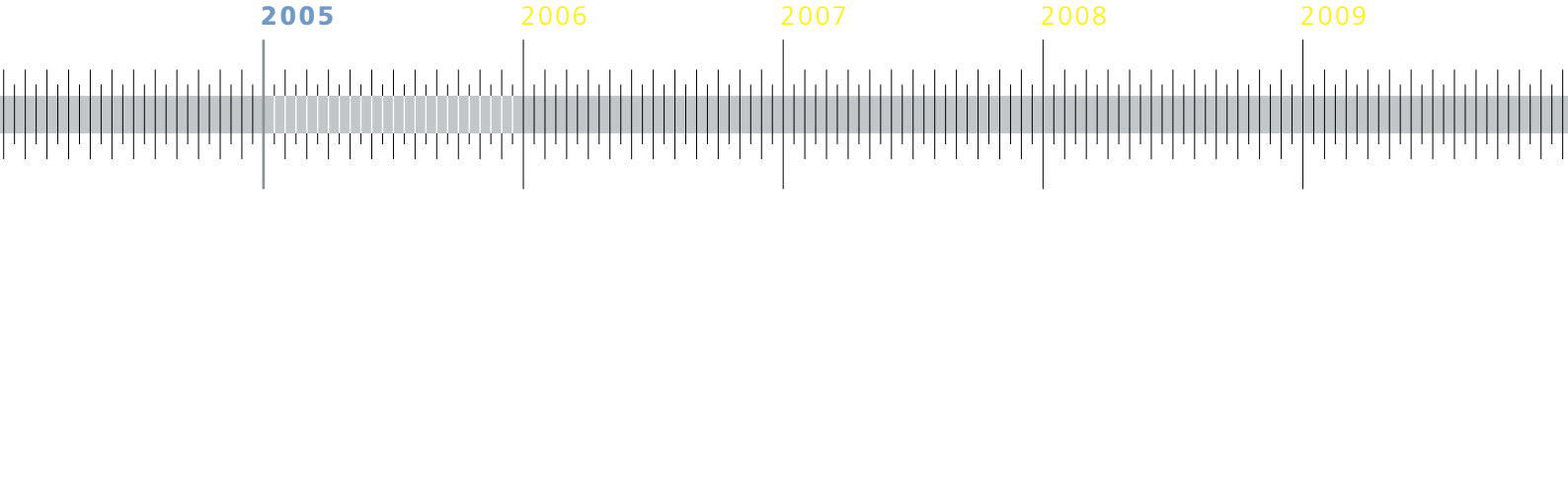
DEUTSCHE
BUNDESBANK

ANNUAL REPORT



We mourn the death in 2005

of the following members of our staff

Uwe Sennheim	19 January 2005
Berthold Becker	21 January 2005
Klaus-Peter Fechner	21 January 2005
Detlef Krawinkel	9 March 2005
Norbert Ulmeyer	4 April 2005
Hans Harmuth	15 April 2005
Ludwig Rubenbauer	11 May 2005
Helmut Andrae	13 May 2005
Herbert Hauling	25 May 2005
Heiner Schmidt	27 May 2005
Wolfgang Rieger	4 June 2005
Wolfgang Kanserske	15 June 2005
Jürgen Melzer	6 July 2005
Christof Kloft	7 July 2005
Andre Gerlach	10 July 2005
Andrea Farfar	26 August 2005
Thomas Lange	4 September 2005
Eckhard Ruthsatz	14 September 2005
Petra Villmow	26 October 2005
Josef Mies	21 December 2005

We also remember the retired staff members of the Bank who died in 2005.

We will honour their memory.

DEUTSCHE BUNDESBANK

Members of the Executive Board of the Deutsche Bundesbank

Professor Axel A Weber
President of the Deutsche Bundesbank

Professor Jürgen Stark
Vice-President of the Deutsche Bundesbank

Dr Hans Georg Fabritius

Professor Hans-Helmut Kotz

Dr Edgar Meister

Dr Hans Reckers

Professor Hermann Remsperger

Professor Franz-Christoph Zeitler

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

Postal address
Postfach 10 06 02
60006 Frankfurt am Main
Germany

Tel +49 69 9566-1

Fax +49 69 5601071

Telex 41227 within Germany
414431 from abroad

Internet http://www.bundesbank.de

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Abbreviations and symbols

p	Provisional
r	Revised
e	Estimated
pe	Partly estimated
...	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	Figure unknown, not to be published or not meaningful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

Last year saw cyclical improvements in the German economy, which coped fairly well with the substantial increase in crude oil prices and benefited from the fact that the additional expenditure on energy was at least partly offset by a rise in the demand for imports from oil-exporting countries. The momentum achieved by German exports in earlier years has meanwhile spread to include investment in machinery and equipment. Consequently, the upturn now has a wider and firmer base. Private consumption has remained muted, however, with the result that in 2005 as a whole the German economy again displayed divergent trends.

The main reason for the weak consumer demand is doubtless the ongoing difficult situation in the labour market. However, the rise in the number of persons officially registered as unemployed overstates the actual development owing to a statistical effect of the Hartz IV labour market reform, which came into force at the beginning of 2005: the amalgamation of unemployment assistance and social assistance meant that former recipients of social assistance were newly included in the unemployment figures. Although the underlying labour market situation was still dampened by the persistently sluggish momentum of overall business activity last year, the signs of an economic recovery are now beginning to mount. For example, there was a slight fall in the seasonally adjusted unemployment rate during the year. The decline in short-time working and the increasing number of vacancies likewise point to a certain revival in the labour market. Unless there are further reforms, however, the efforts to boost employment will make little progress. The structural distortions in the German labour market will not be overcome by a cyclical recovery on its own.

The improved prospects of a gradually accelerating recovery in Germany and in the euro area as a whole, however, have also increased the longer-term price risks in the single currency area. The prolonged increase in oil prices is a major factor in this connection, and the substantial rise in value added tax planned in Germany will add to the price pressures. But inflationary risks have also grown significantly on other fronts, not least with regard to the monetary aggregates. Exceptionally low interest rates are pushing up the demand for lending to the private sector and driving up money holdings in the euro area. The Governing Council of the ECB responded by adjusting the Eurosystem's key interest rates

upwards by ½ percentage point in two stages. That will not hamper the upturn in Germany. Domestic firms continue to enjoy favourable financing conditions, and the level of liquidity throughout the currency area likewise poses no obstacle to a robust economic upswing.

Buoyed by the brighter cyclical setting, the profitability of German credit institutions improved further last year. In particular, a marked drop in the need to make value adjustments strengthened the stability of Germany's financial system. However, risks are posed by the high oil price and the financial imbalances in the world economy, and these could lead to a deterioration in the international environment.

The situation of public finances in Germany is still precarious. The deficit limit of 3 % of gross domestic product (GDP) laid down in the EC Treaty was breached yet again in 2005. Even so, it was down on the year and, at 3.3 % of GDP, was lower than expected. However, the debt ratio increased to 67.7 % and therefore climbed further above the reference value of 60 %.

The Federal Government is not planning to reduce the deficit any further during the current year. It aims to lower the deficit ratio to well below the 3 % ceiling in 2007, primarily by means of the announced increase in value added tax. Yet based on current parameters, achieving compliance with the Maastricht criterion seems possible *this* year because the deficits might well decrease in the context of a stringent expenditure regime and an improving general economic setting. In view of the European and national fiscal rules and given the far from unfavourable current economic outlook, it would seem appropriate to begin implementing the necessary consolidation measures already this year.

Regarding its own internal organisation, the Bundesbank has further advanced the structural reforms adopted in 2002 and 2003. For example, the establishment of service centres, which perform specialised operational tasks centrally for the whole Bank, was completed on schedule. The envisaged consolidation of the branch network to 47 locations by the end of 2007 is proceeding according to plan following the closure of another five branch offices and three operating units last year. The Executive Board has also decided that the two operational areas of banking supervision and credit assessment are to be transferred in their entirety from the branches to the regional offices in 2006. As a result of the reforms, the Bundesbank is well equipped to discharge the duties assigned to it by Parliament properly and efficiently.

The *Annual Report* also contains the Bundesbank's annual accounts for 2005, which were drawn up by the Executive Board and have been independently audited.

My fellow members of the Executive Board join me in taking this opportunity to express our gratitude to all members of the Bundesbank's staff for their work in 2005. Besides thanking them for their past efforts, I call on them to continue to play an active role in ensuring the fulfilment of the Bundesbank's many and varied functions. My thanks also go to the staff representative bodies for their committed and constructive contribution.

Frankfurt am Main, March 2006

Professor Axel A Weber
President of the Deutsche Bundesbank

Currency and economy

I International and European setting

1 Ongoing global economic upturn

Continuing strong growth of the world economy...

Despite considerable strains resulting from the sharp rise in energy and commodity prices, the global economic upturn remained on a growth path in 2005. According to IMF estimates, output rose by 4½% in total, thus almost matching the peak level reached in 2004 (+5%). At the same time, real world trade also went up sharply, although, at 7%, not as sharply as in 2004 when it had expanded by 10½%. Owing to the considerable growth differentials and the shifts in the terms of trade, global economic imbalances intensified further. The US current account deficit, which amounted to 6½% of nominal GDP in 2005, contrasted with large surpluses in Japan and China as well as in the oil-exporting countries.

... despite new highs in oil prices and industrial raw material prices

The further sharp rises in the price of oil contributed to this development. At US$67½ per barrel, the price of Brent crude reached a new high at the end of August/start of September, following the reports of the hurricane damage along the Gulf Coast of the United States, although the market then eased considerably until the end of the year. However, there was another marked rise in oil prices at the start of 2006; by mid-March, they stood at US$63. In euro terms, Brent went up by 46% in 2005. There was likewise continuing upward pressure on the prices of industrial raw materials in 2005. On an annual average, the prices in euro were 14½% higher than in 2004.

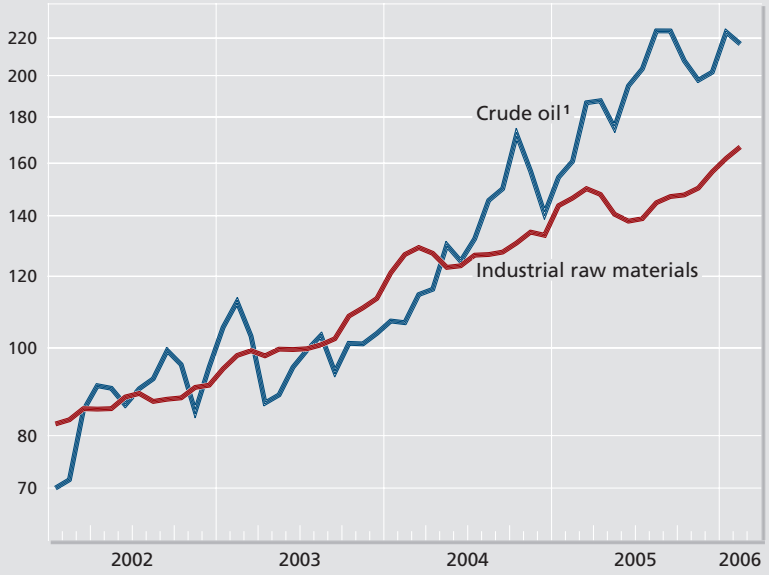
Limited adverse effects of the price rises in the oil and commodity markets, and...

The global economy coped remarkably well with the strains resulting from the rise in the price of energy and commodities in 2005. There are a whole host of reasons for this. In recent years the rise in the price of crude oil has been driven mainly by demand and therefore has not been as abrupt as in previous oil crises, most of which had been brought about by supply shortages. Furthermore, oil intensity in the industrial countries – ie oil consumption per unit of GDP – has roughly halved since the start of the 1970s. Added to this is the fact that the recycling of additional oil revenues to the consumer countries has increased over the past few years. As a result of this, the loss of purchasing power in consumer countries caused by the rising oil prices has been at least partly offset in terms of overall demand. For one thing, there was a rapid increase in import demand in the oil-exporting countries, from which west European economies, in particular, benefited. For another, the recycling of oil-exporting countries' financial sur-

World market prices for crude oil and industrial raw materials

Chart 1

2000 = 100, log scale



Source: Thomson Financial, HWWA; commodity price index and crude oil on US$ basis. — **1** Brent.

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pluses via the capital markets appears to be functioning more smoothly than in previous phases of climbing oil prices. One indication of this is the continuing low level of long-term interest rates in the major capital markets. Besides the increased sophistication of these markets, this no doubt owes something to the fact that currently the USA is by far the largest debtor, whereas – unlike in the 1980s – many emerging market economies with lower creditworthiness are capital exporters.

... moderate indirect and second-round effects

One reason why the global economy has proved to be very resilient is that the impact on general price developments has remained moderate, particularly in respect of indirect and second-round effects. The fact that the shift in price relationships resulting from the fast pace of globalisation has also involved price reductions in internationally traded industrial products is a contributory factor. In the industrial nations, the rate of consumer inflation rose from 2.0% in 2004 to 2.4% in 2005. At 1.5%, core inflation (excluding food and energy) was noticeably lower. However, global price risks increased over the year in the wake of the ongoing inflationary impulses in the commodity markets and the exceptionally favourable financing terms.

Global growth prospects remain good, but still considerable risks

All in all, the global economy has got off to a good start in 2006. The prospects for a continuation of global growth remain favourable. On average in 2006, output is likely to grow at a pace well above the multi-year average for the fourth time in a row. The global upturn is also likely to remain robust in that the differential in growth rates between the major industrial and economic regions USA, Japan and the euro area will probably decrease markedly, with somewhat slower growth in the USA, further sharp expansion in Japan and faster growth in the euro area. However, the possible risks emanating from abrupt adjustments of the global imbalances or that might result in connection with political conflicts from supply-related disruptions should not be overlooked.

Continued strong growth in the USA

The US economy remained one of the global growth centres in 2005. Although, at 3½%, the average growth rate was not as high as in 2004, it remained above potential which, according to common estimates, is between 3% and 3¼%. Had it not been for the adverse effects on aggregate output caused by the hurricane damage in late summer, real GDP would actually have risen somewhat more sharply in 2005. In the year under review the US economy again received considerable impetus from private consumption, although the further rise in energy prices heightened consumer price inflation. At 3.4%, the rise in the headline rate was the highest since the boom year of 2000. Households reacted to the considerable decline in purchasing power resulting from the higher cost of energy by continuing to save less. Added to this was the fact that the continuing rise in property prices encouraged new loans to be taken up. At -½%, the private saving ratio was at an all-time low on an annual average. Investment in housing, new machinery and equipment and commercial buildings also provided discernible positive contributions to growth.

Broadly-based upturn in Japan

Following a slowdown in the last three quarters of 2004, economic activity in Japan picked up strongly in 2005, albeit with a temporary lull in the third quarter. On an annual average, real GDP increased by 2¾%, compared with 2¼% in 2004. At the same time, the basis for the upturn in Japan in 2005 broadened to the extent that it was bolstered by both foreign demand and domestic economic activity. Consumer prices again fell in the year under review (by 0.3% on average). However, this can be put down largely to reductions in food prices. The official core rate, which excludes fresh food prices but includes energy prices, showed only a slight fall of 0.1%. With price developments poised to return to a normal pattern, the Japanese monetary policymakers are increasingly facing the question of how much longer the policy of zero interest rates should be maintained.

Macroeconomic benchmark figures of selected industrialised countries

Table 1

Countries	Real GDP		Consumer prices [1]		Current account balance		Unemployment rate [2]	
	2004	2005 pe	2004	2005	2004	2005 pe	2004	2005 pe
	Annual percentage change				As % of GDP		In %	
OECD	3.3	2.7	2.0	2.1	– 1.2	– 1.8	6.9	6.6
of which								
Euro area	2.1	1.3	2.1	2.2	0.6	– 0.4	8.9	8.6
United Kingdom	3.2	1.8	1.3	2.1	– 2.0	– 2.0	4.7	4.8
United States	4.2	3.5	2.7	3.4	– 5.7	– 6.4	5.5	5.1
Japan	2.3	2.7	0.0	– 0.3	3.7	3.4	4.7	4.4
Canada	2.9	2.9	1.9	2.2	2.2	2.2	7.2	6.8

Sources: IMF, ECB, OECD, national statistics. — **1** Consumer price index; OECD: deflator of private consumption. — **2** Standardised unemployment rate, based on OECD and Eurostat calculations.

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East Asian emerging market economies still on growth path, despite significant burdens

The south and east Asian emerging market economies continued to grow rapidly in 2005, albeit not quite as fast as before in most cases. However, the pace of growth in China in 2005 was practically unchanged at 10%. The very robust momentum in south and east Asia overall is remarkable insofar as, owing to their high energy intensity and heavy dependency on energy imports, the majority of countries in the region were particularly hard hit by the rise in global market prices for crude oil.

Latin America and CIS buoyed by booming commodity and oil markets

By contrast, Latin America and the Commonwealth of Independent States (CIS) are among the regions that continued to benefit from the high and/or rising prices of industrial commodities and energy in 2005. However, in the CIS countries, most of which are experiencing dynamic economic growth, the steep rise in revenue from commodity exports continues to mask considerable structural weaknesses. A particular problem is the large consumption bias of these countries' economic growth profile, whereas in recent years the investment ratio in the CIS fell well short of the corresponding figure for the central and east European transition countries. This can also be attributed to the – in some cases – uncertain institutional conditions for domestic and foreign investors.

High rate of expansion in the new member states

In 2005, the economies of the new EU member states remained on the more moderate growth path on which they had embarked in the second half of 2004. On an annual average of 2005, the new member states' real GDP rose by 4½%, compared with 5% in the previous year. The slowdown in the hitherto dynamic domestic economy, which was linked, not least, to the energy-price-related decline in purchasing power, was accompanied by a noticeable weakening of import growth. As exports did not fall as sharply, there was an improvement in the current account balance of a number of these countries, despite a further worsening of the terms of trade. Although, owing to the increase in the price of crude oil and industrial raw materials in the world markets, the price climate in the new member states deteriorated over the year, consumer price inflation, at 2.6% on average, was well below the 2004 rate (4.2%). The principal factor in this was a statistical drop-out effect relating to – in some cases sharp – increases in tax rates which took effect in some countries when they joined the EU on 1 May 2004. Furthermore, appreciating exchange rates eased the imported price pressures in several countries.

2 Accelerating growth momentum in the euro area

Acceleration over the year, but only moderate rate of growth

The economy in the euro area became noticeably stronger and more stable in the course of 2005. Real GDP rose at an annualised seasonally and calendar-adjusted rate of 2% in the second half of the year, compared with 1¼% in the first half of the year. Nevertheless, owing to the dull momentum with which the euro-area economies began 2005, output increased on balance by just 1¼% last year.

Further buoyant export activity

Strong impulses again came from foreign demand, although they were not as vigorous as in 2004. Real exports, which in the euro-area national accounts include exports to other member countries, rose 3¾% on the year. At the same time, however, imports rose even faster (4½%), with the result that net exports put a slight dampener on GDP growth.

Domestic economy still moderate

Besides the buoyant export dynamics, the increase in overall economic activity was driven mainly by domestic demand, which, at 1½%, grew more slowly than in 2004, however. This can be put down partly to the fact that there were practically no further expansionary effects resulting from stockbuilding. Furthermore, there was a smaller increase in final domestic demand than in the previous year. The reason for this was the fact that private consumption and gross

Economic performance in the euro area

Table 2

Country	Real GDP 2004	Real GDP 2005	Consumer prices [1] 2004	Consumer prices [1] 2005	Unemployment rate [2] 2004	Unemployment rate [2] 2005
	Annual percentage change				In %	
Euro area	2.1	1.3	2.1	2.2	8.9	8.6
Germany	1.6	0.9	1.8	1.9	9.5	9.5
France	2.3	1.4	2.3	1.9	9.6	9.5
Italy	1.1	0.0	2.2	2.2	8.0	[3] 7.7
Spain	3.1	3.4	3.1	3.4	11.0	9.2
Netherlands	1.7	0.9	1.4	1.5	4.6	4.7
Belgium	2.6	[3] 1.4	1.9	2.5	8.4	8.4
Austria	2.4	1.9	2.0	2.1	4.8	5.2
Finland	3.6	2.1	0.1	0.8	8.8	8.4
Portugal	1.1	0.3	2.5	2.1	6.7	7.6
Greece	4.7	3.7	3.0	3.5	10.5	[3] 10.4
Ireland	4.9	[3] 4.4	2.3	2.1	4.5	4.3
Luxembourg	4.5	[3] 4.2	3.2	3.8	4.8	5.3

1 Harmonised Index of Consumer Prices (HICP) — **2** Standardised unemployment rate according to calculations by Eurostat (ILO definition). — **3** European Commission projections (Economic Forecasts, November 2005).

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fixed capital formation grew by no more than 1¼ and 2%, respectively. By contrast, the rise in government consumption expenditure accelerated slightly to 1½%.

Growth differentials among member states

However, this overall result for the euro area masks considerable growth differentials from country to country. For example, the gap between the fastest-growing (Ireland) and slowest-growing (Italy) country amounted to an estimated 4½ percentage points, compared with 3¾ percentage points in 2004 (albeit with somewhat different country rankings). However, weighted by the individual countries' respective share in euro-area GDP, the growth differentials within the euro area have likewise increased. The weighted standard deviation rose from ¾ percentage point in 2004 to 1 percentage point last year.

Slight easing in the labour market

The situation in the labour market in the euro area eased somewhat in 2005. For example, the standardised number of unemployed persons fell steadily from the second quarter and, at 12.5 million on an annual average, was around 360,000 down on the level in 2004. The standardised unemployment rate fell correspondingly by 0.3 percentage point to 8.6%. According to a provisional estimate, the number of people in work in the euro area rose by ¾%. The increase in employment was aided predominantly by persistently moderate labour costs.

These increased in the euro area per hour worked by 2½% in 2005 – just as in 2004. Non-wage labour costs again went up considerably more sharply – at a rate of 3% – than wages and salaries, which were raised by 2¼%.

Inflation rate again above stability zone

The increase in the Harmonised Index of Consumer Prices (HICP) for the euro area amounted to 2.2% in 2005, and thus lay outside the Eurosystem's definition of price stability for the sixth year in a row. One of the main factors contributing to the comparatively sharp rise in consumer prices was the exceptionally steep increase in the cost of energy, which averaged 10.1% for the year. By contrast, the upward thrust of unprocessed food prices remained muted at 0.8%. At 2.0%, the somewhat sharper rise in the price of processed food was linked to the increased tax on tobacco products in various countries. However, this contrasts with a year-on-year rise in the prices of industrial goods (excluding energy) of just 0.3%. Cheap imports from the emerging market economies of eastern Europe and Asia contributed to this. The cost of services increased by 2.3% in 2005 and thus at a similar rate as in 2004.

Regional price developments more even

Measured by the weighted dispersion indicators, the regional pattern of price developments in the euro area in 2005 was more uniform than it had been in 2004, when divergences in the national price trends had already narrowed. One cause of this was the energy price shock originating in the international markets, which affected all euro-area countries similarly. Excluding energy, however, the inflation rate spread remained considerable and was somewhat greater than in the previous year.

Increased price risks

In January/February 2006, inflation pressures, which had eased for a time following the energy-price-related peak in the summer, increased again. The annual increase in the HICP amounted to 2.3% on a two-month average. Excluding energy and unprocessed food, prices rose by 1.3% on average in January and February. The core inflation measure probably understates the current underlying momentum of the HICP, however, since energy prices are on an upward movement that cannot be regarded merely as a reflection of higher volatility. In addition, wages are still more or less tightly indexed to inflation in various member states, which could lead to an increase in home-grown inflationary pressure in the euro area over time. The price risks resulting from the crude oil markets have also increased in recent months as the risk of supply-related disruptions has increased substantially in view of the near full utilisation of global production capacities.

Consumer prices in the euro area

Chart 2

Year-on-year change, quarterly

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II Monetary policy and monetary development in the euro area

1 Monetary policy in the face of growing risks to price stability

(a) Interest rate policy tightened towards the end of the year

Interest rate rise in line with economic analysis…

In line with the Eurosystem's monetary policy objective, last year the Governing Council of the ECB again geared its interest rate policy decisions to the medium-term outlook for prices in the euro area and conducted its assessment based on the two pillar strategy. According to the economic analysis, the outlook for prices initially remained favourable. This was based on the fact that, despite a sustained economic recovery, economic growth was moderate and wage developments were restrained, indicating no discernible threat to price stability, at least domestically. However, the accelerated rise in energy prices, the increase in indirect taxes and administered prices coupled with the growing threat of second-round effects in the wage and price-setting process resulted in a perceptible deterioration of the outlook for prices in the second half of the year. This led the Governing Council of the ECB to abandon its "wait and see" monetary policy and to raise the central bank rates by a quarter of a percentage point in December. This was followed by a further increase of 25 basis points in March 2006. Since 8 March 2006, the interest rates on the marginal lending facility and the deposit facility have been 3½% and 1½% respectively, and the main refinancing operations have been conducted as variable rate tenders with a minimum bid rate of 2½%.

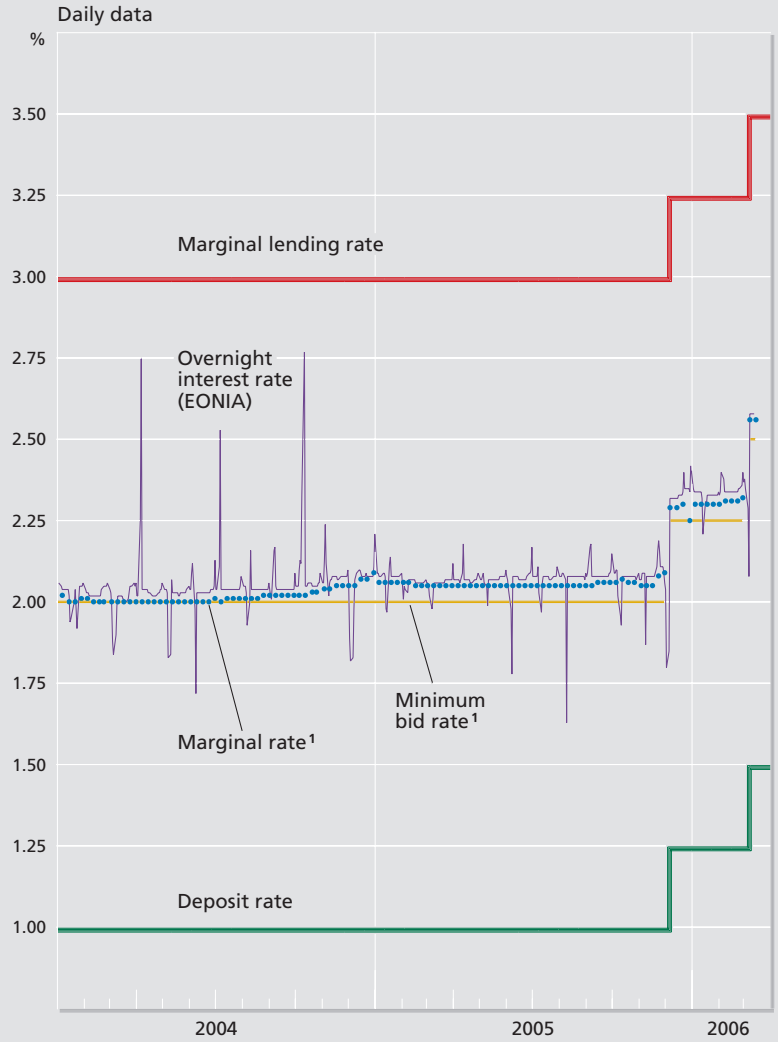
…and monetary analysis

The monetary analysis also pointed to a correction of the exceptionally low central bank rates. After moderate growth in the first quarter, M3 expansion picked up pace significantly during the remainder of the year such that, by year-end, the estimated surplus liquidity of the money stock in circulation had almost doubled from some 3% to about 5%.[1] In contrast to previous years, in 2005 it was not portfolio shifts that provided the momentum for strong overall monetary growth throughout the year, but rather robust demand for credit in the private sector. The decidedly low interest rate did not just have a reanimating effect on household demand for housing loans, but increasingly also on corporate-sector borrowing.

1 Measured in terms of the real money gap which is adjusted for portfolio effects.

Official interest rates and overnight interest rate

Chart 3



1 Interest rate for main refinancing operations.

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Monetary conditions remain expansionary

In spite of the interest rate rises, monetary policy remained expansionary in the winter months and monetary conditions in the euro area allowed sufficient flexibility for more rapid growth in aggregate expenditure.

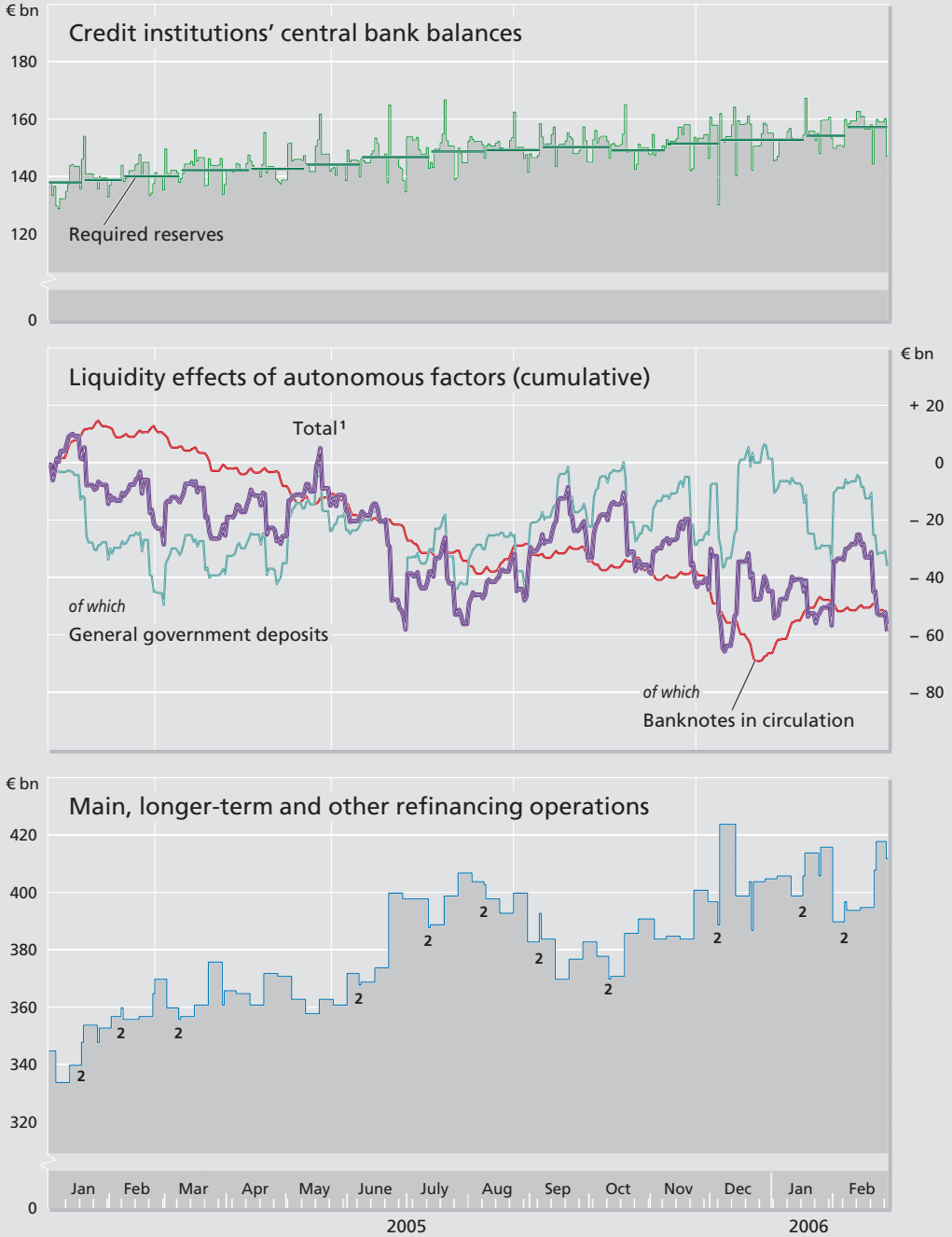
(b) Successful money market management with greater use of fine-tuning operations

Money market management in the past year went mainly smoothly, meaning that the ECB Governing Council's monetary policy could be implemented reliably even in 2005's eventful environment. The overnight interest rate (EONIA)

Liquidity management in the Eurosystem

Chart 4

Daily data



1 Banknotes in circulation, general government deposits with the Eurosystem, net reserve assets of the Eurosystem and other factors; provision (+) or absorption (–) of central bank balances. — **2** Fine-tuning operations: Liquidity-providing reverse transactions (RT) 18 January 2005: €8.0 billion; RT 7 February 2005: €2.5 billion; Liquidity-absorbing collection of fixed-term deposits (FD) 8 March 2005: €3.5 billion; FD 7 June 2005: €3.7 billion; FD 12 July 2005: €9.6 billion; FD 9 August 2005: €0.5 billion; RT 6 September 2005: €9.5 billion; FD 11 October 2005: €8.5 billion; FD 5 December 2005: €7.5 billion; RT 17 January 2006: €7.0 billion; RT 7 February 2006: € 6.5 billion.

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was generally fairly close to the minimum bid rate on the main refinancing operations. If at all, deviations occurred at the end of the reserve maintenance periods. This is attributable not least to the new monetary policy framework introduced in March 2004. Unlike under the old framework, market participants' expectations of an impending change in interest rates normally no longer affect conditions on the overnight money market. However, at the end of the reserve maintenance periods, there has temporarily been more uncertainty about the liquidity position. Thus, since November 2004, in the event of major liquidity imbalances, the ECB has, very successfully, conducted fine-tuning operations on the last day of the reserve maintenance period to soften any marked deviations between EONIA and the minimum bid rate occurring after the last main refinancing operation in a period.

Liquidity management also with recourse to fine-tuning operations

In 2005, the situation on the money market was characterised by expectations of an interest rate rise. Expectations of an interest rate cut arose only temporarily in early summer (June) in connection with the slowdown in macroeconomic growth. As the Governing Council of the ECB held rates at the start of July, these expectations were quickly quelled and then reversed to an increasing degree as oil prices continued to climb. By the beginning of August, the longer-term money market rates once again had a premium of a ¼ percentage point, which continued to grow until early December in keeping with the monetary policy line from the Governing Council of the ECB. Even after the two interest rate rises of a ¼ percentage point in early December 2005 and early March 2006, market players expected further rate rises in the course of the year.

Upward interest rate expectations

2 Strong monetary growth and accelerating lending

(a) Marked rise in money holdings

There was only modest M3 growth in the euro area in the first few months of 2005. However, the pace of expansion stepped up sharply in spring and summer, reflecting the noticeable decline in capital market yields while short-term rates remained almost unchanged. This progression was also underpinned by the temporary rise in uncertainty on the financial markets. The seasonally adjusted six-month rate of M3, which reflects shorter-term monetary dynamics, rose to 10½% by the end of September. This was the fastest monetary growth since the end of the 1980s. Since then, the pace of monetary expansion has slowed down somewhat, although it remained so robust that, at the end of 2005, mon-

Considerable acceleration after initial moderate monetary growth

Money market management and liquidity needs

By supplying or absorbing central bank money via appropriate monetary policy operations, the Eurosystem's money market management enables euro-area credit institutions to fulfil their minimum reserve requirements in a smooth manner. The aim is to achieve an overnight interbank money market rate – measured in terms of the weighted average EONIA – which is as close as possible to the Eurosystem's key interest rate, ie the minimum bid rate for main refinancing operations (MROs, see chart on page 21). This ensures that the monetary policy stance of the Governing Council of the ECB is reflected accurately on the overnight money market.

Development of the factors determining bank liquidity

In 2005, money market management was faced with the task of compensating a 21% increase in the credit institutions' liquidity needs stemming from the autonomous factors and the minimum reserve requirement to an annual average of €376.7 billion. The autonomous factors went up by €56.0 billion (see table on page 25) largely owing to a €69.1 billion increase in the volume of banknotes in circulation. At the end of February 2006, the volume of banknotes in circulation reached €551.1 billion. However, at 15%, the growth rate in 2005 was 4 percentage points less than in the previous year. Liquidity needs arising from general government deposits with the Eurosystem rose, too, by €4.8 billion. Government deposits fluctuated within the usual broad band, ranging from €29.1 billion on 28 December to €90.5 billion on 30 June. At €12.6 billion, volatility measured in terms of intraday standard deviation was €1.7 billion higher than in 2004. In 2005, the volatility of the autonomous factors as a whole was only slightly higher at €15.7 billion. This emphasises the particular significance of government deposits for the Eurosystem's liquidity forecasts, on the basis of which the volume of the monetary policy operations is determined. Thus, the development of the autonomous factors was governed primarily by the growth trend of banknotes in circulation and the short-term fluctuations in government deposits (see chart on page 22). The development of the remaining autonomous factors, via which €17.9 billion flowed into the market, slightly depressed the rise in liquidity needs in net terms. This was largely the result of the Eurosystem increasing its stock of euro-denominated securities by €15.1 billion based on market prices.

In order to meet the increased demand for liquidity, the Eurosystem expanded its monetary policy operations by €65.7 billion. 73% of this increase was achieved through larger MROs and 27% by topping up the longer-term refinancing operations (LTROs) with a three-month maturity from €25.0 billion to €30.0 billion in the first few months of 2005. Bearing in mind that liquidity needs are expected to rise again in 2006 and with the intention of raising the proportion of LTROs in the refinancing volume slightly, the LTROs were each topped up from €30.0 billion to €40.0 billion starting with the operation of 26 January 2006. Thus, as of 30 March 2006 a total of €120.0 billion will be supplied via LTROs. In 2005, Eurosystem money market management was confronted with a significant challenge in the context of the LTRO of 22 December when, owing to an erroneous bid by one counterparty, only €12.5 billion instead of the targeted €30.0 billion could be allotted. The Eurosystem immediately announced a second LTRO with a maturity period commencing one day later. Although the market was short on one day by €17.5 billion owing to the later value date, the EONIA rose only temporarily and slightly by 6 basis points to 2.40% on 22 December. This was because the end of the maintenance period was still far enough away to enable the full stabilising effect of the averaging provision for the fulfilment of the minimum reserve requirement to come to bear.

On an annual average, the credit institutions' central bank balances in 2005 were €9.6 billion higher than in the previous year, roughly reflecting the increase in the minimum reserve requirement. The reserve requirement grew at an accelerated pace from 4% in 2004 to 7% in 2005 owing to the substantial monetary expansion in the euro area. In the period February-March 2006, the reserve requirement, at €157.7 billion, was as much as 12% above the previous year's figure.

Fine-tuning policy

Following the introduction of the new operational framework for monetary policy, it became apparent in autumn 2004 that any marked deviations between the EONIA and the minimum bid rate occurring after the last MRO in a period would, in the event of major liquidity imbalances, need to be countered with a fine-tuning operation (FTO) on the last day of the period. In 2005, the Eurosystem performed nine FTOs: three liquidity-providing operations and six liquidity-absorbing operations. In 2006, so far there have been two liquidity-providing operations and one liquidity-absorbing operation. The target liquidity correction ranged from €2.5 billion to €10.0 billion. In 2005, on three occasions (7 June, 12 July and 9 August), the target volume for liquidity-absorbing FTOs, which closely reflected the actual liquidity surplus, was not achieved owing to insufficient bids. This was also the case for the liquidity-absorbing FTO on 7 March 2006. Market participants claimed that this was due to uncertainty regarding their own liquidity situation at the time the operations were executed and to insufficient remuneration provided by the minimum bid rate. In all four cases, however, it later transpired that the interest rate would have been quite attractive compared with the market interest rate which emerged after the operation, which was well below the respective minimum bid rate. By contrast, in the case of the liquidity-absorbing FTOs on 8 March, 11 October and 5 December 2005, the target volume was fully allotted. A comparison of the periods before and after the introduction of the new fine-tuning policy in autumn 2004 demonstrates the success of this more active policy in stabilising the EONIA in the time between the settlement of the last MRO and the end of the period. An analysis of the last week of the respective maintenance periods shows that the EONIA's average deviation from the minimum bid rate has more than halved.[1] No fine-tuning operation was required on 7 July 2005 even though the terrorist attacks in London drove up quotations on the euro money market for a number of hours. Once it was confirmed in the press conference following the ECB Governing Council meeting on that same day that neither the money market nor the payment systems had been adversely affected, the situation

1 Comparison of the period from 10 March 2004 to 11 October 2004 with the period from 12 October 2004 to 7 March 2006 based on the root mean square deviation of the EONIA from the minimum bid rate, which went down from 24 to 11 basis points. The calculation takes into account only the business days between the value date of the last MRO and the end of the maintenance period.

Factors determining bank liquidity

Year-on-year changes in annual average values, in € billion

Item	2004	2005
I Provision (+) or absorption (-) of central bank balances through changes in autonomous factors		
1 Banknotes in circulation (increase: -)	– 72.6	– 69.1
2 Government deposits with the Eurosystem (increase: -)	– 3.0	– 4.8
3 Net foreign assets [1]	– 28.1	– 6.2
4 Other factors [1]	+ 40.7	+ 24.1
Total	– 63.0	– 56.0
II Monetary policy operations of the Eurosystem		
1 Open market operations		
(a) Main refinancing operations	+ 44.1	+ 48.2
(b) Longer-term refinancing operations	+ 25.2	+ 17.5
(c) Other operations	– 0.0	+ 0.0
2 Standing facilities		
(a) Marginal lending facility	– 0.1	– 0.1
(b) Deposit facility (increase: -)	+ 0.1	+ 0.1
Total	+ 69.3	+ 65.6
III Change in credit institutions' credit balances (I + II)	+ 6.3	+ 9.6
IV Change in the minimum reserve requirement (increase: -)	– 5.6	– 9.9

1 Including liquidity-neutral valuation adjustments at the end of the quarter.

quickly returned to normal, with the EONIA ultimately closing a mere 3 basis points above the previous day's level at 2.11%.

Development of the EONIA spread

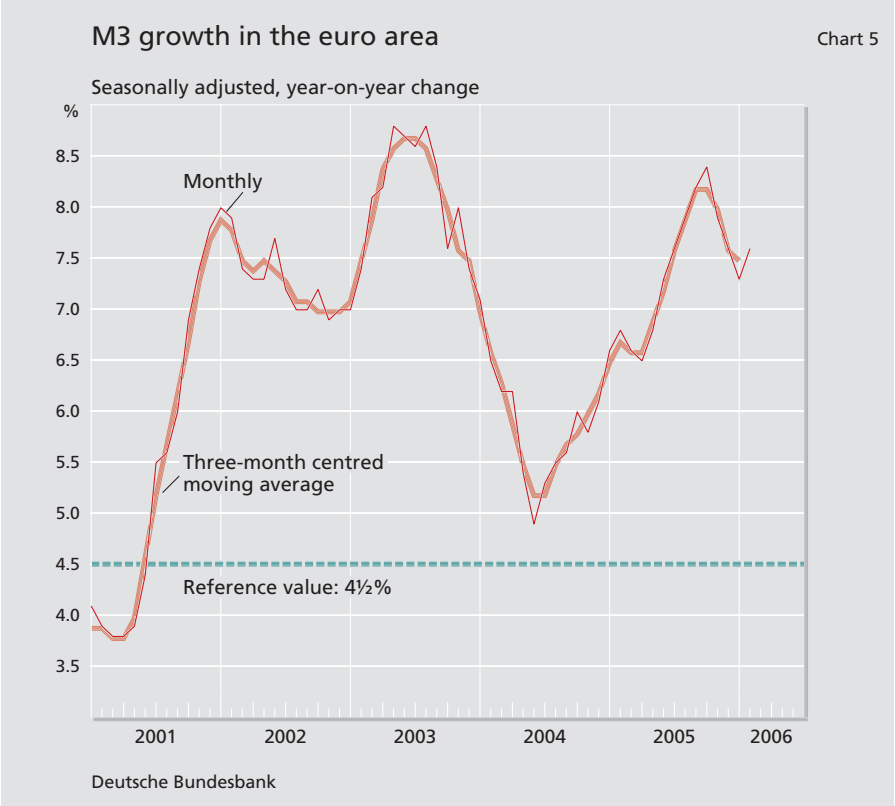
In 2005, the spread between the EONIA and the minimum bid rate rose by 2 basis points to an average of 7 basis points. It is true that this does not pose any threat to the implementation of the ECB Governing Council's monetary policy objectives on the overnight money market. Nevertheless, from October 2005 onwards, the Eurosystem responded to the stealthy increase in the EONIA spread with a systematic allotment of MRO volumes of up to €3 billion above the benchmark amount,[2] after this method had proved successful in restraining the upward trend in the EONIA in the months following the turn of 2004-05. In this way, in 2005 it was at least possible to confine the traditionally high spread at year-end to 17 basis points, which was the lowest level since the start of European monetary union. Nevertheless, in February 2006, the EONIA spread remained at a perceptibly elevated level, for the most part at 9 basis points.

Impact of interest rate expectations on money market management

One of the main advantages of the operational framework for monetary policy in place since March 2004 is that market players' expectations regarding impending interest rate changes by the Governing Council of the ECB should not have any impact on overnight money market conditions during the current maintenance period. In the two weeks prior to the increase in the key interest rate on 1 December 2005, clearly defined short-term interest-rate expectations emerged for the first time since March 2004, causing the EONIA spread to broaden somewhat by 11 basis points on 23 November. However, it declined continuously over the next few days and fell below the minimum bid rate the day after the Governing Council meeting. A major contributing factor was the fact that the ECB allotted, by way of exception, €1 billion above the benchmark amount in the final MRO of the period. As regards the interest rate increase on 2 March 2006, the EONIA spread only started to rise one week before and, at a maximum of 6 basis points at the end of the month on 28 February, was considerably weaker. At the end of the maintenance period, owing to a liquidity surplus, the EONIA was once again below the old minimum bid rate. Thus, the strict distinction between the conditions on the overnight money market in the various maintenance periods, which was one of the aims behind the revised operational framework for monetary policy, has recently been more successful.

All in all, in 2005, the Eurosystem's money market management once again proved reliable at implementing the monetary policy stance of the ECB in an eventful environment and ensured balanced conditions in the euro money market of the euro area.

2 An MRO benchmark allotment amount is the amount which will prospectively enable the credit institutions to fulfil their minimum reserve requirements without difficulty during the term of the MRO. See European Central Bank, Publication of the benchmark allotment in the main refinancing operations, Monthly Bulletin, April 2004, pp 16-18.



etary holdings were 7.3% up on the year. The three-month moving average of annual rates of change for November and December 2005 and January 2006 was 7.5%. Overall, monetary growth in the year under review was not only higher than in 2004, it also significantly exceeded viable levels in terms of longer-term price stability.

Sharp growth in cash and overnight deposits…

Among the components of the money stock, it was again the most liquid M3 components which increased sharply in 2005. In the year under review, it was once again euro currency in circulation outside the domestic banking sector which grew the most. At the end of 2005, it was 13.7% higher than it had been at the end of 2004. Low opportunity costs brought about by low interest rates probably promoted cash holding to a significant extent. Overnight deposits also expanded vigorously in 2005, at a rate of 10.9%. Enterprises, in particular, increased their overnight deposits sharply in 2005, probably reflecting a cyclical improvement in the profit situation as well as a shift away from short-term time deposits.

… and a perceptible rise in other short-term deposits

Other short-term bank deposits also grew fairly strongly last year. Deposits with an agreed maturity of up to 2 years rose by 6.6%. Non-monetary financial institutions were the main contributor to this, significantly increasing their short-

term time deposits. By contrast, households showed a continued preference for deposits with a notice period of up to three months, although the growth rate tailed off perceptibly during the year, ending 2005 at just 4.3%.

On balance, scant demand for marketable instruments

In contrast to currency in circulation and short-term bank deposits, marketable instruments were increased only slightly in the year under review (by 0.8%). In this context, the steep rise in short-term bank debt securities was offset almost entirely by the noticeable decline in repo transactions and the slight decline in money market fund shares. The latter had risen by almost 20% year-on-year in early/mid-2003 when, during the war in Iraq, there were sizable shifts towards secure and liquid investment with banks and in money market funds.

(b) Credit granted to the private sector was the dominant determining factor behind monetary growth

Further marked acceleration in loans to the private sector

Unlike in 2001-03, for example, when robust monetary growth had been driven mainly by uncertainty-induced portfolio shifts, the main factor behind the expansion in 2005 was the very sharp increase in loans to the private sector. Unsecuritised lending to enterprises and households in the euro area rose by 9.2% last year. It is also likely that the decidedly low financing costs contributed to the significant quickening in the demand for credit. This applies both to loans to enterprises and to private households. With annual growth of 11.5%, housing loans to private households climbed especially steeply in the year under review, in particular those over the long-term. Consumer credit growth, at 7.8%, was not as strong, though it also rose perceptibly on the year. The same applies to lending to non-financial enterprises, which ended 2005 8.1% higher on the year. Here, too, long-term credit grew especially strongly, accounting for around half of all lending to private non-financial enterprises. In addition, bank lending to insurance corporations and other financial intermediaries rose sharply once again in 2005.

Lending against securities also climbed significantly

Moreover, banks in the euro area substantially increased their stocks of domestic securities. They invested mainly in shares in euro-area enterprises. However, a sizable volume of fixed-interest securities from this group of borrowers was also added to portfolios; these securities increased at an annual rate of 17.1%. In comparison, the percentage rise in government securities held by domestic banks was noticeably lower at 5.9%. Yet this, too, represented an acceleration on the year. The same applies to loans to general government in the euro area, which had declined slightly in 2004, yet nevertheless rose by 2.0% in 2005.

Monetary developments in the euro area

Table 3

Changes in the course of the year

Item	2004	2005
	in %	
I Growth of the monetary aggregates [1]		
M1 [2]	9.0	11.3
M2 [3]	6.7	8.5
M3 [4]	6.6	7.3
	€ bn	
II Money stock and its counterparts		
M3 (= 1 + 2 – 3 – 4 – 5)	404.7	495.0
Currency in circulation and overnight deposits	230.2	350.2
Other shorter-term bank deposits	118.8	137.2
Marketable instruments	55.7	7.6
Balance sheet counterparts		
1 Total credit to non-MFIs in the euro area	626.3	923.9
Credit to general government	51.1	99.8
Credit to private sector non-MFIs in the euro area	575.2	824.1
2 Net claims on non-euro-area residents	160.7	– 17.3
3 Deposits of central government	6.1	11.9
4 Longer-term financial liabilities to other non-MFIs in the euro area	342.2	381.9
5 Other counterparts of M3 [5]	34.0	17.8

1 Seasonally adjusted. — **2** Currency in circulation and overnight deposits held by euro-area residents with MFIs in the euro area. — **3** M1 plus other shorter-term bank deposits held by euro-area residents with MFIs in the euro area (deposits with an agreed maturity of up to two years and deposits with an agreed notice period of up to three months). — **4** M2 plus marketable instruments held by euro-area residents (repurchase agreements concluded by MFIs with non-MFIs in the euro area, money market fund shares/units and debt securities issued with a maturity of up to two years by MFIs in the euro area). — **5** Calculated as a residual.

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Net external asset position…

In the year under review, the strong demand for credit from euro-area non-banks was set against slight outflows of funds to other countries. This was reflected by a corresponding fall in the net external asset position in the consolidated balance sheet of the euro-area MFI sector and thus curbed monetary growth per se.

… and monetary capital formation dampened monetary expansion

Increased monetary capital formation by euro-area non-banks had a similar effect; they increased their longer-term investments with banks (which are not included in M3) by 8.4% last year. There was particularly robust demand for bank debt securities (with an original maturity of more than two years). At the end of

2005, the amount outstanding outside the banking sector was 10.0% higher than it had been a year before. Longer-term time deposits also rose sharply (by 7.8%), whereas savings deposits with a notice period of more than three months were reduced further (by 4.9%).

III Financial system

1 Appreciation of the US dollar along with increasing global imbalances

Exchange rate gains of the US dollar...

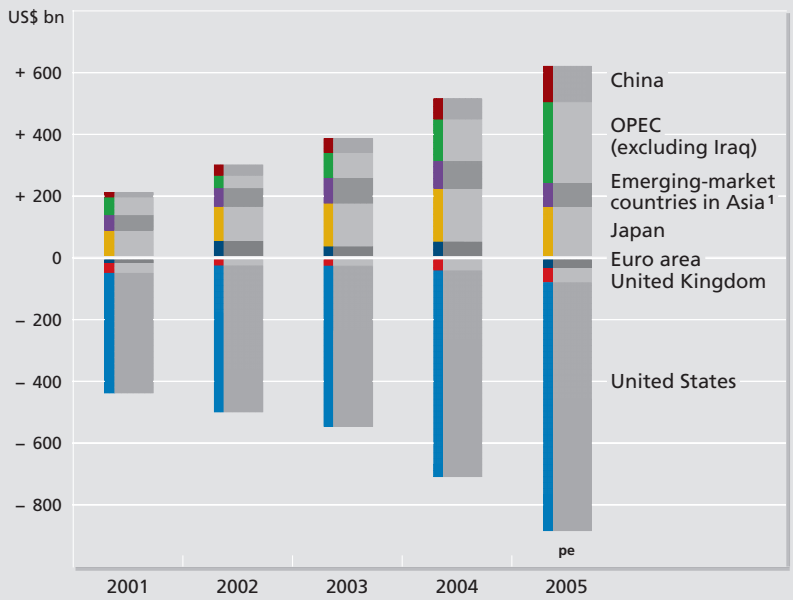
... accompanied by exchange rate losses of the euro in 2005

Developments in the forex markets last year were shaped mainly by the growing yield advantage of US dollar investments and by market players' expectations of future developments regarding the economy and interest rates. Given this situation, the US dollar appreciated significantly – despite the widening US current account deficit – especially in the first half of the year. On a weighted average, the exchange rate gains of the US dollar during 2005 amounted to 10%.[1] The shifts in exchange rate parities were also apparent in the US dollar's rate against the euro, which showed a marked depreciation, especially in the first half of the year, and, at the beginning of July, fell below the level of US$1.20. Besides the cited positive factors benefiting the US dollar, strains were placed on the euro-dollar exchange rate by political events in the euro area such as the rejection of the EU constitution in referendums in France and the Netherlands and the initial failure of the negotiations on the Financial Perspectives for the European Union. After stabilising for a time, the euro came under further downward pressure against the US dollar in the autumn months when concerns about the economic impact of the hurricanes in the USA were easing and further interest rate hikes by the Federal Reserve ensued. Overall, during 2005 the euro depreciated by 13½% against the US dollar. At the turn of 2005-06, there was a turnaround in sentiment in favour of the single European currency for a time following a firming-up of expectations in the forex markets concerning a rapid end to the cycle of interest rate rises in the United States. As this report went to press, the euro was trading at US$1.20.

1 Tax regulations probably also played a part in the strength of the US dollar. These allowed US enterprises to repatriate profits generated abroad for a temporary period at a reduced tax rate of 5¼% rather than 35%.

Current account positions of selected countries and regions

Chart 6



Source: IMF, ECB, BIS. — **1** Hong Kong, South Korea, Singapore, Taiwan.

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Euro depreciation against other currencies, too

The euro also depreciated against the pound sterling and the yen in 2005, although the depreciation was comparatively slight at 3% and ½% respectively. On a weighted average, the euro lost 7% of its external value vis-à-vis the currencies of 23 major trading partners. The single European currency also depreciated in real terms, ie after taking account of the differing rates of inflation in the euro area and in the case of its trading partners.

Exchange rate movements not helpful in reducing external imbalances

The exchange rate shifts described above were not conducive to reducing external imbalances. As already mentioned, the US current account deficit widened further. This was matched by rising surpluses, especially in China and, increasingly, in the oil-exporting countries, too. This development was accompanied by an ongoing accumulation of foreign reserve assets (see section V on pp 69-83.)

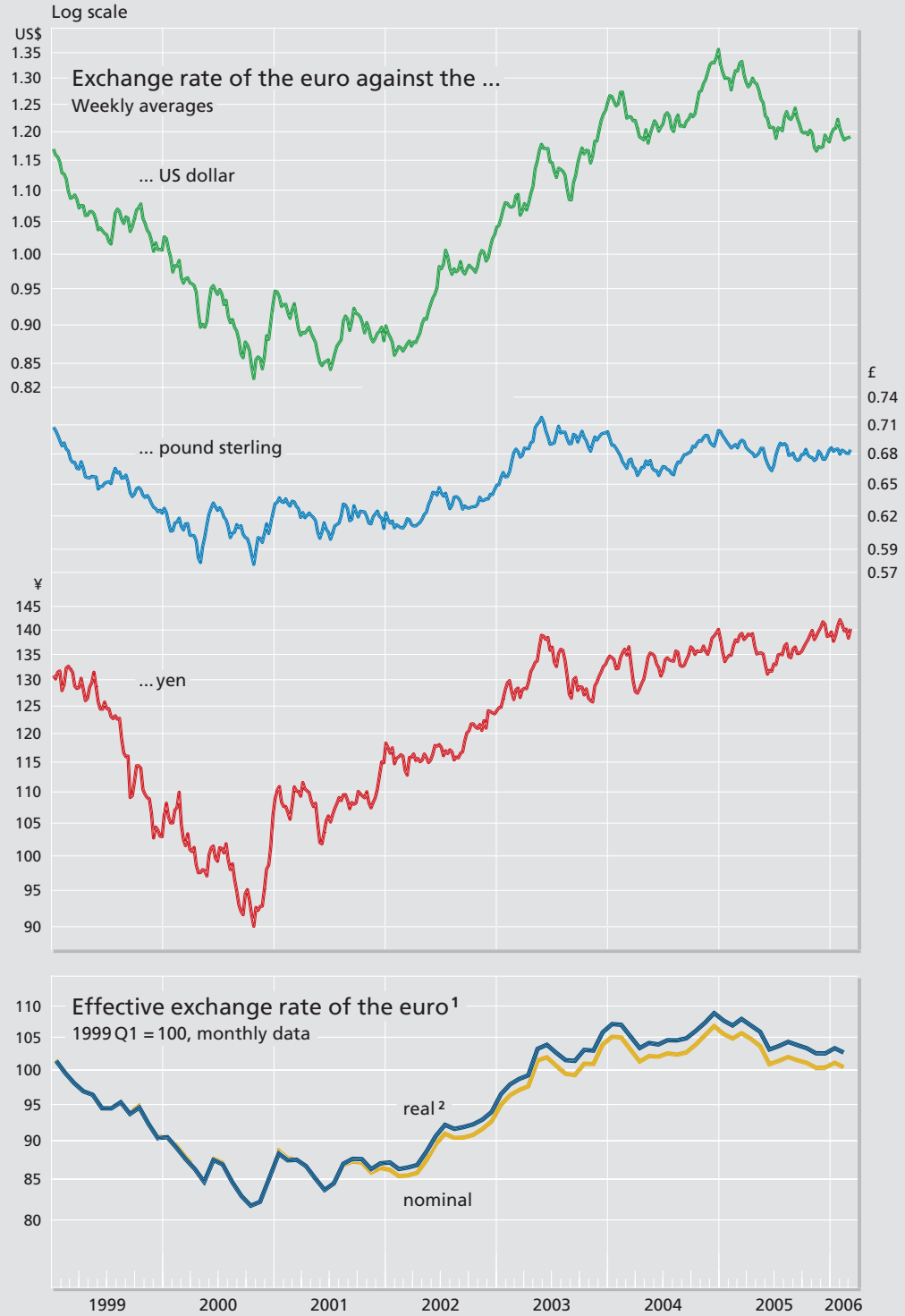
2 Securities markets affected by rising stock prices

Fall in long-term interest rates in the euro area

The abundant supply of liquidity worldwide and buoyant demand for long-term debt securities depressed long-term interest rates for large parts of last year. In autumn 2005, yields on euro-area government bonds temporarily reached an

Exchange rate of the euro

Chart 7



1 According to ECB calculations against the currencies of 23 countries. — **2** Based on consumer prices.

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all-time low. Inflation concerns due to higher energy prices and the improving economic outlook then led to a slight rise again, however. Developments in the United States took a different turn, with yields trending upward slightly amid fluctuations over the course of the year – which probably resulted in part from the Fed's tightening of its interest rate policy. Measured against growth and inflation expectations, however, they were still moving at a relatively low level. Foreign investors' great demand for US paper played a part in this.

Somewhat higher interest rate premiums for enterprises

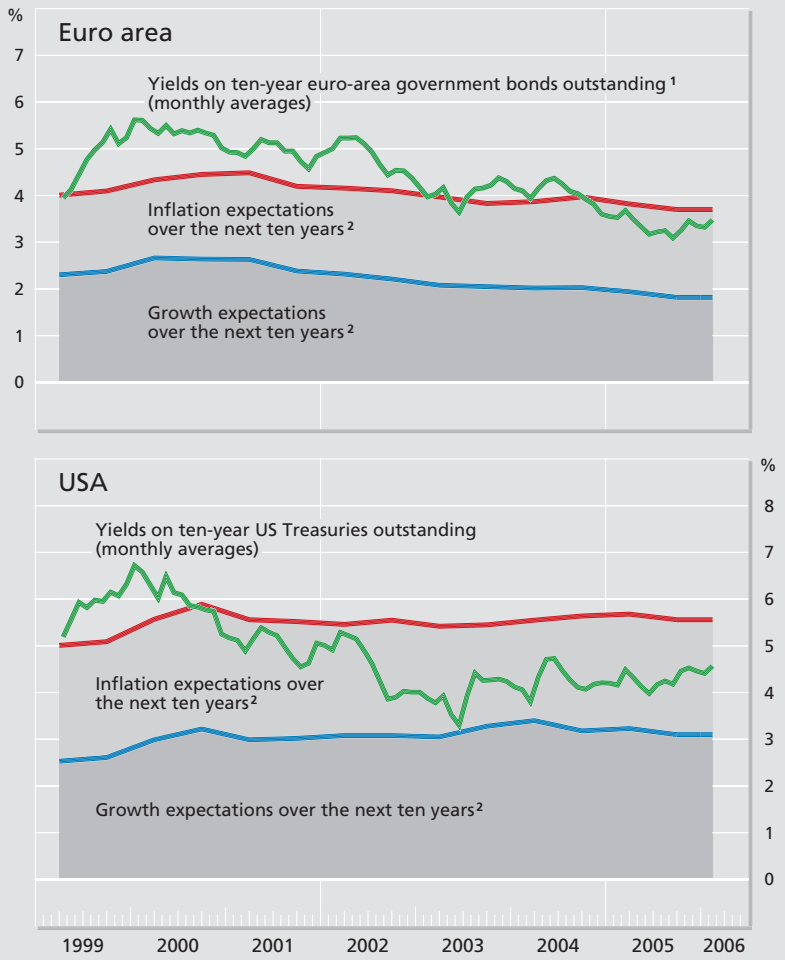
In the course of 2005, the spreads on BBB-rated corporate bonds over euro-area government bonds moved up from their all-time lows at the start of the year and are now at 125 basis points. On the whole, however, this means that corporate financing conditions in the bond market are still quite favourable. The increased spread was probably due in part to a keener risk awareness on the part of investors after the financial difficulties experienced by some US car manufacturers, although enterprises in the euro area had not been faced with a similar situation.

Low level of borrowing in the German bond market…

In the German bond market, where interest rate movements essentially matched those in the euro area, issuers used the favourable financing conditions for vigorous borrowing. With a market value of €1,205½ billion, gross sales of German debt securities in 2005 were only just below their prior-year peak. Nevertheless, at €110½ billion, net sales, ie funds raised from sales of domestic paper after deducting redemptions and changes in issuers' holdings of their own bonds, were clearly down on the 2004 figure of €133½ billion. The decline was due mainly to the credit institutions' operations in the domestic capital market. In 2005, the credit institutions raised funds amounting to €40 billion through domestic sales of their own debt securities. This was almost €24½ billion less than in the previous year. As had already been the case in 2004, there was a preponderance of net redemptions in the case of Pfandbriefe, in particular, since a significant percentage of such bonds is now being issued through foreign financial centres following the relocation of one major German issuing institution to Ireland. Given an overall favourable liquidity situation, domestic non-financial enterprises also reduced their borrowing in the German bond market in 2005. They sold longer-term debt instruments to the amount of no more than €10 billion net, while redeeming short-dated paper on balance (-€7½ billion). By contrast, the government sector drew on the bond market last year to the considerable extent of €68 billion net, compared with €58½ billion in 2004. Sales of foreign bonds and notes in the German bond market increased very sharply, however; at €148 billion net, they were clearly up on 2004 (€103 billion). The majority of these were euro-denominated debt securities from euro-area

Bond yields and inflation and growth expectations

Chart 8



1 GDP-weighted average. — **2** Bundesbank calculations based on biannual surveys of short and long-term expectations concerning developments in the consumer price index and GDP; from October 2005, assuming unchanged values. Source: Consensus Forecast.

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partner countries (€118 billion), which regularly meet with active interest in the German market owing to the fact they carry a higher rate of interest than Bunds.

Purchases of debt securities

The main purchasers were domestic banks, which invested in foreign bonds. In total, they purchased €84 billion of such bonds, while selling domestic interest-bearing paper worth €22 billion. Non-banks took debt securities issued by non-residents amounting to €64 billion into their portfolios. On balance, domestic bonds were sold solely to foreign investors, who increased their holdings of German paper by a total of €156 billion, roughly half of which consisted of public bonds.

Sales and purchases of securities

Table 4

€ billion

Period	Sales					
	Bonds		Equities		Mutual fund shares	
	Total	*of which* Foreign bonds	Total	*of which* Foreign equities	Total	*of which* Mutual funds open to the general public
2001	180.2	93.6	82.7	65.1	97.1	35.5
2002	175.4	51.4	39.3	30.1	66.6	25.9
2003	177.8	43.4	15.5	– 1.4	46.7	20.1
2004	236.9	103.2	3.3	– 6.8	12.4	– 4.0
2005	258.7	148.1	31.8	18.0	81.6	6.4
2005 Q1	113.1	52.2	1.9	– 0.1	23.2	0.4
Q2	104.7	48.2	1.1	– 0.2	18.1	3.2
Q3	30.0	13.7	4.3	0.5	24.5	6.2
Q4	10.9	34.1	24.5	17.8	15.8	– 3.4
	Purchases					
	Non-residents		Domestic non-banks		Domestic credit institutions (including Bundesbank)	
	Domestic bonds	Domestic equities	Bonds	Equities	Bonds	Equities
2001	68.9	84.9	75.4	12.5	35.8	– 14.7
2002	114.9	20.9	46.9	41.6	13.5	– 23.2
2003	91.3	27.3	50.8	– 18.9	35.7	7.1
2004	128.2	– 12.1	– 13.1	10.4	121.8	5.0
2005	156.0	58.8	40.9	– 37.2	61.7	10.2
2005 Q1	51.4	5.6	15.2	– 5.1	46.4	1.5
Q2	62.5	26.4	15.3	– 20.8	26.8	– 4.5
Q3	25.3	7.7	14.9	– 9.5	– 10.2	6.0
Q4	16.8	19.2	– 4.6	– 1.9	– 1.3	7.2

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Robust stock markets in the euro area and Germany

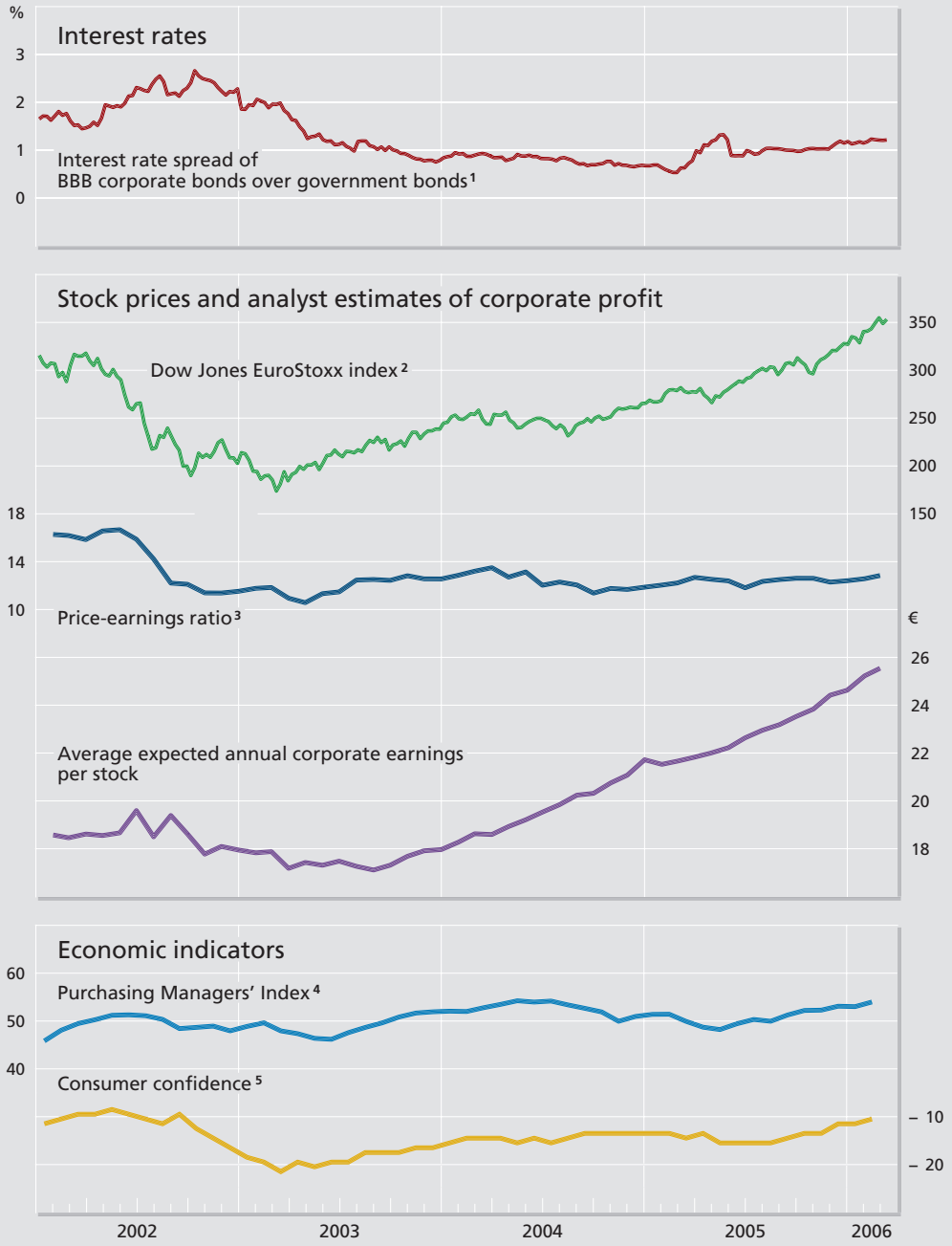
Supported by quite low uncertainty regarding future price developments, the stock markets in Germany and Europe as a whole were in a bullish mood for the third year in succession. Negative factors, such as high energy prices and temporary expectations of higher inflation, were soon shrugged off by the markets. Measured against the broad market indices DAX and EuroStoxx, German and European equities rose by just over 27% and by 23% respectively in 2005, whereas US stocks gained no more than 3% in market value (Standard & Poor's). Thanks to their international orientation and improved competitiveness, German public limited companies (*Aktiengesellschaften*), in particular, benefited from the buoyant global economic momentum. The performance of the US stock market was also handicapped vis-à-vis Europe by rising long-term interest rates.

Slightly more funds raised in equity market

Given the good earnings performance of internationally operating enterprises and the favourable debt financing conditions, the sharp share price increases in the German equity markets were reflected only to a limited extent, however, in increased issuing activity by enterprises in Germany. Listed German enterprises placed new shares to a market value of €14 billion in 2005. This was merely

Corporate valuations and economic indicators in the euro area

Chart 9



1 Euro-area bonds with a residual maturity of seven to ten years; end-of-week levels. Source: Merrill Lynch Indices. — **2** 31 December 1991 = 100; end-of-week levels. Source: Thomson Financial Datastream. — **3** Ratio of stock prices in the Dow Jones EuroStoxx index to the expected average annual corporate earnings per stock based on analyst estimates in accordance with I/B/E/S. Source: Thomson Financial. — **4** Diffusion index (50% represents an equal number of positive and negative assessments of the current situation). Source: NTC Research, London. — **5** According to an EU economic survey for euro-area countries. Balance of the percentages of positive and negative assessments.

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€3½ billion more than in 2004. A considerable part of the issuance volume flowed to two public companies which augmented their capital base in order to acquire foreign enterprises. Moreover, there were several initial public offerings (IPOs).

Share acquisition dominated by direct investment

On balance, domestic equities were bought solely by non-resident investors (€59 billion), while domestic investors were net sellers of German stocks (€45 billion). This was due mainly to a cross-border corporate acquisition that was financed by an exchange of shares, with the non-resident investor using the shares of its foreign-domiciled enterprise to pay for the equities held by German shareholders. Overall, German investors purchased shares of foreign corporations to the amount of €18 billion.

Mutual fund shares

The amount raised by domestic mutual investment funds in 2005 showed a clear increase on the year (€41½ billion compared with €1½ billion). The lion's share of the inflows was placed in special funds, which are reserved for institutional investors. In the case of funds open to the general public, bond-based mutual funds were most favoured by savers. By contrast, open-end real estate funds – against the backdrop of the temporary closure of one fund in December 2005 – recorded net outflows of just over €3 billion in the year as a whole. As usual, the main buyers of mutual fund shares were German non-banks (€59½ billion), which showed a slight preference for foreign funds over domestic ones. The credit institutions, too, invested €21½ billion in mutual fund products, however. Foreign investors, on the other hand, were very restrained when it came to purchasing German mutual fund units (€1 billion).

3 Further stabilisation of the earnings outlook for German banks

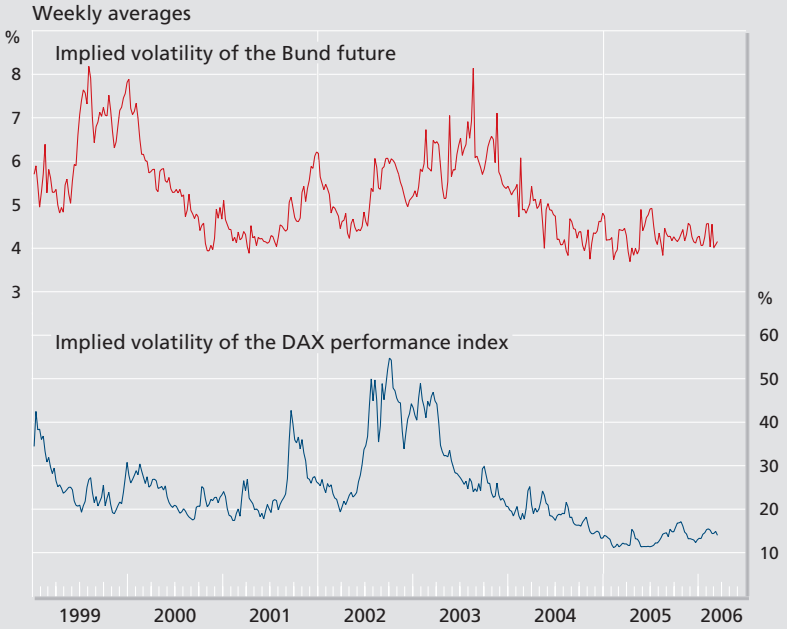
(a) Sharp expansion in short-term bank deposits and weak bank lending

Domestic investors' marked preference for liquidity

In German banks' deposit business, there was a sharp increase in domestic investors' highly liquid overnight deposits last year. At 11%, the rate of growth was just as high as in the euro area as a whole. Non-financial corporations, as well as financial intermediaries outside the banking sector and households, stepped up their overnight money holding on a large scale. By contrast, households' interest in deposits with an agreed period of notice of three months was slight in 2005. Even short-term savings deposits with a rate of interest above the minimum or basic rate of return, which had been showing rapid growth in pre-

Volatility* in the bond and equity markets

Chart 10



* Expected future volatility extracted from option prices on the Bund future and the DAX.

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vious years, increased by no more than 1½%. Deposits with longer periods of notice were reduced, in fact. Overall, domestic non-banks' deposits at German banks rose by 3.7% last year, which was barely more than in 2004 (3.4%).

Low credit growth…

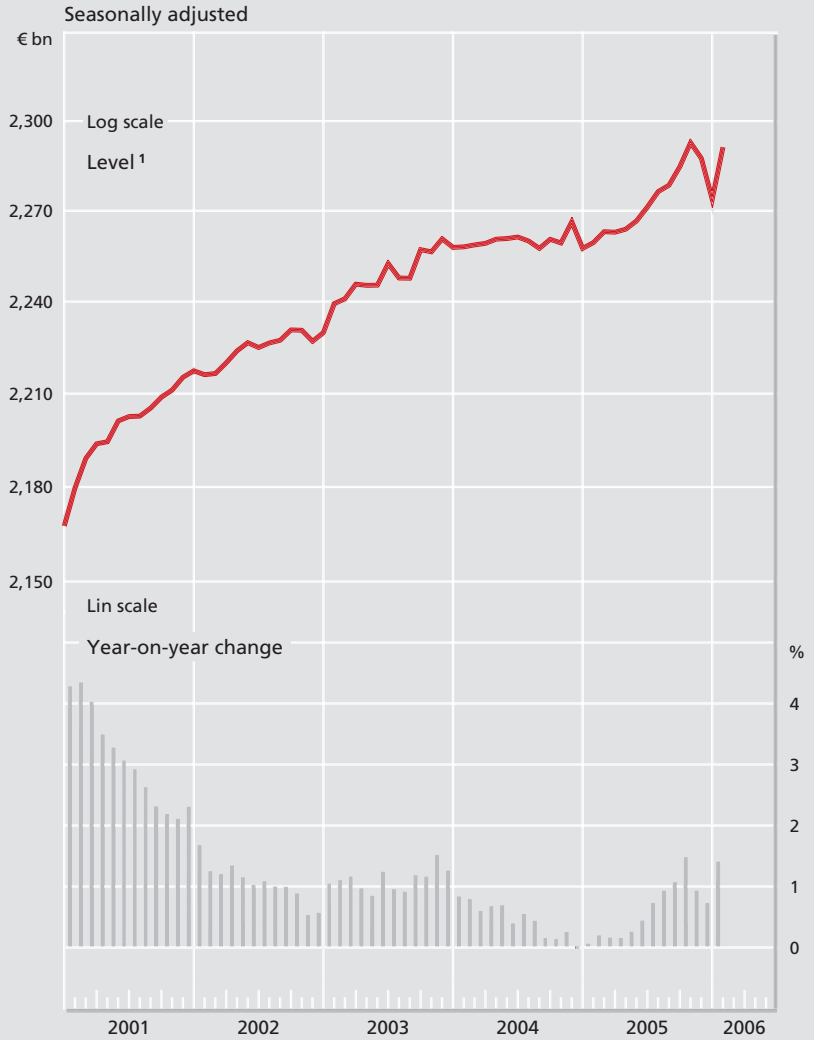
Lending business with domestic customers from the non-bank sector was noticeably weaker. Overall, lending by German banks to domestic non-banks increased by no more than 0.5% in 2005. Unsecuritised lending to the domestic private sector rose by 0.7%. Given a continuing fall in bank interest rates, long-term loans for house purchase were especially in demand. However, this contrasted with a decline in other loans to households. Loans to non-financial corporations also continued to decline, albeit at a much slower pace. As a "substitute", so to speak, for weak lending business, the banks purchased mutual fund shares (excluding money market fund shares) of domestic issuers on a large scale. However, they allowed their holdings of government bonds as well as other loans to German public authorities to be depleted further.

…slightly overstated by special development

In the reporting year, there was, nevertheless, a marked increase in loans to other financial intermediaries outside the banking sector. This was mainly in connection with large-scale securities lending operations by German banks

Loans to enterprises and households in Germany

Chart 11



1 End of month; statistical changes eliminated.

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which, on balance, did not involve any flow of funds to private non-banks. If lending to the domestic private sector is adjusted for such operations, the growth rate of loans to the domestic private sector is, in fact, somewhat smaller.

Bank Lending Survey – indications of slow recovery

However, according to the findings of the Eurosystem's Bank Lending Survey, there are signs that the credit market in Germany has picked up to a certain extent recently. The participating banks expect a further expansion in demand for credit in the current year. Loans to enterprises are likely to be boosted mainly by a greater financing requirement for fixed investment, corporate takeovers, corporate restructuring measures and debt restructuring. More expansionary im-

Bank lending survey
Results for Germany

Chart 12

1 Difference between the sum of the percentages for "tightened considerably" and "tightened somewhat" and the sum of the percentages for "eased somewhat" and "eased considerably".

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pulses are coming from the supply side, too. On the whole, the surveyed banks left their credit standards largely unchanged for all lending categories last year, while simultaneously lowering their margins for average-risk exposures significantly in some cases. Unlike in earlier years, even the margins for riskier loans were increased only in isolated cases.

Bank interest rates fell initially but rose at the end of the year

To begin with, the interest rates charged by German banks in new lending business with domestic households and with non-financial enterprises continued to ease in most cases in 2005 for all periods of interest rate fixation. This development then went into reverse prior to the ECB's interest rate move in early December. Viewed over the reporting period as a whole, interest rates on housing loans with an interest rate fixation of more than ten years declined by just over ¼ percentage point to 4.3%. By the end of 2005, the rates demanded for long-term consumer loans had gone down to 7.9%. In long-term corporate credit business, the German banks were likewise charging less than one year before; depending on the credit volume, the relevant rates of interest for loans with an interest rate fixation of more than five years were 4.1% or 4.5% in December 2005. In the domestic banks' long-term liabilities-side business with households, too, interests rates fell over the year as a whole. By contrast, changes in the rates in short-term deposit business with households were mixed. At the end of 2005, interest rates amounted to 2% for savings deposits with a notice period of up to three months and 2.3% for longer periods of notice. At the end of the year, banks were paying between 2.1% and 2.4% for time deposits, depending on the maturity.[1]

(b) Developments in the banking sector

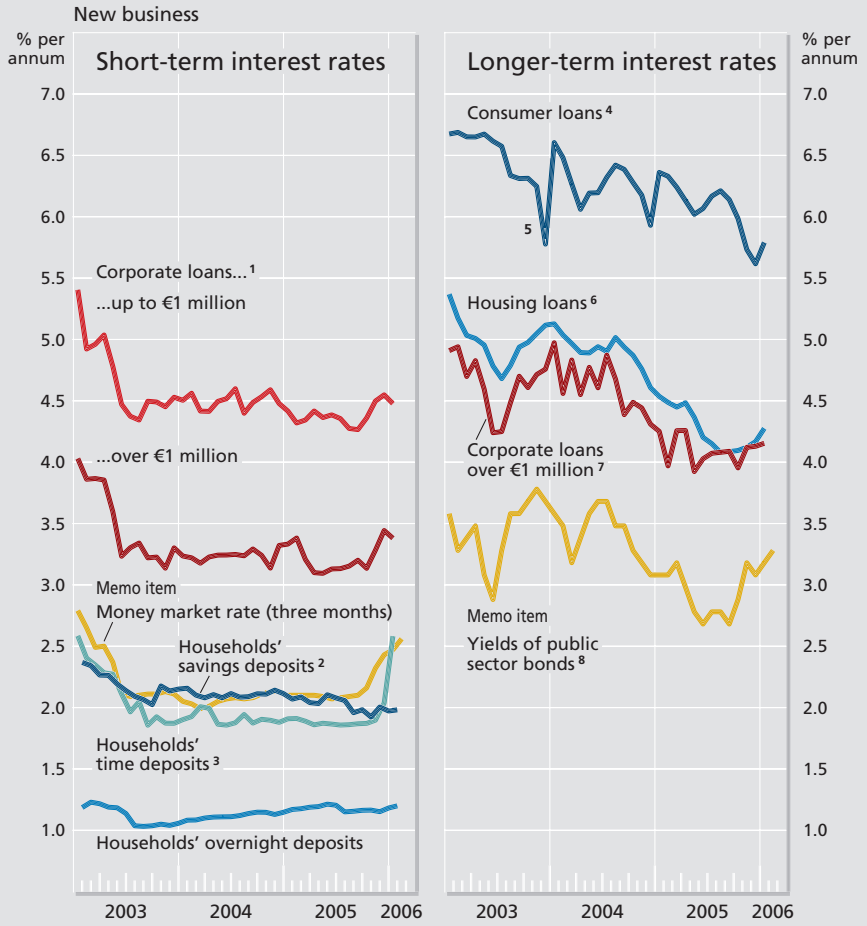
New lending business mainly at smaller banks

The individual categories of banks contributed to a varying extent to the subdued growth of German banks' lending to domestic private customers in 2005. It was mainly those credit institutions traditionally focusing on retail banking which were involved in new business.[2] Besides the savings banks, it was primarily the regional and other commercial banks, the credit cooperatives and the branches of foreign banks whose new business showed above-average growth in the reporting year. By contrast, in the case of the Landesbanken, the regional

1 The level of 2.7% for time deposits with an agreed maturity of over one year and up to two years reported in December 2005 was also influenced by special campaigns and large transactions. The rates of interest paid in this category typically lie between those for short-term time deposits (most recently, 2.1%) and those for long-term time deposits (most recently, 2.4%).
2 The market shares calculated on the basis of credit stocks do not necessarily reflect this development as they include both reclassifications between the individual categories of banks and value adjustments to outstanding loans.

Bank interest rates in Germany

Chart 13



1 To non-financial corporations with an initial rate fixation of up to one year. — **2** Redeemable at notice of up to three months. — **3** With an agreed maturity of up to one year. — **4** Loans to households with an initial rate fixation of over one year and up to five years. — **5** Decline owing to special effect. — **6** To households with an initial rate fixation of over five years and up to ten years. — **7** To non-financial corporations with an initial rate fixation of over five years. — **8** Residual maturity of over five years and up to six years.

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institutions of cooperative banks and the big banks[1] – which typically engage in wholesale banking – loans to private domestic customers declined.

Further moderate recovery in profitability

With regard to German banks' profitability, a continuation of the muted process of recovery which had started in 2004 was apparent in 2005. Once again, savings on the cost side are likely to have played a major part in this. Besides falling administrative costs, which were partly a reflection of earlier restructuring measures, a reduced need for risk provisioning in domestic lending business owing to

1 The big banks showed an increase, but sizeable securities lending transactions were the main factor in this (see page 37).

fewer corporate insolvencies is also likely to have been a significant factor. The German banks were able to achieve improvements on the income side as well, however. Although the earnings opportunities in interest business remained limited owing to the slack momentum of overall economic activity and a comparatively flat yield curve, both commission business and the own-account trading result benefited from developments in the stock markets.

Slower pace of consolidation

The process of consolidation in the German banking sector, which continued at a reduced pace in 2005, probably advanced less as a result of banks' current earnings performance than of longer-term profitability developments. By the end of last year, the number of credit cooperatives and savings banks had fallen by 42 and 14 institutions respectively. Hence, the greatest decline in the number of institutions took place among categories of banks whose profitability had been affected to a comparatively small extent by the fluctuations of the past few years, but which had to cope over a fairly long period with a decline in their earnings in interest business, in particular. In the reporting year, the overall number of credit institutions recorded in the banking statistics fell by 58 to 2,089.

4 Stability of the German financial system

German financial system strengthened

Overall, the stability of the German financial system strengthened further in 2005. Given the robust state of the world economy, moderate rates of inflation and favourable financing conditions in a predominantly benign capital market setting, the German banks succeeded in improving their profitability.

Easing of the risk situation in the banking system

The banking industry benefited mainly from a significant reduction in the need for loan loss provisions, which was a reflection of an obvious easing of the risk situation. Progress in balance sheet adjustment in the corporate sectors of major industrial countries supported this development. Similarly, the loan portfolios of credit institutions with a business focus on SMEs showed a gradual improvement. At the same time, by reducing their credit risk, the banks themselves put in place key underlying conditions for this positive development.

Risk factors on the international front

A deterioration in the world economic situation could affect the German financial system. High oil prices and market players' expectations that they will remain at a high level are posing a certain strain. At the same time, however, improvements in energy efficiency and a more rapid recycling of the oil-producing countries' increasing revenues in the form of export earnings are dampening

the impact of higher oil prices on the German economy. The global imbalances are an additional risk factor; the fact that they are continuing to grow makes their tension-free reduction in the near future – though still possible – less likely.

Role of the international financial markets

The favourable financing conditions in the international financial markets are also reflected in a very abundant supply of liquidity. This is encouraging a heightened risk propensity on the part of many market players, which is revealed not least in relatively low risk premiums and an increase in leveraged trading positions. The effects of any turnaround in sentiment in the financial markets could place an additional strain on existing risks stemming from the increasing preference for less liquid assets and complex new financial instruments. However, stress tests of German banks based on the main market risk factors indicate the banks' ability to cope even with significant shocks.

Domestic risk factors

On the domestic front, the credit institutions find themselves facing improved but still limited income prospects. A weak propensity to invest and the continuing lacklustre development in the real estate markets meant that demand for credit was subdued. At the same time, a persistently large need for loss provisions exists in the case of some banks with a particular involvement in real estate lending business. In addition, some credit institutions are experiencing strains as a result of their links with investment companies that have set up real estate funds. Some of these mutual funds have stopped redeeming units.

Overall, the German banking system appears to be in a sufficiently stable condition and to be in the position to bear the risks emerging from the various market segments. In particular, equity and core capital as a major component of risk sustainability showed a satisfactory development last year across all categories of banks.

Situation in the insurance sector

On the whole, the insurance sector was able to increase its financial strength further. Nevertheless, the low interest-rate level continues to place a strain on life insurance companies, in particular, which are increasingly experiencing problems in ensuring the – partially guaranteed – remuneration of policyholders' accounts. In the case of the reinsurance companies, there was an increase in natural and man-made disasters and insured losses in the reporting year. Owing to the low level of interest rates, the large payments of claims made by the insurance companies were cushioned only partly by a slight improvement in capital investment income.

IV Economic trends in Germany

1 Continued economic recovery in a challenging environment

Recovery process enters second phase despite obstacles

In cyclical terms, the German economy took a major step forward in 2005. Owing to the unfavourable start to the year, overall annual economic growth in 2005, at 1.1%, was no higher than in the previous year in working-day adjusted terms, despite the clearly positive underlying trend in the course of the year. Economic activity in Germany was subject to the pressure of external influences. Continued buoyant global economic activity created strong growth in foreign trade, and the degree of openness of the German economy continued to grow at a rapid pace. However, the obvious deterioration in the terms of trade, primarily as a result of the sharp rise in crude oil prices and the associated withdrawal of real income in Germany, curbed private consumption, in particular. Not least for this reason, the mixed impression given by the German economy on an annual average is still dominant. During 2005, there were, however, signs of a broadening of the cyclical upturn. Thus, growth in exports sparked off an upturn in investment in machinery and equipment, which was stepped up to an increasing extent last year and now represents the second pillar of the economic recovery. Furthermore, there are growing signs that, after a number of years, the process of contraction in the construction sector is slowly coming to an end, even though there was a further significant decline in construction activity on an annual average in 2005. Private consumption remained subdued mainly as a result of the substantial losses in purchasing power due to higher energy prices and the difficult situation in the labour market.

Conditions in place for a stable economy in 2006

Given the generally favourable economic conditions, the cyclical upturn is set to gain a firmer hold this year. According to estimates by international organisations, the global economy will continue to grow at a fast pace in 2006. Also, German enterprises' order situation is decidedly favourable, particularly with regard to export business. Furthermore, the German business sector has become more optimistic again and the financial conditions are all looking positive. There has been no sustained basic disruption to the domestic price climate, despite the sharp increase in energy prices. Furthermore, there are an increasing number of signs that the labour market will stabilise. Some key economic policy decisions for the next few years have already been taken. In this context, the planned increase in the standard rate of value added tax (VAT) from 16% to 19% as of 1 January 2007 is likely to lead to anticipatory effects for purchases

Key economic variables in Germany

Table 5

Annual percentage change

Item	2002	2003	2004	2005
Growth (real) [1]				
Private consumption	– 0.5	+ 0.1	+ 0.6	– 0.0
Government consumption	+ 1.4	+ 0.1	– 1.6	+ 0.1
Machinery and equipment	– 7.5	– 0.2	+ 2.6	+ 4.0
Premises	– 5.8	– 1.6	– 2.3	– 3.4
Other investment	+ 1.3	+ 3.3	+ 1.8	+ 1.8
Domestic use	– 1.9	+ 0.6	+ 0.6	+ 0.3
Exports [2]	+ 4.2	+ 2.4	+ 9.3	+ 6.3
Imports [2]	– 1.4	+ 5.1	+ 7.0	+ 5.3
Gross domestic product	+ 0.1	– 0.2	+ 1.6	+ 0.9
Contribution to GDP growth in percentage points				
Domestic use (excluding stocks)	– 1.3	0.0	0.0	0.0
Changes in inventories	– 0.6	+ 0.5	+ 0.5	+ 0.3
Net exports	+ 1.9	– 0.7	+ 1.1	+ 0.6
Employment				
Employed [3]	– 0.6	– 1.0	+ 0.4	– 0.2
Average working time per employed person	– 0.9	– 0.4	+ 0.4	– 0.4
Total number of hours worked	– 1.4	– 1.4	+ 0.8	– 0.6
Unemployed (in thousands) [4]	4,061	4,377	4,381	4,861
Western Germany	2,498	2,753	2,783	3,247
Eastern Germany	1,563	1,624	1,599	1,614
as a percentage of the civilian labour force	9.8	10.5	10.5	11.7
Western Germany	7.6	8.4	8.5	9.9
Eastern Germany	17.7	18.5	18.4	18.7
Prices				
Consumer prices	+ 1.4	+ 1.1	+ 1.6	+ 2.0
Producer prices of industrial products [5]	– 0.6	+ 1.7	+ 1.6	+ 4.6
Construction prices	– 0.1	+ 0.1	+ 1.1	+ 1.3
Import prices	– 2.2	– 2.2	+ 1.0	+ 4.3
Export prices	– 0.2	– 0.2	+ 0.5	+ 1.3
Terms of trade	+ 2.0	+ 2.0	– 0.6	– 2.9
GDP deflator	+ 1.4	+ 1.0	+ 0.8	+ 0.5
Productivity and labour costs				
GDP per hour worked by employed persons [1]	+ 1.5	+ 1.2	+ 0.9	+ 1.5
Compensation per hour worked by employees [3]	+ 2.1	+ 1.9	+ 0.1	+ 0.8
Labour costs per unit of value added in real terms in the economy as a whole [6]	+ 0.6	+ 0.6	– 0.8	– 0.7

Sources: Federal Statistical Office; Federal Employment Agency. — **1** At constant prices and chained (2000=100). — **2** Balance of transactions in goods and services with the rest of the world. — **3** Domestic concept. — **4** As defined by the Federal Employment Agency. — **5** Domestic sales. — **6** Gross compensation generated in Germany per hour worked by employees divided by real GDP per hour worked by employed persons.

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of durable consumer goods, which will, however, be "missing" in the following year and pose a matching strain for 2007.

Continuing strong impulses from exports

Once again, German exports of goods and services continued to expand strongly in 2005 and are continuing to be a main driving force behind the growth of the economy as a whole. In real terms, exports rose by 6¼%, although this was still less than the extremely high growth in 2004 of 9¼%. Firstly, demand for German products in 2005 was driven by the sustained vigorous growth of the German export markets. Secondly, comparatively moderate price and cost developments in Germany contributed, on an annual average of 2005, to a further improvement of 1¾% on the year in its competitive position within the euro area. Its price competitiveness against non-euro-area countries increased by ½%, compared with a 2½% deterioration on an average of 2004 owing to the appreciation of the euro. Exports to non-euro-area countries grew at a somewhat faster pace than those to euro-area countries. Overall, German exporters further strengthened their market position inside the euro area and largely held their position elsewhere.

Recycling of oil revenues

Particular export successes were achieved in the oil-exporting countries. In terms of value, exports of goods[1] to OPEC countries went up by 18¼% and by 15% to the Russian Federation. For Germany, this meant that a significant amount of the higher oil revenues of these oil-producing countries flowed back in the form of increased orders for goods. In foreign trade with the OPEC countries, Germany managed to keep its surplus (€5 billion) at almost the same level as in the previous year. By contrast, the deficit in trade in goods with the Russian Federation rose by €3 billion to €3¼ billion. The turnover from exports with the emerging market economies in South and South-East Asia (including China), which was still recording double-digit growth rates in 2004, grew by no more than 2¼% in 2005. With regard to the range of goods, German capital goods were in particular demand in the international markets, whereas sales of consumer and intermediate goods expanded much less sharply.

Substantial loss of purchasing power and increasing net exports

In 2005, real imports of goods and services also showed a marked increase of 5¼% on the year. The main reason for this was the high and larger percentage of imported inputs used in the production of export goods. Buoyant export growth was therefore also associated with a sharp rise in real imports. By con-

1 The data on trade in goods also contain supplementary foreign trade items and are calculated on a fob/fob basis, ie without the freight and insurance costs payable on imports, which are shown under services.

trast, domestic demand in Germany, which was still rather sluggish, generated only weak stimuli for imports. In 2005, Germany's net energy imports declined slightly in terms of volume. In nominal terms, however, they recorded a significant increase of 38¼% owing to the sharp rise in the cost of energy sources. Higher prices for energy imports in 2005 resulted in an overall decline in purchasing power of €14½ billion. Nevertheless, at ¾% of GDP, this was considerably less than at the beginning of the 1970s and 1980s when the reduction amounted to just under 1½% of GDP. On balance, there was a goods surplus of €153¼ billion in 2005, which was still €¾ billion up on the high figure recorded in the previous year.[1] Real net exports rose much more steeply and, in purely mathematical terms, accounted for around two-thirds of overall economic growth.

Machinery and equipment as the second pillar of the economic recovery

In addition to exports, investment in machinery and equipment now constitutes the second pillar of the economic recovery. Given the sustained positive trend in export activity, 2005 saw a further 4% growth in investment in machinery and equipment, compared with 2½% in 2004. This investment was again primarily focused on modernisation and purchasing replacements for out-dated machinery. Increased scope for using non-financial assets owing to greater flexibility in labour input and optimisation in the international integration of production meant that investment in capacity expansion was required only in rare cases. However, enterprises – primarily those heavily involved in exporting – are now increasingly reaching their capacity limits, which means that expansion is now likely to play a greater role. Given the generally improved earnings situation, the conditions for this are in place on the financial side, too. For example, enterprises strengthened their capital base and reduced their interest expenditure. Enterprises also benefited from the fact that the cost of debt financing continued to be at an all-time low.

Construction investment bottomed out

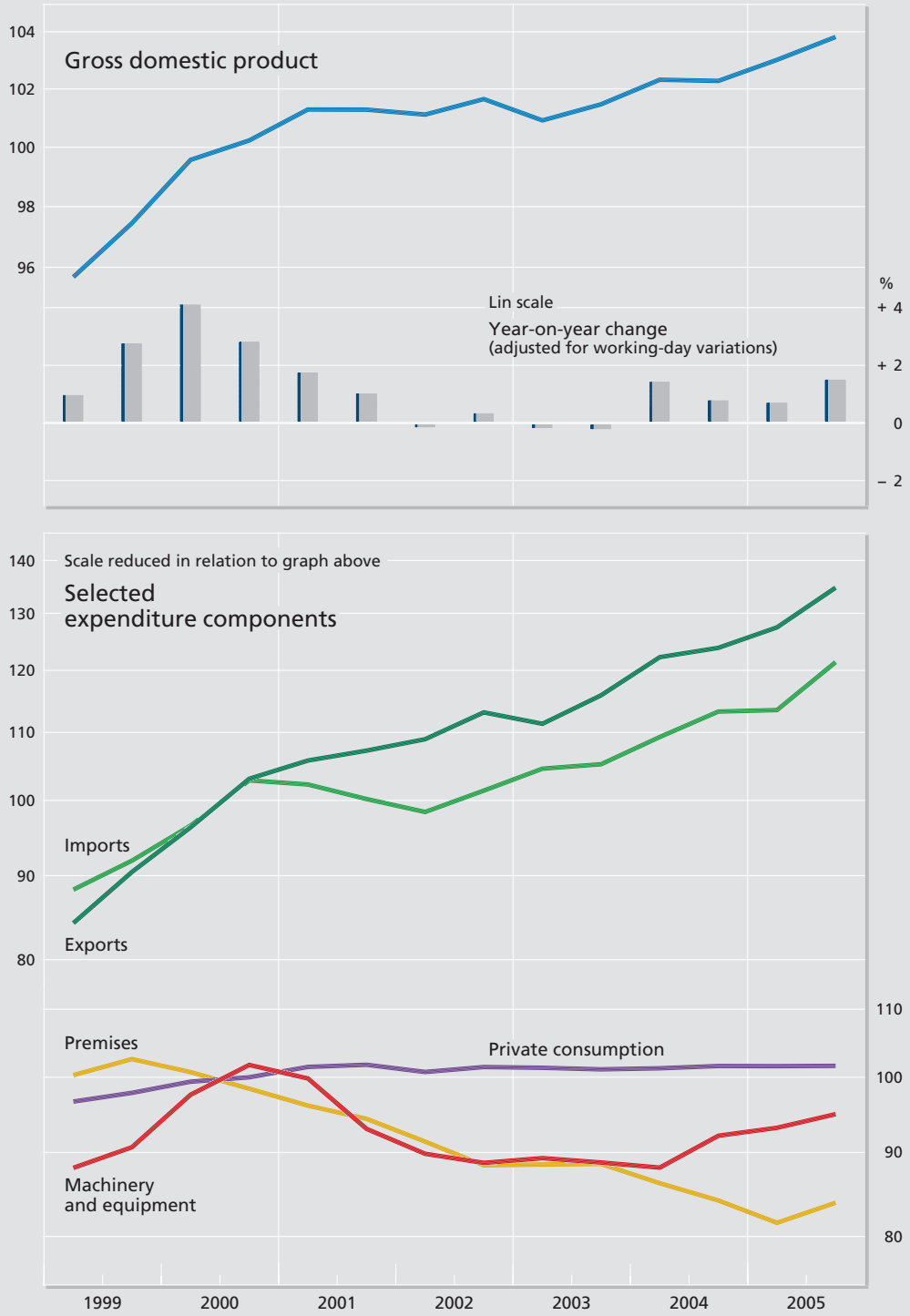
By contrast, construction investment was cut back again, and, on an annual average in 2005, recorded a decrease of 3½%. How great the need for adjustment has been following the exaggerations in the construction sector in the years after German reunification is revealed, for example, by the fact that real construction investment in 2005 was down by more than one-fifth on the most recent peak in 1994. The process of contraction in the construction industry, which has been under way for several years, had an even stronger impact on

1 The current account surplus also increased further by €92¼ billion. This was partly due to the significant improvement in net income from labour and wealth, primarily in the area of invisible current transactions.

Gross domestic product and
selected expenditure components

Chart 14

Real, 2000 = 100, seasonally adjusted, half-yearly, log scale



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employment. Last year, there were only just over 700,000 persons working in the construction industry, ie roughly half as many as ten years earlier. As in previous years, all the major subsectors of construction were affected by the downward trend in 2005 as well. Given the obvious differences between the markets for office space and retail space, the considerable number of vacant commercial properties continued to place a strain on industrial construction activity, especially as only little expansion in equipment and machinery has taken place so far. With regard to residential buildings, the large surplus of dwellings, especially in eastern Germany, as well as the uncertain outlook for incomes, continued to have an adverse impact; government was still under pressure to consolidate. The unfavourable result for the annual average does, however, conceal the fact that there were identifiable signs of the situation stabilising over the course of the year. This confirms the expectation that the trough has now been reached and that the construction industry will no longer pose an obstacle to the growth of the economy as a whole. Various measures taken by the Federal Government are also likely to have a temporary supporting impact. These measures include, for example, incentives for making buildings more energy-efficient, tax deductions for handicraft services for renovation, maintenance and modernisation measures and increased Federal Government investment in transport. Furthermore, the abolition of grants to homebuyers as of 1 January 2006 could generate temporary stimuli for housing construction activity, as a fairly large number of building applications were submitted towards the end of 2005 in order to benefit from the financial incentives that were still available. Furthermore, there could also be anticipatory effects in housing construction activity owing to the announced increase in VAT.

Low level of fixed capital formation

As a result of the decline in construction investment, aggregate gross fixed capital formation in 2005 was slightly down on the year. This was despite the increase in investment in machinery and equipment and in other assets, including, in particular, bought-in software and software developed in-house. Therefore, the capital stock, as a major indicator of the future opportunities for growth, increased by no more than 1½% in total. If new housing is excluded, the capital stock had, in fact, grown by no more than 1% at the end of the period under review.

Private consumption again weak

Private consumption continued to be weak in the reporting year. Despite the relief brought about by the last stage of the income tax reform at the beginning of the year, households' incomes framework was fairly tight. The weak condition of the labour market and, in particular, the marked decline in employment

subject to social security contributions had a particularly dampening effect on an annual average. Given that the increase in actual earnings remained moderate, gross wages and salaries were ¼% down on the year. Furthermore, the contribution rates to the health insurance funds for employees were also increased towards the middle of 2005, which meant that net earnings remained largely at the same level as in the previous year, despite the aforementioned income tax relief. Monetary social benefits received remained weak with a growth of ¼%. More funds flowed to households after unemployment assistance was merged with social assistance paid to persons able to work to create "unemployment benefit II". Nevertheless, the freeze on old age pensions again meant that pension benefits, which account for roughly half of social benefits received, were scarcely higher than in 2004. Taking other sources of income into account – which includes, in particular, self-employed persons' income and property income – households' disposable income rose by 1½% in nominal terms. In real terms, however, household budgets were only slightly higher than in the previous year, as significant price burdens, especially as a result of the sharp rise in energy prices, had an adverse impact. Given a further slight increase in the saving ratio to 10¾%, real consumer spending by households in 2005 remained at no more than the previous year's level.

Rise in statistically recorded unemployment

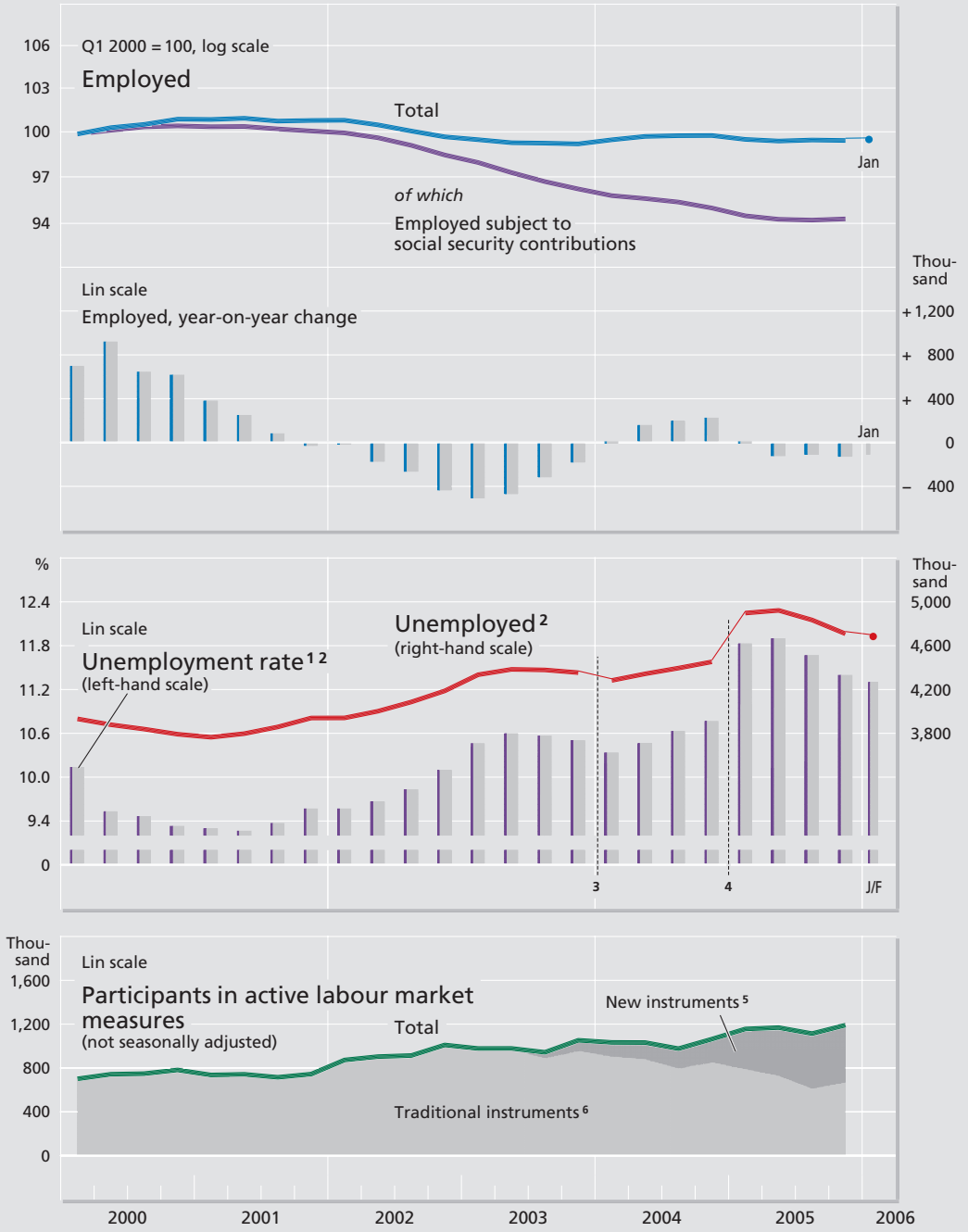
Labour market policy measures played an important role in shaping the employment and unemployment statistics in 2005. The replacement of the two traditional transfer payments for the long-term unemployed, unemployment assistance and social assistance, by a basic allowance for jobseekers (unemployment benefit II) played a crucial role in this. As a result, the number of persons officially registered as unemployed showed a sudden rise at the beginning of 2005.[1] The fact that an increasing number of employment opportunities was being created for recipients of unemployment benefit II (one-euro jobs) largely explains why the official unemployment figure was showing a trend decline during the course of the year. Furthermore, persons who lost their claim to benefits owing to the stricter entitlement requirements under the new regulation often did not reregister at the unemployment office. The ability to work of such persons receiving benefits was also examined more closely. At the end of 2005, however, the seasonally adjusted number of persons registered as unemployed (4.64 million) was still 3.1% up on the year. On an annual average, this amounted to

1 Owing to the belated inclusion of persons receiving social assistance in those municipalities having separate responsibility for the unemployed, there was an initial further increase in the official unemployment figures in September. In January 2006, this effect was revised and brought forward to the start of 2005.

Labour market

Chart 15

Quarterly, seasonally adjusted



1 Unemployed as a percentage of the civil labour force. — **2** As defined by the Federal Employment Agency. — **3** From January 2004, unemployed excluding participants in aptitude testing and training schemes. — **4** Increase influenced by inclusion of persons receiving social assistance who are able to work. — **5** Personal Service Agencies (PSAs), government-assisted one-person businesses, employment opportunities (one-euro jobs). — **6** Job creation measures and structural adjustment measures, promotion of further vocational training, reintegration grants, bridging payments for self-employed persons, early retirement schemes (pre-retirement part-time work: 2005 Q4 estimated).

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4.86 million persons, almost 500,000 more than in 2004. This was also the highest level of registered unemployment since German reunification. The official unemployment rate stood at 11.7%, compared with 10.5% in 2004. This was 0.3 percentage points higher than the previous record peak in 1997. As explained earlier, these statistics cannot be equated with a matching deterioration in the actual labour market situation. At the beginning of 2006, there was an initial further increase in unemployment, which was due to the very cold winter weather and the anticipatory effects of the reduction in the maximum period of entitlement to unemployment benefit I, which came into effect at the beginning of February.

Slight decrease in employment

According to the calculations of the Federal Statistical Office, 38.78 million persons were in gainful employment in Germany on an annual average of 2005. This was almost 90,000, or 0.2%, fewer than in the previous year, in which gainful employment was still showing an increase. The decline in employment subject to full social security contributions initially continued in 2005 before coming to a halt. Conversely, exclusively low-paid part-time employment showed no further increase. The number of mini-jobs even declined slightly in the course of 2005 with a certain degree of saturation appearing to have been reached. In 2005, the number of self-employed persons did not show such a marked increase as in the previous year. This was primarily due to the fact that labour market policy incentives to move from unemployment into self-employment were no longer as generous. Since the beginning of 2005, for example, detailed business plans have to be submitted in order to obtain a grant and these have to be examined by expert assessors. On a sectoral level, construction was particularly affected by job losses (-5%). By contrast, there was a slight increase in employment in the services sector (+½%). In conclusion, 2005 may be seen as a transitional phase, in which the current situation was still heavily influenced by the earlier cyclical weakness. However, the decline in short-time working and the increasing number of vacancies reported to the labour exchanges point to a cyclical upturn.

"Promote and push"

The merging of unemployment assistance and social welfare benefits was designed to achieve a greater commitment to cooperation and to place greater emphasis on individual responsibility to earn a living by means of gainful employment. This is emphasised, for example, by the fact that basic social security protection is no longer paid out on the basis of previous earnings but – with the exception of a temporary supplement – as an amount that is the same for all recipients of assistance. This is intended to ensure that the long-term un-

employed take up new jobs more rapidly. The labour exchanges can also urge recipients of unemployment benefit II to take up job opportunities. These "one-euro jobs" are intended to maintain the employability of the long-term unemployed, who do not have any prospects of a regular job in the primary labour market in the short term, and is also a way of testing their willingness to work. Owing to the level of remuneration for these jobs of between €1 and €2 per hour, which is not offset against the amount received from unemployment benefit II, the income situation of participants can, however, improve so much that regular employment becomes less attractive. The relaxation of the regulations governing additional earnings for recipients of unemployment benefit II in October 2005 has a similar effect. Like one-euro jobs, this kind of subsidised pay model encourages the continued drawing of benefits. Traditional instruments of active labour market policy, such as job creation measures and the promotion of vocational training, which have proved to be not very effective in the past, have been cut back. However, the total number of persons receiving assistance has not decreased in the past five years.

Deregulation and promotion of persons on the margins of the labour market

Success in reintegrating the long-term unemployed into gainful employment is more likely to be achieved if there is a greater degree of absorption capacity in the labour market. Besides the underlying macroeconomic conditions, the wage-setting system and the regulation of the labour market also play a major role in this. In the past few years, a number of steps have been taken to strengthen the efficiency of the labour market. These are, for example, the deregulation of hiring out labour, the relaxation of time limits in employment contracts, incentives for self-employment, the expansion of "mini-jobs" and "midi-jobs", which carry tax and social security benefits, as well as the relaxation of employment protection rights for newly recruited older employees, although this has now been classified as discriminatory by the European Court of Justice. Many of these measures are aimed at deregulation or improving the conditions for persons on the margins of the labour market, although there has been little change with regard to the mass of regulations and the tax and social security burden associated with full-time employment subject to full social security contributions. This policy has succeeded insofar as the promoted forms of employment have indeed become considerably more important. At the same time, full-time employment subject to full social security contributions has been reduced. This was due to the substitution of employment forms in some cases. The degree of labour market segmentation is ultimately being increased as a result and this is causing an erosion of traditional employment. Insulating parts of the labour market by means of sector-specific statutory minimum wages, which has

already been achieved in certain industries by declaring collective labour agreements to be generally binding, would reinforce such tendencies and would at least delay the reduction of long-term unemployment.

"Small" pay round

In 2005, there was only one "small" pay round with a few new agreements. This was because earlier long-term agreements were still in force in a number of economic sectors or agreements on incremental pay increases came into effect. Given the pressure of fiercer international competition, the unsatisfactory labour market situation and the cuts in wage substitutes, the negotiations were focused on securing jobs and ensuring the future viability of production sites. There was a matching willingness to make concessions in the form of zero-wage rounds and longer working hours. On balance, the pay agreements were, on average, at much the same level as last year. The sole exception was the new collective pay agreement for the steel industry. This industry is benefiting, in particular, from developments in international demand. Here, remuneration for 2005 increased by 3.4%. For the most part, one-off payments were agreed, which do not affect the negotiated wage structure. Across all the sectors, negotiated pay rates went up by an average of 1.1% on a monthly basis in 2005. Calculated on an hourly basis, the figure was 0.9%.

Negative wage drift and declining unit labour costs

Along with the overall moderate wage agreements, there was a continued reduction in non-core payments. Added to this was the intensive use of liberalisation clauses. As a result, actual earnings per employee increased by a mere ½%. Shifts in the employment structure contributed significantly to the negative wage drift of just over ½ percentage point (calculated on a monthly basis). Owing to the lower employers' contributions to the statutory health insurance scheme since 1 July 2005, company-relevant labour costs remained almost unchanged. Combined with the cyclical pick-up in labour productivity, this led to a fall of over ¾% in unit labour costs. Given an increase in the GDP deflator of ½%, the profit margin also increased in macroeconomic terms. Continued wage moderation is improving the profitability of producing enterprises in Germany and thus making a vital contribution to ensuring the country's locational attractiveness.

Sharply rising energy prices, ...

The sharp rise in energy prices in the international markets has left a distinct mark on price developments in Germany. The cost of fuel and heating oil, which is derived primarily from crude oil prices, increased at the consumer level by 8% and 32% respectively on an annual average of 2005. The price of gas, which is usually linked by escalator clauses to crude oil prices, rose by 10½%. In 2005,

Prices at various levels of the economy

Table 6

Percentage year-on-year changes

Item	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Jan
Import prices	3.0	3.5	3.3	4.8	5.5	6.8
Energy	27.8	33.0	33.8	43.4	41.0	49.9
Metal ores	26.2	27.1	47.1	49.9	54.6	44.7
Basic metals and semi-finished products	22.9	18.1	13.3	8.0	8.5	10.8
Other	– 1.3	– 1.1	– 1.6	– 1.1	– 0.2	0.2
Industrial producer prices	3.0	4.1	4.4	4.7	5.0	5.6
Tobacco	16.4	19.9	11.1	13.7	14.9	7.2
Energy	4.7	8.5	12.8	16.7	17.7	21.4
Basic metals and semi-finished products	21.4	21.1	14.0	6.5	4.6	4.4
Other	1.0	1.4	1.1	0.7	0.8	0.6
Consumer prices	2.0	1.7	1.7	2.1	2.2	2.1
Healthcare	20.3	3.9	1.7	1.0	0.9	0.7
Tobacco	16.2	19.4	10.7	13.0	13.4	6.0
Energy	7.1	6.8	8.4	13.1	12.9	15.5
of which						
Refined petroleum products	11.2	8.3	9.4	16.6	14.3	18.3
Gas	2.2	7.3	8.4	10.8	15.2	19.0
Electricity	3.9	4.1	4.3	4.3	4.2	4.2
Other	0.4	0.7	0.8	0.7	0.8	0.6
Construction prices	1.7	2.0	1.1	0.9	1.0	.
Residential buildings	1.7	1.8	0.8	0.6	0.6	.
Industrial and office buildings	2.4	3.0	1.9	1.4	1.4	.
Road construction	0.1	0.1	0.3	0.1	1.2	.

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households paid 4.2% more for electricity than in the previous year, and electricity prices doubled in price for some industrial customers.

... otherwise moderate price developments with some exceptions

With the exception of the energy component, price developments were quite subdued in 2005. Indirect effects of prices were very limited and there were no second-round effects resulting from the quite sharp increase in energy prices that had already taken place in the previous two years. Nevertheless, the price of important industrial raw materials continued to rise and accelerated in some cases owing to the exchange rate. Import prices for metal ores went up by 45% on an annual average. The higher cost of raw materials was also reflected to a

lesser extent in other import prices and in German industrial producer prices. Higher steel prices were also the main reason for the almost 1.3% increase in construction prices. These idiosyncratic developments aside, prices for imports declined by just under 1% on an annual average, compared with an increase of 4.3% for imports as a whole. Producer prices for industrial products, which were also driven upwards as a result of the increases in tobacco tax, rose by 4.6%. The figure was no more than 1% if the cited items are excluded. Consumer prices, excluding energy, healthcare and tobacco, went up by 0.8%; including these other products, the figure was 2.0%. The Harmonised Index of Consumer Prices (HICP), which is calculated for European purposes, shows inflation at 1.9% for 2005. Price developments in the housing market, too, were subdued. The consumer price index shows an increase in housing rents of just 1% on the year. According to our calculations based on data of BulwienGesa AG, rents for new lettings were scarcely higher than in the previous year on average. Despite somewhat higher construction prices, the prices of newly constructed residential dwellings remained unchanged; the cost of older housing even became somewhat cheaper. In late 2005 and early 2006, there was a sharp increase in the prices of grid-dependent energy sources. On the other hand, there were very sharp price reductions in the winter sales. Personal liability insurance also decreased in price. The rate of price increase remained unchanged at 2.1% in January and February.

2 Public finance situation remains very problematic

(a) Developments in 2005

Renewed breach of 3% ceiling

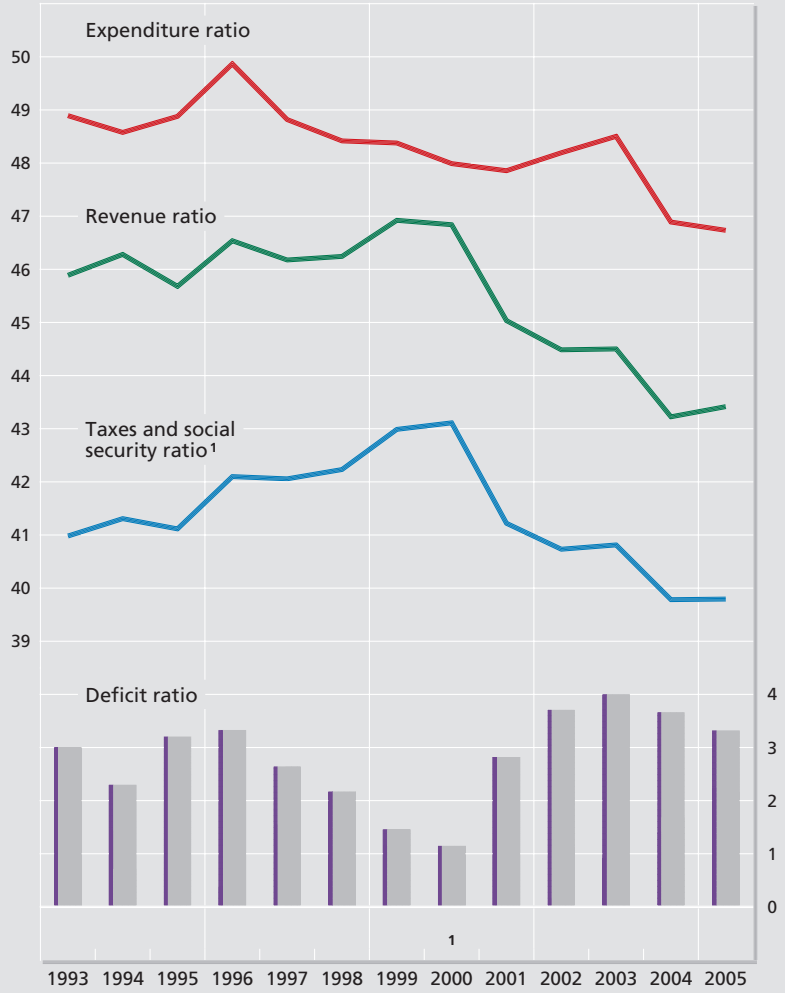
Overall, the public finance situation in Germany is still very problematic. Germany's general government deficit amounted to 3.3% of GDP in 2005.[1] This was almost ½ percentage point below the previous year's level and markedly lower than had been expected by the Federal Government, among others. However, the 3% ceiling for the deficit ratio enshrined in the EC Treaty was overshot for the fourth year in succession. The general economic situation and temporary effects had almost no net impact on the change in the deficit. The structural fiscal balance, ie the fiscal balance adjusted for cyclical and temporary effects, improved perceptibly.

1 The securitisation of Post Office pension fund claims on the Deutsche Post successor enterprises was recorded in the national accounts as not affecting the deficit.

General government fiscal ratios*

Chart 16

As a percentage of GDP



* As defined in the national accounts. — **1** Excluding the proceeds from the UMTS auction.

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Further sharp rise in debt ratio

Nevertheless, government debt rose again sharply in 2005. Owing to the high deficit and the comparatively low macroeconomic growth, the debt ratio increased by roughly 2 percentage points to 67.7% despite extensive financial asset disposals. Over the last four years, the debt ratio has increased by approximately 9 percentage points. Germany has, therefore, also failed to comply with the second fiscal reference value of the EC Treaty, which stipulates a debt ceiling of 60% of GDP and allows exceptions only when the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

General government as defined in the national accounts *

Table 7

Item	2003	2004	2005	2003	2004	2005
				Year-on-year change		
	€ billion			As %		
Expenditure	1,050.3	1,039.9	1,050.4	1.5	– 1.0	1.0
of which						
Social benefits	588.1	586.6	598.1	2.4	– 0.3	2.0
Compensation of employees	169.0	168.7	167.3	– 0.1	– 0.2	– 0.8
Intermediate consumption	89.2	89.5	94.4	0.5	0.3	5.5
Interest	64.6	62.9	63.4	2.7	– 2.6	0.8
Gross capital formation	32.9	30.7	29.1	– 7.5	– 6.5	– 5.1
Memo item						
Old-age provision [1]	285.7	286.1	288.7	2.2	0.1	0.9
Health [2]	148.6	143.7	147.5	1.4	– 3.3	2.6
Revenue	963.7	958.7	975.9	0.9	– 0.5	1.8
of which						
Taxes	489.6	487.2	497.6	0.9	– 0.5	2.1
Social contributions	394.4	395.3	397.0	1.3	0.2	0.4
				€ billion		
Balance	– 86.6	– 81.2	– 74.5	– 7.0	5.3	6.7
Memo item						
As defined in the Maastricht Treaty						
Debt level	1,381.0	1,451.0	1,520.5	88.0	69.9	69.6
	As % of GDP [3]			In percentage points		
Debt ratio	63.8	65.5	67.7	3.5	1.7	2.2
Deficit [4]	4.0	3.7	3.3	0.3	– 0.3	– 0.4

* In accordance with ESA 95, including customs duties, the EU's share in VAT revenue and EU subsides which have no effect on the balance. — **1** Expenditure of the statutory pension insurance scheme and on civil servants' pensions. — **2** Expenditure of the statutory health insurance scheme and on government assistance towards civil servants' medical bills. — **3** GDP including financial intermediation services indirectly measured (FISIM). — **4** In contrast to the budget balance in the national accounts, the Maastricht deficit is calculated taking into account interest payments from swap transactions and forward rate agreements.

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Marginal rise in the revenue ratio

The revenue ratio rose slightly to 43½% in 2005.[1] As in previous years, gross wages and salaries – the assessment base for wage tax and social security contributions – developed less strongly than GDP. Moreover, revenue shortfalls in consequence of the final stage of the income tax reform had a far greater impact than revenue-boosting measures elsewhere (profit-related taxes, tobacco tax, motor vehicle tax). Finally, consumer restraint in response to higher energy prices depressed receipts from mineral oil tax, which is a volume-based tax. On

1 In the result for 2005, the Post Office pension fund has been assigned to the government sector. This results in a slight rise in revenue and expenditure compared with the (still unadjusted) figures for 2004.

the other hand, profit-related tax receipts increased sharply, not least as a result of the favourable trend in business profits. On balance, tax revenue was higher than had been expected both in the official estimate from November 2004 and the latest estimate from November 2005. There was a marginal rise in the tax ratio while, by contrast, social security contributions in relation to GDP declined somewhat. Other revenue grew strongly. Subsidy repayments from the Landesbanken and, in particular, the motorway tolls for heavy goods vehicles that were introduced last year played a significant role in the positive development of other revenue.

Expenditure ratio down slightly

In 2005, expenditure in relation to GDP decreased slightly to 46¾%. As in the past few years, spending on compensation of employees and investment expenditure fell in absolute terms. Moreover, there was only a comparatively moderate rise in expenditure on old-age provision. Finally, despite rapidly growing government debt, only a small increase in interest expenditure occurred as low interest rates continued to facilitate favourable refinancing terms for maturing securities. On the other hand, healthcare expenditure and transfers to the EU budget went up again considerably. There was also a significant rise in labour-market-related expenditure. Both unfavourable labour market developments and – contrary to original expectations – the labour market reforms placed strains on government budgets.

Budget deficit of central, state and local government restrained primarily by asset disposals

At €52½ billion, the budget deficits of central, state and local government (as defined in the government's financial statistics) were probably about €13 billion less than in 2004. According to the preliminary outturn, the central government deficit went down by more than €8 billion to €31½ billion simply because of the greater use of asset disposals for current budget financing. However, the deficit was still €9 billion above the budget estimate, largely owing to the budget overshoot in connection with the Hartz IV reform, but also to the fact that the Bundesbank profit was smaller than predicted. Extensive outstanding loan authorisations were drawn on in order to plug this gap. By contrast, state government budget deficits were not only less than had been envisaged in the revised budget plans, at €24 billion they were also slightly down on the year. Cuts in personnel expenditure clearly played a significant role in this. Local government deficits are likely to have fallen compared with 2004 (€4 billion) owing, in particular, to the favourable trend in local business tax, but also to a further decline in investment expenditure. The surplus of the Federal special funds rose sharply (by €2 billion to €4 billion). This was due largely to the fact that loan repayments to the ERP Special Fund outweighed new loans by far more than they had done in 2004.

General government finances *

Table 8

Item	2003 pe	2004 pe	2005 pe	2003 pe	2004 pe	2005 pe
	€ billion			Year-on-year change		
Central, state and local government				as %		
Expenditure	614.4	609.3	620	0.6	– 0.8	2
of which						
Central government	278.8	273.6	281.5	2.0	– 1.9	3
State government	259.7	256.6	260	0.6	– 1.2	1.5
Revenue	547.1	543.8	567.5	– 1.4	– 0.6	4.5
of which						
Taxes	442.2	442.8	451	0.1	0.1	2
				€ billion		
Balance	– 67.3	– 65.4	– 52.5	– 11.1	1.8	13
of which						
Central government	– 39.2	– 39.8	– 31.5	– 6.5	– 0.6	8.5
State government	– 30.5	– 24.0	– 23.5	– 1.3	6.5	0.5
Social security funds				as %		
Expenditure	474.3	468.8	471.5	1.8	– 1.2	0.5
Revenue	467.7	470.3	468.5	2.2	0.5	– 0.5
				€ billion		
Balance	– 6.6	1.5	– 3	1.7	8.1	– 4.5
of which						
Statutory pension insurance scheme	– 2.4	– 1.7	– 4	2.0	0.7	– 2.5
Statutory health insurance scheme	– 3.7	3.9	1.5	– 0.1	7.5	– 2

* The budgetary definition used here differs from the definition of the government account within the national accounts.

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Financial situation of social security funds deteriorates

In 2005, in contrast to the developments in central, state and local government finances, the budgetary position of the social security funds deteriorated significantly. The deficit of the statutory pension insurance scheme went up to more than €4 billion and, as a result, the reserves fell well short of their minimum level of 0.2 month's expenditure. The statutory health insurance institutions also recorded a far less favourable outturn in 2005 than in the previous year. The surplus of €4 billion recorded in 2004 fell to half this amount owing to the vigorous increase in expenditure, which reflects, in particular, the marked renewed rise in spending on pharmaceuticals. By contrast, the financial situation of the statutory long-term care insurance scheme improved in 2005. Its deficit was somewhat lower on account of the relief provided by the additional contribution from childless persons and increased revenue from contributions as a result of the Hartz IV reform. The Federal Employment Agency receives a Federal grant to balance its budget. In 2005, the required grant amounted to only €½ billion, mainly owing to reduced expenditure on unemployment benefit and active labour market policy measures as well as a smaller than estimated compensatory payment to central government.

(b) Further outlook

Although no further consolidation is planned in 2006, ...

The coalition deal from November 2005 outlined fiscal reforms in a number of key areas for the current legislative period. These include, in particular, income and business taxation and the social security funds. In addition, a review of the active labour market policy instruments is planned, partly with a view to increasing incentives for taking up low-paid employment. Detailed proposals for a reform of Germany's federal structure have already been drawn up, although these have yet to be complemented by a further reorganisation of the financial constitution. A set of consolidation measures and a scheme aimed at stimulating economic growth and employment, which spans several years, were also announced. Certain measures have since been spelled out in detail or adopted. On balance, the new measures are likely to increase the deficit marginally this year. This reflects the Federal Government's objective of stabilising the economic cycle by largely foregoing any additional consolidation steps and by taking individual measures which, it is hoped, will stimulate business activity. A significant reduction in the general government deficit is not planned until 2007.

... the 3% ceiling could be achieved this year

However, a moderate reduction of the government deficit may be expected this year even if no new measures are introduced provided that stringent budget management is exercised. The structural budget deficit could go down slightly given a stringent expenditure policy. Moreover, the overall momentum of business activity should have a positive impact on the development of public finances, which means that the 3% ceiling is certainly achievable. Next year, if the measures announced are implemented, the deficit could fall comfortably below the 3% mark.

Excessive deficit procedure against Germany tightened

On 14 March 2006, in response to a recommendation from the European Commission, the Ecofin Council decided to step up the excessive deficit procedure against Germany and to issue it notice pursuant to article 104(9) of the EC Treaty. The Council has called on Germany to correct the excessive deficit as quickly as possible, and by 2007 at the latest. It demands that the structural deficit – ie the deficit adjusted for cyclical and temporary effects – be reduced by at least 1% of GDP altogether in the course of this year and next.

Economic situation poses no obstacles to a greater deficit reduction this year

Germany has overshot the reference value for the deficit ratio every year since 2002; furthermore, last year the 3% ceiling was exceeded by a fairly modest margin. Moreover, under the amended Stability and Growth Pact, countries with an excessive deficit are obliged to achieve annual structural consolidation

Chronology of general economic and fiscal policy measures

1 January 2005
Various new economic and fiscal policy regulations enter into force in Germany: with the final stage of the 2000 tax reform, income tax rates are lowered again (starting rate cut from 16% to 15%, top rate cut from 45% to 42%). The gradual transition to downstream taxation in the statutory pension insurance scheme and comparable private pension products begins. Unemployment assistance and social assistance for persons able to work are merged to create "unemployment benefit II". In the long-term care insurance scheme a special contribution of 0.25% is introduced for childless members. The motorway toll for heavy goods vehicles is introduced on Germany's motorways.

14 January 2005
The Governing Council of the ECB decides to increase the allotment amount for all the longer-term refinancing operations conducted in 2005 from €25 billion to €30 billion. This reflects the growing demand for liquidity in the European banking system.

26 January 2005
According to its 2005 Annual Economic Report, the Federal Government expects the growth path which began in mid-2003 to continue. 1.6% real GDP growth is projected. This assumes a clear upturn in domestic demand, in particular in the areas of private consumption and investment in machinery and equipment. By contrast, export activity is expected to slacken off. The number of persons in work is predicted to rise by 0.8%, more than twice the rate recorded in 2004, and unemployment, measured in terms of the unemployment rate calculated by the Federal Employment Agency, is expected to rise to 10.7%.

9 February 2005
A pay agreement with a term of 35 months is concluded for the salaried staff and wage earners of central and local government. For employees in western Germany it provides for one-off payments of €300 a year instead of pay rises. For employees in eastern Germany it foresees a progressive increase in negotiated pay rates from 92.5% to 97% of the level in western Germany by 2007. As part of a wider overhaul of the remuneration system, performance-related bonuses and deductions are to be introduced from 2007. A standard working week of 39 hours is introduced throughout Germany for central government employees covered by

the collective labour agreement.

18 February 2005
The Bundestag votes down the Bundesrat's objection to the 2005 Federal budget. No further changes are made.

15 March 2005
The Bundesbank presents its annual accounts for 2004 and transfers a profit of €676 million to the Federal Government (€248 million in 2003).

21 March 2005
In a statement, the Bundesbank criticises the planned changes to the Stability and Growth Pact which will crucially weaken it. This is consistent with its firm belief that sound government finances are a cornerstone of price stability.

29 April 2005
The currencies of Latvia, Cyprus and Malta join the Exchange Rate Mechanism II. A standard fluctuation band of ±15% applies to all three currencies, based on their central rates on 2 May 2005. However, Latvia maintains its unilateral commitment to a 1% band. No additional obligations are placed on the ECB as a result.

12 May 2005
According to figures from the Working Group on Tax Estimates, tax revenues for 2005 are expected to increase only slightly in 2005 and then more markedly during the estimation period up to 2009. Owing to considerably less favourable macroeconomic assumptions, shortfalls of just over €5 billion are expected for 2005 compared with the estimate from November 2004, increasing to almost €23½ billion in 2008 in a departure from the May 2004 medium-term estimate.

30 June 2005
No decisions are taken at the 102nd meeting of the Financial Planning Council.

1 July 2005
The health insurance institutions reduce the general contribution rate, which is equally split between employee and employer, by 0.9 percentage points. At the same time, a special contribution is introduced for exactly that amount, which only members of the statutory health insurance scheme have to pay.

7 July 2005
The State Constitutional Court of Mecklenburg-West Pomerania rules that the supplementary budget for 2003 and the 2004-05 Budget Act (*Haushaltsrechtsgesetz*) breach the constitution. The fact that the constitutional upper borrowing limit was exceeded in 2003, in particular, is ultimately without consequence, as the books have already been closed for that year. Instead, it simply means obtaining a subsequent borrowing authorisation.

8 July 2005
The Act Amending the Fourth and Sixth Books of the Social Security Code is passed by the Bundesrat without conciliation proceedings. The Act provides that, from 2006, the social security contributions on wages and salaries paid at month-end must be transferred in that same month rather than the middle of the following month as has previously been the case. The one-off increase in revenue from contributions means that the 2006 annual result of the Federal Employment Agency and the statutory pension insurance scheme (as defined in the government's financial statistics) will be far more favourable. In the national accounts, the contributions are already recorded on an accruals basis, meaning that the absence of real consolidation measures will result in a significant deficit in this definition. In the case of the statutory health and long-term care

Chronology of general economic and fiscal policy measures

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insurance schemes, contributions are already booked on an accruals basis in the government's financial statistics. Thus, there will not be any deficit-reducing effect here. The Bundesrat also passes the New Income Threshold Act (*Freibetragsneuregelungsgesetz*) which relaxes the rules regarding the offsetting of income from employment against unemployment benefit II.

13 July 2005
In view of the plans to hold Bundestag elections in the autumn, the Federal cabinet foregoes the adoption of the draft Federal budget for 2006 and medium-term financial plan. The documents presented by the Federal Ministry of Finance envisage net borrowing of €22 billion for 2006. Exceptionally large privatisation proceeds of €23 billion, the securitisation of Post Office pension fund claims, which is expected to save €5½ billion, and a cut of a little over €3 billion in central government contributions towards the cost of accommodation for recipients of unemployment benefit II mean that the constitutional limit for new borrowing pursuant to article 115 of the Basic Law is expected to be met. It has been shown that for the financial planning period beginning in 2007, fiscal policymakers must find €25 billion annually in order to remain below the borrowing limit.

1 September 2005
The last stage of the increase in tobacco tax to finance a Federal grant to the statutory health insurance scheme enters into force.

1 October 2005
As part of an organisational reform of the statutory pension insurance scheme, the distinction between wage and salary earners is abolished. It is now called the German pension insurance scheme (*Deutsche Rentenversicherung*). In particular, the reform aims to increase administrative efficiency.

3 November 2005
The Working Group on Tax Estimates revises the May estimate upwards by €3 billion for 2005 and by €1 billion for 2006, despite somewhat unfavourable macroeconomic conditions.

9 November 2005
In its 2005-06 annual report, the German Council of Economic Experts forecasts real GDP growth of 1.0% in 2006. Foreign trade continues to be the main stimulus. By contrast, a widespread revival in domestic consumption is not expected. The report predicts that pro-

spects for the labour market will brighten only gradually and that, at 11.6%, the unemployment rate will be just 0.2 percentage points lower than in the previous year. High energy prices are sapping household purchasing power. In real terms, household expenditure will fall by 0.2% in 2006. A 4.3% increase in expenditure on machinery and equipment is expected in real terms whereas the adjustment process in the construction industry is not yet complete.

12 November 2005
Almost two months after the early general election, the CDU/CSU and SPD coalition deal is presented. They announce that in 2006 central government will significantly overshoot the constitutional upper borrowing limit pursuant to article 115 of the Basic Law. This limit and the deficit ceiling prescribed by the Stability and Growth Pact will not be met before 2007. Most of central government's planned spending cuts will affect social security funds and result in an increase in the contribution rates. There is greater emphasis on revenue-increasing measures where, in addition to the broadening of the tax exemption base, plans are also in place to raise the standard rate of VAT by 3 percentage points from 2007. Some of the additional revenue is earmarked for financing the reduction in contribution rates to the Federal Employment Agency by 2 percentage points. A programme to encourage economic growth is also unveiled, which includes increased spending on promising sectors and tax breaks – in particular to promote investment and for special household expenditure. The cost to the Federal budget as a whole is expected to amount to €25 billion over the next four years. Including the tax shortfalls of state and local government, this amounts to €37 billion. Overall, the burden on the Federal budget is increased slightly in 2006 by virtue of the package of measures that has been announced, whereas a significant contribution to structural consolidation is expected in 2007 owing, above all, to the increase in the rate of VAT. A reform of the federal system is also announced. Part one has already been finalised and is largely based on the interim results of the Federalism Commission which was disbanded at the end of 2004. Part two, including a reform of financial relations is to be drawn up during this legislative period. Finally, in the current legislative term decisions are expected on healthcare reform, business tax reform and an increase in the statutory retirement age. The numerous instruments of active labour market policy are also to be reviewed.

25 November 2005
Slovakia joins the Exchange Rate Mechanism II. A standard fluctuation band of ±15% applies to the Slovak koruna, based on its central rate on 28 November 2005.

1 December 2005
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by ¼ percentage point to 2.25%, with effect from 6 December 2005. The interest rates on the marginal lending facility and the deposit facility are likewise raised by ¼ percentage point to 3.25% and 1.25% respectively, both with effect from 6 December 2005.

16 December 2005
The Governing Council of the ECB decides to increase the allotment amount for all of the longer-term refinancing operations (LTROs) conducted in 2006 from €30 billion to €40 billion. This reflects the growing need for liquidity in the European banking system and slightly increases the structural share of LTROs in MFIs' total refinancing volume. The Eurosystem will, however, continue

Chronology of general economic and fiscal policy measures

(cont'd)

to provide the bulk of liquidity through its main refinancing operations.

17 December 2005
The European Council agrees the Financial Perspectives for the European Union for the period 2007-13. They predict that EU budget expenditure will remain, on average, at just under 1% of the total GDP of all EU member states. A comprehensive reform of expenditure does not take place. The European Commission's original proposal envisaged an increase in the ratio to 1.14%.

21 December 2005
The Bundesrat approves the abolition of the grant to homebuyers, the bill to limit the offsetting of losses in connection with tax deferral models and the bill to launch an immediate tax programme which will, in particular, eliminate the tax-free status of settlements and the special allowance for private tax consultancy fees.

22 December 2005
In a press release, the Bundesbank welcomes the Federal Government's nomination of its Vice-President Professor Jürgen Stark to the Executive Board of the European Central Bank.

1 January 2006
Several new economic and fiscal policy regulations enter into force. In addition to some of the provisions of the legislation passed by the Bundesrat on 21 December 2005, earlier deadlines for the transfer of social contributions apply to most employers. Furthermore, the regulation allowing people over the age of 58 to draw employment substitution benefits without being available for work is extended again to the end of 2007.

18 January 2006
The European Parliament rejects the European Council's decision on the 2007-13 Financial Perspectives. Agreement is now expected to be reached by May 2006.

25 January 2006
In its Annual Economic Report, the Federal Government forecasts real GDP growth of 1.4% in 2006 following 0.9% last year. Domestic demand, in particular, is expected to increase, on the assumption of stronger impulses from investment in machinery and equipment and a halt in the downward trend in the construction industry. In the light of the more favourable cyclical trend, the situation on the labour market is expected to improve. However, roughly half

the expected reduction in the unemployment level – by around 350,000 on an annual average – is related to the improvement during 2005. The number of people in employment may pick up somewhat during the year.

16 February 2006
Following a unanimous decision in the Financial Planning Council, central, state and local government will endeavour to curb expenditure growth to an annual average of 1% between 2007 and 2009. There is a broad consensus on the need to raise the standard rate of VAT by 3% from 2007.

22 February 2006
The Federal Cabinet adopts the draft Federal budget for 2006 and medium-term financial plan for 2005 to 2009. Net borrowing in 2006, at €38½ billion, is expected to exceed total investment expenditure by €15 billion. This is justified by invoking the exemption clause that it serves to avert a disruption of the overall economic equilibrium. A return to compliance with the upper borrowing limit stipulated in article 115 of the Basic Law is planned for the following years. Alongside tax increases, the realisation of central government assets – originally planned for 2006 – is expected to contribute significantly towards achieving this objective. In addition, the updated stability programme is adopted. Accordingly, in 2006 the deficit ratio is to be maintained at the previous year's level of 3.3%. The 3% reference value is to be met in 2007 with a substantial cut to 2½%. A further decrease of ½ percentage point is expected for 2008 and 2009 respectively. The debt ratio is forecast to climb further to 69% before tailing off slightly.

2 March 2006
The Governing Council of the ECB raises the minimum bid rate on the main refinancing operations by a ¼ percentage point to 2.50%, starting from the operation to be settled on the 8 March 2006. It also raises the interest rates on the marginal lending facility and the deposit facility by a ¼ percentage point to 3.50% and 1.50% respectively, likewise with effect from 8 March 2006.

14 March 2006
The Ecofin Council decides to intensify the excessive deficit procedure with regard to Germany and gives notice to Germany under Article 104(9) of the EC Treaty.

21 March 2006
The Bundesbank's profit, amounting to €2,860 million, is distributed to the Federal Government.

of at least 0.5% of GDP. Against this backdrop, the fact that Germany is not pursuing the objective of correcting the excessive deficit this year is a cause for concern. It should be remembered in this context that the correction deadline has in effect already been extended once by one year to 2005. The current general economic outlook is rather favourable and would not pose any obstacles to a more even spread of the consolidation efforts over several years. Thus, the tightening of the excessive deficit procedure against Germany is justified. Also problematic in light of the economic outlook is that the draft Federal budget for 2006 envisages a sizeable overshooting – €15 billion, which is larger than the overshoot in 2005 – of the constitutional limit for new borrowing pursuant to article 115 of the Basic Law.

Latest consolidation measures rely strongly on higher tax and contribution rates

On balance, the fiscal consolidation announced for 2007 onwards will, in the first few years, in particular, involve only minor spending cuts, which go beyond the moderate expenditure policy already in place. On the revenue side, while various measures are planned to broaden the tax basis, a more comprehensive approach would have been possible here, especially as the impact of these measures will be diminished by the creation of new tax exemptions elsewhere. Most of the additional consolidation is to be achieved through higher tax and social security contribution rates, in particular VAT, which will be offset only partly by a cut in the contribution rate to the Federal Employment Agency. All in all, increases in tax and contribution rates do not help to promote long-term growth and employment.

In the medium term, further retrenchment and…

Even if the 3% deficit ceiling is observed, this will not mean that consolidation of public finances has been achieved. Rather, in order to halt and ultimately reverse the rise in the debt ratio and to ensure that Germany is in a better position to tackle future budgetary burdens engendered by demographic developments, further rapid reductions in the structural deficits are needed. This could also help to create scope for cyclical fluctuations in the fiscal balance. Only then will renewed structural compliance with the constitutional borrowing limits and the objective of a close-to-balance budget enshrined in national and European budgetary law be possible. In view of this, the target specified in the updated stability programme from February 2006 to reduce the structural deficit ratio by barely ½ percentage point a year in 2008 and 2009 seems rather unambitious. Based on this roadmap, the objective of a close-to-balance budget will still be a long way off at the end of the programme in 2009. In addition to this, the Federal Government's medium-term financial planning envisages compliance with the constitutional borrowing limits by only a narrow margin during the entire

planning horizon. Moreover, the plan figures probably include extensive asset disposals. Some of the state governments are also experiencing considerable difficulty in observing the budgetary rules.

... the implementation of fiscal reforms are needed

The other reforms announced could significantly improve the fiscal framework. This will hinge upon strengthening individual responsibility and competition, improving incentive structures, taking due account of demographic changes and enhancing system transparency.

V European and international cooperation

1 Progressive monetary integration in Europe under less favourable general conditions

(a) Further accessions to the exchange rate mechanism

Latvia, Malta, Cyprus and Slovakia join ERM II

Estonia, Lithuania and Slovenia became the first new EU member states to join the European exchange rate mechanism II (ERM II) in 2004; Latvia, Malta and Cyprus followed suit in May 2005, as did Slovakia in November 2005. The standard fluctuation band of ±15% applies to all countries which have joined ERM II since 2004, although several countries are unilaterally pursuing a policy which allows the exchange rate of their currencies to fluctuate only minimally or not at all. Upon acceding to ERM II in 2005, all four of the new participating countries – like the countries that had joined before them – entered into self-imposed commitments to rapidly alleviate ongoing domestic and external economic problems in order to boost the credibility of their fixed exchange rate policy and thus also protect the entire exchange rate mechanism from disruptions.

Euro area could possibly be enlarged soon

According to the EC Treaty, the new EU member states are obliged to adopt the euro as soon as they meet the convergence criteria defined in the Treaty. The prerequisites include a minimum two-year period of participation in ERM II without severe tensions. In particular, the country's currency may not become subject to considerable downward pressure or be devalued. Therefore, enlargement of the euro area to include the countries which joined ERM II in 2004 could soon be possible. In this respect, the European decision-making bodies should not lower their sights with regard to the fulfilment of all the convergence criteria

laid down in the Treaty. It is in the interests of the euro-area members to admit to the single currency only those countries for which it can be assumed with some certainty that they are pursuing a sustainable stability policy and have fixed the exchange rate of their currencies against the euro at an appropriate level. Unusually large current account deficits must be viewed critically in this connection – as stated in the Treaty – as they may indicate that a currency is overvalued. In early March 2006, Slovenia made use of the option laid down in the Treaty of asking the European Commission and the ECB to rapidly submit convergence reports in the hope of being able to accede to the euro area as soon as possible. These reports are scheduled to be published in May 2006. The regular convergence reports, which must be prepared for all of the non-euro-area countries (with the exception of Denmark and the United Kingdom) at two-yearly intervals, are scheduled for presentation in the autumn of 2006.

(b) Dilution of the Stability and Growth Pact

Watering-down of the fiscal policy rules

In the light of considerable budgetary problems on the part of several member states, not least the large ones, in March 2005 the EU Heads of State or Government endorsed an Ecofin Council report envisaging extensive changes to the existing rules of the Stability and Growth Pact (SGP). The Ecofin Council finally approved the Council Regulations containing the politically desired relaxation of the rules in June 2005; these Regulations entered into force upon their subsequent publication in the Official Journal of the European Union.[1] The first acid test faced by the Pact therefore led to its rules being adapted to suit a budgetary policy which failed to meet expectations. The Bundesbank voiced its opposition to this watering-down of the fiscal policy rules.

Preventive arm weakened by country-specific objectives

The key changes with regard to the ongoing surveillance of budgetary positions (the SGP's preventive arm) concern the "medium-term budgetary objective." In this respect, the uniform obligation hitherto applicable to all of the EU member states of striving to have a budgetary position that is close to balance or in surplus has been abandoned in favour of country-specific objectives. Countries belonging to the euro area or participating in ERM II with a relatively high level of economic growth and low debt ratios may now sustain structural budget deficits of up to 1% of GDP.[2] Account is taken neither of cyclical effects nor consoli-

1 The Council Regulations of relevance to the SGP (1466/97 and 1467/97) were amended by two further Council Regulations (1055/2005 and 1056/2005) for this purpose.
2 The EU countries which do not belong to the euro area or do not participate in ERM II have been totally omitted from the objectives.

dation based on one-off measures in the calculation of these objectives. If targets are not achieved, structural corrections of at least 0.5% of GDP per year are to be made. However, consolidation is allowed to be less concerted in economically difficult times, while greater efforts should be made if economic developments are favourable. In the case of structural reforms which involve temporary budgetary strains but promise to relieve the pressure on public finances in the longer term (switching to more capital-based pension systems is a case in point), further deviation from the medium-term budgetary objective as well as from the pace of adjustment normally required is possible.

Greater leniency if the government deficit exceeds the reference value

According to the former rules, a government deficit in excess of the reference value could be justified only in the event of distinctly negative economic developments (a fall in annual GDP of at least 2%; discretionary scope existed as of a fall in GDP of 0.75%). Under the amended SGP, any decrease in annual GDP as well as the underutilisation of potential output during a protracted period of low growth rates can now be put forward as an exceptional situation. Moreover, such matters as the medium-term economic and budgetary positions, public investment as well as strains resulting from financial contributions to fostering international solidarity and the European budget can now be taken into account as other exonerating factors of relevance for assessing the deficit pursuant to the EC Treaty. This is, however, subject to the condition that the general government deficit remains close to the reference value and its excess over the reference value is only temporary. One consequence of this greater leniency regarding an excess over the reference value could be that the Commission and the Council may tend to decide only in rare cases that an excessive deficit exists and thus initiate an excessive deficit procedure geared towards fiscal adjustments. In addition, the deadline for the requisite correction of the excessive deficit – which hitherto had to be completed in the year following the identification of a breach of the rules – may be extended under special circumstances. Not least, the maximum period following identification of an excessive deficit and before sanctions can be imposed under normal circumstances was extended from 10 to 16 months. If unexpected adverse economic events occur during an ongoing excessive deficit procedure, all of the procedural steps can be repeated. This means that both the adjustment process and the earliest possible date for the imposition of sanctions can be postponed accordingly.

The Bundesbank considers the package of reforms to have substantially weakened the SGP and thus to have worsened the underlying conditions for Euro-

All participants must exercise more self-discipline

pean monetary policy.[1] The Pact has become an opaque and complicated set of rules. Moreover, the fact that the upper limit for annual new borrowing of 3% of GDP has been relaxed is a particular cause for concern. The SGP's key objective, namely to ensure sound public finances, will therefore require even more self-discipline on the part of all the participants. The member states, the Commission and the Council must handle the greater leeway afforded in an extremely responsible manner. Breaches of the amended rules could irretrievably destroy any remaining confidence in the Pact. A cornerstone of monetary union would thus be lost.

Strict interpretation of the new rules is necessary, not least in view of the increased need for consolidation

Strict interpretation of the new rules is needed, not least in view of the unsound state of public finances in many of the member states. Of the euro-area countries, France, Germany and Greece continued to have an excessive deficit in 2005. In February 2005, the excessive deficit procedure against Greece was intensified owing to the country's failure to implement the recommended corrective measures; a further breach of the rules is likely to lead to sanctions. In mid-March 2006, Germany too was given notice under the excessive deficit procedure. Furthermore, in 2005, the Commission initiated excessive deficit procedures against Italy and Portugal owing to breaches of the 3% reference value. Of the remaining EU countries not subject to the possible application of sanctions, Cyprus, the Czech Republic, Hungary, Malta, Poland, Slovakia and the United Kingdom also had considerable budgetary problems in 2005. Given the demographic trends emerging in all of the EU countries – which will also entail increasing budgetary strains – there is an even greater need for consolidation.

(c) Reorientation of the Lisbon Strategy following disappointing mid-term review

National action plans to promote growth and employment

At its spring meeting in Lisbon in March 2000, the European Council set an ambitious goal for economic progress in the EU countries. The European Union was to become the most competitive and dynamic knowledge-based economy in the world within a decade. However, the mid-term review of the Lisbon Agenda showed that the member states had not made sufficient headway in enacting the necessary structural reforms. Therefore, in March 2005, the European Council decided to increase the focus on promoting growth and employment through national action plans. In order to underline the fact that the member states are

1 See Deutsche Bundesbank, Stability and Growth Pact crucially weakened, press release of 21 March 2005; The changes to the Stability and Growth Pact, Monthly Report, April 2005. The Monthly Report article also contains a synopsis of the old and new provisions of the SGP.

still responsible for making progress with the reforms, the European Council did not make any country-specific recommendations in modifying the Lisbon Strategy. However, since 2005, the EU countries have been obliged to report, every October, on the implementation of their reform programmes on the basis of the "Integrated Guidelines", which bring together the Broad Economic Policy Guidelines and the Employment Guidelines. The Commission must evaluate the implementation of the national reform projects at the beginning of the following year. Its recommendations will be reflected in proposed amendments to the Integrated Guidelines, which must be approved by the European Council.

Commission calls for stronger fiscal consolidation

In its first Progress Report in January 2006, the Commission concluded that the new national reform programmes offer a good basis for the success of the modified Lisbon Strategy. However, it criticised the fact that most of the countries have, up to now, done too little to address the impending budgetary burdens resulting from their ageing populations. In addition, more attention should be paid to improving competitiveness through the implementation of microeconomic reforms. The Commission also recommended that efforts should be made to heighten public awareness of the fact that greater labour market flexibility is imperative.

(d) European Constitution not deliverable for the time being

Ratification by 14 countries so far

The Treaty establishing a Constitution for Europe (European Constitution) signed by the Heads of State or Government of the EU countries in October 2004 must be ratified by all 25 member states in accordance with their own national provisions in order to become legally valid. Up to now, the European Constitution has been ratified by 14 countries, including Germany.[1] However, it was rejected in referendums held in France and the Netherlands. The Constitution thus cannot – as originally envisaged – enter into force on 1 November 2006.

Further political integration necessary to preserve monetary union

In June 2005, the European Council decided to continue with the ratification process despite the "No" votes in France and the Netherlands. However, several member states subsequently announced that they would postpone their referendums or parliamentary decisions or would even suspend the ratification process indefinitely. It is currently not foreseeable whether and, if so, when and in

1 In Germany, the parliamentary ratification process was completed with approval by the Bundestag on 12 May 2005 and the Bundesrat on 27 May 2005. However, the President of the Federal Republic of Germany has not yet signed the Act of Assent for the Constitutional Treaty (Zustimmungsgesetz zum Verfassungsvertrag), as an action before the Federal Constitutional Court is still pending.

what form the objectives pursued by means of the Constitution could be achieved. The hold-ups in the political integration process which emerged as the Constitution came to a standstill could well be largely attributable to insufficient acknowledgement of the people's will in the further development of the European Union. Both the question of the EU's borders as well as that of the thrust and speed of further economic integration appear to be crucial for permanently safeguarding European monetary union in political terms.

2 Issues relating to the international monetary and financial system

(a) Improvements needed in exchange rate surveillance

Current account situation polarised further

The renewed sharp rise in energy prices in 2005 contributed to a further polarisation of global current account balances. The US deficit widened to around US$800 billion or 6½% of GDP. This contrasted sharply with the current account surpluses accumulated by Japan, China and other Asian countries and by the oil-exporting countries' continuing influx of foreign currency. Several European countries, including Germany, Switzerland and some Scandinavian economies, posted large surpluses last year; however, this was associated partly with other European countries' sizeable current account deficits. The current account for the entire euro area was virtually in balance. In addition to private capital movements, large official purchases of US dollars helped to finance the US deficit. This cannot be derived completely from the available statistics, however. Capital imports, which are posted in the US balance of payments as inflows of foreign private sector funds, often actually contain public sector assets since a significant volume of foreign reserves are invested in international financial markets and therefore also contribute indirectly (through financial intermediaries) to financing the US current account deficit. In addition, surplus countries' official foreign assets do not always appear exclusively as foreign reserves. Several oil-exporting countries, in particular, pour a considerable share of their foreign currency revenues into special official funds. By contrast, China has actually seen strong growth in its foreign reserves. Given an increased influx of foreign currency from current account transactions as well as net capital imports, China's interventions served to keep the renminbi's exchange rate low in order to support its largely export-driven economic growth. China's foreign reserves were extremely large – totalling nearly US$820 billion – at the end of 2005. They have grown even further since then and have now surpassed Japanese levels, which were just under US$830 billion at the end of 2005. Japan, previously the

Movement of the foreign currency reserves of selected countries and groups of countries

Table 9

Country/ group of countries [1]	Year-end holdings [2]		Year-on-year change [3]					
	1998	2005	2003	2004	2005	2003	2004	2005
	US$ bn					in %		
Japan	203.2	828.8	201.3	171.5	4.5	44.6	26.3	0.6
Asian developing countries [4]	575.3	1,860.1	270.9	365.7	255.4	28.0	29.5	15.9
of which								
China [5]	145.0	818.9	116.8	206.7	208.9	40.8	51.3	34.3
Hong Kong	89.6	124.2	6.5	5.2	0.7	5.8	4.4	0.6
India	27.0	131.0	30.6	27.5	5.9	45.7	28.2	4.7
Indonesia	22.4	32.8	4.0	0.0	– 1.9	13.0	– 0.1	– 5.6
Malaysia	24.7	70.4	10.2	21.9	5.0	30.6	50.5	7.7
Philippines	9.1	15.8	0.3	– 0.5	2.8	2.4	– 4.0	21.7
Singapore	74.4	115.3	13.6	16.5	3.8	16.7	17.4	3.4
South Korea	52.0	210.0	33.7	43.7	11.8	27.9	28.3	6.0
Taiwan	90.3	253.3	45.0	35.1	11.6	27.8	17.0	4.8
Thailand	28.4	50.5	2.9	7.5	2.0	7.7	18.4	4.1
Asia, total	778.5	2,688.9	472.3	537.2	260.0	33.3	28.4	10.7
Industrial countries excluding Japan	467.4	463.4	17.2	24.1	– 26.9	3.8	5.2	– 5.5
of which								
USA	36.0	37.8	5.9	3.0	– 4.9	17.5	7.5	– 11.4
Euro area [6]	284.4	167.3	– 27.8	– 7.3	– 13.4	– 12.9	– 3.9	– 7.4
Other developing countries	398.0	1,018.6	130.5	159.1	188.8	24.2	23.7	22.7
Africa	40.7	159.4	18.7	35.8	33.1	26.1	39.5	26.2
Europe [7]	101.0	423.2	63.1	80.3	94.2	34.0	32.3	28.6
Latin America and Caribbean	158.4	248.1	33.2	25.1	32.0	21.1	13.2	14.8
Middle East [8]	97.9	187.8	15.5	17.9	29.5	12.4	12.8	18.6
Memo item								
Oil-exporting countries	95.1	255.9	27.1	38.6	50.2	19.4	23.1	24.4
All countries	1,643.9	4,170.9	620.0	720.3	421.8	25.7	23.8	11.3

Source: IMF. — **1** Classified into industrial and developing countries according to the IMF's International Financial Statistics. — **2** At current exchange rates. — **3** Including exchange rate-induced changes. — **4** Excluding the Middle East. — **5** In 2003 and 2005, foreign currency inflows were even higher than shown, as US$45 billion and US$15 billion worth of foreign exchange reserves respectively were used to recapitalise state banks. — **6** Comprises the foreign exchange reserves of all of today's member states for the period prior to the beginning of monetary union (end-1998). — **7** Including Turkey and the countries of the former Soviet Union. — **8** Bahrain, Egypt, Israel, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates and Yemen.

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holder of the world's largest accumulation of foreign reserves, has not intervened in the forex markets since March 2004, however.

Agreed counterstrategy includes exchange rate corrections

The persistently high US current account deficit could put a visible dent in the current confidence placed in the US dollar's relative exchange rate stability. In such a scenario, the faster the US dollar encounters downward pressure and the more extensive this pressure is – potentially in conjunction with much higher US capital market interest rates – the greater the impact on the global economy will be. In 2004, the IMF, in order to reduce the risk of such a solely market-driven adjustment process occurring, agreed a strategy – inspired by Group of 7

(G7) initiatives – which assigns key economic policy tasks to launch and promote an orderly reduction of current account imbalances to all of the parties involved. Major elements of this strategy include a reduction in the US budget deficit, a structural strengthening of growth forces in Europe and Japan (which, in Europe's major economies and Japan, likewise urgently requires public budget consolidation) and a revaluation of the currencies of those emerging market economies that are keeping their currencies' external value artificially low. The exchange rate policy recommendations are directed mainly at China. This comprehensive strategy of assigned responsibilities, however, must not be misunderstood as a package of mutually interdependent elements. Each individual recommendation is to stand alone. These recommendations should be implemented as quickly as possible, in the interests of both the particular countries concerned and the world at large.

G7 calls for more effective IMF surveillance role

With regard to the efficiency of the international monetary and financial system, which is intended to provide a sound basis for world trade and capital movements and to promote the necessary adjustment processes, China's exchange rate policy is receiving the special attention it deserves in the light of the country's major international position. For instance, the non-stop high influx of foreign currency into China shows that the renminbi clearly needs to be revalued. As mentioned earlier, this consequence cannot be explained away by indicating that partner countries might possibly have taken insufficient steps towards adjustment or reform. In a functioning monetary system, exchange rates are supposed to react to precisely these types of shortcomings. China's exchange rate policy measures, however, have failed to meet expectations. Modifications to the exchange rate regime since July 2005 have, up to now, led only to a slight effective appreciation of the renminbi.[1] The G7 finance ministers and central bank governors therefore called on the IMF in December 2005 to improve the effectiveness of surveillance (which is a core activity of the IMF), including ex-

1 After having de facto pegged the renminbi's exchange rate to the US dollar since 1995, the Chinese authorities initially revalued their currency against the US dollar by 2.1% with effect from 21 July 2005. The renminbi correspondingly rose against all other currencies as well. From this somewhat elevated level, a new regime of flexible, but still strictly managed, exchange rates was then launched. The new system allows the US dollar-renminbi exchange rate to fluctuate – in terms of the official opening rate – by no more than 0.3% from one trading day to the next. The maximum daily change for all other currencies was initially set at 1.5%, then raised to 3% from 23 September 2005. However, by February 2006 (average for the month), the renminbi had appreciated against the US dollar by all of 0.7% since the beginning of the new regime. The renminbi's appreciation against the euro (2.6%) and the yen (7.7%) likewise remained relatively low. According to IMF calculations, the nominal effective external value of the renminbi has risen by 4.7% since June 2005, which is due partly to the depreciation of various currencies against the US dollar and thus also against the Chinese currency. The official description of the current system is a "managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies." The way in which this system is applied is not transparent, however.

change rate surveillance. The practical steps that could be taken in this regard will need to be examined as part of the pending discussion on reforming the tasks of the Bretton Woods institutions.

(b) Reduced IMF lending commitments could make it easier to critically review its financing role

Outstanding debt to IMF back to end-1994 level

As in 2004 already, the IMF's members reduced their aggregate indebtedness to the Fund sharply in 2005. The Fund's outstanding loans fell by SDR 27.4 billion in the past year to only SDR 34.7 billion (US$49.7 billion). Brazil's early repayment in December 2005 of its SDR 10.8 billion of total debt played a key role here. The IMF's outstanding loans thus fell back down almost to their end-1994 level (SDR 30.3 billion), ie to the level prior to the onset of a phase of high net lending caused by a succession of capital account crises which drove total IMF lending to a peak of SDR 71.9 billion by 2003. In January 2006, the decline in borrowing from the IMF was further accentuated by the fact that Argentina repaid its total debt of SDR 6.7 billion to the IMF – like Brazil, by tapping into its foreign currency reserves. The Bundesbank welcomes the attendant reduction in the IMF's financial risks.

Reduced financing needs should make it easier to observe access criteria

This new situation, which also reflects fundamental improvements in the economic policies of many emerging market economies, should make it easier to comply with the agreed criteria for exceptional access to IMF lending in the future. Since the mid-1990s, the IMF, in view of numerous debt crises, often saw itself compelled to interpret its exceptional access criteria generously. By contrast, it must be emphasised that only the strict application of existing rules will enable the IMF to maintain its credibility in being able to say "No", thereby curbing the excessive risk appetite of borrowers and lenders who believe that the public sector will bail them out of a crisis. When granting exceptional access, as with any lending, it is particularly important that the borrower's debt sustainability seems reasonably ensured. This is necessary to prevent future situations – like those, most recently, involving Uruguay and Turkey – in which pending repayments to the IMF of exceptionally large loans become the cause of new balance of payments problems. If the Fund reacts in the same way as it did in the aforementioned cases, ie by prolonging its assistance, the condition of providing IMF resources only for short-term liquidity difficulties and not for solvency problems will be undermined.

IMF credit: purchases, repurchases and amounts outstanding

Table 10

SDR billion

Item	2001	2002	2003	2004	2005
Purchases	24.6	26.6	21.1	5.0	2.7
Repurchases	14.1	16.0	19.7	14.8	30.1
Net purchases	10.6	10.6	1.4	– 9.8	– 27.4
Total IMF credit outstanding, by component and region [1]					
Type of credit/facilities					
Credit tranches [2]	34.8	46.5	49.6	42.6	20.1
Extended Fund Facility (EFF)	15.0	14.6	13.9	11.7	7.9
Compensatory Financing Facility (CFF) [3]	0.8	0.6	0.2	0.1	0.1
Poverty Reduction and Growth Facility (PRGF) [4]	6.5	6.9	6.9	6.8	6.3
Other facilities	2.8	2.0	1.3	0.9	0.4
Regional breakdown [5]					
Africa	6.2	6.1	5.5	5.1	4.2
The Americas	19.0	28.2	32.1	27.9	9.2
Asia	12.4	10.3	9.9	8.6	7.5
Europe	21.6	25.2	23.8	19.8	13.2
Middle East	0.6	0.6	0.6	0.8	0.7
Total	59.9	70.5	71.9	62.1	34.7
of which					
Exceptional access [6]	14.1	24.4	28.7	21.5	8.4

Sources: IMF and Bundesbank calculations. — **1** End-of-year level. — **2** Including total credit outstanding under the Supplemental Reserve Facility (SRF). — **3** Formerly the Compensatory and Contingency Financing Facility (CCFF). — **4** The PRGF is the successor facility to the Enhanced Structural Adjustment Facility (ESAF), which in turn succeeded the Structural Adjustment Facility (SAF). It is financed out of special assets administered by the Fund. — **5** Delineation of regions according to IMF definitions; Europe therefore includes Turkey and the countries of the former Soviet Union. — **6** Above the access limit of 300% of the quota.

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No convincing justification for desired insurance role

In this connection, it is also significant to note that, during the current strategic review of the IMF's tasks – in which the Group of 20 (G20) has taken on a leadership role – a contentious debate is currently in progress about whether or not to confer to the IMF the function of a readily available liquidity source (an international risk insurer, so to speak). Proponents of this notion propose binding precautionary credit lines that are independent of the debtor's quota and which could automatically be drawn in a crisis. The Bundesbank's view is that such insurance would contradict the Fund's financing mechanism, which is based on deposits of member countries' international reserves to grant urgently needed short-term balance of payments assistance at uniform financial terms (independent of country risk). Without a mechanism for differentiating lending conditions by risk, however, the demand for such insurance protection could not be controlled. In addition, this would exacerbate the moral hazard problem on the part of debtors and private creditors if official financial assistance were to be explicitly assured even prior to the onset of balance of payments problems. The IMF's current flexibility to grant even exceptional access to financial resources in a crisis (provided the agreed criteria are met) should therefore suffice for it to do justice to its crisis management role. An explicit IMF insurer role would, not least, render the current exceptional access framework irrelevant. Furthermore,

it should be pointed out that there is abundant liquidity in international financial markets which can also be tapped by solvent countries to form a security buffer through private precautionary credits. Given the decline in the use of the Fund's financial resources, fears that the IMF's importance for its member countries is vanishing cannot be put forward to justify assigning to the Fund the role of an insurer, which would be alien to or would enlarge its mandate and therefore present serious governance issues. The assertion that the lower lending volume is creating income losses for the Fund and corresponding cost-coverage problems does not justify such initiatives, either.

Debt relief by multilateral institutions creates obligation to be vigilant in lending

Even in its normal lending to developing countries, the IMF needs to display greater vigilance in order to avoid incurring the risk of loss. This is demonstrated anew by the cancellation of the debts of Heavily Indebted Poor Countries (HIPC) to multilateral agencies at the initiative of the Group of 8 (G8) in 2005. The agencies involved in this process – the IMF, the International Development Association (IDA) and the African Development Fund (AfDF) agreed to completely cancel outstanding debts once the borrower countries have reached the "completion point" under the HIPC initiative. This Multilateral Debt Relief Initiative (MDRI) goes beyond the HIPC initiative – established by the IMF and the World Bank in 1996 and expanded in 1999 – which is designed to give poor countries the opportunity to reduce their debt service obligations to sustainable levels. The aim of the MDRI is to help the recipients to achieve the Millennium Development Goals by taking pressure off their government budgets. At the end of 2005, the IMF already approved debt relief for 19 authorised recipients, which will cost around US$3.3 billion. In the next few years, nearly as many other countries may also qualify for debt relief by meeting certain economic policy criteria. For this purpose, they need to demonstrate satisfactory performance in three areas: macroeconomic performance, poverty reduction and public expenditure management. The costs to the IMF of this total possible debt relief are estimated to run up to US$5 billion (in end-2005 NPV terms), although this does not include some countries whose participation in the MDRI is uncertain. The losses to the IMF will be funded in part from its profits from sales of gold in 1999-2000 as well as by bilateral contributions from its members that have either already been made (to the Subsidy Account of the PRGF Trust) or are pending. In this context, the G8 countries have agreed to ensure that the debt relief does not undermine the financial integrity of the three multilateral institutions concerned. The Bundesbank endorses this initiative on the condition of strict compliance with the economic policy criteria. It is also important for this relief to be financed, as envisaged, exclusively from the IMF's special funds and bilateral

contributions. Recourse to the IMF's risk reserves or further use of its gold reserves should be rejected. Moreover, this debt relief should enable a distinct reduction in the Fund's concessional lending. New concessional lending to countries having obtained 100% debt relief should, in future, be possible only under exceptional circumstances. This would also help, in the medium term, to achieve a better distribution of work between the IMF and the World Bank in development assistance.

New facility for poor countries to cushion exogenous shocks

The IMF will nevertheless remain especially committed to the welfare of poor developing countries, including in financial terms. In December 2005, therefore, the IMF created a special facility to cushion exogenous shocks, not least owing to the sharp rise in energy prices. This Exogenous Shocks Facility (ESF) gives certain low-income countries (which must be generally eligible for the PRGF) quick access to concessional financial assistance in the event of temporary, shock-induced balance of payments problems. This is predicated on an agreed adjustment programme and proof of progress in reducing poverty. At an interest rate of 0.5% and a repayment deadline of ten years, the lending terms correspond to those of the PRGF. ESF programmes, however, are only for one or two years, and hence shorter than PRGF assistance. Annual lending should not exceed 25% of the quota and should be subject to a cumulative limit of 50% of the quota. Disbursements can be front-loaded in order to quickly ameliorate the consequences of the shock. The ESF is financed from voluntary contributions by financially healthy bilateral donors and from the IMF's own resources. The Bundesbank approved the establishment of the ESF in the expectation that, in extreme economic circumstances, previously achieved progress in stabilisation can be better secured thanks to such assistance.

Special programmes without financial assistance also possible for bolstering confidence

The Fund also reacted to the increase in the number of developing countries no longer requiring IMF loans by creating, in October 2005, a Policy Support Instrument (PSI), which gives those PRGF countries that have made significant progress in reducing poverty a framework for the ongoing public monitoring of their economic policies by the IMF. Even though no financial assistance is being given, a programme to be agreed with the Fund for this purpose would be subject to precisely defined conditionality and should generally be reviewed semi-annually. This review would thus be more timely and up-to-date than the Article IV consultations, which are mostly annual. This consequently enables programme success to be endorsed publicly. Such "seals of approval" for a country's economic policy are likely to provide reassurance to potential capital donors and investors. Hence the Fund's catalyst role is undergoing a shift from financial assist-

ance towards policy assistance, which the Bundesbank believes should become the IMF's main sphere of future activity.

(c) Quotas, voting rights and representation in the IMF likewise under scrutiny

Adjustment of quotas and voting rights to match economic weight would be appropriate

In the current strategic discussion on the future of the Bretton Woods institutions, the question of how appropriately the quotas and voting rights at the IMF, and thus the representative positions of member countries in the Fund's decision-making bodies, are distributed is a key issue. It is undisputed that member countries that are clearly underrepresented in terms of their economic power should be given greater weight in the Fund. In addition, some countries are striving for an increase in developing countries' voting rights, irrespective of their quota, while another proposal is aimed at reducing the influence of the EU countries. It is the view of the Bundesbank that the distribution of quotas and voting rights should remain oriented solely to members' importance in the world economy. Those countries that make the greatest financial contributions to the IMF should also have a commensurate say in the use of these funds. Germany, at its present quota, is underrepresented in terms of its economic importance. Similarly, many fast-growing economies – particularly in Asia, but also in other parts of the world – are no longer adequately represented. Conversely, other IMF members, especially oil-exporting countries, have, in some cases, considerably excessive quotas.

Consolidation of Europe's representation not yet justifiable

Given the current abundance of Fund liquidity, it would be inadvisable to aim at a general increase in IMF quotas in order to adapt them to changes in members' world economic weights. What the Bundesbank does support, however, is a voluntary and even-handed quota redistribution without changing the total quota. Another conceivable idea might be to permit a slight increase in the total quota by means of *ad hoc* quota increases only for certain underrepresented countries. Since, however, the developing countries are already overrepresented in the IMF by any recognised measure, a general increase in their voting rights does not seem warranted. Furthermore, it is too early to consolidate Europe's representation in the IMF in the absence of further progress in the political integration of the EU. The current international representation of the EU and the euro area corresponds to the current status of political integration and to the division of tasks between European and national institutions which is fundamentally laid down in the EC Treaty.

(d) Progress in implementing principles for cooperation between debtor nations and the private sector

Wide support among emerging market economies and in the private sector

Efforts by internationally active financial institutions, their associations and numerous debtor countries to adopt a number of voluntary guidelines for crisis prevention and crisis management were continued in 2005. The "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets", drafted in 2004 with the support of the G20, were published in November 2004 by the Washington DC-based Institute of International Finance (IIF). This was followed in March 2005 by an annotated version containing slight changes as a result of the ongoing discussion. The aim of these principles is to mitigate the volatility of emerging market economies' capital flows by way of confidence-building policies and to ensure a *bona fide* reconciliation of interests in the event that restructuring is unavoidable. According to the IIF, more than 30 emerging market economies active in international financial markets have now signed on to these principles.

Three-pronged surveillance of implementation

A three-pronged surveillance procedure was introduced to promote the application of the guidelines in practice. The IIF itself wants to monitor the progress of implementation. It will focus initially on the specific steps taken by emerging market economies to foster dialogue with their private creditors and to locate vulnerabilities in a timely manner. In addition, a group of advisers composed of representatives from emerging market economies and the private sector is to present proposals (tailored to individual countries, if necessary) for ways in which the governments concerned and their private creditors can best observe the principles. In addition, a group of trustees composed of high-ranking representatives of the official sector and the financial industry should, if required, give general guidance on applying the principles. It remains to be seen how this three-pronged surveillance approach will work in practice.

Final restructuring of Argentina's debt would also have systemic advantages

Notwithstanding the crisis prevention and crisis management principles, to which more and more market participants are subscribing, the Argentinian debt restructuring case continues to be an unresolved problem. In a departure from the path of good faith negotiations reaffirmed by the principles, Argentina presented a unilateral offer to exchange defaulted government bonds which, if rejected, could have led to a total loss on all investment. Compared to other restructuring cases, the rejection rate was very high – nearly one-quarter of bondholders turned down the offer. For this reason, it will probably be difficult for Argentina to return to the international financial markets without restrictions, at

least until a comprehensive restructuring agreement is reached. With regard to the functioning of the international monetary and financial system, it would also be desirable not to give the impression that it is acceptable for a debtor country, in a crisis, to unilaterally set the terms of restructuring. The multilateral monetary and financial system established after the Second World War is based, among other things, on cooperative approaches and a degree of self-restraint among all the parties concerned in order to ensure the best possible results for the global economy.

Operational tasks and other activities of the Deutsche Bundesbank

I Structural reform

Objectives of the structural reform

The Annual Reports of the past few years have already reported in detail on the extensive organisational reform of the Bundesbank, which was decided by the Executive Board in 2002 in order to improve the Bank's operational efficiency and enhance its structural effectiveness in the European context.

All service centres have fully taken up their scheduled operations

As of 1 April 2005, the last two service centres to be set up as a result of the structural reform fully took up their scheduled operations. Each of the 21 service centres is located at one of the regional offices and performs specialised operational tasks for the Bank as a whole. With all operations now up and running, the establishment of the service centres was completed as scheduled. This means that the organisational blueprint for Central Office and the regional offices adopted in 2002 was implemented within the time-frame set by the Executive Board.

Further consolidation of the branch network

The consolidation of the branch network to 47 locations by the end of 2007, which was decided in 2003, is progressing according to plan. As envisaged, a further five branches and three operating units were closed in 2005.

Decision to concentrate banking supervision and credit assessment at the regional offices

In the year under review, the Executive Board spelled out further details of the basic structural reform adopted in 2002 by announcing that the two operational areas of banking supervision and credit assessment would be transferred in their entirety from the branches to the regional offices in 2006. The concentration of these two functions at the regional offices will enable further synergies to be achieved.

Streamlining the management structure at the regional offices

In addition, in 2005 the Executive Board decided to further streamline the management structure at the regional offices. Under this new organisational set-up, which is to be implemented in stages at all the regional offices by 2009, one management tier, ie the current function of "Head of Regional Office Division for In-house Operations" with responsibility for the work areas of business organisation, administration and personnel, will be abolished. The relevant work units will report instead direct to the President of the Regional Office.

Further organisational streamlining by restructuring construction functions

Besides the general decisions taken on structural reform, the amalgamation, in the reporting year, of the construction and premises planning and management activities of the regional offices with the corresponding functional units at Cen-

tral Office has led to a further streamlining of the Bundesbank's organisational structure.

Cost savings due to structural reform

The actual costs for the provision of services in 2005 (excluding the costs of banknote printing) were €256.0 million, which was roughly 20% lower than the comparable figure for 2002.

II Tasks and responsibilities in cash payments and securities transactions

1 Cash payments

Euro currency in circulation in the Eurosystem

During 2005, the volume of euro banknotes in circulation issued by the Eurosystem increased by 12.8% to €565.2 billion. The volume of coins in circulation rose by 8.4% to €16.6 billion.

In the financial year 2005, the Bundesbank paid out 14.8 billion euro banknotes with a value of €450.2 billion and 12.6 billion euro coins with a value of €6.4 billion. During the same period, the Bundesbank received inpayments of 14.2 billion euro banknotes from its customers with a value of €421.1 billion and 10.8 billion euro coins with a value of €6.1 billion.

Deutsche Mark currency in circulation

The volume of Deutsche Mark currency in circulation was reduced to DM14.7 billion by the end of 2005. Banknotes accounted for around DM7.5 billion of this amount and coins for roughly DM7.2 billion.

Euro counterfeits

In 2005, 73,598 counterfeit euro banknotes with a value of €4.896 million and 46,300 counterfeit euro coins valued at €90,000 were detained in German cash payments and registered by the Bundesbank; this was slightly down on the year. The €50 banknote was by far the most frequently counterfeited denomination, accounting for 70% of counterfeits followed by the €100 banknote which accounted for 11%. The sharp drop in €100 counterfeits, which comprised 35% in 2004, has led to a 20% decrease in the losses arising from euro counterfeits, bringing this figure down to €4.9 million. The counterfeit coins were primarily of the €2 denomination (94%).

Counterfeit prevention

The training courses offered free of charge by the Bundesbank within the framework of its counterfeit prevention programme were again very popular in 2005 among representatives from the retail and banking sectors and other interested parties. In total, around 1,000 training courses were organised across Germany, attracting some 20,000 participants.

Involvement in development of euro series II banknotes

As well as increasing its involvement in various research and development projects aimed at establishing a portfolio of banknote security features for the ESCB in the longer term, as part of the preparatory work for the second series of euro banknotes, the Bundesbank's main focus has been on the development of security features which are easily recognisable by the general public – in the most self-explanatory way – without the need for counterfeit detection devices.

Future procurement of Eurosystem banknotes

By 2012 at the latest, the Eurosystem's banknote requirements are to be met by means of a single tender procedure. National central banks with in-house/public banknote printing works have the option of opting out of this procedure. For a transitional period, a single tender procedure and the direct placement of orders by national central banks with in-house/public printing works may coexist. Provided that a critical mass is reached in terms of the number of participants and volumes of tenders, this transitional period could begin on 1 January 2008 at the earliest. This should ensure that central banks and printing works have sufficient time to adjust to the new framework conditions. In September 2004, the Governing Council of the ECB laid down the rules for the single European tender in a Directive (ECB/2004/18). This decision left a number of details to be clarified last year regarding the allocation procedure. The preparatory work will continue into 2006.

Damaged banknotes and coins

In the financial year 2005, the National Analysis Centre for damaged banknotes and coins received 21,470 applications (2004: 18,983). These applications for reimbursement were submitted along with 366,859 banknotes with a value of €13.7 million and 263,921 coins with a value of €64,000.

Recommendation of the European Commission for checking the authenticity of euro coins

According to a recommendation from the European Commission, at least 10% of the coins (50 cent, €1 and €2 denominations) in circulation in each euro-area country should be checked every year for authenticity by the public authorities, credit institutions or other professional cash handlers. In connection with this, the coin sorting and processing systems used by these authorities should also be tested accordingly. The recommendation also states that the member states' obligation to accept coins that are no longer fit for circulation should be harmon-

ised. The implementation of this recommendation is planned for the first half of 2006.

Simplified requirements for banknote inpayments

In 2005, the Bundesbank started to use more efficient banknote processing machines as part of its replacement investment. By the end of 2008, all Bundesbank branches should be equipped with multi-denomination processing machines. These machines are able to process bundles containing different denominations and notes packed in different directions, the banknotes do not have to be sorted beforehand. The requirements for banknote inpayments at the Bundesbank have been simplified accordingly and took effect on 1 February 2006 for the branches in Bayreuth, Flensburg, Hamburg, Leipzig and Oldenburg, which switched over to multi-denomination processing on that date. A fee is charged for multi-denomination inpayments. As in the case of standard inpayments, multi-denomination inpayments are not processed on an individual pack basis, but as an inpayment as a whole. The inpayer does, however, have the option of splitting the inpayment into reconciliation units (subject to a fee). Safebags are also accepted as packaging in their own right in those branches that have switched over to multi-denomination processing. The introduction of Electronic Access and a barcode system for Bundesbank cash transactions is also in the pipeline.

Changes in coin services

As of 2007, the Bundesbank will accept and issue coin containers free of charge from/to business customers only if they contain the standard amount of coins. Following the discussions with cash handling organisations, from 2007 the Bundesbank will offer the inpayment and outpayment of coin packages which do not conform to the standard container criteria for a charge of €3 per inpayment/outpayment. The plan to offer "portioning of coin outpayments" for a charge of €3 per portion, which was decided in 2005, will also be offered as an additional coin-related service as of 1 April 2006.

The Eurosystem's framework for banknote processing

Since September 2005, the Bundesbank, together with representatives of professional cash-handling companies, has been working towards implementing the Framework for the detection of counterfeits and fitness sorting of euro banknotes by credit institutions and other professional cash handlers. The Framework aims to create a set of common rules throughout the euro area for banknote processing to help to ensure the quality and authenticity of euro banknotes in circulation and to support professional cash handlers in fulfilling their obligations laid down in Article 6 of the European Union Council Regulation (EC) No 1338/2001 of 28 June 2001.

Prosecution of breaches of administrative regulations in connection with the prerogative for issuing coins and medals

Since 20 September 2005, the Bundesbank has been responsible for prosecuting breaches of administrative regulations in connection with the prerogative for issuing coins and medals. The relevant provisions are contained in Council Regulation (EC) No 2182/2004 concerning medals and tokens similar to euro coins, in the Coinage Act and in the regulation on the production and distribution of medals and tokens for the protection of German euro commemorative coins.[1]

2 Cashless payments

(a) Settlement of payments

Slight decrease in the number of payments

During the year under review, in total around 2.2 billion credit transfers and collection orders with a counter value of just over €140 trillion were settled by the Bank. However, the growth in the number of credit transfers was not enough to fully offset the decline in the number of cheque and direct debit collections.

Positive development in RTGS^{plus}

Business developments in the German individual payments system RTGS^{plus} were particularly promising. By the end of 2005, the number of direct participants had increased on the year by 44 to 170 banks. Since July 2005, 17 Slovenian credit institutions have also been using remote access to participate in RTGS^{plus} and are, therefore, directly addressable by German credit institutions and European banks via TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system).

Further rationalisation in RPS

In a further measure to consolidate the services offered in the Retail Payment System (RPS), the decision was taken to centralise data media processing in the Service Centre for Computer Centre and Retail Payment Systems Operations at the Düsseldorf Regional Office as of 2007. The closure of the current regional RPS input/output units is planned for the first quarter of 2007. In line with this, it will be obligatory for all banks to use data telecommunication from January 2007 onwards. Since January 2006, it has also been permissible to use SWIFTNet FileAct as an additional communication/submission procedure.

1 For further information on these regulations, see Bundesbank notice No 3007/2005 (published in the Federal Gazette (Bundesanzeiger) No 183 of 27 September 2005) and No 3009/2005 (published in the Federal Gazette (Bundesanzeiger) No 230 of 6 December 2005).

Cashless payments of the Deutsche Bundesbank

Table 11

Item	2004		2005			
	Number (million)	€ billion	Number (million)	Percentage change	€ billion	Percentage change
Domestic payments	2,259.7	93,487	2,203.8	– 2.5	101,179	8.2
Retail payments	2,228.7	2,122	2,172.2	– 2.5	2,099	– 1.1
RPS						
Direct debits, cheques	1,244.5	1,054	1,179.6	– 5.2	971	– 7.9
of which Conversions	22.1	544	13.6	– 38.5	451	– 17.0
Prior 3 payments	984.2	1,067	992.5	0.8	1,129	5.7
of which Conversions	1.5	9	1.4	– 7.9	9	– 2.2
Large-value payments	31.0	91,365	31.6	1.9	99,080	8.4
RTGS^{plus} 1	29.1	89,282	30.8	5.8	97,203	8.9
Other 2	2.0	2,084	0.9	– 55.1	1,877	– 9.9
Cross-border payments	10.6	37,133	11.3	7.0	41,367	11.4
Retail payments	5.4	3	6.1	13.2	4	38.3
MASSE 3	3.8	2	3.6	– 4.4	2	– 1.9
STEP2 via RPS 4	1.6	1	2.5	53.9	2	107.5
Large-value payments	5.2	37,130	5.2	0.6	41,363	11.4
TARGET 5						
via RTGS^{plus}	5.0	37,084	5.0	0.8	41,295	11.4
AZV 6	0.2	47	0.2	– 6.2	68	46.3
Cashless payments	2,270.3	130,620	2,215.1	– 2.4	142,546	9.1

1 Bundesbank's real-time gross system. — **2** For example, special procedures for public authorities, payments within Customer Access Mechanism (CAM). — **3** Procedure for cross-border retail payments of public authorities. — **4** Procedure for cross-border retail payments (link to the STEP2 procedure of the EBA, Paris). — **5** Procedure (of the EU central banks) for cross-border individual/large-value payments in EU countries. — **6** Procedure for cross-border individual/large-value payments in EU/EEA countries and non-EU/EEA countries.

Deutsche Bundesbank

Modernisation of internal processing with introduction of Customer Access Mechanism (CAM)

During the fourth quarter of 2005, Customer Access Mechanism (CAM) – a system which consolidates the functions of the two "old procedures", the Euro Link System (ELS) and the Cross-border Payments Services (AZV), in a single system – was introduced to rationalise internal processing. CAM serves primarily as a standard access procedure for non-banks to the RTGS^{plus} and TARGET payment systems. Credit institutions may also use CAM for a transitional period (for a maximum of four years after the launch of TARGET2) to participate in TARGET2. Furthermore, CAM is used to settle euro and foreign currency payments as part of the Bundesbank's correspondent banking.

(b) Developments in the European setting

Status of the TARGET2 project

During the year under review, the planned tasks for the creation of the new TARGET2 single shared platform went according to schedule. This project is of particular interest to the Bundesbank. Firstly, the present RTGS^{plus} participants constitute a significant mainstay of TARGET as they account for around 47.5% of the total volume of payments. Secondly, the Bundesbank, along with the Banque de France and the Banca d'Italia, is part of a centre of know-how and expertise which is responsible for the conceptual preparation, development and operation of the future TAGET2 single shared platform for the Eurosystem.

Launch of TARGET2 in November 2007 ...

Following extensive consultations with users regarding their functional requirements for the system, work was able to commence on the actual project in June 2005. Only at this stage was it possible to assess the extent of the work involved and to draw up a precise schedule for the development of the TARGET2 system and to set the launch date. Allowing a sufficient time period for the various test activities by the banks, 19 November 2007 was set as the launch date for TARGET2. At the end of November 2005, the market participants were issued with the final version of the TARGET User Detailed Functional Specifications which provides a stable basis for the banks' TARGET2 migration projects.

... with a phased migration approach

To keep risks to a minimum, the Eurosystem opted for a phased migration approach with three "country windows". Each country window covers several central banks, including their respective national banking communities. The migration process is scheduled to be completed by mid-May 2008. The Bundesbank and the German banking community will be in the first country window. All of the current RTGS^{plus} participants will be affected by the migration to TARGET2 since RTGS^{plus} will be shut down when the single shared platform is launched.

Presentation of a TARGET2 price model

In October 2005, a dual price model was presented to TARGET participants. Under this price model, in future, smaller banks would pay a small fixed fee per month and a charge of €0.80 per transaction; large and medium-sized banks would pay a fixed monthly fee of €1,250 and a degressive transaction fee ranging from €0.60 to €0.20. The Governing Council of the ECB will take the final decision following discussions with the national banking communities. From the Bundesbank's point of view, the new price model should also be attractive for processing commercial payments – as RTGS^{plus} is today. These commercial payments are essential for TARGET2 in order to achieve economies of scale, which

result in favourable average costs and attractive prices for all participants. Smaller banks would also benefit from these. Moreover, the price model should not pose an unreasonable hindrance for this target group with regard to direct participation in TARGET.

Contribution to the work for the Single Euro Payments Area (SEPA)

In the year under review, the Bundesbank was actively involved in the preparations for the Single Euro Payments Area (SEPA). In doing so, it has made a lasting contribution to the formation of political opinions at Eurosystem level. On a national level, the Bundesbank participated in the mirror working groups of the European Payments Council (EPC), thereby continuing the long tradition of cooperation with the German banking industry in the Central Credit Committee (CCC). Furthermore, the Bundesbank also conducted a political dialogue with SEPA end-users at association level, which should help to improve the transparency of the current activities and increase the level of awareness of the general public.[1]

Bundesbank link to STEP2

In November 2003, the Bundesbank opened its national RPS clearing procedure to cross-border payments, linking it to the STEP2 procedure of the Euro Banking Association (EBA). The number of cross-border payments in the RPS increased sharply in 2005, even though the figure was still significantly lower than the number of domestic payments made. Nevertheless, this link is of particular strategic importance in the developing Single Euro Payments Area. From today's perspective, it appears necessary to maintain the range of Bundesbank services, ie adapting the RPS to the requirements resulting from the new SEPA payment instruments and technical standards. In doing so, the Bundesbank would continue its established role in retail payments, which focuses on offering complementary services. In particular, institutions which are not linked to a giro network and for which a bilateral exchange with other banks is not worthwhile owing to their size could continue to benefit from competitively neutral access to interbank clearing via the Bundesbank. In addition, this would also ensure that all credit institutions nationwide were accessible for SEPA-compliant payments from Europe.

(c) Payment systems oversight

Oversight of systems

As well as being responsible for the oversight of German payment systems, in 2005, the Bundesbank participated in the cooperative oversight of cross-border

1 This was also the objective of the article "The road to the Single Euro Payments Area", Deutsche Bundesbank, Monthly Report, December 2005, p 29 ff.

systems with several other central banks and was involved in the oversight of other infrastructures important to the financial system (eg the provider of secure messaging services SWIFT).[1]

Correspondent banking survey

Payment systems oversight also involves monitoring and analysing important activities in the payment landscape. In 2005, the central banks of the Eurosystem and other EU central banks carried out another correspondent banking survey. The Bundesbank collected data from the most significant German institutions in this business line which should ultimately provide information about any risks that could hinder the smooth functioning of euro funds transfers.

Innovative electronic payment procedures

In fulfilling its mandate to monitor payments, the Bundesbank also oversees the market for innovative electronic payment methods. The Bundesbank supports the activities of the Eurosystem within the framework of the "electronic Payments Systems Observatory" (ePSO), the freely accessible online platform for monitoring developments in electronic payments.[2] The focus is on electronic payments in electronic commerce with customers and between individuals.

Only slow growth in use of e-money

Despite new activities in the area of prepaid cards, the use of e-money in Germany is increasing at a sluggish pace. However, there has been a rise in the number of e-money acceptance points, for example on cigarette machines. Furthermore, positive incentives could be created in the local public transport sector, if the potential of card-based e-money, electronic tickets and innovative contactless technology were combined to an increased extent.

Electronic access to payment systems

In 2005, the number of attacks on the security of electronic identification measures via the internet increased considerably both in Germany and worldwide. Fraudulent and bogus emails and special attack programmes (viruses and Trojan horses) are being used to obtain information (PIN, password, TAN, etc) that enable the user to be identified in electronic procedures. It is not just banking services that are being targeted by these attacks, but also internet auction houses, for example. While the potential scope of these attacks goes far beyond that of payment transactions, online banking services are at the forefront of these attacks. Since these attacks undermine the users' confidence in the security of an increasingly important access channel for payment transactions, the Bundesbank is carefully monitoring the situation and it is also involved in discussions on

1 See the Bundesbank's Financial Stability Review from November 2005 for a more detailed description of these oversight activities.
2 See also: http://www.e-pso.info.

this issue at national, European and G10 level. Finding an effective means to combating these attacks poses an immense challenge. In addition to providing comprehensive and timely awareness campaigns for users, service providers must also monitor the technical and organisational security measures on an ongoing basis and adapt them to the current risk situation as quickly as possible.

(d) Activities at G10 level

Work in the G10 Committee on Payment and Settlement Systems

In the year under review, the Bundesbank actively participated in the G10 central banks' Committee on Payment and Settlement Systems (CPSS) at the Bank for International Settlements (BIS) in Basel, particularly in the preparation of the various reports that were published in 2005 and in January of 2006.[1]

Publication of various reports on selected payments issues

A comparative study addressed the issue of the "Central bank oversight of payment and securities settlement systems". The principles and recommendations contained in this study are intended to serve central banks as a guideline for their activities within this field. Furthermore, the report "New developments in large-value payment systems" was published, demonstrating, among other things, that the settlement of interbank payments has accelerated substantially over the past few years and that this can be achieved with a lower amount of liquidity, mostly central bank money. The report "General guidance for national payment system development" offers advice and assistance on planning and implementing (reform) projects in payment systems.

Task Force on "General principles for international remittance systems"

In 2005, the CPSS and the World Bank set up a new task force to draw up principles for the settlement of remittances from migrants in industrial and developing countries. This is intended to take due account of the growing significance of those economically important payment flows for the migrants' home countries.

3 Securities clearing and settlement

Role of the Bundesbank

The Bundesbank's activities include overseeing securities clearing and settlement systems. The Bundesbank also offers procedures for these systems to settle in central bank money. In doing so, the Bundesbank makes a significant contribution to the efficiency and safety of the settlement of securities and, thus, to the

1 See also Chapter 3, Securities clearing and settlement.

stability of the financial market. Furthermore, the Bundesbank is represented in national, European and international bodies in the area of securities clearing and settlement.

Report of the ESCB/CESR working group on standards for securities clearing and settlement systems

In November 2004, the Governing Council of the ECB and the Committee of European Securities Regulators (CESR) approved the draft on standards for securities clearing and settlement systems that had been prepared by a joint working group. This draft report contains 19 standards designed to enhance the safety and efficiency of securities clearing and settlement systems. It was initially agreed that these standards would not come into force until an assessment methodology had been developed and the impact of the standards had been analysed. The introduction to the report listed various issues on which the working group had been unable to agree and the decision was taken to examine these issues in close cooperation with market players in the course of developing the assessment methodology. So far work on the standards has come to a standstill and no further market consultations are being carried out as the respective bodies have been unable to reach a consensus on certain issues, in particular the requirements for the lending business which is associated with securities settlement and is conducted by banks and central securities depositories with a banking licence. The Bundesbank remains committed to adapting the requirements to the implementation of Basel II in Europe and attaches great importance to striking a reasonable balance between the costs and benefits of any additional regulatory measures. Deviating from the Basel rules and taking a European go-it-alone approach to regulating lending activities in the context of clearing and settlement based on ESCB/CESR standards could result in competitive distortions to the disadvantage of European banks.

Assessment of cross-border collateral arrangements

In January 2006, the G10 central bank governors approved a report by the CPSS which addresses the US Payments Risk Committee's concern that a worldwide shortage of eligible securities might materialise. The CPSS's work did not find this concern to be justified. While consultations with internationally active commercial banks confirmed that additional refinancing options might be required in the case of acute liquidity crises, there was no indication of a general shortage of eligible securities. This is why the CPSS merely suggested that, in future, the respective central banks should decide independently whether and to what extent they shall accept additional categories of securities – in particular, debt instruments issued by other G10 countries in a foreign currency – for refinancing purposes.

III Money market operations and foreign reserve management

Launch of OMTOS

The new bidding system OMTOS (Open Market Tender Operations System) was launched in Germany on 14 November. OMTOS superseded the existing Automatic Bidding System (ABS), which was based on e-mail communication, and the bidding process migrated to a web-based procedure. Since OMTOS was launched, the average number of German participants in the two regular refinancing operations has risen.

Main and longer-term refinancing operations

As in previous years, most of the refinancing needs – 77% or €290 billion on an annual average – were met by the main refinancing operations, which are offered weekly and carried out as American-style variable rate tenders with a minimum bidding rate. The German share in these operations averaged 50% or €145 billion. Some 23% (€88 billion on an annual average) of the money market's refinancing needs were met through 13[1] longer-term refinancing operations where the Eurosystem operated as a rate taker. The German share in these operations averaged €53 billion or 60%.

Fine-tuning operations

To even out liquidity imbalances at the end of reserve maintenance periods, nine fine-tuning operations were conducted in 2005 using a quick tender procedure.

Standing facilities

On a daily average, recourse to the standing facilities in 2005 was less frequent than in previous years owing to the more active fine-tuning policy. In the Eurosystem as a whole, recourse to the marginal lending facility halved compared with the previous years to €0.1 billion, three-quarters of which was accounted for by counterparties of the Bundesbank. Use of the deposit facility also declined in the past year; it, too, amounted to €0.1 billion across the Eurosystem, compared with €0.2 billion in previous years. In this case, counterparties of the Bundesbank only accounted for approximately half the total.

Range of assets eligible as collateral for refinancing operations

Assets which the Bundesbank accepts as collateral to be used for the Eurosystem's monetary policy operations are, pending the eventual introduction of a single list of collateral in January 2007, placed into two categories: tier one

1 Owing to a bidding error in the December 2005 longer-term refinancing operation, it was only possible to provide €12.5 billion of liquidity, not €30 billion as planned. The Eurosystem supplied the market with the outstanding €17.5 billion in a second longer-term refinancing operation the following day.

assets and tier two assets. At the end of December 2005, the volume outstanding of marketable eligible assets was just under €8,500 billion. Slightly more than 30% of that sum was accounted for by assets quoted or held in Germany.

Collateralisation of refinancing operations

At the end of 2005, counterparties had eligible assets totalling €498 billion pledged in their collateral pools at the Bundesbank as cover for refinancing operations (and intraday credit in the context of settling payment transactions). That figure included €253 billion of assets held in other member states and made available across national borders for refinancing purposes at the Bank. Just under 30% of the assets pledged to the Bundesbank were covered bank debt securities (Pfandbriefe). Slightly more than one-fifth was accounted for by government bonds and just under two-fifths by uncovered bank debt securities. Just over one-tenth of the total was made up of other marketable assets and lending to the private sector (approximately 4,400 bills of exchange and 3,400 bank loans, amounting in all to €3.7 billion).

Single list of collateral: range of assets expanded ...

In the first step towards establishing a single list of collateral, the range of marketable assets was extended on 30 May 2005. Euro-denominated debt instruments issued by entities domiciled in a G10 country outside of the European Economic Area were newly added to the list of tier one assets. In addition, markets that are not "regulated markets" as defined by the Investment Services Directive became eligible for tier one. Furthermore, the requirement for uncovered bank debt securities to be awarded an issue rating was abolished. The fact that the issuer's rating is now sufficient meant that a large number of bank debt securities were eligible for central bank refinancing for the first time.

... and decision to introduce bank loans

Following the decision of principle in 2004 to include bank loans in the single list in a second step, further details were agreed and published. The inclusion of bank loans will commence in January 2007 ushering in a five-year transitional arrangement. All regulations governing recourse to bank loans in the euro area will be harmonised by 2012 and a minimum amount of €500,000 will apply (during the transitional period, the Bundesbank will retain the current minimum amount of €10,000 until further notice). It was also agreed that bills of exchange would cease to be eligible for central bank refinancing at the end of 2006.

Positioning of the foreign reserve asset portfolios

The framework for managing the foreign reserve assets is defined by benchmarks for each currency which reflect the desired long-term level of risk and act as a guideline for asset management. Investment decisions may deviate from

the benchmark within a certain margin to achieve the most favourable result possible by managing duration and yield curve positions and selecting instruments. Whereas the Executive Board sets the benchmark for the Bundesbank's own reserve assets on an annual basis, the Bundesbank manages the ECB reserves for which it is responsible using two-level benchmarks fixed by the ECB Governing Council and ECB Executive Board.

IV The Bundesbank's involvement in the issuance of Federal securities; asset management and central bank services

Issuance of Federal securities

As the Federal Government's fiscal agent, the Bundesbank carries out various tasks relating to the issuance and settlement of Federal securities. In particular, the Bundesbank conducts auctions of Federal securities and carries out market-management operations on the German stock exchanges on behalf of the German Finance Agency (Federal Republic of Germany – Finance Agency GmbH) and for the account of the Federal Government. One-off Federal securities are issued by auction through the Bund Issues Auction Group. The electronic Bund Bidding System (BBS), recently developed by the Bundesbank, was used for this purpose for the first time in April 2005 and replaced the Automatic Bidding System (ABS) used hitherto. The allotment volume of the 34 auctions carried out in 2005 came to €184.9 billion (2004: €187.5 billion, also in 34 auctions). In the year under review the Bundesbank continued to be involved, through credit institutions, in selling Federal savings notes and Federal Treasury financing paper issued on tap.

Market management operations

As in previous years, the Bundesbank carried out market-management operations (for the account of the Federal Government) for Federal securities which are officially listed on the German stock exchanges.

BaFin added to third-party portfolio

In January 2005 the Bundesbank took on the task of managing the special pension provisions of the Federal Financial Supervisory Authority (BaFin). Similar to the existing portfolio of the Monetary Stability Foundation, the new portfolio is also passively invested in bonds and equities. In addition, the Bundesbank manages portfolios of pension reserves for the Federal Government and the Association of German Pension Insurance Funds. In its function as the Federal Govern-

Issues of Federal securities in 2005

Table 12

Security	Auction date	Amount issued (€ billion)			Terms	
		Total	Amount allotted by auction	Market manage-ment amount	Weighted average allotment price (%)	Average yield (% pa)
3.75% Federal bonds of 2004 (2015) [1]	5 Jan	8.0	6.6	1.4	100.67	3.67
Bubills January 2005 issue	10 Jan	6.0	5.3	0.7	98.956	2.087
2.25% Federal Treasury notes of 2004 (2006) [1]	19 Jan	7.0	6.1	0.9	99.800	2.36
4% Federal bonds of 2005 (2037)	26 Jan	6.0	5.5	0.5	99.21	4.04
Bubills February 2005 issue	14 Feb	6.0	5.4	0.6	98.962	2.075
3.75% Federal bonds of 2004 (2015) [1]	23 Feb	7.0	5.9	1.1	100.40	3.70
Bubills March 2005 issue	14 Mar	6.0	5.7	0.3	98.963	2.073
2.50% Federal Treasury notes of 2005 (2007)	16 Mar	8.0	6.9	1.1	100.067	2.47
3.25% 5-year Federal notes s 146 of 2005 (2010)	30 Mar	7.0	5.8	1.2	100.52	3.14
2.50% Federal Treasury notes of 2005 (2007) [1]	13 Apr	7.0	5.7	1.3	100.234	2.37
Bubills April 2005 issue	18 Apr	6.0	5.1	0.9	98.97677	2.0449
Bubills May 2005 issue	9 May	6.0	4.6	1.4	98.94097	2.0388
3.25% 5-year Federal notes s 146 of 2005 (2010) [1]	11 May	5.0	4.4	0.6	102.32	2.74
3.25% Federal bonds of 2005 (2015)	18 May	8.0	6.7	1.3	99.15	3.35
Bubills June 2005 issue	13 June	6.0	5.0	1.0	99.03757	1.9991
2% Federal Treasury notes of 2005 (2007)	15 June	8.0	7.1	0.9	99.811	2.10
3.25% 5-year Federal notes s 146 of 2005 (2010) [1]	22 June	5.0	4.0	1.0	103.44	2.48
3.25% Federal bonds of 2005 (2015) [1]	29 June	7.0	6.2	0.8	100.52	3.19
Bubills July 2005 issue	11 July	6.0	4.9	1.1	98.95197	2.0174
2% Federal Treasury notes of 2005 (2007) [1]	13 July	5.0	4.4	0.6	99.657	2.18
4% Federal bonds of 2005 (2037) [1]	20 July	5.0	4.5	0.5	103.90	3.78
Bubills August 2005 issue	15 Aug	6.0	4.8	1.2	98.97399	2.0505
3.25% Federal bonds of 2005 (2015) [1]	17 Aug	6.0	5.3	0.7	100.08	3.24
Bubills September 2005 issue	12 Sep	6.0	4.8	1.2	98.97484	2.0488
2.25% Federal Treasury notes of 2005 (2007)	14 Sep	8.0	7.0	1.0	100.089	2.20
2.50% 5-year Federal notes s 147 of 2005 (2010)	21 Sep	7.0	5.9	1.1	99.67	2.57
2.25% Federal Treasury notes of 2005 (2007) [1]	12 Oct	7.0	6.2	0.8	99.630	2.44
Bubills October 2005 issue	17 Oct	6.0	4.8	1.2	98.97481	2.1308
2.50% 5-year Federal notes s 147 of 2005 (2010) [1]	26 Oct	5.0	4.2	0.8	98.07	2.92
Bubills November 2005 issue	14 Nov	6.0	4.9	1.1	98.82505	2.3517
3.50% Federal bonds of 2005 (2016)	23 Nov	8.0	6.5	1.5	100.12	3.48
2.50% 5-year Federal notes s 147 of 2005 (2010) [1]	30 Nov	5.0	4.2	0.8	97.45	3.07
Bubills December 2005 issue	5 Dec	6.0	4.9	1.1	98.73280	2.4447
2.75% Federal Treasury notes of 2005 (2007)	14 Dec	7.0	6.0	1.0	99.928	2.79

1 Increase.

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ment's fiscal agent the Bundesbank also advised on investing the assets of charitable foundations.

Central bank services

In 2005, the Bundesbank's reserve management services for foreign central banks, monetary authorities and international organisations were provided for the first time in accordance with harmonised Eurosystem conditions. This includes the limited remuneration of overnight deposits, forwarding overnight and fixed-term deposits to the money market and executing securities, safe deposit and foreign exchange transactions for harmonised fees.

V The Bundesbank's participation in banking supervision and changes in banking supervision legislation

1 International harmonisation of banking supervision

(a) Activities in the Basel Committee on Banking Supervision

Finalisation and implementation of the Framework

In 2005, the Basel Committee's work essentially focused on the finalisation of the outstanding parts of Basel II and the debate on the implementation aspects of the Framework. On the regulatory side, work on more risk-sensitive capital requirements for trading book positions and with regard to recognising "double default effects" was stepped up and concluded – as envisaged when the Framework was published in the summer of 2004. The review of risk weight calibration is still to be carried out and is planned for the spring of 2006.

Further Quantitative Impact Study in progress

The results of the Fourth Quantitative Impact Study (QIS 4) regarding the likely impact of future regulatory capital requirements, in which around 100 credit institutions participated, were published in Germany in June 2005. The Basel Committee has been conducting a further Quantitative Impact Study (QIS 5) since October 2005 involving not only the G10 countries but also numerous other states. The impact on the minimum capital requirements of the rules which have been newly introduced since QIS 4, in particular the rules for calculating economic downturn loss given defaults (LGDs), the double default effect with regard to guarantees as well as trading book business, are of particular interest in this study. The result evaluations, which are to be performed separ-

ately for the G10 countries, the EU member states and the remaining participants, will be coordinated by the Bundesbank.

Research papers on implementation and validation

Two key issues in the implementation of the new Basel Capital Accord are the validation of internal rating systems and the treatment of concentration risk in credit portfolios. The Bundesbank, through its own research work as well as through its chairmanship of two working groups under the aegis of the Basel Committee's Research Task Force, has made important contributions in this field, which have met with great interest. The Basel Committee published the Validation Subgroup's results in February 2005. The working group on concentration risk organised a workshop for international experts together with the Journal of Credit Risk in November 2005.

Accord Implementation Group

The Bundesbank, like BaFin (the Federal Financial Supervisory Authority), is a member of the Basel Committee's Accord Implementation Group (AIG), which was set up in 2002 to promote the harmonised implementation of Basel II. In 2005, the AIG published a recommendation regarding the exchange of information between home and host supervisors, and asked for comments.[1] In the same year, the Bundesbank together with BaFin organised a total of nine multilateral conferences which the host supervisors of internationally active German banking groups were invited to attend in order to lay the foundations for close coordination and cooperation, for instance, in the cross-border approval of Basel II methods. The AIG also deals with special implementation issues in three subgroups. For example, it has drafted recommendations for the validation of internal rating systems for low-default portfolios.[2]

Consultation on the application of the fair value option pursuant to IAS 39

In the area of accounting, the Basel Committee published a consultative document entitled "Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards" (specifically IAS 39) in July 2005. In view of the potential impact of the fair value option on the book values of balance sheet items and institutions' regulatory capital, the Basel Committee deems it necessary to provide instructions on the risk management systems used.

1 Basel Committee on Banking Supervision, Consultative Document, Home-host information sharing for effective Basel II implementation, November 2005 (http://www.bis.org/publ/bcbs120.pdf).
2 AIG Validation Subgroup, Validation of low-default portfolios in the Basel II Framework, September 2005 (http://www.bis.org/publ/bcbs_nl6.pdf).

Revision of the Basel Core Principles

After completing work on the Revised Framework for the International Convergence of Capital Measurement and Capital Standards, the Basel Committee turned its attention to revising the Core Principles for Effective Banking Supervision and their methodology. The intention is not to lay down the introduction of Basel II as a precondition for compliance with the Core Principles, however. A draft version of the revised Core Principles has already been sent for comment to the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissions (IOSCO), the Committee on Payment and Settlement Systems (CPSS) and the Financial Action Task Force (FATF).

Corporate governance

Furthermore, in the year under review, the Basel Committee revised its guidance on corporate governance practices for banks, which it originally published in 1999, and released its ideas for enhancing corporate governance in banking organisations for public consultation in the autumn of 2005. The final version of the guidance was published on 13 February 2006.

(b) Activities in connection with the Committee of European Banking Supervisors

Development of common guidelines

In 2005, the Bundesbank and BaFin worked intensively with the other European banking supervisory authorities within the framework of the Committee of European Banking Supervisors (CEBS) to promote the coordinated supervisory implementation of Basel II. This involved developing common standards and guidelines and releasing them for consultation with market participants before adoption by CEBS. For example, the Joint Working Group on Validation is to harmonise across Europe the approval process for banks' internal risk measurement methods under Basel II. Banking groups active in Europe now have to submit only one group application to their home supervisor, who then coordinates cooperation activities with the host supervisors and the audits of internal models. The Common Reporting (COREP) working group has developed and approved new EU-wide templates for reporting the solvency ratio. Every national supervisor will use these reporting templates (or parts of them) to obtain the solvency data which he deems necessary. The European reporting concept developed by the Financial Reporting (FINREP) working group provides for common reporting formats for data relating to the consolidated balance sheet or profit and loss account based on International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS).

(c) Cooperation within the European System of Central Banks

Analyses of stability and structural developments

In the year under review, the Banking Supervision Committee (BSC) published further reports on the stability of and structural developments in the European banking and financial system. A further focal point of the work carried out by the Committee involved participation in the conclusion of a memorandum of understanding – based on an agreement concluded in 2003 between the central banks and supervisory authorities who are members of the BSC – regarding cooperation and the exchange of information between the central banks, supervisory authorities and finance ministries within the EU in the event of a crisis.

2 Development of the national prudential supervisory standards

Pfandbrief Act

The new Pfandbrief Act *(Pfandbriefgesetz)*[1] as well as the Refinancing Register Act *(Refinanzierungsregistergesetz)*[2] brought about substantial amendments to the German Banking Act *(Kreditwesengesetz)* in 2005. The elimination of guarantors' uncalled liability *(Gewährträgerhaftung)* and the modification of guarantors' responsibility for ensuring the solvency of public-sector credit institutions *(Anstaltslast)* on 18 July 2005 gave occasion to extensively amend the legal basis for the issuance of Pfandbriefe as different demands on the cover fund pursuant to the Public Pfandbrief Act *(Öffentliches Pfandbriefgesetz)* and the Mortgage Bank Act *(Hypothekenbankgesetz)* were found to be no longer appropriate. Moreover, in view of the strengthening of the cover fund through the latest Act Amending the Mortgage Bank Act of April 2004, it no longer appeared necessary to maintain the specialist bank principle. The new Pfandbrief Act now enables all credit institutions to issue Pfandbriefe provided that they meet certain quality standards for the Pfandbrief business contained in the list of banking business in the Banking Act.

Refinancing register

The aim of the Refinancing Register Act is to improve the supply of credit to enterprises through making it easier to conduct securitisation transactions as certain obstacles to securitisation under insolvency law, especially in connection

1 Act to Reform German Pfandbrief Legislation (Gesetz zur Neuordnung des Pfandbriefrechts) of 22 May 2005 (Federal Law Gazette I, p 1373).
2 Act on the Reorganisation of the Federal Revenue Administration and the Creation of a Refinancing Register (Gesetz zur Neuorganisation der Bundesfinanzverwaltung und zur Schaffung eines Refinanzierungsregisters) of 22 September 2005 (Federal Law Gazette I, p 2809).

with transfer of ownership requirements under property law, have been removed.

Implementation of Basel II

Drawing on the results of the "Implementation of Basel II" Working Group, which is co-chaired by the Bundesbank and BaFin, in 2005 work was started on the legal implementation of Basel II and the Capital Requirements Directive (CRD) comprising the amendments to the Consolidated Banking Directive and the Capital Adequacy Directive. In Germany, implementation will take the form of an amendment to the Banking Act, the re-enactment of the Regulation governing large exposures and loans of €1.5 million or more *(Grosskredit- und Millionenkreditverordnung)* and the passing of a Solvency Regulation *(Solvabilitätsverordnung)*, which will replace Principle I. As part of this national implementation process, Principle II will simultaneously be transformed into a Liquidity Regulation *(Liquiditätsverordnung)* and groups of institutions will be given the option of providing financial statements drawn up in accordance with the German Commercial Code *(Handelsgesetzbuch)* or using IAS/IFRS for supervision on a consolidated basis.

Transformation of Principle II into a Liquidity Regulation

"Minimum requirements for risk management"

The "Minimum requirements for risk management" (*Mindestanforderungen an das Risikomanagement,* MaRisk) were published on 20 December 2005. They contain key qualitative elements of Pillar Two of the Basel Framework and are aimed at bolstering the quality of the internal management, steering and monitoring processes. The various existing minimum requirements (the "Minimum requirements for the trading activities of credit institutions" (*Mindestanforderungen an das Betreiben von Handelsgeschäften der Kreditinstitute,* MaH), the "Minimum requirements for the credit business of credit institutions" (*Mindestanforderungen an das Kreditgeschäft der Kreditinstitute,* MaK) and the "Minimum requirements for the organisation of internal auditing" (*Mindestanforderungen an die Ausgestaltung der Internen Revision,* MaIR)) have been incorporated into this new set of rules, whereby the credit institutions have been afforded greater operational discretion than they have hitherto had. In addition, the "Minimum requirements for risk management" take into account aspects for which the German supervisors had not yet developed any framework provisions (eg interest rate risks in the banking book). The "Minimum requirements for risk management" were drafted in close dialogue with the institutions and their central associations in the technical forum which was established for that very purpose at the beginning of 2005.

3 Ongoing banking supervision operations

Further slowdown in the concentration process

At the end of 2005, 2,346 domestic credit institutions had been registered for supervisory purposes (the figure had been 2,400 at the end of 2004).[1] The net decrease of 54 credit institutions indicates a slowdown in the streamlining of the German banking network for the sixth year in succession (decrease of 164 institutions in 2002, 146 in 2003 and 71 in 2004). A total of 92 credit institutions closed down, owing predominantly to mergers; 47 of these institutions were credit cooperatives and 14 were savings banks. The decrease was partly offset by 38 new institutions, mainly investment companies, branches of foreign banks and securities trading banks. The number of supervised financial services institutions fell further to 800 (compared with 906 in 2002, 831 in 2003 and 827 in 2004).

Credit register of loans of €1.5 million or more

The number of loans of €1.5 million or more to be reported quarterly pursuant to section 14 of the Banking Act fell slightly in the 12 months from 30 September 2004 to 30 September 2005 by 0.1% to just under 503,300 reports. The volume of reported loans of €1.5 million or more increased by around 10% during this period from €7.1 trillion to €7.8 trillion (Table 14 shows the figures since 1998). On the reporting date of 30 September 2005, 2,517 institutions, 1,428 financial enterprises and 623 insurance corporations had submitted reports on loans of €1.5 million or more.

International cooperation between European credit registers

In June 2005, the regular cross-border exchange of information on borrowers' indebtedness was started between the credit registers in Belgium, Germany, Italy, Portugal and Spain. Austria and France linked up with the procedure in the second half of the year. Thus, all of the EU central banks which signed the Memorandum of Understanding concluded in the BSC in 2003 have been participating in the data exchange since the end of 2005.

Bundesbank audits of banking operations and models

In the year under review, the Bundesbank performed audits of the "Minimum requirements for the credit business of credit institutions" at 71 institutions and audits of the "Minimum requirements for the trading activities of credit institutions" at 28 institutions, all of which were conducted in the form of risk-oriented system audits. Moreover, in 2005, the Bundesbank conducted follow-up and extension audits of internal market risk models on the basis of section

1 Credit institutions pursuant to section 1 (1) of the Banking Act (including institutions which are in liquidation or being wound up). For the sake of systematic classification, all 50 securities trading banks are also included here although 40 of these institutions provide only financial services.

Ongoing monitoring of institutions

Table 13

Number of operations conducted

Item	2003	2004	2005
Individual reports pursuant to sections 13 to 14 of the Banking Act	153,035	186,754	165,477
Single borrowers listed in the summary reports submitted pursuant to sections 13 to 14 of the Banking Act	1,832,038	2,126,336	2,035,187
Reports pursuant to sections 24 and 24a of the Banking Act	44,561	47,002	34,951
Monthly returns and other data pursuant to sections 25 and 25a of the Banking Act	40,918	38,558	29,262
Reports on the volume of foreign lending (country risk) pursuant to section 25 (3) of the Banking Act	370	912	824
Audit reports on annual accounts	3,263	3,253	3,181
Reports on the auditing of safe custody accounts	483	644	407
Routine, special and deposit guarantee fund audit reports	1,755	1,678	1,695
Audits pursuant to sections 44 and 44c of the Banking Act	79	155	164
Audit reports on the special funds of investment companies	1,309	1,459	1,384
Reports from investment companies on their activities	6,891	6,606	5,664
Reports under Principle I	29,923	28,907	28,452
Reports under Principle II	28,990	27,789	27,140
Audits of internal risk models	9	6	4
Reports under the Basel Capital Accord	76	81	73

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44 of the Banking Act in conjunction with section 10 (1c) of the Banking Act and section 32 (3) sentence 2 of Principle I at four institutions. Besides performing on-site audits, the Bundesbank discussed both methodological problems with respect to internal market risk models and issues concerning implementation with various institutions in numerous prudential and audit preparatory meetings.

Credit register of loans of €1.5 million or more

Table 14

Third quarter	Volume of loans of €1.5 million or more		Number of loans of €1.5 million or more reported		Number of reporting		
	€ billion	Change (%)	Number	Change (%)	institutions 1	financial enterprises	insurance corporations
1998	4,790	+ 16.3	464,507	+ 4.1	3,496	963	607
1999	5,662	+ 18.2	484,443	+ 4.2	3,355	900	626
2000	6,487	+ 14.6	509,567	+ 5.2	3,129	993	645
2001	7,087	+ 9.2	525,020	+ 2.9	2,946	955	644
2002	7,161	+ 1.0	526,552	+ 0.3	2,777	1,075	621
2003	6,995	– 2.3	514,433	– 2.3	2,624	1,174	633
2004	7,118	+ 1.8	503,632	– 2.3	2,547	1,271	635
2005	7,843	+ 10.1	503,290	– 0.1	2,517	1,428	623

1 Credit institutions and financial services institutions.

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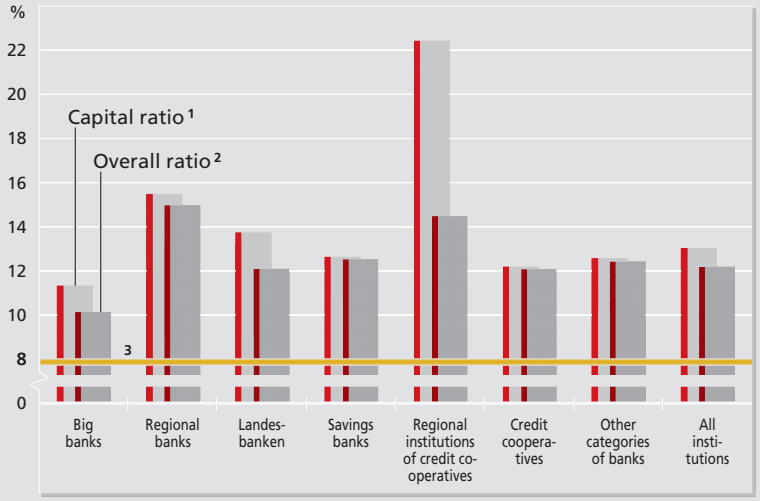
Ratio of the liable capital and liable own funds of individual institutions submitting Principle I reports *

Chart 17

End-2005 levels



* Credit institutions and financial services institutions on a non-consolidated basis. — **1** Capital ratio = (liable capital ÷ risk-weighted assets) x 100. — **2** Overall ratio = (eligible own funds ÷ (risk-weighted assets + capital charges for market risk x 12.5)) x 100. — **3** Under Principle I, the minimum percentage for both ratios is 8%.

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IRBA approval examinations

In 2005, the Bundesbank started to perform suitability examinations as part of the licensing of internal ratings-based systems at three institutions. The Bundesbank is expecting to conduct IRBA approval examinations at more than 30 institutions in 2006. These examinations will be performed either solely by the Bundesbank or jointly by the Bundesbank and BaFin. Furthermore, in 2005, the Bundesbank discussed issues concerning implementation as well as methodological and audit preparatory questions with various institutions and associations in numerous meetings in preparation for IRBA approval. In the area of operational risk, BaFin and the Bundesbank published guidelines regarding the approval and reporting process for the Advanced Measurement Approaches (AMA) in the fourth quarter of 2005.

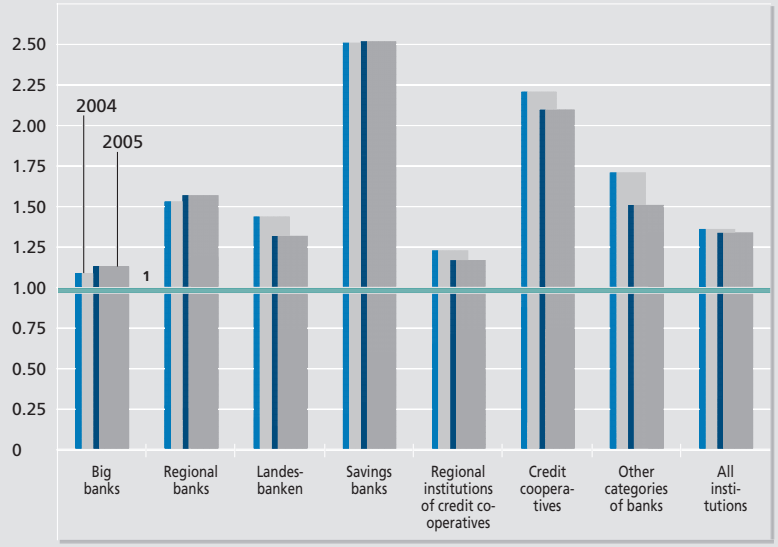
Principle I/capital ratios

The capital ratio under Principle I pursuant to section 10 of the Banking Act – which reflects the ratio of risk-weighted assets to liable capital – of single institutions was 13.0% on average (2004: 13.3%) on the reporting date of 31 December 2005. Groups of institutions/financial holding groups submitting Principle I reports on a consolidated basis pursuant to section 10a of the Banking Act had an average capital ratio of 11.8% (2004: 12.5%). The average overall ratio – which gives the ratio of all risk positions that have to be backed by capital

Liquidity ratio of individual institutions submitting Principle II reports*

Chart 18

End-of-year levels



* Credit institutions and financial services institutions on a non-consolidated basis. Liquidity ratio = total payment assets ÷ total payment liabilities. — **1** Under Principle II, the required minimum liquidity ratio is 1.0.

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to eligible own funds – of institutions reporting on an individual basis was 12.2% on 31 December 2005 (2004: 12.4%). Groups of institutions/financial holding groups had an average overall ratio of 10.8% (2004: 11.5%). Risk-weighted assets accounted for the bulk (92.0%) of all risk positions to be backed by own funds. The average capital ratios and overall ratios of various types of German banks are shown in Chart 17.

Principle II/ liquidity ratios

On 31 December 2005, the average liquidity ratio of German banking institutions – bearing in mind the minimum liquidity ratio of 1.0 laid down by the regulatory liquidity standard Principle II – was 1.34 (2004: 1.36). Chart 18 shows the average liquidity ratios of various types of German banks on 31 December 2005 and a comparison with 2004. Differences in the liquidity ratio level could be the result of special structural features in the refinancing operations of the individual types of banks.

VI UN/EU financial sanctions: new developments

Cooperation with national bodies in the restriction of capital movements and payments

Under foreign trade and payments law, the Bundesbank is competent within the field of restrictions of capital movements and payments. Such restrictions currently consist only of financial sanctions that are based partly on the actions of the United Nations (UN) Security Council and partly on autonomous decisions by the European Union. They are implemented through directly applicable EC regulations and represent a key element in the fight against the financing of international terrorism. Within the scope of its responsibilities, the Bundesbank works closely with the other responsible national and European agencies, especially the Federal Ministry of Economics and Technology, and is involved in the international exchange of experience regarding the implementation of the aforementioned measures. Financial sanctions generally comprise the freezing of funds and economic resources of certain persons, entities or bodies and a ban on making funds and economic resources available to these parties.

New EU sanctions against Côte d'Ivoire ...

During the period under review, restrictions on the movement of capital and payments were imposed on three countries. The EC regulations,[1] based on UN measures, involving financial sanctions against Côte d'Ivoire include a ban on the financing of military activities. They also contain a freezing of funds and a ban on the provision of funds. However, the list of persons, entities and bodies affected by these regulations did not yet contain any entries at the end of the year under review.

... against the Democratic Republic of the Congo ...

The EC regulations[2] imposing financial sanctions in respect of the Democratic Republic of the Congo, which are likewise based on UN measures, comprise comparable restrictions to the measures imposed on Côte d'Ivoire.

... and against Uzbekistan

The EU imposed financial sanctions on Uzbekistan[3] for the first time. They prohibit the direct or indirect provision of financing or financial assistance related to military activities and for equipment that might be used for internal repression.

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1 Council Regulation (EC) No 174/2005 of 31 January 2005, OJ EU L 29/5 and Council Regulation No 560/2005 of 12 April 2005, OJ EU L 95/1.
2 Council Regulation (EC) No 889/2005 of 13 June 2005, OJ EU L 152/1 and Council Regulation No 1183/2005 of 18 July 2005, OJ EU L 193/1. The list of persons, entities and bodies affected was appended by Commission Regulation (EC) No 1824/2005 of 9 November 2005, OJ EU L 294/3.
3 Council Regulation (EC) No 1859/2005 of 14 November 2005, OJ EU L 299/23.

Sanctions against Sudan

The EU financial sanctions against Sudan were supplemented by a freeze on funds and a ban on the provision of funds in implementing the financial sanctions imposed by the UN.[1] The list of persons, entities or bodies affected by these measures does not yet contain any entries.

Change to the list of parties affected by legal acts imposing financial sanctions

In the legal acts imposing financial sanctions on Burma/Myanmar, in support of the International Criminal Tribunal for the former Yugoslavia (ICTY), on Iraq, on Liberia, against persons and entities associated with Usama bin Laden, the Al-Qaida network and the Taliban, and against Zimbabwe, the lists of affected persons, entities and bodies were changed. The persons and entities covered by the Council Regulation on combating terrorism are defined by the Council through a separate Decision, the most recent having been taken on 21 December 2005.

VII The Bundesbank's involvement in the Initiative Finanzstandort Deutschland (IFD)

IFD's objectives

The IFD was created in May 2003 as an association of institutions from the German banking and insurance industries, the German stock exchange (Deutsche Börse), the Bundesbank, the Federal Ministry of Finance and the central associations of the German financial industry. Its goal is a sustainable enhancement of the growth, innovativeness and competitiveness of Germany as a financial centre. The IFD has established 12 working groups which are drawing up lists of measures and elaborating implementation strategies.[2]

IFD financial centre report

The Bundesbank is involved *inter alia* in the "Economists Group", which published its first financial centre report in June 2005. This report, which will appear annually from now on, will analyse the progress made by Germany as a financial centre and its potential for improvement.

Chair of the "Modern Financial Education" working group

In addition, the Bundesbank chairs the "Modern Financial Education" working group, the focus of which is the German financial industry's efforts to improve financial education at secondary schools and to promote the new Bachelor's

1 Council Regulation (EC) No 1184/2005 of 18 July 2005, OJ EU L 193/9.
2 For more on the IFD's members, aims, themes and publications, please visit www.finanzstandort-deutschland.de. The IFD is headed by initiators and "sherpas" from the 17 member institutions (as at end-2005); Professor Axel Weber and Professor Hans-Helmut Kotz are the Bundesbank's representatives.

and Master's programmes at German universities. In 2005, a special internet portal, "KursraumGeld" (Classroom Money), was established to provide centralised access to a wealth of information and services for teachers and pupils offered by the financial industry. Furthermore, IFD's members have undertaken to provide internships for Bachelor students and to promote the hiring of Bachelor students by their institutions. The Bundesbank has joined other IFD institutions in supporting the establishment of the "House of Finance" at the Goethe University of Frankfurt; this is a network created to amalgamate and coordinate the German financial industry's current financial research and teaching activities.

Involvement in other working groups

The Bundesbank is likewise involved in the "EU Financial Market Integration" working group, which in July 2005 issued a written comment in the name of the IFD on the Commission's Green Paper on Financial Services Policy (2005-2010). It is also a member of the "Better Governance/Bureaucracy Reduction" and "Fund Industry Deregulation" working groups, created at the beginning of 2005.

VIII Research Centre

Extension of Research Centre

In the year under review, the Bundesbank focused its financial stability research within its Research Centre and accordingly added capacity. It did so in recognition of the fact that academic basic research in this field has gained increasing significance in the past few years. In the research programme, the topic of "Financial Systems/Financial Stability" has been extended and "Risk Modelling" newly added. Additional focal points of research include current issues relating to monetary policy strategy, the monetary transmission process, the international integration of the German economy and econometric models and forecasting procedures. A total of 58 discussion papers were published in the year under review, 43 in the "Economic Studies" series and 15 in the "Banking and Financial Studies" series. In addition, the research work carried out by Research Centre staff members has led to 39 publications in academic journals and to many presentations at academic conferences and similar events.

Increasing importance of micro data ...

Micro data have become an increasingly important element of empirical research in the past few years. The Research Centre has accordingly established several large micro panel databases which chiefly contain information on credit institutions and firms. These data are available to Bundesbank and external re-

searchers alike, subject to observing certain confidentiality rules. In addition, a real-time database for a number of macroeconomic variables is being enlarged. These data have been used to run projects in the areas of interbank competition and bank concentration, domestic and foreign investment, international tax competition and monetary policy strategy. Around one-third of the working papers published in 2005 were based on such data.

... and general equilibrium models

An increasingly large area of research is being devoted to dynamic general equilibrium models. Existing models have been upgraded, in some cases in close co-operation with university researchers. Special emphasis is being placed on the estimation of such models and their application to questions of economic policy relevance.

Conferences and other events

The Spring Conference in the year under review was devoted to the topic of "Macroeconomic Risk and Economic Policy Responses". It was co-hosted by the Bundesbank, the Humboldt University of Berlin and the Centre for Economic Policy Research. Papers on monetary policy strategy under uncertainty were discussed, among other things. New theoretical research results on the modelling of pricing behaviour in financial markets were presented at the Autumn Conference. In addition to these two conferences, various workshops were held. At an event held jointly with the University of Bonn, participants discussed what central banks could learn from the development of monetary and credit aggregates. Another workshop organised jointly with the Free University of Berlin was dedicated to euro-area enlargement. In addition, research using Bundesbank micro data were presented at workshops on foreign direct investment (FDI) and financial stability, and an event on dynamic general equilibrium models was held. Finally, the Research Centre, in some cases together with the University of Frankfurt and the European Central Bank, organised several regular series of seminars on macroeconomic and banking issues.

Scientific Advisory Council

Professor Bronwyn Hall of the University of California at Berkeley joined the Bundesbank's Scientific Advisory Council in 2005. Professor Martin Hellwig (Max Planck Institute for Research on Collective Goods) and Professor Manfred J M Neumann (University of Bonn), members of the council since it was founded in 2000, left at the end of the year upon the expiry of their terms.

IX Technical central bank cooperation

Setting-up the Centre for Technical Central Bank Cooperation

For many years, the Bundesbank has been supporting central banks in setting up and developing a market-oriented central banking system worldwide. In order to have the organisation to cope with the demand, which had been growing steadily from the time the scheme started, the Bundesbank set up an operational unit in 1991, which was converted into the independent Technical Central Bank Cooperation Division within the International Relations Department three years later. The change in the range of interests of partner central banks that could be observed over the past 15 years as well as the growing importance of projects funded by third parties – including the European Commission – were a good reason to reorganise the Technical Central Bank Cooperation Division. The Bundesbank's Executive Board decided to restructure the existing division responsible for these tasks, from 1 July 2005, as a Centre for Technical Central Bank Cooperation. In addition to its existing sphere of activity, the centre will, in future, work more closely in the field of central bank cooperation with external bodies and institutions (banking associations, credit institutions, universities etc) in Germany, thereby providing its partner central banks with access to an even broader and more integrated framework of advice.

Continuing high demand for, and increasing Europeanisation of, technical central bank cooperation

As in previous years, the Bundesbank's technical central bank cooperation programme met with great interest throughout the world in 2005, when some 3,000 members of staff from over 75 national central banks took part in around 300 training and advisory activities in Germany and abroad. The Bundesbank again used its tried and tested instruments to carry out the technical central bank cooperation programme. The project work gained increasing importance for the Bundesbank in a European context.

EU twinning projects

The Bundesbank has been increasingly involved in EU twinning projects since 2004. These help to strengthen the structures in the EU accession countries and new EU member states. In 2005, its main involvement was again with the Czech Republic. Banking supervision and financial market stability were the key issues tackled. Preparations are currently being made for projects with various central banks in south-eastern Europe.

Joint ESCB projects

The third TACIS (Technical Assistance to the Commonwealth of Independent States) programme for the Bank of Russia, which began in 2003 with eight other central banks and the ECB, was successfully completed in the year under

review. The programme involved supporting the Bank of Russia in banking supervision matters. The Bundesbank has been involved in a MEDA (EuroMediterranean Partnership) project for the Central Bank of Egypt since the end of 2005. MEDA funds are available to promote economic and social reforms in Mediterranean partner countries. The objective of the new project is to support the Central Bank of Egypt's internal reform efforts, particularly in the area of banking supervision, thereby making a contribution towards the functional viability of the Egyptian financial system.

"Partnership with Africa" initiative

In 2006, the Bundesbank will comply with the Federal President's request to take part in the "Partnership with Africa" initiative which he set up.

X Organisation and staff

Further reduction in staff

As expected, the pace of staff cuts slowed down over the course of 2005 compared with the previous few years. The number of core staff continued to fall, by 651 (about 5%) to 12,308. As in previous years, the branch network was most affected. If part-time and full-time employees are taken together on the basis of their contractual working hours, the Bundesbank had the equivalent of around 11,502 full-time employees (in 2004, the number was 12,133; ie staff figures decreased by approximately 5%). At about 16%, the ratio of part-time employment was again slightly up from the previous year (15%).

Taking advantage of staff reduction options

Around 300 members of staff took advantage of the option of early retirement on reaching 55 years of age in the year under review. On 31 December 2005, 928 members of staff had been admitted to the partial retirement scheme. The vast majority have contracts based on a "phase model", which means that a phase of full-time employment with reduced remuneration is followed by a second pre-retirement phase in which the employee does not work but receives the same (reduced) remuneration as in the previous phase. There are now 425 employees in the second pre-retirement phase.

Great demands on the mobility of staff

As part of the ongoing organisational restructuring of the Bundesbank, great demands are being placed on the professional and geographical mobility of many members of staff. Holding appropriate training measures should ensure that employees are transferred from surplus areas of work to those which hold

Bundesbank staff on 31 December 2005 *

Table 15

Item	Staff numbers [1]				Year-on-year changes			
	Total	Regional Offices	Branches	Central Office	Total	Regional Offices	Branches	Central Office
Civil servants	5 928	1 648	2 330	1 950	– 181	– 133	– 200	+ 152
Salaried staff	6 846	1 690	3 197	1 959	– 459	– 165	– 394	+ 100
Total	12 774	3 338	5 527	3 909	– 640	– 298	– 594	+ 252
of which								
Trainees	466	146	94	226	11	19	– 31	+ 23
Core staff	12 308	3 192	5 433	3 683	– 651	– 317	– 563	+ 229
of which								
Staff with permanent contracts	12 207	3 183	5 404	3 620	– 636	– 312	– 549	+ 225
Staff with temporary contracts	101	9	29	63	– 15	– 5	– 14	+ 4
Memo item								
Core staff pro rata (Full-time equivalent)	11 501,5	2 973,0	5 017,3	3 511,2	– 631,4	– 320,8	– 521,8	+ 211,2

	End-2005	End-2004
* Not included:		
Members of staff on secondment	126	121
Members of staff on unpaid leave	544	582
Members of staff in the second phase of the partial retirement scheme	425	400
1 *Of which* part-time employees	1,953	1,948

Deutsche Bundesbank

more promise for the future. In addition, instruments available as part of the staffing concept accompanying the structural reform are being used to promote mobility. At the same time, all possible means of placing employees externally are being examined and exploited in order to help those for whom relocating is not an option for family reasons.

Number of trainee places remains stable

The number of trainee civil servants and the number of other salaried trainees were almost the same as in the previous year. In all, 466 members of staff were undergoing practical professional training or were attending other training programmes in the year under review.

Bundesbank involvement in training pact

Whereas the civil service sector was very cautious in respect of taking on staff in the Upper Intermediate Service and Higher Service owing to the general staffing situation, there were again far more commercial training vacancies at the Bundesbank than were needed to ensure an intake of junior staff in the year under review (284). In doing so, the Bundesbank is taking part in the "training pact" between employers and the Federal Government aimed at helping to reduce youth unemployment.

Bundesbank staff at European Central Bank

At the end of the year under review, 68 members of the Bundesbank's staff were on secondment to the European Central Bank. Most of the seconded members of staff at the ECB are employed at professional and managerial levels.

XI Offices held by members of the Executive Board of the Deutsche Bundesbank

At its meeting on 14 July 2004, the Executive Board of the Deutsche Bundesbank, in consultation with the Corporate Governance Compliance Adviser, Professor Theodor Baums, approved a Code of Conduct for the members of the Executive Board of the Deutsche Bundesbank. This code states, *inter alia,* that details of offices held by Board members on supervisory boards or similar inspection bodies of business enterprises shall be disclosed in the *Annual Report*.

The Board members hold the offices indicated below.

– Professor Axel A Weber, President
  Member of the Board of Directors, BIS[1]

– Professor Jürgen Stark, Vice-President
  Alternate, Board of Directors, BIS[1]
  Deputy Chairman of the Executive Board and of the Board of Trustees, Ifo Institute, Munich
  Chairman of the Board of Trustees, University of Hildesheim Foundation

1 *Ex officio.*

- Dr Hans Georg Fabritius
  Member of the Administrative Council, Rhineland-Westphalian Institute for Economic Research

- Professor Hans-Helmut Kotz
  Member of the Administrative Council, Liko-Bank[1]
  Member of the Credit Committee, Liko-Bank[1]
  Standing guest on the Central Capital Market Committee
  Member of the Stock Exchange Expert Commission

- Dr Edgar Meister
  Member of the Administrative Council, Liko-Bank[1]
  Member of the Administrative Council, BaFin
  Member of the Auditor Oversight Commission in Germany

- Dr Hans Reckers
  Alternate, Administrative Council, Liko-Bank[1]

- Professor Hermann Remsperger
  Chairman of the Board of Trustees, Monetary Stability Foundation

- Professor Franz-Christoph Zeitler
  Alternate, Administrative Council, Liko-Bank[1]
  Alternate, Credit Committee, Liko-Bank[1]

1 Partnership agreement.

Annual accounts of the Deutsche Bundesbank for 2005

I Balance sheet of the Deutsche Bundesbank as at 31 December 2005

Assets

			31.12.2004
		€ million	€ million
1 Gold and gold receivables		47,924	35,495
2 Claims on non-euro-area residents denominated in foreign currency			
2.1 Receivables from the IMF	4,549		(6,548)
2.2 Balances with banks, portfolio investment, external loans and other external assets	33,708		(29,292)
		38,257	35,840
3 Claims on euro-area residents denominated in foreign currency		—	—
4 Claims on non-euro-area residents denominated in euro		300	300
5 Lending to euro-area credit institutions related to monetary policy operations denominated in euro			
5.1 Main refinancing operations	146,529		(143,005)
5.2 Longer-term refinancing operations	56,448		(47,318)
5.3 Fine-tuning reverse operations	—		(—)
5.4 Structural reverse operations	—		(—)
5.5 Marginal lending facility	949		(109)
		203,927	190,432
6 Other claims on euro-area credit institutions denominated in euro		116	3
7 Securities of euro-area residents denominated in euro		—	—
8 Claims on the Federal Government		4,440	4,440
9 Intra-Eurosystem claims			
9.1 Participating interest in the ECB	1,183		(1,183)
9.2 Claims arising from the transfer of foreign reserves to the ECB	11,762		(11,762)
9.3 Claims related to the allocation of euro banknotes within the Eurosystem (net)	—		(—)
9.4 Other claims within the Eurosystem (net)	29,834		(7,793)
		42,779	20,737
10 Items in course of settlement		1	39
11 Other assets			
11.1 Coins	555		(514)
11.2 Tangible and intangible fixed assets	1,722		(1,837)
11.3 Other financial assets	2,809		(2,669)
11.4 Off-balance-sheet instrument revaluation differences	—		(—)
11.5 Accruals and prepaid expenses	775		(649)
11.6 Sundry items	314		(316)
		6,174	5,985
		343,919	293,272

Liabilities

				31.12.2004
			€ million	€ million
1	Banknotes in circulation		153,739	136,342
2	Liabilities to euro-area credit institutions related to monetary policy operations denominated in euro			
2.1	Current accounts	46,301		(41,218)
2.2	Deposit facility	12		(96)
2.3	Fixed-term deposits	—		(—)
2.4	Fine-tuning reverse operations	—		(—)
			46,314	41,314
3	Other liabilities to euro-area credit institutions denominated in euro		—	—
4	Liabilities to other euro-area residents denominated in euro			
4.1	General government deposits	28		(36)
4.2	Other liabilities	374		(355)
			402	392
5	Liabilities to non-euro-area residents denominated in euro		3,438	5,903
6	Liabilities to euro-area residents denominated in foreign currency		4	4
7	Liabilities to non-euro-area residents denominated in foreign currency		2,834	2,021
8	Counterpart of special drawing rights allocated by the IMF		1,465	1,380
9	Intra-Eurosystem liabilities			
9.1	Liabilities to the ECB arising from promissory notes	—		(—)
9.2	Liabilities related to the allocation of euro banknotes within the Eurosystem (net)	75,134		(63,392)
9.3	Other liabilities within the Eurosystem (net)	—		(—)
			75,134	63,392
10	Items in course of settlement		6	3
11	Other liabilities			
11.1	Off-balance-sheet instruments revaluation differences	—		(—)
11.2	Accruals and income collected in advance	414		(303)
11.3	Sundry items	2,678		(2,834)
			3,092	3,137
12	Provisions		5,359	5,907
13	Revaluation accounts		44,274	27,801
14	Capital and reserves			
14.1	Capital	2,500		(2,500)
14.2	Statutory reserves	2,500		(2,500)
			5,000	5,000
15	Profit for the year		2,860	676
			343,919	293,272

II Profit and loss account of the Deutsche Bundesbank for the year 2005

			2004
		€ million	€ million
– Interest income	6,001		(4,903)
– Interest expense	– 2,168		(– 1,742)
1 Net interest income		3,833	3,161
– Realised gains/losses arising from financial operations	335		(191)
– Write-downs on financial assets and positions	– 230		(– 2,389)
– Transfers to/from provisions for general risks, foreign exchange risks and price risks	188		(224)
2 Net result of financial operations, write-downs and risk provisions		293	–1,974
– Income from fees and commissions	50		(59)
– Expense relating to fees and commissions	– 12		(– 11)
3 Net income from fees and commissions		38	48
4 Income from participating interests		21	35
5 Net result arising from allocation of monetary income		–51	– 461
6 Other income		187	1,314
7 **Total net income**		4,321	2,122
8 Staff costs		970	935
9 Other administrative expenses		223	224
10 Depreciation on tangible and intangible fixed assets		154	178
11 Banknote printing		93	53
12 Other expenses		21	56
13 **Profit for the year**		2,860	676

Frankfurt am Main, 21 February 2006

DEUTSCHE BUNDESBANK

Executive Board

Professor Axel A Weber

Professor Jürgen Stark

Dr	Professor	Dr	Dr	Professor	Professor
Hans Georg	Hans-Helmut	Edgar	Hans	Hermann	Franz-Christoph
Fabritius	Kotz	Meister	Reckers	Remsperger	Zeitler

III Unqualified auditor's report for statutory audits of annual financial statements

Auditors' report

We have audited the annual financial statements – consisting of the balance sheet and the profit and loss account – together with the bookkeeping system of the Deutsche Bundesbank for the business year from 1 January 2005 to 31 December 2005. The maintenance of the books and records and the preparation of the annual financial statements in accordance with generally accepted accounting principles and the principles for the accounting of the Deutsche Bundesbank approved by the Executive Board pursuant to section 26 (2) of the Bundesbank Act are the responsibility of the Executive Board of the Deutsche Bundesbank. Our responsibility is to express an opinion on the annual financial statements, together with the bookkeeping system, based on our audit.

We conducted our audit of the annual financial statements in accordance with section 317 HGB ["Handelsgesetzbuch": "German Commercial Code"] and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer *[Institute of Public Auditors in Germany]* (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the annual financial statements in accordance with [German] principles of proper accounting are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Deutsche Bundesbank and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the books and records as well as the annual financial statements are examined primarily on a test basis within the framework of the audit. The audit includes assessing the accounting principles used and significant estimates made by the management, as well as evaluating the overall presentation of the annual financial statements. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the annual financial statements comply with the legal requirements and the additional provisions of the principles for the accounting of the Deutsche Bundesbank and give a true and fair view of the net assets, financial position and results of operations of the Deutsche Bundesbank in accordance with [German] principles of proper accounting.

Frankfurt am Main, 14 March 2006

PricewaterhouseCoopers
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Borgel	ppa. Theobald
Wirtschaftsprüfer	Wirtschaftsprüfer

Overview of the principles for the accounting of the Deutsche Bundesbank

General accounting principles

Record of economic reality, thus reflecting the Bundesbank's assets and liabilities, financial position and profitability;
prudence;
account to be taken of post-balance-sheet events that affect the balance sheet;
materiality;
going-concern principle;
accruals principle (income and expenditure to be recognised in the accounting period in which they are earned or incurred);
consistency and comparability.

Cash/settlement approach

Recording of spot transactions in gold, foreign currency instruments and securities in the Bundesbank's accounts shall be based on the date of payment (settlement date).

Balance sheet valuation rules

Gold, foreign currency instruments, securities and financial instruments shall be valued at mid-market rates and prices on the balance sheet date.

No distinction shall be made between price and currency revaluation differences for gold, but a single gold revaluation difference shall be accounted for on the basis of the euro price per defined unit of weight of gold derived from the euro-US dollar exchange rate on the balance sheet date.

Revaluation shall take place on a currency-by-currency basis for foreign exchange (including off-balance-sheet transactions).

In the case of securities revaluation shall be on a code-by-code basis (same ISIN number/type).

Repurchase agreements

A repurchase agreement (repo) shall be recorded as a collateralised inward deposit on the liabilities side of the balance sheet while the item that has been given as collateral remains on the assets side of the balance sheet. A reverse repurchase agreement (reverse repo) shall be recorded as a collateralised outward loan on the assets side of the balance sheet for the amount of the loan.

In the case of security lending transactions the assets shall remain in the balance sheet of the transferor.

Income recognition

Realised gains and realised losses shall be taken into the profit and loss account. Unrealised gains shall not be recognised as income but shall be transferred direct to a revaluation account. Unrealised losses shall be taken into the profit and loss account if they exceed previous revaluation gains registered in the corresponding revaluation account. Unrealised losses recorded in the profit and loss account in previous years shall not be reversed in subsequent years in the event of new unrealised gains. There shall be no netting of unrealised losses in any one security, in any currency or in gold holdings against

unrealised gains in other securities, currencies or gold.

Premiums or discounts arising on purchased securities shall be treated as part of interest income and shall be amortised using either the straight line method or the implicit rate of return method. The implicit rate of return method shall be used in the case of zero-coupon bonds with a residual maturity of more than one year at the time of acquisition.

Accrual and deferral items covering foreign currency holdings must be converted at the mid-market rate at the end of the year and reversed at the same rate. Realised gains and losses can arise only in the case of transactions which result in a change in a foreign currency position.

The average method shall be used on a daily basis for calculating the acquisition cost in the case of assets that are subject to exchange rate and/or price movements. The average cost price or rate of the assets shall be reduced by unrealised losses taken into the profit and loss account at the end of the year.

Accounting rules for off-balance-sheet instruments

Foreign exchange forward transactions, the forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date shall be included in the foreign currency position.

Interest rate swaps, futures, forward rate agreements and other interest rate instruments shall be accounted for and revalued on an item-by-item basis.

Gains and losses arising from off-balance-sheet instruments shall be recognised and treated in a similar manner to on-balance-sheet instruments.

Tangible and intangible fixed assets

Tangible fixed assets shall be valued at cost less depreciation, which shall be calculated on a straight-line basis and applied over the expected economic life of the assets. A distinction shall be made as follows:

– Computers, related hardware and software, and motor vehicles: four years
– Equipment, furniture and plant in buildings: ten years
– Building and capitalised refurbishment expenditure: 25 years
– Depreciation shall not apply to land

Tangible fixed assets whose acquisition value after deduction of value added tax is less than €10,000 shall be fully amortised in the year in which they were acquired.

Provisions

The regulations set out in the Commercial Code continue to apply to the reporting of provisions in the balance sheet. Pursuant to section 26 (2) of the Bundesbank Act, the creation of liability items for general risks associated with domestic and foreign business remains unaffected.

Transitory rules

The assets and liabilities shown in the closing Deutsche Mark balance sheet of 31 December 1998 shall be revalued on 1 January 1999. Unrealised gains arising on or before 1 January 1999 are to be recorded separately from the unrealised gains which arise after 1 January 1999. The market rates/prices applied by the Bundesbank in the euro-denominated opening balance sheet of 1 January 1999 shall be deemed to be the average acquisition rates/prices as at 1 January 1999. The revaluation items for unrealised gains accruing on or before 1 January 1999 shall be dissolved only in connection with decreases in value and in the event of disposals after 1 January 1999.

IV General information on annual accounts

Legal basis

Sections 26 and 27 of the Bundesbank Act form the legal basis for the annual accounts and the distribution of profit. In accordance with the provisions on accounting laid down in the second sentence of section 26 (2), the Bundesbank may apply the accounting principles governing the annual accounts of the ECB.

Accounting principles of the Bundesbank

The Governing Council of the ECB adopted the principles it applies to its annual accounts in accordance with Article 26.2 of the ESCB Statute. The (former) Central Bank Council of the Deutsche Bundesbank decided to adopt those principles as the "accounting principles of the Deutsche Bundesbank"[1] (decision of 3 December 1998, amended by the decisions of 9 March 2000 and 28 December 2000 as well as by that of the Executive Board of 18 December 2002). An overview of the principles for the accounting of the Deutsche Bundesbank is given above.

Notes on balance sheet entry of euro banknotes and associated intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem

The ECB and the 12 national central banks of the euro-area countries, which together comprise the Eurosystem, have been issuing euro banknotes since 1 January 2002. The following allocation procedure was approved for recording the euro banknotes in circulation in the financial statements of the individual central banks in the Eurosystem.[2] The respective share of the total value of euro banknotes in circulation due to each central bank in the Eurosystem is calculated on the last business day of each month in accordance with the key for allocating euro banknotes. The ECB has been allocated an 8% share of the total value of the euro banknotes in circulation; 92% of the euro banknotes has been allocated to the 12 national central banks in proportion to their paid-up shares in the capital of the ECB. Since 1 May 2004 the Bundesbank has had a 29.6% share in the paid-up capital of the ECB and therefore a 27.2% share of the euro banknotes in circulation in accordance with the banknote allocation key. The value of the Bundesbank's share in the total amount of euro banknotes issued by the Eurosystem is shown in item 1 "Banknotes in circulation" on the liabilities side of the balance sheet.

The difference between the value of the euro banknotes allocated to each national central bank in accordance with the banknote allocation key and the

1 Published as a revised edition in Bundesbank Notice No 10001/2003 of 14 January 2003.
2 Decision of the European Central Bank of 6 December 2001 on the issue of euro banknotes (ECB/2001/15).

value of the euro banknotes that this national central bank actually puts into circulation also gives rise to remunerated intra-Eurosystem balances.[1] If the value of the euro banknotes actually issued is greater than the value according to the allocation key, the difference is recorded in the balance sheet in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)". If the value of the euro banknotes actually issued is less than the value according to the allocation key, the difference is recorded in asset sub-item 9.3 "Claims related to the allocation of euro banknotes within the Eurosystem (net)". These balances are remunerated at the current main refinancing operations rate.

From 2002 until 2007 the intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are being adjusted in order to avoid significant changes in NCBs' relevant income positions from those in previous years. The adjustments are effected by taking into account the differences between the average value of the banknotes which each national central bank had in circulation in the period between July 1999 and June 2001 and the average value of the banknotes which would have been allocated to them during that period in accordance with the ECB's capital key. The adjustments will be reduced in annual stages until the end of 2007, after which income on banknotes will be allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital. The interest income and interest expense arising from the remuneration of the intra-Eurosystem balances are cleared through the accounts of the ECB and are shown in the profit and loss account of the Bundesbank in item 1 "Net interest income".

Furthermore, the ECB's seigniorage income from the transfer of 8% of the euro banknotes in circulation to the ECB is allocated to the national central banks in the form of an interim quarterly distribution of profit in the same financial year as the income arose at the ECB. It is distributed in full in proportion to the paid-up shares of the national central banks of the Eurosystem in the ECB capital unless the ECB's net profit for the year is less than the income earned on euro banknotes in circulation or, as a result of a decision by the Governing Council of the ECB, the amount is retained for allocation to a risk provision.[2] For the finan-

1 Decision of the European Central Bank of 6 December 2001 on the allocation of monetary income of the national central banks of participating member states from the financial year 2002 (ECB/2001/16).
2 Decision of the European Central Bank of 17 November 2005 on the distribution of the income of the European Central Bank on euro banknotes in circulation to the national central banks of the participating member states (ECB/2005/11).

cial year 2005 all of the ECB's income from the banknotes allocated to it will be required to fund a risk provision. The interim profit distributed for 2005 has therefore been transferred back to the ECB.

Preparation and auditing of financial statements

The Executive Board drew up the Bundesbank's financial statements for the financial year 2005 on 21 February 2006. The financial statements were audited by PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft (which until 30 June 2005 had been trading as PwC Deutsche Revision Aktiengesellschaft Wirtschaftsprüfungsgesellschaft), Frankfurt am Main. The Executive Board had appointed the firm as external auditors on 18 January 2005 in accordance with section 26 (3) of the Bundesbank Act. The auditors confirmed without qualification on 14 March 2006 that the Bundesbank's financial statements for 2005 – consisting of the balance sheet and the profit and loss account – comply with the statutory provisions and the additional provisions of the principles for the accounting of the Deutsche Bundesbank and give a true and fair view of the net assets, financial position and results of operations of the Deutsche Bundesbank. After studying the external auditors' report, the Executive Board decided to publish the financial statements and transfer the Bundesbank's profit to the Federal Government on 21 March 2006.

V Notes on the individual balance sheet items

1 Assets

Gold and gold receivables

At the end of 2005 the Bundesbank's holdings of fine gold (ozf) amounted to 3,427,816 kg or 110 million ounces. The gold was valued at market prices (1 kg = €13,980.95 or 1 ozf = €434.856). In the year under review the gold holdings declined by 5,443 kg or 0.2 million ounces. This was due to the sale of gold to the Federal Government at market prices for the purpose of minting gold coins.

Claims on non-euro-area residents denominated in foreign currency

The claims on the International Monetary Fund (IMF) as well as balances with banks, portfolio investment, loans and other foreign currency claims on non-euro-area residents are shown in this item.

Receivables from the IMF

This sub-item contains the claims on the IMF which are financed and held by the Bundesbank and which arise from the Federal Republic of Germany's member-

Receivables from the IMF

Table 16

Item	31.12.2005		31.12.2004		Change from previous year			
	SDR million	€ million	SDR million	€ million	SDR million	%	€ million	%
Drawing rights within the reserve tranche (net)	2,437	2,948	4,419	5,036	– 1,983	– 44.9	– 2,088	– 41.5
Special drawing rights	1,324	1,601	1,327	1,512	– 3	– 0.2	+ 89	+ 5.9
Total	3,760	4,549	5,746	6,548	– 1,986	– 34.6	– 1,999	– 30.5

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ship of the IMF. The claims, which total €4,549 million (SDR 3,760 million), consist of drawing rights within the reserve tranche and special drawing rights.

The drawing rights within the reserve tranche correspond to the amounts actually paid to the IMF in gold, special drawing rights (SDRs), foreign exchange and national currency under the German quota. The drawing rights held represent the difference between the unchanged German quota of SDR 13,008 million (€15,783 million) and the euro balances amounting to €12,790 million (SDR 10,572 million) at the disposal of the IMF at the end of the year. In 2005 there was a net decline in the holdings of special drawing rights amounting to SDR 1,983 million (€2,088 million).

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. A corresponding counterpart is shown as liability item 8, "Counterpart of special drawing rights allocated by the IMF". The level of special drawing rights held at the end of 2005 amounted to €1,601 million (SDR 1,324 million) compared with €1,512 million (SDR 1,327 million) on 31 December 2004.

No loans were granted to the IMF as a result of special credit arrangements under both the General Arrangements to Borrow and the New Arrangements to Borrow in 2005.

The drawing rights in the reserve tranche, special drawing rights and the counterpart of special drawing rights allocated are shown in the balance sheet on the basis of the market rate of SDR 1 = €1.2099 (2004: SDR 1 = €1.1396) calculated by the ECB at the end of the year for all central banks participating in the Eurosystem.

Balances with banks, portfolio investment, external loans and other external assets Table 17

Item	31.12.2005	31.12.2004	Change from previous year	
	€ million	€ million	€ million	%
Current account holdings and overnight deposits	837	572	264	46.2
Claims arising from reverse repurchase agreements (reverse repos, held in US dollars)	4,105	3,613	491	13.6
Fixed-term deposits and deposits at notice (held in US dollars)	4,942	5,603	– 661	– 11.8
Marketable securities	23,695	19,383	4,312	22.2
of which: amount held in US dollars	23,394	19,178	4,215	22.0
Other	130	121	9	7.4
Total	33,708	29,292	4,416	15.1

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Balances with banks, portfolio investment, external loans and other external assets

The balances with banks, portfolio investment, loans and other foreign currency claims which are shown in this sub-item amounted to €33,708 million at the end of 2005 compared with €29,292 million on 31 December 2004. These are almost exclusively US dollar holdings amounting to US$39,068 million (= €33,117 million), representing a decline of US$32 million from the previous year. This sub-item also contains holdings in yen (¥81,192 million = €585 million) and a very small amount in other currencies. The holdings are interest-bearing. If all US dollar items on the assets side and the liabilities side of the balance sheet are taken into account, the net US dollar item valued at market prices amounted to US$35,753 million, which is US$597 million down on the year. The foreign currency items were valued at the end-of-year market rate; in the case of the US dollar item this amounted to €1 = US$1.1797 (compared with €1 = US$1.3621 at the end of the previous year).

Claims on non-euro-area residents denominated in euro

A long-term interest-free loan amounting to €300 million which the Bundesbank made available to the IMF in agreement with the Federal Government in 2000 is shown in this item. The loan is in connection with the financing of debt relief which the IMF grants to the heavily indebted poor developing countries (Heavily Indebted Poor Countries Initiative or HIPC initiative). The interest income from the investment of this money is at the disposal of a trust fund which is administered by the IMF and from which the debt relief granted by the IMF is financed. The loan has a maturity of ten years.

Lending to euro-area credit institutions related to monetary policy operations denominated in euro

This item reflects the volume and pattern of the Bundesbank's refinancing of the credit institutions. At the end of the year under review the amount of funds loaned for refinancing purposes was €13,495 million higher than on 31 December 2004.

The main refinancing operations undertaken as part of money market management account for the bulk of the monetary policy operations. These operations are regular weekly transactions with a normal one-week maturity, the purpose of which is to provide liquidity. In the year under review the main refinancing operations were conducted as interest rate tenders with a minimum bidding rate. At the end of the year the main refinancing operations amounted to €146,529 million, which was €3,525 million more than the level on 31 December 2004. On a daily average the main refinancing operations amounted to €144,559 million (2004: €123,929 million).

The longer-term, and in terms of value smaller, refinancing operations held at monthly intervals and with a maturity of three months are used to provide additional longer-term liquidity. In the year under review they were held as variable rate tenders. The volume of longer-term refinancing operations amounted to €56,448 million at the end of 2005 and was therefore €9,130 million above that of the previous year. On a daily average the volume of longer-term refinancing operations amounted to €53,000 million (2004: €46,870 million).

The marginal lending facility (overnight liquidity) is permanently available at a predetermined interest rate (standing facility). The extent to which recourse to the marginal lending facility was being taken on 31 December 2005 had risen by €840 million since the previous year to €949 million. The extent to which it was being used on a daily average amounted to €81 million (2004: €130 million).

Other claims on euro-area credit institutions denominated in euro

This item, amounting to €116 million (2004: €3 million), contains claims on credit institutions which have no connection with monetary policy operations. These are almost exclusively fixed-term deposits which are held at German credit institutions and which arise from funds received in connection with central bank services (see liability item 5 "Liabilities to non-euro-area residents denominated in euro"). This item also contains balances which are held at commercial banks in other euro-area countries and which are used for settling payments.

Claims on the Federal Government

This item shows the equalisation claims on the Federal Government and the non-interest-bearing debt register claims in respect of Berlin; both date back to the currency reform of 1948. They form the balance sheet counterpart of the amounts paid out at that time in cash per capita and per enterprise and of the initial provision of credit institutions and public corporations with central bank money. Equalisation claims yield interest at the rate of 1% per annum. In connection with Article 101 of the EC Treaty it has been stipulated that equalisation claims and the debt register claims are to be redeemed in ten annual instalments, starting in the year 2024.

Intra-Eurosystem claims

The Bundesbank's claims on the ECB and on the other central banks participating in the Eurosystem are combined in this item.

Sub-item 9.1 shows the Bundesbank's participating interest in the ECB. Pursuant to Article 28 of the ESCB Statute, the ESCB national central banks are the sole subscribers to the capital of the ECB. The capital key was last adjusted on 1 May 2004 in connection with the accession of ten new countries to the EU. Since then the Bundesbank has had a 21.1% share of the ECB's capital. This share amounts to €1,176 million excluding the Bundesbank's share of the ECB's net assets on 1 May 2004, which – as at that time – amount to €7 million.

Sub-item 9.2 contains the Bundesbank's euro-denominated claims arising from the transfer of foreign reserves to the ECB. In accordance with Article 30 of the ESCB Statute, the central banks participating in the Eurosystem transferred foreign reserves (15% in gold and 85% in foreign exchange) to the ECB at the beginning of 1999. The adjustment to the key for subscribing to the ECB's capital on 1 May 2004 also resulted in an adjustment to the Bundesbank's claims arising from the transfer of foreign reserves to the ECB. Since then these claims have amounted to €11,762 million. As the transferred gold does not earn interest, the claims are remunerated at 85% of the present main refinancing operations rate.

Sub-item 9.3 "Claims related to the allocation of euro banknotes within the Eurosystem (net)" shows the claims which arise from applying the euro banknote allocation key. As at the end of 2004, the Bundesbank again had no claims at the end of last year but, instead, liabilities, which are shown in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)".

A daily netting-by-novation procedure produces either a net assets balance or a net liabilities balance vis-à-vis the ECB from the TARGET settlement balances between the central banks of the ESCB. Sub-item 9.4 "Other claims within the Eurosystem (net)" contains a net assets balance together with the very small settlement balances arising from the traditional correspondent banking operations within the Eurosystem. The balances are remunerated at the current main refinancing rate. At the end of the year the Bundesbank obtained from its assets and liabilities net claims amounting to €30,073 million (2004: €8,010 million). This item also contains the liabilities arising from the allocation of monetary income to the national central banks amounting to €51 million (see profit and loss item 5 "Net result arising from allocation of monetary income") and the liabilities to the ECB arising from the retransfer of the interim distribution of profit for the first three quarters of the year amounting to €188 million (see *General information on annual accounts*) as they were not settled with the ECB as TARGET payments until January 2006.

Items in course of settlement

This item contains the asset items arising from payments still being processed within the Bundesbank.

Other assets

The Bundesbank's holdings of euro coins are shown in sub-item 11.1 "Coins". New coins are received from the federal mints at their nominal value for the account of the Federal Government, which holds the coin prerogative.

Sub-item 11.2 "Tangible and intangible fixed assets" amounted to €1,722 million compared with €1,837 million in 2004; it comprises land and buildings, furniture and equipment and computer software.

Sub-item 11.3 "Other financial assets" amounting to €2,809 million contains the Bundesbank's fixed-interest euro assets (€2,719 million) as a counterpart to the pension and health care assistance commitments as well as its participating interests (€90 million). The participating interests are in the Bank for International Settlements (BIS), Basel, the Liquiditäts-Konsortialbank GmbH, Frankfurt am Main, and the cooperative society SWIFT, La Hulpe (Belgium).

In 2005 the participating interest in the BIS increased by €38 million to €50 million as a result of the purchase of 2,423 shares. Consequently, the Bundesbank now holds 50,100 shares.

Tangible and intangible fixed assets — Table 18

€ million

Item	Purchase/ production costs 31.12.2004	Additions	Disposals	Accumulated depreciations	Book value 31.12.2005	Book value 31.12.2004	Depreciation in 2005
Land and buildings	3,134	30	– 134	– 1,485	1,546	1,657	– 95
Furniture and equipment	825	66	– 104	– 619	168	169	– 51
Computer software	99	5	– 2	– 95	8	11	– 8
Total	4,058	102	– 240	– 2,199	1,722	1,837	– 154

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As in the previous year, the balance sheet value of the participating interest in the Liquiditäts-Konsortialbank GmbH amounted to €38 million. The 30% interest continues to entail a maximum additional commitment of €300 million for the Bundesbank.

The participating interest in the cooperative society SWIFT increased in the year under review and amounted to just over €2 million at the end of 2005.

Sub-item 11.5 "Accruals and prepaid expenses" contains the accrued and prepaid expenditure identified at 31 December 2005. These chiefly consist of interest income which is due in the new financial year from securities denominated in US dollars, from the transfer of foreign reserves to the ECB and from monetary policy operations acquired or undertaken in the financial year just ended.

2 Liabilities

Banknotes in circulation

The total value of euro banknotes issued by the central banks in the Eurosystem is distributed among these banks on the last business day of each month in accordance with the key for allocating euro banknotes (see *General information on annual accounts*). In accordance with the banknote allocation key applying since 1 May 2004, the Bundesbank had a 27.2% share of the value of all euro banknotes in circulation. During the year under review the total value of banknotes in circulation within the Eurosystem rose from €501,257 million to €565,216 million. In accordance with the allocation key, the Bundesbank shows holdings of euro banknotes worth €153,739 million at the end of the year compared with €136,342 million at the end of 2004. The value of the euro bank-

notes actually issued by the Bundesbank in the year under review increased from €199,734 million to €228,873 million. As this was more than the allocated amount, the difference of €75,134 million (2004: €63,392 million) is shown in liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)".

Liabilities to euro-area credit institutions related to monetary policy operations denominated in euro

Sub-item 2.1 "Current accounts" contains the deposits of the credit institutions, amounting to €46,301 million (31 December 2004: €41,218 million), which are used to meet the minimum reserve requirement and settle payments. The main criterion for including these deposits in this sub-item is that the respective business partners appear in the list of institutions which are subject to the minimum reserve regulations in the Eurosystem. On a daily average the current account deposits amounted to €38,524 million (2004: €37,887 million).

Sub-item 2.2 "Deposit facility" amounting to €12 million (31 December 2004: €96 million) contains overnight deposits at a predetermined interest rate (standing facility). On a daily average the deposit facility amounted to €53 million (2004: €119 million).

Liabilities to other euro-area residents denominated in euro

Sub-item 4.1 "General government deposits" encompasses the balances of the Federal Government, its special funds, the state governments and other public depositors. The deposits of other public depositors constitute balances held by social security funds and local authorities. On 31 December 2005 general government deposits amounted to €28 million in all (31 December 2004: €36 million).

Sub-item 4.2 "Other liabilities" amounted to €374 million compared with €355 million on 31 December 2004. The deposits of enterprises and individuals are the main items shown here.

Liabilities to non-euro-area residents denominated in euro

This balance sheet item, amounting to €3,438 million (31 December 2004: €5,903 million) contains primarily the fixed-term deposits of central banks and the working balances held for settling the payments of monetary authorities, commercial banks and international organisations. These deposits are accepted mainly as part of the Bundesbank's central bank services; some of the proceeds were invested in the money market (see asset item 6 "Other claims on euro-area credit institutions denominated in euro").

Liabilities to euro-area residents denominated in foreign currency

This item contains the US dollar deposits of banks and of branches that are domiciled in the euro area and owned by banks domiciled outside the euro area and those of central government.

Liabilities to non-euro-area residents denominated in foreign currency

The foreign-currency-denominated liabilities towards banks outside the euro area are recorded in this item. These are almost exclusively liabilities in US dollars, amounting to US$3,341 million (€2,832 million) compared with US$2,710 million (€1,990 million) in 2004, which have arisen from securities repurchase agreements (repos).

Counterpart of special drawing rights allocated by the IMF

The counterpart of the special drawing rights allocated by the IMF free of charge and shown as sub-item 2.1 "Receivables from the IMF" on the assets side of the balance sheet corresponds to the allocations of SDRs to the Federal Republic of Germany from 1970 to 1972 and from 1979 to 1981, which totalled SDR 1,211 million.

Intra-Eurosystem liabilities

The Bundesbank's liabilities to the ECB and to the other central banks participating in the Eurosystem are combined in this item.

The "Liabilities to the ECB arising from promissory notes" shown as sub-item 9.1 arise in connection with the issue of ECB debt certificates. The ECB did not issue such paper during the year under review.

Sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)" contains the liabilities arising from the application of the banknote allocation key (see liability item 1 "Banknotes in circulation"). At the end of the year these liabilities amounted to €75,134 million (2004: €63,392 million).

The net liabilities balance arising from other assets and liabilities within the Eurosystem would be shown in sub-item 9.3 "Other liabilities within the Eurosystem (net)". At the end of the year the Bundesbank incurred a net claim, and this is shown on the asset side under sub-item 9.4 "Other claims within the Eurosystem (net)" and explained in the explanatory notes above.

Items in course of settlement

This item contains the liabilities items arising from the settlement transactions circulating within the Bundesbank.

Other liabilities

Sub-item 11.2 "Accruals and income collected in advance" contains the accrued income identified at 31 December 2005. These consist essentially of interest expenditure which is due in the new financial year but was incurred in the financial year just ended and which arose in connection with the allocation of banknotes within the Eurosystem and from deposits which are used to fulfil the minimum reserve requirement.

Sub-item 11.3 "Sundry items" essentially consists of the liabilities arising from the Deutsche Mark banknotes still in circulation. Although Deutsche Mark banknotes are no longer legal tender, the Bundesbank has publicly undertaken to redeem Deutsche Mark banknotes that are still in circulation for an indefinite period. The Deutsche Mark banknotes still in circulation belong to the series BBk I/Ia and BBk III and at the end of 2005 amounted to a total of €3,833 million. The banknote series BBk I/Ia accounted for €1,341 million of this sum (2004: €1,364 million) and the banknote series BBk III for €2,492 million (2004: €2,663 million). In 2004 part of the liabilities arising from Deutsche Mark BBk I/Ia series banknotes still in circulation and amounting to €1,237 million of the total amount involved were taken off the books and transferred to profit and loss item 6 "Other income" as it is highly unlikely that this amount of the banknote stock will now be exchanged for euro. As a result of this partial write-off, the liabilities arising from Deutsche Mark banknotes still in circulation on 31 December 2005 amounted to €2,596 million.

Provisions

The provisions for general risks, pursuant to the regulations governing the Bundesbank's annual accounts contained in section 26 (2) of the Bundesbank Act, are created in view of the foreign currency risks, especially in the case of the Bundesbank's US dollar and SDR positions. The €188 million decline in the provisions is due mainly to the year-on-year reduction in the SDR position (see asset sub-item 2.1 "Receivables from the IMF").

The provisions for direct pensions were increased by €6 million and now amount to €1,874 million. As a result of the Bundesbank's obligation to act as guarantor for pension payments out of the supplementary pension funds for public sector employees, indirect pension liabilities amounted to €327 million on 31 December 2005 (2004: €406 million). The provision for health care assistance for pensioners was reduced by €27 million to €342 million. After a reduction of €10 million a provision of €96 million for pre-retirement part-time work was shown in the balance sheet as of 31 December 2005. The provision for future payment commitments arising from staff restructuring schemes that had already been

Provisions Table 19

Provision for	31.12.2005 € million	31.12.2004 € million	Change from previous year € million	%
General risk	2,078	2,266	– 188	– 8.3
Direct pension commitments	1,874	1,868	6	0.3
Indirect pension commitments (supplementary pension funds)	327	406	– 78	– 19.3
Health care subsidy commitments to civil servants	342	369	– 27	– 7.2
Pre-retirement part-time work	96	106	– 10	– 9.8
Staff restructuring schemes	352	187	165	88.5
Share of ECB loss	–	402	– 402	– 100.0
Other	289	303	– 14	– 4.5
Total	5,359	5,907	– 548	– 9.3

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carried out by the balance sheet day was increased as of 31 December 2005 by €165 million to €352 million. The main reason for this increase was the change in the fiscal treatment of severance payments, which resulted in an increase in the contracts concluded under the early retirement scheme for those to whom the wage agreement applies. The calculations of the provisions for pensions and health care assistance as well as for pre-retirement part-time work are based on an actuarial expert opinion. The reduction in the necessary provisions for supplementary pension rights, health care assistance and pre-retirement part-time work totalling €115 million is included in the profit and loss item 6 "Other income". The provisions for indirect pension liabilities and for commitments arising from staff restructuring schemes resulted in an increase in "Staff costs".

The provision of €402 million that was made on 31 December 2004 to cover the Bundesbank's share of the ECB's loss for the financial year 2004 (see profit and loss item 5 "Net result arising from allocation of monetary income") was spent.

The other provisions were created primarily for the threat of losses on the sale of property and for unrealised holidays, overtime worked and balance of flexible working hours as well as for doubtful liabilities.

Revaluation accounts

This item contains the disclosed hidden reserves from the initial valuation at the time of the changeover to market valuation on 1 January 1999 (revaluation items "old") and the resultant unrealised profits arising from market valuation on 31 December 2005 (revaluation items "new").

Revaluation accounts

Table 20

Item	Revaluation items "old"	Revaluation items "new"	Total 31.12.2005	Total 31.12.2004	Change from previous year	
	€ million	€ million	€ million	€ million	€ million	%
Gold	19,048	20,773	39,821	27,379	12,442	45.4
US dollars	–	3,961	3,961	–	3,961	–
SDRs	–	168	168	–	168	–
Yen	–	3	3	–	3	–
Securities	–	321	321	422	– 101	– 24.0
Total	19,048	25,225	44,274	27,801	16,473	59.3

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Revaluation items "old"

A revaluation item "old" now remains only for the gold position. It represents the difference between the market value of the gold on 1 January 1999 and the lower value of the gold prior to that date. In the balance sheet on 31 December 1998 the value for gold was 1 ozf = DM143.8065 (€73.5271) while the market value on 1 January 1999 was 1 ozf = €246.368. Although the valuation gains arising from the initial valuation of the gold holdings are not eligible for distribution, they will be dissolved under certain circumstances. Besides a dissolution in the case of valuation losses on the gold item, a proportionate dissolution also takes place in the event of net reductions if the end-of-year gold holdings are below their lowest end-of-year level since 1999.

The reduction of 0.2 million ozf (see asset item 1 "Gold and gold receivables") in the gold holdings resulted in a dissolution amount of €30 million in the year under review. The dissolution amount is shown in the profit and loss item 2/sub-item "Realised gains/losses arising from financial operations".

Revaluation items "new"

In the case of gold holdings, the net positions in each foreign currency and the securities portfolio the positive difference between their market value on 31 December 2005 and their value in terms of the average acquisition costs carried forward from 1 January 1999 is shown in the revaluation items "new".

In the case of gold the acquisition costs have remained unchanged at 1 ozf = €246.368 since 1 January 1999. At the end of 2005 the market price for a fine ounce of gold was €434.856, with the result that the market value of the gold position exceeded its acquisition value and a revaluation item amounting to €20,773 million arose (2004: €8,300 million). In contrast to the situation in 2004, the market values at the end of 2005 in the case of the US dollar position,

the SDR position and the yen position were above the respective acquisition values, with the result that there were revaluation gains amounting to a total of €4,132 million. There were only slight valuation gains in the case of the other foreign currencies.

In the case of the valuation of securities valuation gains of €237 million arose from the valuation of US-dollar-denominated assets, €83 million from the euro portfolio and marginal gains from yen-denominated paper.

Capital and reserves

In accordance with section 2 of the Bundesbank Act, the liable capital amounts to €2.5 billion. The statutory reserves amount to the fixed upper limit which is laid down in section 27 (1) of the Bundesbank Act and which is likewise €2.5 billion.

Profit for the year

The profit and loss account for the year 2005 closed with an annual surplus of €2,860 million. Pursuant to section 27 of the Bundesbank Act, it will be transferred in full to the Federal Government as the statutory reserves are at their maximum level of €2.5 billion.

VI Notes on the profit and loss account

Net interest income

This item shows interest income less interest expenditure. Net interest income was greater than in the previous year, rising by €672 million to €3,833 million. Of this total amount, €1,144 million was in foreign currency (primarily foreign reserves) while the euro holdings amounted to €2,689 million (primarily from the use of monetary policy instruments).

Interest income

Interest income in foreign currency increased year on year by €308 million to €1,223 million. This was due primarily to the higher annual average rate of interest on US dollar assets. The interest income from gold is derived from gold leasing transactions, which are remunerated in US dollars.

Interest income in euro increased year on year by €790 million to €4,778 million. Income from the refinancing of credit institutions rose by €651 million to €4,188 million. This was due primarily to the increases in the average volumes of the main refinancing operations and the longer-term refinancing operations as well as to the slightly higher interest rate level on an annual average (see

Interest income

Table 21

Item	2005	2004	Change from previous year	
	€ million	€ million	€ million	%
Interest income in foreign currency				
Gold	6	6	– 1	– 8.7
IMF	92	93	– 1	– 0.9
Current account holdings and overnight deposits	4	1	2	150.2
Reverse repo transactions	155	67	89	132.4
Fixed-term deposits and deposits at notice	147	64	83	131.0
Marketable securities	815	682	133	19.5
Other	4	2	2	95.0
Total	1,223	915	308	33.7
Interest income in euro				
Main refinancing operations	3,049	2,553	496	19.4
Longer-term refinancing operations	1,136	980	156	15.9
Other refinancing operations	3	4	– 1	– 27.7
TARGET balances in the ESCB	225	94	132	140.5
Claims arising from the transfer of foreign reserves to the ECB	210	205	5	2.7
Financial assets	100	98	3	2.7
Other	54	55	– 0	– 0.8
Total	4,778	3,988	790	19.8
Grand total	6,001	4,903	1,098	22.4

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asset item 5 "Lending to euro-area credit institutions related to monetary policy operations denominated in euro").

Interest expenses

Interest expenditure increased by €426 million to €2,168 million year on year. This was the result of the fact that expenditure on remunerating intra-Eurosystem balances arising from the allocation of euro banknotes increased by €446 million owing to the rise in the euro banknotes in circulation (see *General information on annual accounts* and liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)"). Owing to the increase in both the average minimum reserve volume and the average interest rate, expenditure on remunerating the minimum reserve balances rose by €32 million year on year.

Net result of financial operations, write-downs and risk provisions

The net income shown in sub-item "Realised gains/losses arising from financial operations" amounted to €335 million compared with €191 million in 2004. In the case of foreign currency there were realised gains which arose almost exclusively from the disposal of US dollars (€136 million) and SDRs (€118 million). The realised gains from gold also include the partial dissolution (€30 million) of the

Interest expenditure

Table 22

Item	2005	2004	Change from previous year	
	€ million	€ million	€ million	%
Interest expenditure in foreign currency				
Repo transactions	79	26	53	204.1
Other	0	0	0	.
Total	79	26	53	203.8
Interest expenditure in euro				
Minimum reserves	803	771	32	4.2
Time deposits/deposit facility	2	2	– 0	– 1.1
Fixed-term deposits	61	107	– 46	– 42.9
TARGET balances in the ESCB	14	73	– 60	– 81.1
Net liabilities related to the allocation of banknotes	1,208	762	446	58.6
Other	2	2	0	1.3
Total	2,089	1,716	373	21.7
Grand total	2,168	1,742	426	24.4

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revaluation item "old" created on 1 January 1999 (see liability item 13 "Revaluation accounts").

The valuation losses of €230 million recorded in the sub-item "Write-downs on financial assets and positions" occurred in the US-dollar-denominated securities (€226 million) and euro paper (€4 million).

The sub-item "Transfers to/from provisions for general risks, foreign exchange risks and price risks" contains the reduction of €188 million in the provision for general risks (see liability item 12 "Provisions").

Net income from fees and commissions

There was a year-on-year decline of €10 million to €38 million in net income from fees and commissions. The income from handling cash and cashless payments as well as from trading in securities and carrying out safe custody account business declined.

Income from participating interests

This item contains the Bundesbank's profit from its participating interests in the Liquiditäts-Konsortialbank GmbH, the BIS and the ECB. The fall in total income of €14 million to €21 million is due to the reduced income from the Bundesbank's participating interest in the ECB.

Net result of financial operations, write-downs and risk provisions

Table 23

Item	2005	2004	Change from previous year	
	€ million	€ million	€ million	%
Realised gains/losses				
Gold	47	50	– 4	– 7.2
Foreign currency	255	32	222	.
Securities	34	108	– 74	– 68.5
Total	335	191	145	76.0
Write-downs				
Foreign currency	0	– 2,310	2,310	– 100.0
Securities	– 230	– 78	– 152	194.5
Total	– 230	– 2,389	2,158	– 90.4
Transfers to/from provisions for general risks, foreign exchange risks and price risks	188	224	– 36	– 16.1
Grand total	293	– 1,974	2,267	– 114.9

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Net result arising from allocation of monetary income

The monetary income of the Eurosystem national central banks is allocated in accordance with a decision taken by the Governing Council of the ECB.[1] Since 2003 the amount of monetary income allocated to each national central bank is measured on the basis of the actual income which arises from the earmarked assets that each holds as a counterpart to its liability base.

The liability base contains the following items: liability item 1 "Banknotes in circulation"; liability item 2 "Liabilities to euro-area credit institutions related to monetary policy operations denominated in euro"; liability sub-item 9.1 "Liabilities to the ECB arising from promissory notes"; liability sub-item 9.2 "Liabilities related to the allocation of euro banknotes within the Eurosystem (net)"; and the net liabilities arising from TARGET accounts contained in liability sub-item 9.3 "Other liabilities within the Eurosystem (net)". All interest expenditure which a national central bank has had to pay on the items of the liability base mentioned reduces the amount of the monetary income to be transferred by the national central bank concerned.

A national central bank's earmarked assets consist of the following items: asset item 5 "Lending to euro-area credit institutions related to monetary policy operations denominated in euro", asset sub-item 9.2 "Claims arising from the trans-

1 Decision of the European Central Bank of 6 December 2001 on the allocation of monetary income of the national central banks of participating member states from the financial year 2002 (ECB/2001/16).

Net income from fees and commissions

Table 24

Item	2005	2004	Change from previous year	
	€ million	€ million	€ million	%
Income				
Cashless payments	30	33	– 3	– 8.9
Cash payments	5	9	– 4	– 48.3
Securities trading and safe custody account business	9	12	– 3	– 23.8
Other	7	5	1	26.5
Total	50	59	– 9	– 14.7
Expenditure				
Securities trading and safe custody account business	7	7	0	5.6
Other	5	4	0	11.4
Total	12	11	1	7.8
Grand total (net income)	38	48	– 10	– 20.1

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fer of foreign reserves to the ECB", asset sub-item 9.3 "Claims related to the allocation of euro banknotes within the Eurosystem (net)", the net assets arising from TARGET accounts contained in asset sub-item 9.4 "Other claims within the Eurosystem (net)" and a limited amount of the national central banks' gold holdings corresponding to their capital share. Gold is considered to generate no income.

If the value of a central bank's earmarked assets is above or below the value of its liability base, the difference is offset by applying to the value of the difference the average income from the earmarked assets of all the national central banks. At the end of each financial year the total monetary income transferred by all national central banks is distributed among the national central banks in proportion to their respective paid-up shares in the capital of the ECB.

In the year under review the allocation of monetary income resulted in a net liability of €51 million for the Bundesbank. This net liability represents the difference between the €2,949 million in monetary income paid by the Bundesbank into the common pool and the Bundesbank's claim of €2,898 million – corresponding to the Bundesbank's share of the ECB's paid-up capital – on the common pool. In 2004 the distribution of monetary income among the national central banks resulted in net expenditure of €58 million and an additional item of expenditure amounting to €402 million stemming from the creation of a provision to cover the Bundesbank's share of the ECB's loss in the financial year 2004 (see liability item 12 "Provisions").

Other income

The remaining income amounted to €187 million compared with €1,314 million in 2004 when this item included the countervalue of the partial write-off of Deutsche Mark banknotes belonging to series BBk I/Ia and amounting to €1,237 million (see liability item 11.3 "Sundry items"). In the financial year 2005 the release of provisions accounted for €121 million of this income while €115 million of the €121 million was attributable to provisions for staff (see liability item 12 "Provisions").

Staff costs

Total expenditure on staff increased by €35 million (3.7%) to €970 million in 2005. If the additions to and deductions from the provisions are excluded, expenditure declined year on year by €10 million (-1.2%) as a result of the reduction in staff numbers.

Pursuant to the *Code of Conduct for the members of the Executive Board of the Deutsche Bundesbank,* the remuneration received by each member of the Bundesbank's Executive Board is to be published. For the year 2005 the President of the Bundesbank received a pensionable salary of €280,183.00, a special non-pensionable remuneration of €76,693.78, a special payment of €14,004.15 in accordance with the *Bundessonderzahlungsgesetz* (federal special payment law) and a standard expenses allowance of €5,112.96, amounting to a total of €375,993.89. In 2005 the Vice-President received a pensionable salary of €224,166.40, a special non-pensionable remuneration of €61,355.03, a special payment of €11,203.32 in accordance with the *Bundessonderzahlungsgesetz* and a standard expenses allowance of €3,067.80, amounting to a total of €299,792.55. In 2005 each of the six other members of the Executive Board received €225,125.17; €168,149.92 of this was in the form of a pensionable salary, €46,016.27 as a special non-pensionable remuneration, €8,402.50 as a special payment in accordance with the *Bundessonderzahlungsgesetz* and 2,556.48 as a standard expenses allowance.

Total payments to serving and former members of the Executive Board, former members of the Bundesbank's Directorate, of the Central Bank Council, of the Board of Managers of the Bank deutscher Länder and of the Executive Boards of Land Central Banks, including their surviving dependants, amounted to €12,514,290.24 in 2005.

In the year under review total expenditure on retirement pensions declined to €138 million (2004: €183 million) because, in contrast to the position in 2004, no transfers to the provisions for indirect pension liabilities and health care as-

sistance commitments were necessary and only a slight increase had to be made to the provision for direct pension liabilities. If the transfer of funds to provisions is excluded, the year-on-year increase in expenditure amounted to €3 million.

The main staff-related provisions, other than the provisions for pensions and health care assistance commitments, are those for commitments under pre-retirement part-time working agreements and staff restructuring schemes (see liability item 12 "Provisions").

Other administrative expenses

The other (non-staff) operating expenditure fell slightly, namely by €1 million, year on year to €223 million.

Depreciation on tangible and intangible fixed assets

The depreciation of land and buildings, of furniture and equipment and of computer software amounted to €154 million compared with €178 million in 2004 (see asset sub-item 11.2 "Tangible and intangible fixed assets"). The main reason for the reduction was the lower level of depreciation of furniture and equipment.

Banknote printing

Expenditure on banknote printing increased by €40 million (74.6%) to €93 million because the Bundesbank procured a much greater number of banknotes than in 2004. This was due mainly to the rise in the number of banknotes in circulation and to the increased replacement of banknotes that were no longer fit for circulation.

Other expenses

Other expenses declined by €35 million to €21 million year on year because in the year under review no further provisions had to be made for anticipated losses on the sales of property.

Branches and operating units of the Deutsche Bundesbank

on 1 April 2006

Locality number	Bank location	Regional Office[1]
390	Aachen	D
720	Augsburg	M
	Kempten[2]	
	Memmingen[2]	
773	Bayreuth	M
100	Berlin	B
480	Bielefeld	D
430	Bochum	D
	Gelsenkirchen[2]	
380	Bonn	D
290	Bremen	H
270	Brunswick	H
870	Chemnitz	L
570	Coblenz	MZ
370	Cologne	D
180	Cottbus	B
440	Dortmund	D
850	Dresden	L
300	Düsseldorf	D
350	Duisburg	D
820	Erfurt	L
360	Essen	D
215	Flensburg	HH
500	Frankfurt/M	F
	Hanau[2]	
170	Frankfurt/O	B
680	Freiburg	S
	Lörrach[2]	
513	Giessen	F
260	Göttingen	H
450	Hagen	D
	Siegen[2]	
800	Halle	H
200	Hamburg	HH
410	Hamm	D
250	Hanover	H
620	Heilbronn	S
660	Karlsruhe	S
520	Kassel	F
210	Kiel	HH
	Itzehoe[2]	
860	Leipzig	L
545	Ludwigshafen	MZ
230	Lübeck	HH
810	Magdeburg	H
	Halberstadt[2]	
550	Mainz	MZ
670	Mannheim	S
840	Meiningen	L
490	Minden	D
310	Mönchengladbach	D
700	Munich	M
	Rosenheim[2]	
400	Münster	D
150	Neubrandenburg	HH
760	Nuremberg	M
280	Oldenburg	H
	Wilhelmshaven[2]	
265	Osnabrück	H
160	Potsdam	B
750	Regensburg	M
	Passau[2]	
640	Reutlingen	S
130	Rostock	HH
590	Saarbrücken	MZ
	Saarlouis[2]	
140	Schwerin	HH
600	Stuttgart	S
	Sindelfingen[2]	
585	Trier	MZ
630	Ulm	S
	Aalen[2]	
694	Villingen-Schwenningen	S
790	Würzburg	M
	Aschaffenburg[2]	
330	Wuppertal	D

1 Abbreviations
B = Berlin
D = Düsseldorf
F = Frankfurt am Main
H = Hanover
HH = Hamburg
L = Leipzig
M = Munich
MZ = Mainz
S = Stuttgart
2 Operating unit