BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
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TO: Federal Open Market Committee

FROM: Murray Altmann M.A.

Attached for your information is a memorandum prepared by Klaus Friedrich of the Board's Division of International Finance, dated September 12, 1979, and entitled "German Monerary Policy."

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Office Correspondence

Date September 12, 1979

To Edwin M. Truman

Subject: German Monetary Policy

From Klaus Friedrich

Introduction and Summary

After four years of easy money, falling interest rates and repeated overshooting of monetary targets, German monetary policy has undergone a clear change of course since the beginning of this year. Several factors contributed to this change. As late as November 1978 the Bundesbank had tolerated very large increases in the monetary aggregates in large part resulting from exchange market intervention, because confidence in the recovery of economic activity was not yet strong and the appreciating DM through its effects on import prices was holding the domestic inflation at very low rates. By early 1979 both of these factors had changed. Confidence in a broadly based upswing in activity was affirmed and import prices rose rapidly pushing up consumer prices at a more rapid rate. Under these altered conditions, the high level of bank reserves stemming from the previous year's exchange market interventions became a source of concern. The Bundesbank has responded with a series of tightening moves (see attached chronology) and is likely to remain in this posture over the next 12 months.

Discussion of Policy Measures

A reduction in January of rediscount quotas and an increase of reserve requirements reduced the banks' free liquid reserves (excess reserves plus unused rediscount quotas) drastically, removing much of the liquidity overhang present at the end of 1978. Coupled with an increase in the lombard rate, the money market became tighter and interest rates moved upwards. (See Table 1).

From March to May foreign exchange outflows led to losses in free liquid reserves equal to the gains during all of 1978. In addition, government transactions and increases in cash circulation drained liquidity. Together the liquidity loss to the banks was DM20 billion.

The Bundesbank now found itself in a position of having to supply liquidity to the banks. It did so in April by reversing the January DM5 billion rediscount quota reduction, and by dollar swaps of DM4.5 billion, (spot purchases of dollars matched by forward sales) and by early repurchase of money market paper of DM0.6 billion in May and especially by allowing high lombard indebtedness. Nevertheless, the banks' free liquid reserves in May fell to a historic low of DM3.8 billion. (See Table 1).

Bank lending, meanwhile, proceeded at a very brisk pace. During the six months to July, bank credits to the private sector grew at an annual rate of 14 percent seasonally adjusted. The comparable figure for July 1978 was 11 percent. It became evident that the banks -- without usable free reserves left -- were relying more and more heavily on lombard credit, which reached DM10.7 billion by the third week in August. The Bundesbank's decision on August 23 to put a tight limit on lombard credit was therefore aimed at a very sensitive area and caused considerable upheaval in the money market.

The new lombard limit was expected to reduce lombard credit by about DM4 billion. The fact that the Bundesbank concurrently offered repurchases at a rate one-half of one percentage points above the lombard rate suggests that the Bundesbank estimated that the banks would take about DM4 billion or less. When the banks, however, borrowed DM10-12 billion, the market temporarily became flooded with liquidity and the call money rate dropped to 3 percent on August 30. The Bundesbank hastened to conclude about DM3.6 billion of dollar swaps with the banks (dollar spot sales matched with forward purchases) to mop up at least part of the excess. As a consequence of this new restrictive measure the call money rate on August 31 rose to a peak of 8-1/2 percent. The three-month rate has risen by about one half of one percentage point since then. On September 9 and 10 another DM3 billion was taken out of the market by swap transactions.

The banks' access to lombard credit has been a sore point with Bundesbank officials in Frankfurt for some time. A number of measures, apart from increases in the lombard rate, were aimed at this problem. The April expansion of rediscount quotas, for example, was expected to relieve the pressure on lombard credit. The introduction in June of the new repurchase facility was again expected to effect a shift out of lombard credit into the new facility. While lombard credit, according to Bundesbank law, is given at the discretion of the Bundesbank, operational control has been with the Bundesbank district offices (Landeszentralbanken). Bundesbank officials in Frankfurt have recently referred to the lombard facility as a "self-service store" and the attempts to replace lombard credit with other forms of credit such as the repurchase facility can be viewed as efforts by the central office of the Bundesbank to gain control of its monetary policy instruments. The issue was presumably settled with the imposition of a strict limit on lombard credit on August 23.

Monetary Aggregates and Interest Rates

The Bundesbank's declared central bank money target (CBM -- cash in circulation plus required reserves at constant reserve rates) of 6-9 percent growth from 1978Q4 to 1979Q4 was still being exceeded in May. Since there has been no further growth from May through July, CBM has been brought inside the target range. Among the other aggregates M_1 has grown at an annual rate of 3 percent through July this year, compared to 14 percent growth during last year. M_3 growth this year has been 6.5 percent against 11 percent last year.

The three-month interbank interest rate rose by 3.8 percentage points between January and early September. While there were some discrete changes in anticipation of the discount and lombard rate increases, there was no clear break in the general upward trend. The call money rate, having remained below the lombard rate early in the year, remained close to the lombard rate through May-July. In August, reflecting the end of unlimited lombard credit, the call money rate began to rise above the lombard rate until in early September the difference was 1-1/2 percentage points. Long term rates, on the other hand, peaked in the first half of July slightly above 8 percent and subsequently fell about 30 basis points to early September. Apparently passing the 8 percent barrier triggered a flow of funds into the market which had been held back previously.

Prospects

The outcome of next fall's German election may well be determined by the performance of the economy in the coming months. The major opposition to the incumbent Social Democrat government comes from the right in the person of Franz Joseph Strauss, CDU/CSU candidate for Chancellor. Price stability may, therefore, be given even higher priority than usual by the government. These circumstances make serious disagreement between the government and the Bundesbank unlikely before the fall of next year. This gives the Bundesbank a relatively free hand to continue its restrictive monetary policy. For the remainder of this year, the Bundesbank has declared it is aiming at the lower limit of its target range.

The current aim of German economic policy is to allow the oil-induced inflation to pass through without being built into the system through wage and non-oil price increases. The unions so far have cooperated. When the current labor contracts were negotiated last year, the rate of inflation was below 3 percent and falling. In view of this year's inflation, the possibility of union demands for supplemental increases has become a hot topic. A recent statement by the leadership of the large and often pace-setting metal workers union, indicating that the union would abstain from supplemental demands this year, appears to have calmed the fears that the oil shock inflation would be built into the system. If this can be taken as a sign pointing toward restraint next year, the inflation outlook may improve considerably. Under these circumstances it is conceivable that the government could gain a degree of freedom in its fiscal policy and cut taxes next year. The otherwise anticipated drop in consumer spending could thereby be partly offset with the result of only a moderate decline in GNP growth to 3 or 3-1/2 percent instead of the sharp drop to 2 percent projected by several of Germany's economic research institutes. In this scenario of slowing inflation and only moderately reduced activity growth next year, it appears possible that the Bundesbank will be able to maintain its restrictive posture without further major increases in nominal interest rates. But it is unlikely that the Bundesbank will reverse its course and lower interest rates quickly even if activity growth turns out less favorably. In this case the government would turn to more extensive fiscal stimulation. Prospects for a shift of the policy mix toward more restrictive fiscal and less restrictive monetary policy appear remote. Fiscal policy is already mildly restrictive, with declining budget deficits anticipated for 1979 and 1980. Tax increases would be difficult to distribute between income brackets in view of wide dissatisfaction with the rate structure as it is now, and they would be politically damaging to the government.

Chronology of German Monetary Policy Since November 1978

Nov. 1, 1978	Reserve requirement rates raised by 9 percent in order to tie down some of the liquidity stemming from foreign exchange inflows.
Dec. 14, 1978	Announcement of 1979 monetary target: 6-9 percent growth of central bank money between 1978QIV and 1979QIV.
Jan. 1, 1979	Reduction of rediscount quotas by DM5.0 billion to DM22.0 billion.
Jan. 18, 1979	Increase of the lombard rate from 3-1/2 to 4 percent. Increase of reserve requirement rates by 5 percent.
Mar. 29, 1979	Increase of the discount rate from 3 to 4 percent. Increase of the lombard rate from 4 to 5 percent.
April 1, 1979	Expansion of rediscount quotas by DM4.7 billion to about DM27 billion. DM4.5 billion swap transactions. (Dollar purchases with matched forward sale)
May 18, 1979	Announcement of repurchases prior to maturity of money market paper by the Bundesbank in response to bank liquidity losses due to foreign exchange outflows.
June 1, 1979	Increase of the lombard rate from 5 to 5-1/2 percent. Announcement of new open market purchases under a 30-day repurchase agreement of fixed-interest securities which are eligible for lombard loans.
June 12, 1979	Increase of the discount rate from 4 to 5 percent. Increase of the lombard rate from 5-1/2 to 6 percent.
Aug. 23, 1979	New rules for the granting of lombard credit by the regional offices of the Bundesbank. Each bank will be limited to a monthly average on lombard credit of 15 percent of its rediscount quota. This measure would reduce lombard credits by about DM4 billion from their August level. In order to alleviate the full impact of this measure, the Bundesbank announced open market purchases under its repurchase facility -- but at an interest-rate which, at 6-1/2 percent, was above the lombard rate.
Aug. 30, 1979	DM3.6 billion in swap transactions. (Dollar sales with matched forward purchase).
Sept. 9, 10, 1979	DM3 billion in swap transactions.

Table 1

		Free Liquid Reserves 1/ (monthly average) DM billion	Outstanding Lombard Credits (end of month) DM billion	3-Month Money Market Rate (monthly average)	Central Bank Money 2/ Growth Rate (monthly average)
1978	Oct.	9.8	0.1	3.95	1.0
	Nov.	13.0	0.9	3.85	1.2
	Dec.	13.8	6.2	4.06	0.8
1979	Jan.	6.9	0.1	3.89	0.8
	Feb.	5.3	8.7	4.15	0.3
	Mar.	4.1	8.4	4.47	1.3
	Apr.	5.1	7.4	5.54	0.3
	May	3.8	3.8	5.92	0.8
	June	3.6	6.0	6.46	0.0
	July	2.8	5.7	6.84	-0.1
	Aug.	n.a.	10.7*	7.06	n.a.
	Sept.	n.a.	n.a.	7.69**	n.a.

* August 23.
**Average through September 12.
1/ Excess reserves and unused rediscount quotas.
2/ CBM equals cash in circulation plus required reserves on domestic liabilities.
Source: Bundesbank Monthly Report.