2 Equalisation of Burdens Fund, ERP Special Fund, "German Unity" Fund	9,044,650.06		(22)
3.3 Länder Governments	135,663,085.90		(387)
3.4 Other public depositors	29,522,940.08		(62)
		215,744,833.03	13,496
4 Deposits of other domestic depositors		710,873,266.37	781
5 Liabilities arising from liquidity paper sold		6,038,500,000.–	26,207
6 Liabilities arising from external transactions			
6.1 Deposits of foreign depositors	18,545,636,924.57		(22,033)
6.2 Other	5,017,902.56		(19)
		18,550,654,827.13	22,052
7 Counterpart of special drawing rights allocated		2,737,552,575.20	2,876
8 Provisions			
8.1 for pensions	2,753,000,000.–		(2,665)
8.2 for other purposes	7,257,480,108.80		(8,643)
		10,010,480,108.80	11,308
9 Items in course of settlement		1,955,073,820.35	–
10 Other liabilities		539,534,380.18	560
11 Accruals		722,303,723.69	485
12 Capital		290,000,000.–	290
13 Reserves			
13.1 Legal reserves	11,217,100,000.–		(10,668)
13.2 Other reserves	290,000,000.–		(290)
		11,507,100,000.–	10,958
14 Unappropriated profit		10,858,238,905.98	18,835
		356,482,982,873.01	405,567

II. Profit and loss account of the Deutsche Bundesbank for 1994

Expenditure

			DM	1993 DM million
1	Interest expenditure		2,197,804,497.74	3,391
2	Staff costs			
	2.1 Wages and salaries	1,040,594,064.10		(1,039)
	2.2 Social security contributions, spending on retirement pensions and on maintenance payments	443,769,265.73		(460)
			1,484,363,329.83	1,499
3	Other operating expenditure		359,482,173.24	392
4	Banknote printing		156,666,628.07	236
5	Depreciation			
	5.1 of land and buildings	221,772,397.42		(233)
	5.2 of furniture and equipment and of other assets	155,119,941.78		(155)
			376,892,339.20	388
6	Write-downs of monetary reserves and other foreign currency positions		2,803,755,505.10	–
7	Other expenditure		62,910,184.04	260
8	Profit for the year (= unappropriated profit)		10,858,238,905.98	18,835
			18,300,113,563.20	25,001

Receipts

		DM	1993 DM million
1	Interest	17,859,825,314.49	24,520
2	Fees	97,860,620.05	112
3	Receipts from purchases and sales of foreign currencies and from the valuation of the monetary reserves and other foreign currency positions	–	59
4	Other receipts	342,427,628.66	310
		18,300,113,563.20	25,001

Frankfurt am Main, February 15, 1995

Deutsche Bundesbank
The Directorate

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

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 the principles of orderly bookkeeping, and present a picture of the Bank's assets, liabilities, financial position and profitability which is consistent with the actual state of affairs.

Frankfurt am Main, March 17, 1995

C & L TREUARBEIT
DEUTSCHE REVISION
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

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 1994

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 is also subject to the principles of orderly bookkeeping. In particular, the legal basis for its accounts is provided by sections 26 and 27 of the Bundesbank Act *(Gesetz über die Deutsche Bundesbank – BBankG),* in the wording of July 8, 1994. In accordance with those provisions, the layout of, and the notes on, the annual accounts must take due account of the Bundesbank's functions. 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 in line with the strict lower value principle (section 253 (3) of the Commercial Code). Furthermore, write-downs may be effected in order to obviate the need to change the valuation in future on account of fluctuations in value. Such a lower valuation may be retained in the following years, too (section 253 (5) of the Commercial Code). The creation of liability items in respect of general hazards encountered in domestic and international transactions is regulated by section 26 (2) of the Bundesbank Act.

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

Classification

In accordance with Article 104 of the Maastricht Treaty, central banks are no longer allowed to extend any direct loans to public authorities. The regulations on cash advances were repealed accordingly under the Act Amending the Regulations on the Deutsche Bundesbank of July 8, 1994. As a consequence, the previous balance sheet items "Cash advances" and "Lending to the Federal Railways and Federal Post Office" have been deleted.

In addition, following the reform of the railways from January 1, 1994, the previous breakdown of the item "Deposits of other domestic depositors" into deposits of the Federal Railways, deposits of the east German Railways and deposits of other depositors was deleted.

In accordance with Article 109 (f) of the Maastricht Treaty, the European Monetary Institute has assumed the functions of the European Monetary Cooperation Fund. Because this alteration is not accompanied by any factual changes in the European Monetary System, only the designation of the item is amended; it now reads "Claims on the European Monetary Institute".

Auditing and approval of the annual accounts

The annual accounts of the Bundesbank for 1994 were audited by C&L Treuarbeit Deutsche Revision AG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft of Frankfurt am Main and Wollert-Elmendorff Deutsche Industrie-Treuhand GmbH Wirtschaftsprüfungsgesellschaft of Düsseldorf, whom the Central Bank Council had appointed to be auditors in accordance with section 26 (3) of the Bundesbank Act. In their certificate of audit, the auditors confirmed without qualification that the annual accounts for 1994 and the Bank's bookkeeping comply with German law, and present a true picture of the Bank's assets, liabilities, financial position and profitability. The Central Bank Council approved the annual accounts for 1994, along with the profit distribution, on April 20, 1995.

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 is 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 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 and arising 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 under the German quota in gold, special drawing rights and Deutsche Mark. At December 31, 1994 their level came to DM 6,242 million (= SDR 2,760 million), compared with DM 6,833 million (= SDR 2,877 million) at the end of 1993. They represent the difference between the German quota of SDR 8,242 million and the Deutsche Mark balances equivalent to DM 12,392 million (= SDR 5,482 million) at the disposal of the IMF at the end of the year. Owing to Deutsche Mark drawings and Deutsche Mark repayments by other member countries, the holding of drawing rights decreased by SDR 116 million in 1994.

During the year under review, the Bank did not grant the IMF any new loans under special borrowing arrangements. At present only one credit line in favour of the IMF amounting to SDR 2.4 billion is outstanding under the General Arrangements to Borrow (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 amount of special drawing rights held at the end of 1994 came to DM 1,726 million (= SDR 763 million). Increases totalling SDR 84 million due to interest receipts were accompanied by decreases amounting to SDR 20 million due to interest payments.

Claims on the European Monetary Institute

This balance sheet item is factually identical with the previous item "Claims on the European Monetary Cooperation Fund (EMCF) in connection with the European Monetary System". The designation of the item was amended upon the transfer of the functions of the European Monetary Cooperation Fund to the European Monetary Institute in line with Article 109 (f) of the Maastricht Treaty; this does not involve any substantive change in the Bank's accounting. 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 are shown in this item. The ECU balances, amounting to DM 44,433 million, derive mainly from the contribution of 20 % of the Bank's gold and dollar reserves to the EMI. In addition, these balances include the reserve ECUs (DM 11,392 million) transferred to the Bank by other central banks participating in the EMS. The gold and dollar reserves contributed to the EMI against the crediting of ECUs under the terms of the EMS were transferred at market prices, and therefore at values higher than those shown in the balance sheet. The resulting difference of DM 12,692 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 1994.

Balances with foreign banks and money market investments abroad

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 60,188 million at the end of 1994, against DM 61,762 million at December 31, 1993 (not counting the dollar reserves contributed to the EMI). This asset item, which in previous years was subject to sharp fluctuations owing to exchange market interventions in the EMS, changed only marginally compared with the end of 1993. The assets and liabilities denominated in US dollars were valued at the balance sheet rate of US$ 1 = DM 1.3870, which represented, on the balance sheet date, the all-time lowest level of the dollar on September 2, 1992.

External loans and other external assets

The main constituents of this item are loans to the World Bank (which were mostly granted against borrowers' notes denominated in Deutsche Mark). No loans under the EC medium-term balance-of-payments assistance arrangement or other loans to foreign monetary authorities were outstanding on December 31, 1994. The other external assets constitute limited investments with foreign institutions. Because of their lower 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 agreements used as part of the flexible money market management arrangements. In this 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 146,285 million; the decline of DM 38,246 million against the previous year owed something to the fact that the lowering of the minimum reserves on March 1, 1994 was offset by a reduction in securities repurchase agreements. The portfolio of domestic and foreign bills of exchange which the Bank purchases at the discount rate under the rediscount quotas increased by DM 3,518 million compared with December 31, 1993. Lombard loans, by means of which the Bank supplies central bank money against the collateral of securities and Debt Register claims, serve to meet short-term liquidity needs on the part of credit institutions. On the balance sheet date they amounted to DM 9,753 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 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 conformity with Article 104 of the Maastricht Treaty, it has been stipulated 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, the Federal Railways and the Federal Post Office, decreased from DM 4,729 million to DM 3,173 million on account of transactions in the open market.

German coins

The Bank's portfolio of coins is held as a reserve for use in payments. The Bank, acting for the account of the Federal Government (which holds the coinage prerogative), receives new coins from the mints at face value. At the end of 1994 the amount of coins in the Bank's portfolio was equivalent to about 14.4% of the volume of coins outstanding; under the supplementary provisions of Article 104 of the Maastricht Treaty, the ceiling for this amounts to 10%; for a transitional period, a ceiling of 15% applies until the end of 1996 (as in the Coinage Act).

Land and buildings

In 1994 the balance sheet value of land, bank offices and residential buildings increased by DM 189 million. Additions of DM 411 million were accompanied by depreciation amounting to DM 222 million.

Furniture and equipment

In the year under review the value of the furniture and equipment of the Bank fell by DM 24 million, after additions of DM 122 million and depreciation totalling DM 146 million.

Items in course of settlement

At the end of 1994, in contrast to the previous years, the "Items in course of settlement" showed a deficit, which is indicated in liability item 9.

Other assets

"Other assets" primarily comprise interest income from external assets and securities transactions which is not due until 1995 but is assignable to the profit and loss account for 1994. This item also includes participating interests in the Bank for International Settlements, Basle, the cooperative society S.W.I.F.T., La Hulpe (Belgium) and the Liquiditäts-Konsortialbank GmbH, Frankfurt am Main. The 30% interest in the Liquiditäts-Konsortialbank entails for the Bank a maximum commitment of DM 558 million.

Prepayments

The prepayments consist mainly of interest payments booked in the year under review, but relating to 1995, for salary and pension payments and for interest expenditure on liquidity paper sold.

3. Liabilities

Banknotes in circulation

Compared with the end of 1993, the amount of banknotes in circulation rose by DM 11,824 million to DM 236,165 million, representing an increase of 5.3 %. In the preceding year the increase came to 5.1 %.

Compared with the previous year, the amount of currency in circulation went up by DM 12,266 million to DM 250,907 million; DM 14,742 million of this sum was accounted for by coins.

Deposits of credit institutions

Credit institutions' deposits on giro accounts came to DM 56,154 million at the end of 1994, against DM 73,345 million on December 31, 1993; the decline is mainly due to the lowering of the minimum reserves on March 1, 1994. The sub-item "Other" contains the deposits of domestic credit institutions and of the branches of foreign banks on US dollar accounts (DM 28 million).

Deposits of public authorities

This item comprises the balances of the Federal Government, the Equalisation of Burdens Fund, the ERP Special Fund and the Länder Governments, which, until the repeal of section 17 of the Bundesbank Act in mid-1994, were required to deposit their liquid resources with the Bundesbank. In anticipation of the amendment of the law, the Bank enabled the Federal and Länder Governments to invest their liquid funds at interest outside the Bank from January 1, 1994 onwards by means of blanket quotas. In addition, this item includes deposits of the "German Unity" Fund. The deposits of other public depositors constitute balances of the social security funds and local authorities. At December 31, 1994 such deposits amounted to DM 216 million (1993: DM 13,496 million).

Deposits of other domestic depositors

This balance sheet item contains the deposits of enterprises and individuals. The deposits of the Federal Railways and the east German Railways are no longer shown separately, after these public enterprises had been organised under private law as part of the reform of the railways. At the end of 1994 the deposits totalled DM 711 million, against DM 781 million in the previous year.

Liabilities arising from liquidity paper sold

"Liabilities arising from liquidity paper sold" relate to Treasury bills and Treasury discount paper issued by the Federal Government. At the end of 1994 they amounted to DM 6,039 million (1993: DM 26,207 million). The major part thereof was made up of Bundesbank liquidity paper ("Bulis"), the regular issue of which was discontinued after the auction in September 1994. At December 31, 1994 the amount of such paper outstanding came to DM 4,909 million. Furthermore, Treasury bills were sold to credit institutions as part of the money-market-management operations to mop up liquidity at short notice. They also serve public authorities, foreign monetary authorities and international organisations as a means of investing in an interest-bearing manner such balances as they do not require for payment purposes. DM 1,130 million of Treasury bills were outstanding at the end of 1994.

Liabilities arising from external transactions

This balance sheet item, totalling DM 18,551 million (1993: DM 22,052 million), consists primarily of Deutsche Mark deposits of foreign monetary authorities, and results in the main from their Deutsche Mark interventions in the foreign exchange markets. Specifically, DM 17,622 million (1993: DM 21,933 million) was accounted for by the balances of foreign banks and DM 929 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 of 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 88 million, the provisions for pensions amount to DM 2,753 million; they are in line with the actuarially computed requirements.

Provisions for other purposes

The provisions for other purposes, which serve primarily to cover general risks inherent in domestic and international operations and doubtful liabilities, declined by DM 1,386 million net on December 31, 1994. Since then, these provisions have amounted to DM 7,257 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 by return-date effects in particular, mainly consist of the cheques, direct debits and credit transfers in transit within the Bank at the end of the year. Following the introduction of the large-value cheque collection procedure, the asset-side ratio of the items in course of settlement declined significantly. At December 31, 1994 the negative balance came to DM 1,955 million, against a positive balance of DM 2,963 million at the end of 1993.

Other liabilities

The other liabilities, amounting to DM 540 million (1993: DM 560 million), constitute amounts not yet passed on and interest expenditure falling due in 1995 but relating to 1994.

Accruals

Accruals totalled DM 722 million at December 31, 1994 (1993: DM 485 million). This item comprises the interest received during the year under review, but relating to the following year, on domestic and foreign bills of exchange and US Treasury notes.

Reserves

In accordance with the decision taken by the Central Bank Council on April 14, 1994, the legal reserves were increased by DM 549 million out of the unappropriated profit for 1993. Since that increase, the legal reserves have totalled DM 11,217 million; they have thus reached the maximum level permissible by law of 5 % of the amount of banknotes in circulation, which was DM 224,341 million at the end of 1993. The other reserves 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 1,193 million in the year under review. Interest expenditure on both external and domestic operations decreased.

Staff costs

Staff costs went down by 1.0 % in 1994 to a total of DM 1,484 million. A significant factor was that the number of employees declined by 2.4 % on average in 1994. DM 289 million (1993: DM 309 million) of the staff costs was accounted for by retirement pensions. This sum includes the increase of DM 88 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 9,641,755.74 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, as well as of the Executive Boards of the Land Central Banks, including their surviving dependants, received payments totalling DM 13,595,882.81.

Other operating expenditure

The other (non-staff) operating expenditure of the Bank decreased by DM 33 million (8.3 %) compared with 1993, and amounted to DM 359 million. This reflected, in particular, the smaller increase than in the previous year in spending on office buildings.

Banknote printing

In the year under review expenditure on banknote printing declined by DM 80 million to DM 157 million. This is attributable, in particular, to the low replacement needs for the banknotes of the new series in circulation.

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 profits and losses arising from purchases and sales of foreign currencies and the changes in the provisions also affecting the external position. Altogether, losses of DM 2,804 million were recorded.

5. Receipts

Interest

In the year under review the interest received, at DM 17,860 million, was DM 6,660 million lower than in 1993. The crucial factor here was interest income from lending to domestic credit institutions; it declined by DM 5,236 million owing to the further fall in central bank interest rates and the reduced average refinancing volume on account of the lowering of the minimum reserves. Interest income from securities, at DM 294 million, had only a minor impact on total interest receipts. Interest income from international operations decreased by DM 1,264 million against the previous year, to DM 6,771 million. In the case of dollar investments, interest receipts decreased owing to declining average interest rates and exchange rates.

Fees

Fees, which accrue first and foremost in connection with payments, went down by DM 14 million to DM 98 million owing to the increased use of cost-effective paperless procedures by banks.

6. Profit for the year

The profit and loss account for 1994 records a profit for the year of DM 10,858,238,905.98, which is shown in the balance sheet as unappropriated profit (net profit). In accordance with section 27 of the Bundesbank Act, DM 591,200,000.00 of this sum will be transferred to the legal reserves and DM 30,000,000.00 to the Fund for the Purchase of Equalisation Claims. The balance, amounting to DM 10,237,038,905.98, will be paid over to the Federal Government. After this appropriation, the legal reserves will total DM 11,808,300,000.00; 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

The fund for the purchase of equalisation claims as at December 31, 1994 was audited by C&L Treuarbeit Deutsche Revision AG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft 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 purchase fund had been properly managed. The Central Bank Council approved the Report on the Fund for the Purchase of Equalisation Claims as at December 31, 1994 on April 20, 1995.

During the year under review the purchase fund again received DM 30 million from the profit of the Deutsche Bundesbank for the preceding year. In addition, DM 445 million of interest and redemption payments from the debtors of equalisation claims and DM 6 million of interest from the temporary investment of available resources accrued to the fund. Together with the DM 218 million carried forward from the financial year 1993, DM 699 million was at the fund's disposal. A total of DM 454 million was disbursed in 1994 on the purchase and the general acquisition of equalisation claims in accordance with section 9 of the Act on the Redemption of Equalisation Claims. Of that sum, DM 9 million in all was accounted for by purchases and the acquisition of minor equalisation claims in accordance with section 9 (2) number 2 and section 9 (3). DM 445 million was disbursed in the 21st acquisition round on the general acquisition of 66 % of all remaining equalisation claims on the Federal Government and ten Länder Governments. Emergency purchases of equalisation claims in accordance with section 9 (1) were effected on only a small scale. As at June 30, 1994 all the 4.5 % equalisation claims had been redeemed by the debtors, so that the fund only had 3 % and 3.5 % equalisation claims in its portfolio at the end of the year.

Total fund assets amounted to DM 2,791 million on December 31, 1994. DM 245 million of this sum (mainly comprising interest and redemption payments due at the end of the year) was not yet invested in equalisation claims, but was temporarily lodged in Federal Government money market paper. It is to be expected that the resources available to the fund in mid-1995 will be large enough to enable it generally to acquire all the outstanding equalisation claims in the 22nd acquisition round. The function of the fund will then be fulfilled. After reimbursement of any remaining obligations, the fund will be wound up in accordance with section 10 (2), with the result that the equalisation claims purchased are extinguished.

Equalisation claims in the purchase fund
Changes in 1994

Deutsche Mark

Interest rate (%)	Initial capital [1]				Remaining capital [2]
	Holding at Dec. 31, 1993	Additions due to purchases and general acquisition [3]	Deductions due to extinction	Holding at Dec. 31, 1994	Holding at Dec. 31, 1994
3	4,899,416,077.04	977,726,399.38	–	5,877,142,476.42	1,578,756,219.32
3½	4,488,742,746.16	883,932,720.92	–	5,372,675,467.08	967,442,267.90
4½	446,518,336.02	–	446,518,336.02	–	–
Total	9,834,677,159.22	1,861,659,120.30	446,518,336.02	11,249,817,943.50	2,546,198,487.22

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** Including minor equalisation claims where transferred to the Fund in the event of general acquisition.

Fund for the purchase of equalisation claims in 1994

Deutsche Mark

	Equalisation claims (remaining capital)	Available resources	Liabilities	Fund assets, total
Holding at December 31, 1993	2,454,104,196.43	218,125,294.53	63,942.49	2,672,165,548.47
Transfer from the profit of the Deutsche Bundesbank in 1993	–	30,000,000.–	–	30,000,000.–
Purchases and general acquisition of equalisation claims	454,093,615.73	−454,093,615.73	–	–
Redemptions	−361,999,324.94	361,999,324.94	–	–
Interest income from equalisation claims	–	83,106,076.51	–	83,106,076.51
temporary investment of the Fund's cash resources	–	6,117,244.30	–	6,117,244.30
Holding at December 31, 1994	2,546,198,487.22	245,254,324.55	63,942.49	2,791,388,869.28

Frankfurt am Main, February 15, 1995

Deutsche Bundesbank
The Directorate

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