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Some Aspects of German Interest Rates
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Some Aspects of German Interest Rates

Gordon B. Grimwood

In recent discussions of Germany's growing surplus position in the European Payments Union, the view has been expressed that a change in German monetary and fiscal policies would contribute to a correction of the present imbalance. Attention is now centered upon the import side of the balance of payments, and less is heard of charges that Germany is encouraging exports by excessive tax and interest concessions. It has been argued that the development of Germany's balance of payments may be partly explained by the maintenance of high interest rates in Germany which are retarding the expansion of economic activity and discouraging imports.

This paper outlines the development of the German money market during the past two years and attempts to describe the interest rate structure in the Federal Republic at the present time. Some tentative conclusions will be presented as to whether the interest rate structure is appropriate in the light of the monetary situation.

Money and credit, 1952-1953

During 1952 and 1953, the money market became more and more liquid, owing to the movement of central bank money into the commercial banking system. This movement resulted primarily from consistent surpluses in the balance of payments; it was partially offset from time to time by seasonal movements in the circulation of notes and coins, and, over the period as a whole by increased deposits of public authorities in the central banking system. The net effect, however, has been a sharp increase in commercial bank liquidity which was reflected: (1) in successive decreases in the central bank discount rate; (2) by the elimination of commercial bank indebtedness to the central banking system; and (3) by the virtual elimination of central bank holdings of government securities (see Table 1 below).

During the period under review, the central bank discount rate has been reduced successively from 6 to 3 1/2 per cent. The commercial banks have similarly reduced their short-term rates from 10 1/2 to 8 per cent in the case of credits on current account, and from 9 1/2 to 7 per cent for acceptance credits. Bill credits, which vary according to the amount of the credit, were reduced by the same amounts. Call money rates during the period have fluctuated around the discount rate according to the seasonal tightness and ease of the market; the basic situation is reflected by the fact that these rates were more often below rather than above the official discount rate.

Table 1Commercial Bank Liquidity
(Millions of DM)

	<u>Net indebtedness to central bank 1/</u>	<u>Holdings of short- term gov't paper 2/</u>	<u>Central bank holdings of short-term gov't paper 2/</u>
1950	-3,119	154	330
1951	-2,678	599	573
1952			
June	-1,570	854	248
December	- 972	703	367
1953			
June	- 210	1,088	11
December	- 27	809	198
1954			
January	+ 127	1,077	6
February 15	n.a.	n.a.	2

1/ Central bank lendings to banks less banks' deposits at central bank.

2/ Treasury bills and non-interest-bearing Treasury bonds.

Source: Monthly Reports of Bank deutscher Laender.

Official interest rates paid by banks have been reduced slightly during the past two years from 4 1/2 per cent on savings deposits for one year or more to 4 1/4 per cent. It is known, however, that "grey" market rates as high as 7 or 7 1/2 per cent are paid for this money, presumably because banks are able to lend at medium and long term at substantially higher rates.

Despite increasing bank liquidity and the reductions in the short-term rates, short-term credit outstanding to business and private customers increased by only DM 2.6 billion in 1953 as compared with DM 3.3 billion in 1952. Medium- and long-term credits, on the other hand, increased by DM 5.1 billion in 1953 as compared with DM 3.1 billion in 1952. Bank holdings of securities and participations, excluding governments, increased by DM 653 million in 1953 compared with a rise of DM 423 million in 1952.

Table 2

Volume of Commercial Bank
Credit Outstanding ^{1/}
(Millions of DM)

	<u>Short-term</u> ^{2/}	<u>Medium- and</u> <u>long-term</u>	<u>Securities and</u> <u>participations</u> ^{3/}
1950	12,964	5,284	289
1951	15,055	8,480	415
1952			
June	16,128	9,797	562
December	18,332	11,557	838
1953			
June	19,679	13,580	1,081
December	20,975	16,669	1,491
1954			
January	21,145	16,925	1,634

^{1/} Lendings to business and private customers.

^{2/} For less than six months.

^{3/} Excluding governments.

Source: Monthly Reports of Bank deutscher Laender.

Accumulation by banks of funds at medium and long term, defined by the Bank deutscher Laender as net increases in long-term savings deposits and the sale of bank bonds, has consistently exceeded the expansion of credit at medium and long term during the past two years (see Tables 3 and 4, below). The accumulation of funds is even larger if the increase in time deposits is included, a procedure for which a good case might be made.

During the earlier part of the period under review, the failure of long-term lending to keep pace with the accumulation of long-term funds probably represented a consolidation of commercial bank balance sheets. Prior to the sharp increase in savings in 1952, commercial banks generally had been loaning at short term for long-term purposes with commitments to renew the advances. The continuing accumulation of funds, in the light of the present favorable position of the banks, might be explained by a lack of demand for long-term funds at the prevailing high rates of interest.

Table 3Accumulation of Long-Term Funds
(Millions of DM)

	<u>Change in savings deposits</u> 1/	<u>Placing of bank bonds</u>	<u>Change in time deposits</u> 2/	<u>Total, excluding time deposits</u>	<u>Total, including time deposits</u>
1950	+ 964	+ 544	+1,261	+1,508	+2,769
1951	+ 871	+ 727	+ 759	+1,598	+2,357
1952	+2,274	+ 821	+ 931	+3,095	+4,026
Jan-June	(+ 938)	(+ 355)	(+ 346)	(+1,293)	(+1,639)
July-Dec	(+1,336)	(+ 466)	(+ 585)	(+1,802)	(+2,387)
1953	+3,597	+1,650	+ 980	+5,247	+6,227
Jan-June	(+1,379)	(+ 648)	(+ 680)	(+2,027)	(+2,707)
July-Dec	(+2,218)	(+1,002)	(+ 300)	(+3,220)	(+3,520)
1954					
January	+ 726	+ 204	+ 33	+ 930	+ 963

1/ Includes deposits of public authorities.

2/ Time deposits of business and private customers.

Source: Monthly Reports of Bank deutscher Laender.

Table 4Extension of Long-Term Credit
and Accumulation of Funds

	<u>Medium-and long-term credit extended</u>	<u>Accumulation of long-term funds</u>
1950	+3,466	+1,508
1951	+3,196	+1,598
1952	+3,077	+3,095
Jan-June	(+1,317)	(+1,293)
July-Dec	(+1,760)	(+1,802)
1953	+5,112	+5,247
Jan-June	(+2,023)	(+2,027)
July-Dec	(+3,089)	(+3,220)
1954		
January	+ 256	+ 930

Source: See Tables 2 and 3.

Fixed-interest-bearing securities

Sales of fixed-interest-bearing securities, due to government tax policies, have been almost entirely of mortgage bonds and government issues. Prior to October 1952, the rate for fixed-interest-bearing securities was fixed by governmental decree at 5 per cent, although permission to issue somewhat below par raised the effective yield to a maximum 5 1/2 per cent.

The effective yield on investments was fixed by the Government at this level in order to channel available funds into the housing market. It was considered that 5 - 5 1/2 per cent was the highest interest which could be paid without raising rents. However, this yield was not high enough to encourage private investors; the bulk of the money invested in housing has come from public and institutional savers.

Table 5

Placement of Long-Term
Bonds and Shares
(Millions of DM)

	<u>Mortgage bonds</u>	<u>Municipal bonds</u>	<u>Industrial bonds</u>	<u>Loans of public authorities</u>	<u>Total bonds</u>	<u>Shares</u>
1950	211	99	53	217	676	51
1951	468	159	62	57	747	165
1952	628	161	130	418	1,358	259
1953	1,073	429	429	786	2,849	269

Source: Monthly Report of the Bank deutscher Laender, February 1954.

The First Law for Capital Market Reform of October 1952 removed the restriction on the interest rate for bonds. As indicated in the above table, the placement of industrial bonds increased sharply in 1953 as compared with 1952, but still remains insignificant relative to the net increase in savings deposits and the expansion of medium- and long-term bank credit. This is probably explained by the fact that the Government, through tax concessions, restricts the yield on industrial bonds to the level considered the "maximum bearable" for mortgage bonds and certain other issues (primarily federal and state government issues).

Under the First Law for Capital Market Reform, earnings from mortgage bonds, government bonds, and some reconstituted Reichsmark bonds which bear interest at not more than 5 1/2 per cent are tax free. Certain types of mortgage bonds and all industrial bonds issued after the passage of the law are subject to a capital yields tax of 30 per cent, provided they meet certain requirements; otherwise the capital yields tax increases to 60 per cent. Under these conditions an industrial borrower whose issue falls within the 30 per cent category must, in order to compete with the tax-free mortgage bond, pay about 8 per cent; in addition, he finds it necessary under present market conditions to commit himself to redeem his issue at around 103, which raises his total cost to 9 or 9 1/2 per cent. A borrower whose issue falls within the 60 per cent category would have to pay as high as 15 per cent to be competitive with the non-taxed bonds.

Equity financing

The part played by dividend-bearing shares in the financing of investment has been even less significant than that of fixed-interest-bearing securities. Prior to the First Law for Capital Market Reform dividends could not exceed the limit of 6 per cent imposed by the Government of the Third Reich. The real deterrent to equity financing, however, has not been the arbitrary level of dividends but the way in which taxes bear upon income derived from dividends. The tax policy acts as a deterrent in two ways: first, the level of taxes discourages potential investors in dividend-bearing shares; and second, the rate of corporate taxes upon income set aside for dividends makes the cost of this type of financing prohibitive. The First Law for Capital Market Reform removed the dividend stop but made no concessions in the realm of taxes. Until some such adjustments are made, it cannot be expected that there will be any significant increase in equity financing.

It should be pointed out that, despite these obstacles and the consequent slow revival of the capital market, Germany has maintained the highest rate of investment in fixed assets in Western Europe. Prior to 1950, a large share of such investment was financed by the plowing back of earnings of industry; in recent years a growing proportion of the total has been financed from the public budgets.

Export credits

Until the establishment early in 1952 of the Ausfuhrkredit A.G., long-term export credit financing was made available by the Bank deutscher Laender through a line of credit granted to the Reconstruction Loan Corporation. The Ausfuhrkredit A.G., established by a consortium of commercial banks, took over the export credit line of the Reconstruction Loan Corporation.

The Ausfuhrkredit A.G. makes loans up to four years within two ceilings, i. e., the funds made available by the commercial banks (about DM 270 million), and the credit line of DM 600 million taken over from the RLC. The latter credits have full discount privileges with the Bank deutscher Laender and bear a lower rate of interest than credits granted under the DM 270 million ceiling. It has not been possible to ascertain definitely at what rates these loans are made, but there are indications that loans under the DM 270 million ceiling cost the borrower from 9 1/2 to 12 per cent, which is within the range of interest charged by the commercial banks for medium- and long-term credits.

The amount of exports financed through the Ausfuhrkredit A.G. is small compared to total exports. This does not mean that these credits represent the total of long-term export financing, since some credits of this nature may be contained in the medium- and long-term loans of the commercial banks. However, a responsible official of the Bank deutscher Laender recently stated that a calculation had been made by the Bank for the purpose of analyzing the effects of export credits upon Germany's balance of payments. It was discovered that the effects were negligible, and this factor was ignored in preparing balance of payments projections.

Conclusions

The following tentative conclusions regarding the German interest rate structure appear reasonable on the basis of the information now available.

One should have expected the increasing liquidity of the commercial banks, together with an apparent decline in demand for short-term credits, to exert a downward pressure on the short-term rate; yet that rate has been reduced only at the same time and by the same amounts as reductions in the central bank discount rate. A part of the sharp decline in the reported amount of short-term credit expansion during 1953 probably can be attributed to the substitution of medium- and long-term credits for credits which previously were made (nominally) at short term. It seems probable, however, that a reduction in the short-term rate would result in an increased use of credits.

A recent protest by German commercial banks to a suggestion that the central bank discount rate be further reduced may serve as a clue to the reason for a continuing high short-term rate under the conditions described in previous sections of this paper. The banks argued that a further reduction in rates would "squeeze" their profit margins. Banks compare their overall costs, both for short- and long-term money, with the revenue from both types of loans. It may be that the German banks, in

their eagerness to attract funds to lend at high medium- and long-term rates, have permitted their marginal costs for funds to rise to such a level that they cannot afford to lower the short-term rates.

The problem of the medium- and long-term rates is more complex, and is closely connected with government tax policy with regard to different types of fixed-interest-bearing securities. As long as government action results in costs to the industrial borrower of 9 per cent or higher, the commercial banks can afford to keep their own rates for medium- and long-term loans at the same, or even a higher level than that of the nominal rate for fixed-interest-bearing bonds.

Another factor on the side of the supply of loanable funds which has operated to keep interest rates high has been the liquidity preference schedule of the German saver. It appears that he prefers saving in the form of savings deposits at $4 \frac{1}{4}$ per cent (bearing in mind that the rate for some of these deposits is higher) to investing on a market providing a net yield of no more than $5 \frac{1}{2}$ per cent. This presumption is borne out by the sharp increase in savings deposits relative to the placement of securities, and by the fact that the bulk of the securities placed were taken by public bodies or by other institutional savers. Resources in the form of long-term savings are growing steadily, but at the present time are being channeled almost entirely through the banking system.

There has been a relatively sharp increase in the extension of medium- and long-term loans during 1952 and 1953, a part of which, as mentioned above, may result from a more realistic designation of loans formerly made at short term. The accumulation of funds during 1952 may be partially ascribed to a balance sheet consolidation; the continuing accumulation during 1953, however, together with complaints of a shortage of capital, seem to indicate that the rates are too high in relation to effective demand.

Assuming that a reduction in the interest rate structure would be desirable in the interests of a continuing expansion of economic activity, how best could such a reduction be achieved? Since we have established that a primary factor in the present long-term rate structure is the tax policy regarding fixed-interest-bearing bonds, action might be taken to equalize the tax treatment for all such bonds. This might be done in either of two ways: first, by applying the same capital yields tax to all bonds, including mortgage and government bonds; and second, by completely eliminating the capital yields tax.

If the first course were adopted, the effective yield on government and mortgage bonds would be reduced to approximately 3.8 per cent; issuers of industrial bonds would be able to reduce

their nominal rates accordingly. Bank rates presumably would follow suit, and the desired objective of a downward readjustment of the rate pattern would be achieved. However, since it is apparent that the present effective yield of 5 1/2 per cent is not sufficient to attract funds to the capital market, this solution would continue the stagnation of that market and would insure that funds would continue to be channeled through the banking system.

The elimination of the capital yields tax from industrial issues would raise the yield of those bonds to a level at or above the nominal interest rate, depending upon the issue price. The immediate result would probably be a net decrease in total demand since housing, by definition, would be priced out of the market. At this point, with the supply of loanable funds unchanged and total demand reduced, the rate should tend to decline, a movement that will continue until a new equilibrium is reached with (a) greater demand from industrial borrowers, (b) reduced demand--*ceteris paribus*--for housing, (c) increased supply of loanable funds, and (d) a long-term rate somewhere between the old rate and the old yield. In other words, the cost of funds to industrial borrowers will have declined and the yield to lenders will have risen. Needless to say, this analysis abstracts from over-all income and expenditure variations for the economy or, alternatively, implies the assumption that a rise or fall in investment demand resulting from the changes in income under the new rate are offset by appropriate changes in saving.

With the decrease in long-term rates, interest revenue of commercial banks would decline and, therefore, the interest rates paid by banks would be reduced. The short-term rate, under market forces, should reflect the greater demand for medium- and long-term money by falling to a point which would insure a sufficient spread between the short- and long-term rates. The Bank deutscher Laender could assist in this process by lowering the discount rate and by engaging in such open market operations as the state of the capital market permitted.

A diversion of private funds away from housing presumably would necessitate the tapping of other sources of finance for housing. Perhaps it would be possible to transfer the payments of the subsidy, now borne primarily by industrial borrowers, to the public budgets, particularly since these budgets now provide the bulk of the funds available at present capital market yields.