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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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REVIEW OF FOREIGN DEVELOPMENTS

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Recent Economic Developments in Germany:
October 1965 - January 1966

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Summary

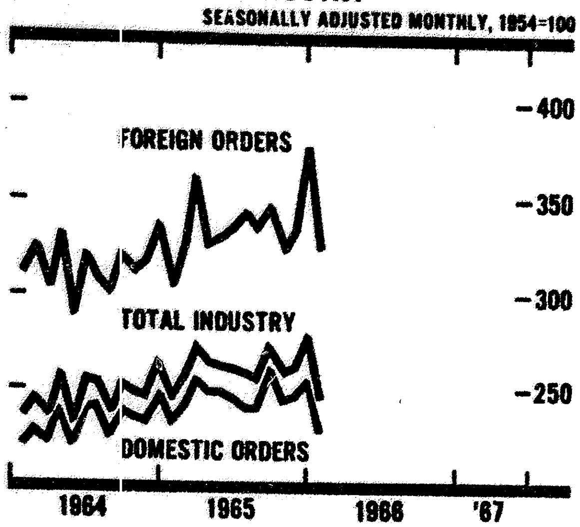
High levels of demand continued to exert pressure on German supply capabilities during the October-January period, resulting in continued upward pressure on prices and a high level of imports.1/ (See Chart.) The expansion of demand appeared, however, to be slowing down somewhat from the pace in the first half of the year. This change in pace is attributed to the effects of the Bundesbank's restrictive monetary policy and to somewhat greater restraint in the spending programs of the public authorities at the Federal and local levels. The expansion of demand varied from sector to sector. Some slowing down in demand in the investment and basic goods sectors caused production in some industries to ease. Consumer demand remains strong, however, and production in this area and in "growth" industries continues to bump against capacity ceilings.

The clearest indication of moderating tendency is to be found in investment activity. For the second half of 1965, total gross fixed investment in plant and equipment showed a year-to-year increase of 7.4 per cent following an increase of 10.6 per cent in the first half of the year. Public authorities have curtailed or postponed investment plans

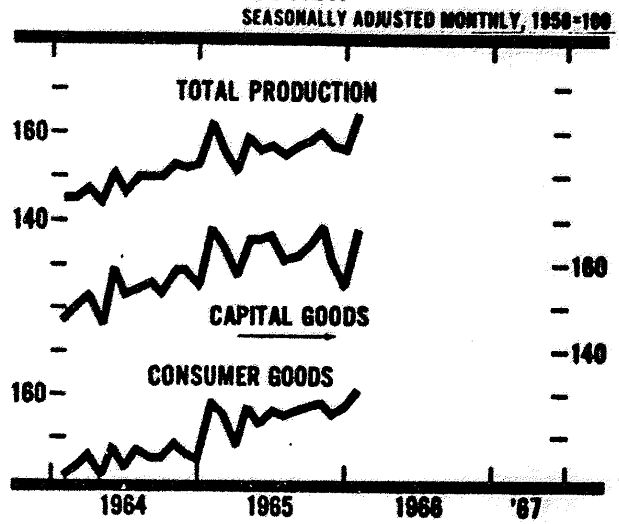
1/ For previous developments see "Recent Economic Developments in Germany: July-October 1965," dated January 4, 1966.

GERMANY: MAIN ECONOMIC INDICATORS

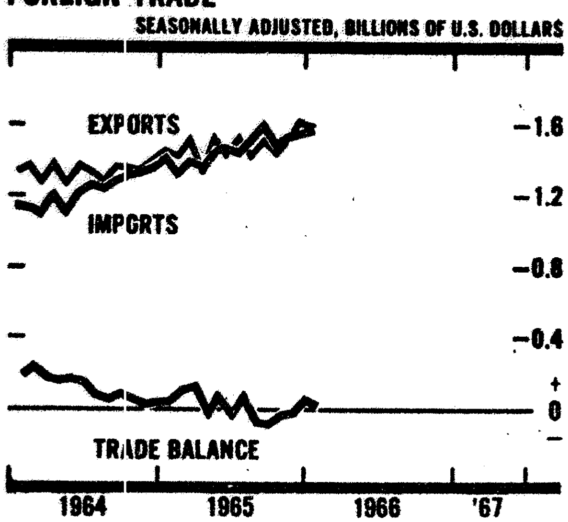
NEW ORDERS IN INDUSTRY



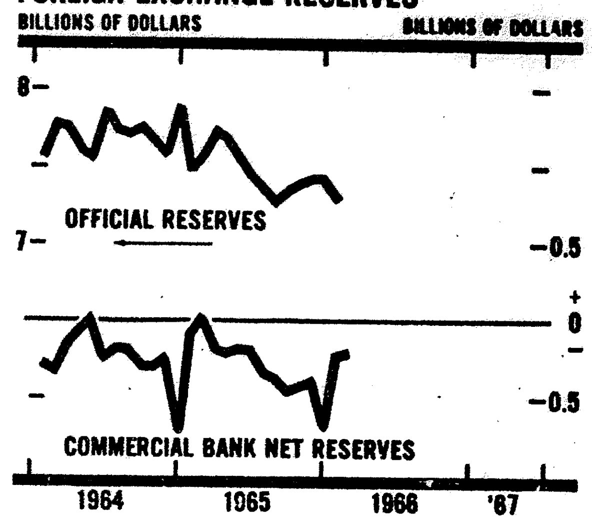
INDUSTRIAL PRODUCTION



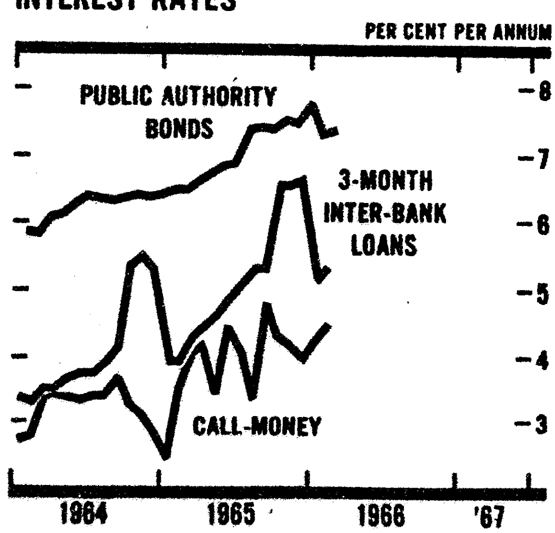
FOREIGN TRADE



FOREIGN EXCHANGE RESERVES



INTEREST RATES



for the current year, easing demands especially in the construction areas. The increase in private investment in 1966 is also expected to be below the growth in 1965.

Growth of demand also slowed down in some of the industries in the basic goods sector. To a certain extent, this easing was a reflection of demand problems of the coal and steel industries but it also reflected producers' decisions to maintain or reduce the levels of their stocks. This decision has affected import orders more than orders to domestic industries. Consumer demand, on the other hand, continued to expand strongly; it is now the predominant expansionary force in the German economy.

Despite the easing of activity in certain areas, aggregate demand continues to press against available supply. The labor market remains extremely tight. Despite easier demand pressures in some industries, the strain on the labor market has not been reduced. Producers tended to hoard labor for fear of recruitment difficulties in the future.

The continued boom conditions of the economy are being reflected in persistent upward pressure on prices. The rise in the consumer price index accelerated during the fourth quarter and was 4.2 per cent above the year-ago level. Higher food prices and rents accounted for much of this increase but prices of industrial products also continued to rise. Wholesale prices of industrial goods rose 0.6 per cent between the third and fourth quarters to a level 2.2 per cent above year earlier levels.

A continued weakness of the bond market and a slower expansion of bank credit have contributed somewhat to a slowing of expansion in the economy. The restrictive effects of the Bundesbank's policy, which until now have been largely confined to the bond market, now seem to be spreading to bank lending activity: thus, the rise in net bank lending to non-bank customers was less in the October-January period than it had been a year earlier. The reduced rate of growth of long-term loans and the marked pickup in medium-term credits suggests that the reduced liquidity of the banking system is being reflected in a greater unwillingness on the part of banks to commit funds for long periods and an increased willingness to supply shorter-term credits.

An improved trade performance, although influenced in part by special factors, was further evidence of a more moderately-paced advance in business activity. Imports rose much more slowly in the fourth quarter than they had earlier in 1965; at the same time, exports continued to rise strongly as a result of demands in important trading partners. (See Chart.) The deficit in Germany's seasonally adjusted trade balance was cut from a total of $82.5 million[2/] in the third quarter to only $15 million in the fourth.

The improved trade balance and a seasonal strengthening of the services account led to a substantial improvement of the balance of payments in the fourth quarter. The gains in Germany's goods and services

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2/ Imports c.i.f., exports f.o.b.

account were enough to offset a sizable outflow of private capital which was concentrated in December and was apparently connected with temporary repayment of short-term loans by German-based firms for the purpose of window-dressing year-end balance sheets. Short-term funds returned in even greater volume in January, however, exceeding the December outflow. When the October-January period is considered as a whole, therefore, Germany showed an overall payments surplus of $128 million. Considering just the fourth quarter, Germany's deficit shrank to $176 million compared to a deficit of $282 million in the second and $359 million in the third quarter.

The Bundesbank took action to offset additions to bank liquidity from the payments surplus and other sources during the period under review and again pointed out the necessity of continuing a restrictive policy until a more basic easing of inflationary pressures had been achieved. In a series of three steps between January 7 and March 3, the Bundesbank raised its selling rates on open market paper by 1/8 per cent in shorter maturity ranges and by a total of 1/4 to 5/8 per cent in maturities of 6 months to 2 years. This brought the Bank's open-market rates into better alignment with market conditions; Bundesbank selling rates had been substantially below market rates for some time. The Bundesbank also took advantage of the increased liquidity position of the banking system to announce the second half of the 25 per cent reduction in commercial bank rediscount quotas.[3/] This will reduce bank liquidity cushions by a total of DM 1.3 billion on May 1.

3/ This measure was discussed in a previous review of German economic developments, dated October 25, 1965, p. 26.

Bundesbank officials are clearly intent upon maintaining pressure on bank liquidity, but they apparently would prefer not to see a further rise in the interest rate structure, both for domestic and international considerations. To cushion the effects of the domestic credit restriction, therefore, the central bank now appears to be encouraging commercial banks to hold their liquid reserves at home rather than abroad. At the beginning of January, the Bundesbank ceased to offer special swap rates to commercial banks for investment in U.S. Treasury bills. In addition, the rise in its open-market rates has also served to increase the relative attractiveness of investing in domestic as opposed to foreign money market paper.

Slowdown in expansion of domestic demand achieved

Domestic demand continued to expand in the fourth quarter, but the pace appears to have become less hectic than it had been earlier in 1965. It appears, therefore, that the restrictive policy which the Bundesbank has been pursuing for the past year or more is finally beginning to have the desired effects on excess demand pressures within the German economy.

The slowing down in business expansion is suggested by a reduced rate of domestic order inflows to industry and by a less vigorous expansion of imports. New domestic orders have in general continued to tend upward but they were on the average only slightly higher in the fourth quarter than they had been in the third quarter and were about the same as in the second quarter. However, an appreciable rise in foreign orders offset the slightly slower growth of domestic orders, so that total order inflows rose 1.5 per cent in the fourth quarter. (See Chart.)

The higher cost and the more limited availability of private credit, and cutbacks in public sector spending programs have contributed to a slower pace of growth of investment activity. On a year-to-year basis, total gross fixed investment by the public and private sectors rose 10.6 per cent in the first half and only 7.4 per cent in the second half of 1965. Public authorities curtailed their longer-run programs: the estimated cost of public building projects proposed during the fourth quarter was almost 2 per cent below that of a year ago. Public construction plans provided for increased activity only in the area of road construction, where activity has been less buoyant than in other construction areas for some time. Private investment has also shown signs of moderating. The results of a recent IFO Institute survey suggest a 5 per cent increase in gross fixed investment by industry in the current year, in contrast to a 15 per cent rise in investment in 1965. Since gross fixed investment by the public and private sector in 1965 was equivalent to 26 per cent of GNP, however, a 5 per cent increase in investment spending in 1966 indicates a continued large volume of investment in absolute terms, despite the slower growth.

The rise in demand in the basic and producer goods sectors was uneven. The expansion of demand was concentrated in "growth industries," such as the plastics and chemicals industries; however basic demand problems in both the coal and steel industries, and a tendency on the part of producers to reduce inventories caused the growth of demand in some of the less dynamic industries to ease off somewhat.

As a result, consumer demand became more predominant as the major expansionary factor in the domestic economy. This strength is not clearly seen in the new order inflows to the consumer goods sector because important consumer durables, such as automobiles, are excluded. Evidence can be found, however, in the 3.3 per cent rise in retail sales in the last four months of 1965 over the preceding four months (on a seasonally-adjusted basis) following a 2.7 per cent rise in the preceding four months.

Growth of industrial production restrained

Only a small further growth in German industrial production was realized in the fourth quarter and January. Production in the fourth quarter advanced only one point beyond the second quarter average; in January the index was only two points above January 1965. (See Chart.) Production increases continued to be limited by capacity and manpower shortages and by lessening productivity gains, particularly in areas of strong demand concentration such as the consumer goods sector. However, the slower expansion of demand was thought to be of increasing importance in explaining small production gains, at least in some sectors of production.

Industry continued to work close to the limits of effective capacity in the fourth quarter. According to an IFO survey, industry was utilizing approximately 90 per cent of its capacity at that time--

the high level at which it has been holding for the past 18 months. Thus, industry apparently continued to put new capacity into use as soon as it became available. Furthermore although some 108,000 additional workers (+1.3 per cent) were employed in the industrial sector in November 1965 than a year earlier, industrial demand for labor remained unsatisfied.

In the first few months of 1966, however, there were reports of some reduction in capacity utilization. The reduction probably occurred in the capital or basic goods industries where a softening of demand has been in evidence for the past few months.

Labor shortage remains keen

The persistent tightness of the labor market continued to highlight tensions in the German economy. The slowdown in certain industrial sectors has not yet produced any significant shift of labor from those industries to rapidly expanding industries. Management tended on the whole to hoard workers for fear of recruitment difficulties later. As a result, therefore, the labor market did not ease but actually tightened somewhat further in the fourth quarter: the ratio of vacancies to the number of unemployed rose to 4.7 in contrast to a level of 4.0 a year earlier. (See Table 1.)

Wages and prices continue under upward pressure

The keen competition for labor led to further advances in the wage level. Total contractual hourly wages were 7 per cent higher in the

Table 1. Germany: Labor Market, 1964-February 1966
(thousands, seasonally adjusted, monthly averages)

	Unemployment	Vacancies	Ratio of vacancies to unemployment
1964			
IV	158	636	4.0
1965			
I	154	637	4.1
II	147	650	4.4
III	141	655	4.6
IV	140	658	4.7
Oct.	137	658	4.8
Nov.	148	654	4.4
Dec.	135	660	4.9
1966			
Jan.	138	627	4.5
Feb.	131	606	4.6

Source: OECD, Main Economic Indicators.

fourth quarter than they had been a year earlier. As in the past, however, actual hourly wages undoubtedly rose more than the contract wage level.

The combination of cost and demand pressures continued to cause prices to rise; these pressures were reinforced by a seasonal increase in food prices. Wholesale prices continued to rise at about the same rate as in the previous quarter, but the increase was greater in the consumer than in investment price component of index. Export prices also moved up slightly, but less than the domestic wholesale price level. The rise in consumer prices accelerated over the fourth quarter, bringing the consumer price index to a level 4.2 per cent above that of a year ago. About 60 per cent of the increase in 1965 was accounted for by higher food prices and rents. (See Table 2.)

Table 2. Germany: Prices and Wages, December 1964-January 1966
(index numbers 1962=100)

	1964 Oct.	1965 Jan.	1965 Apr.	1965 July	1965 Oct.	1966 Jan. a/
Producer Prices						
Total industrial products	102.4	103.0	103.8	104.1	104.7	105.3
Investment goods b/	103.9	105.3	105.6	106.1	106.4	106.9
Consumer goods b/	102.3	103.2	103.9	104.6	105.1	105.7
Consumer Prices						
General index	105.7	107.0	107.8	110.1	109.7	111.5
Food	105.2	107.4	108.6	114.1	110.8	111.6
Export Prices						
General index	104.8	105.8	106.1	106.1	106.4	106.7
Consumer goods b/	103.0	104.0	104.6	104.9	105.9	106.0
Investment goods b/	105.0	106.5	106.9	107.4	107.8	108.2
Import Prices						
General index	104.7	104.6	107.3	107.2	107.2	108.8
Consumer goods b/	99.8	99.8	100.1	100.9	101.1	101.3
Investment goods b/	104.2	104.3	104.3	104.9	105.4	105.5
Earnings						
Average hourly earnings in industry	121.0	123.5	126.5	129.9	131.7	n.a.

a/ Preliminary.
b/ Grouped according to end-use of goods.
n.a. Not available.
Source: Statistisches Bundesamt, *Wirtschaft und Statistik*.

Credit expansion slows

The reduced pace of business expansion in recent months was probably related to a slower expansion of bank credit. The effects of the Bundesbank's restrictive credit policy seem finally to have spread from the bond market (where they have been important for some time) to other credit sectors. Net bank loans extended to the non-banking sector during the October-January period rose DM 9.8 billion this year in comparison to DM 10.5 billion a year earlier; this is the first year-to-year decline in credit growth since credit policy began to tighten late in 1964.

Bank liquidity has declined over the past year and a half and the banks have begun to curtail the rate of new credits in the long maturity ranges. Such loans rose DM 1.5 billion less in the four month period ended January 1966 than they had 12 months earlier. (See Table 3.) Short-term loans also showed a smaller expansion for the current period. There was, however, a sharp increase in short-term loans in December which was offset by repayments in January; this movement is thought to reflect the December repayment to and January reborrowing from foreign parent firms by German subsidiaries. The scale of these short-term credit extensions indicates that bank liquidity is sufficient to meet short-term financing demands in volume. The continued ability of banks to satisfy shorter-term financing demands is further indicated by the relatively large expansion of medium-term credit. Medium-term loans rose DM 1.0 billion in the October-January period in comparison to a rise of only DM 0.4 billion in the same period last year. Slightly more than half of this growth was in loans to the public sector. The rapid expansion of medium-term credits at a time when long-term credit expansion is slowing suggests that investors--public and private--are shifting to shorter-term financing arrangements to meet necessary expenditures where longer-term financing is currently not, or not so easily available.

Table 3. Credit Expansion: Net Lending to Domestic Non-bank Customers
1965-January 1966
(in DM millions)

	I	II	III	Oct.-Jan. 1966 p/
Total lending to non-banks (excl. securities)				
1965	5,943	9,106	7,822	10,104
1964	4,772	7,926	6,968	10,547
Short-term				
1965	1,250	3,429	334	1,213
1964	859	2,413	514	1,776
Medium-term				
1965	137	1,260	1,632	1,011
1964	-48	1,121	740	410
Long-term				
1965	4,556	4,417	5,856	7,880
1964	3,961	4,392	5,714	8,361

p/ Preliminary.
Source: Bundesbank, Monthly Report, Table III.A.1.

Bond market remains weak

The limited capacity of the bond market to meet financing demands was an additional restraint on the pace of business activity. Although the bond market remained relatively calm during the first three months of 1966 following a shake-out in December, there was an underlying weak tone in the market. Limitations on new public-authority offerings to the market have contributed to the relative price stability in recent weeks.

Bond yields declined from a late-December high of 8.02 per cent (when the announcement of a heavy slate of public authority loans sparked a selling wave) to a level of 7.66 per cent in mid-March. But there has been a continued rationing of new bond issues. As a result, new issues in January and February (which are normally the months of heaviest security placements), totalled only DM 2,496 million (at issue value), or about 1/3 less than the DM 3,766 million placed in January-February 1965.

The rationing of public authorities' access to the bond market has led, however, to a backlog of financing demands which remains large despite postponement of a number of public authority investment plans. As a result, "round-table discussions" between the Bundesbank, the Federal and Laender Governments, and other major public authorities continue in an attempt to coordinate the timing and volume of public authority loans coming to the market. In addition, new bonds in many cases no longer provide for intermediate redemption, thus insuring the investor full yield to maturity. The recent Bavarian bond issue went one step further and offered a redemption price of 101, thus providing investors with an added incentive to hold the bond to maturity.

Bundesbank acts to maintain liquidity squeeze

There have been additions to banking liquidity in the past few months. Large government disbursements, a re-emergence of a foreign payments surplus in this period, and a strong seasonal decline in the volume of currency in circulation in January resulted in the addition of a total of DM 854 million to bank liquidity in the October-January period. The withdrawal of liquidity during the six preceding quarters was thus, at least temporarily, reversed.

The Bundesbank took a number of new restrictive measures to neutralize these additions to liquidity.

The Bundesbank raised its rates on open-market paper by 1/8 per cent in the shorter maturity ranges and by a total of 1/4 to 5/8 per cent in maturities of 6 months to two years. These increases were made in three steps: on January 7, February 23, and March 3. The change in rates three times within so short a period represented a marked departure from previous practice since the Bundesbank has changed these rates only infrequently in the past. Although the Bundesbank offered no official explanation of the moves, the increases seem designed to encourage bank purchases of open-market paper to absorb reserves and to discourage bank sales of present holdings. However, the Bundesbank action--especially the last two instances when only maturities of 6 months to two years were effected--was also directed towards discouraging the growth of trading in a new form of money market paper issued by one of the large commercial banks. To attract liquid funds, the Dresdner Bank took advantage of the limited selection and unattractive yields of existing money market paper and introduced its own instrument in maturities of six months and one year at rates more attractive than those offered by the Bundesbank on comparable open-market paper. The three-step increase in the Bundesbank rate has served to bring rates on its paper into line with other market rates.

In another move, the Bundesbank announced that the remaining half of the 25 per cent reduction in commercial bank rediscount quotas, all of which was originally to have been effected at the beginning of October 1965, will now take place on May 1. The Bundesbank had postponed half of the reduction on the occasion of the August discount rate increase in view of the already strained situation on financial markets.

Recently, financial circles have again begun to discuss the possibility of a rise in discount rate. Money market rates have been above the discount rate for months and in the first week of March the spread between call money and the discount rate had widened to 1.15 per cent. Both from the international and domestic points of view, however, the Bundesbank may find a further rise in the discount rate undesirable. The current economic situation does not appear to call for any additional tightening. Furthermore, a rise in discount rate would tend to push up the entire structure of interest rates, which would probably lead to a renewed weakening of the bond market and to the possibility of increased inflows of foreign capital.

The Bundesbank has been increasingly involved in maintaining a balance in its pursuit of tightened bank liquidity and holding the present level of interest rates. In order to ease pressures on interest rates, the Bundesbank has recently begun to encourage banks to hold their liquid assets at home rather than abroad. Both the rise in German open-market rates and the discontinuation at the beginning of January of the special swap rates previously available to banks for investment in U.S. Treasury bills have encouraged banks in this direction.

Trade balance improves

The improvement in Germany's foreign trade balance in the fourth quarter provided clearer evidence of the easing of demand pressures in the economy than either labor market or wage/price developments. There was a slow-down in the expansion of imports; imports rose less than 1 per cent between the third and fourth quarters in contrast to expansions of 3.6 and 6.3 per cent in the two previous quarters. Exports, on the other hand, rose somewhat more than they had in the two previous quarters. As a result, the seasonally-adjusted German trade deficit shrank to a monthly average of only $5 million. (See Chart.)

Part of the slower expansion of imports come from a diminished growth of military imports following earlier rapid increases in the inflow of these goods, but the effects of the demand and production slowdowns were also evident. Imports of raw materials and semi-manufactures did not rise beyond the fourth quarter 1964 level whereas imports of these items had expanded quite strongly in previous quarters. This stabilization corresponded closely to the decline of new orders to domestic producers of basic materials and reflected the fact that producers no longer added to stocks. Imports of finished manufactures continued to show the strongest expansion.

German exports, on the other hand, expanded strongly. German exports to Italy scored a year-to-year increase of 23 per cent in the fourth quarter and exports to France, which had stagnated for months, also showed a substantial increase. The strong economic expansion in the United States allowed Germany to increase its exports to the U.S. by 26 per cent on year-to-year basis. The rise in new foreign orders to German industry over the past two quarters and the prospect of further economic expansion in Italy and France suggest that German export growth should expand further in 1966. Since the lessening of demand pressures in Germany may lead to a slower growth of imports during 1966, there would seem to be good prospect that Germany's trade balance will improve further in the quarters ahead.

Balance of payments deficit shrinks

Improvement in Germany's trade account and a seasonally strengthening of the services account led to a substantial improvement in Germany's payments balance in the fourth quarter. The overall deficit was only DM 0.7 billion, or about half the size of the third quarter deficit and substantially smaller than that of the second quarter. Germany's balance of payments closed the year with an annual deficit of DM 1.8 billion.

The dwindling of the deficit on goods and services and the continued inflow of private capital allowed a payments surplus to re-emerge in October and November. The fourth quarter deficit therefore arose entirely in December as the result of large outflows of private short-term capital connected with year-end window dressing operations of private firms. German-based companies had borrowed abroad in increasing volume during the course of 1965, taking up a net total of approximately DM 700 million in short-term loans from January through September; these companies added another DM 700 million to their short-term indebtedness in October and November. In December, however, the flow of funds was reversed as they repaid DM 334 million, evidently for end-of-year balance sheet purposes; total short-term capital outflows, however, were much larger at DM 1,223 million. Since the largest outflow of short-term capital were unrecorded flows, it is possible that window-dressing activities on the part of foreign owned companies took place in even greater volume than the recorded transactions indicate.

Following the turn of the year, however, short-term funds returned to Germany in greater volume than exported in December. Referring to the total net flow of short-term private capital (including errors and omissions, which allegedly consists largely of unrecorded capital movements), DM 1,223 million moved out of Germany in December while DM 1,407 million entered in January. In other words, a net inflow of private short-term capital totalling DM 184 million occurred over this two-month period. Therefore, when the December and January payments balances are combined (to eliminate offsetting turn-of-year movements), Germany's balance of payments shows a small deficit of only DM 57 million. For the October-January period as a whole, the German balance of payments showed a surplus of DM 592.

Table 4. Germany: Balance of Payments, 1965-January 1966
(in millions of DM)

	1965				
	I	II	III	IV	Dec. '65 Jan. '66
1. Goods and Services					
Trade balance	1098	- 46	- 453	604	831
Services	- 2	- 789	- 852	45	- 456
Total	1096	- 835	-1305	649	375
2. Official Payments					
Donations 1/	-1349	-1778	-1359	-1333	- 968
Long-term capital	- 172	- 334	- 735	- 502	- 416
Short-term capital	138	- 49	620	421	209
Total	-1383	-2161	-1474	-1414	-1175
3. Private Capital					
Securities transactions					
Foreign purchases 2/	109	172	144	340	136
German purchases 3/	- 625	- 112	- 55	- 254	- 199
Other long-term	926	462	425	454	622
Short-term 4/	273	- 12	303	236	237
Errors and omissions	1041	1358	527	- 715	- 53
Total	1724	1868	1344	61	743
Surplus or deficit (-)	1437	-1128	-1435	- 704	- 57
Financed by:					
1. Commercial banks' net foreign exchange assets (increase -)	-2069	4	1039	876	- 646
2. Reserve movements					
Drawing rights on IMF (increase -)	132	- 715	- 8	- 60	- 56
Bundesbank liabilities	63	- 32	47	84	64
Gold and foreign exchange (increase -)	437	1871	357	- 196	657
Total	632	1124	396	- 172	703
Total financing	-1437	1128	1435	704	57

1/ Also includes foreign workers' remittances.
2/ Net foreign purchases of German securities.
3/ Net German purchases of foreign securities (minus).
4/ Excludes total net commercial bank foreign exchange holdings.
Source: Basic data from Bundesbank and International Financial Statistics, rearranged by author.

Reserve changes

The movements in the balance of payments were financed primarily by changes in commercial banks' net foreign exchange positions, which deteriorated $219 million in the fourth quarter but rose $457 million in January for a net gain of $238 million over the four months. The commercial bank gain was partly offset by a $163 million decline in Bundesbank's foreign exchange holdings in January which reflected purchases of foreign

Table 5. Germany: Changes in Reserve Position
(in millions of U.S. dollars)

	1965					1966	
	II	III	IV	Nov.	Dec.	Jan.	Feb.e/
A. Bundesbank gold and foreign exchange							
Gold	135	12	20	2	4	--	- 4
Foreign exchange	-602	-102	29	17	- 6	-163	-47
Total	-467	- 90	49	19	- 2	-163	-51
B. Drawing rights on IMF	-179	12	15	10	--	14	--
C. Commercial banks net foreign exchange	- 1	-260	-219	41	-296	457	9
Total A through C	-289	-348	-155	70	-298	308	-42

e/ Estimated.
Source: Bundesbank and International Financial Statistics.

exchange from the Bundesbank by the commercial banks preparatory to investing funds abroad again. A small loss of 42 million in total German reserves for February indicated a small payments deficit for that month. However for October-February as a whole, total German reserves rose $209 million.