L.5.2 RFD 534

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

April 2, 1965

Recent Economic Developments in Germany:
January-March 1965

30 pages

Helen B. Junz

April 2, 1965

Helen B. Junz

Recent Economic Developments in Germany, January-March, 1965

Summary

The basic trends in the German economy evident at the end of 1964 continued into early 1965: economic activity expanded further, but rising demand put increasing pressures upon available capacities.[1/] Nevertheless, industrial capacity so far has continued to prove to be rather more elastic than anticipated and there are hopes that industrial output can continue to grow steadily during 1965 as it did in 1964, except perhaps in the building sector.

The heavy investment in equipment in 1964--which was 12 per cent above 1963--undoubtedly contributed substantially to the ability of industry to continue to meet growing demands upon its capacity. However, despite the satisfactory growth in output, the Economics Ministry reported that order backlogs are currently rising in a number of industries, particularly in the producer goods sector. Some of the pressure on domestic capacities is being alleviated by continually growing imports; imports are reported to be rising particularly in those categories where domestic delivery periods have been lengthening. The appreciable rise in imports since mid-1964 reflects both these developments and lowering of tariffs in July (1964). The growth of exports, on the other hand, has remained moderate. As a result, trade surpluses have been reduced from the huge annual rate (after seasonal adjustment) of DM 9 billion ($2.25 billion) in the first half of 1964 to a still substantial rate of DM 3.8 billion ($0.95 billion) in January-February 1965. Although the high level of export demand, as

1/ See "Recent Economic Developments in Germany, September-December, 1964," dated January 13, 1965.

it continues to exceed imports, adds to the pressure on domestic resources, the consensus of opinion in Germany is that the danger of "imported inflation" has passed.

The present German expansion seems to be following the three-stage pattern of the 1951, 1954 and 1960 expansions: a sequence from exports as the major expansionary force to investment and, in the third stage, to private consumption. During 1964, exports yielded to investment as the main expansionary factor in aggregate demand; in 1965 investment appears to be yielding to private consumption demand as the major upward force. The Council of Economic Experts, in its first Annual Report to Parliament, foresaw such a development. The shift toward consumption is being aided by the tight labor situation. Under current buoyant demand conditions, wage rates are increasing and the difference between contract rates and effective hourly earnings is also widening. The Bundesbank recently estimated that effective hourly earnings in the first quarter of 1965 will show a year-to-year increase of about 10 per cent. The increases to labor income, added to the income tax reduction which became effective on January 1, 1965, will bring about substantial increases in private disposable incomes. This is expected to stimulate private consumption expenditures considerably, even though there is an upward trend in the already very high rate of personal savings.

With export and domestic investment demand still strong and private consumption demand poised for an expansion, the German authorities have become increasingly worried about a potential build-up of inflationary pressures, particularly as it is reflected in the upward trends of domestic costs and prices. In the light of this worry, the Bundesbank, on January 22, 1965, raised its discount rate from 3 to 3.5 per cent. This action followed a number of restrictive measures which, in early 1964, had been aimed to reduce capital inflows from abroad and later in the year to reduce the liquidity position of commercial banks. These measures, combined with the reduction of the huge trade surpluses, had the desired effect of tightening bank liquidity considerably and promoting an upward movement in the cost of credit during the second half of 1964. The latest Bundesbank action was seen as a further step in that direction. In addition, coming on the heels of the January 1 income tax cut, it served notice that the authorities were prepared to move against any increase in inflationary pressure.

The general tightening in the availability of liquid funds, the authorities' move to increase the cost of credit, a recent revision of the rules governing short- and medium-term deposit and loan rates of credit institutions and the final passage of the 25 per cent withholding tax on nonresident income from fixed interest securities--all these factors are putting upward pressure on the interest rate structure.

The bond market, which had appeared somewhat more settled towards the end of the year, again was under pressure during early 1965. Large Government borrowing requirements (estimated at DM 5 billion for 1965) raised doubts that bond prices could be maintained at 98 per cent of par. In fact, these doubts were realized when support prices were allowed to drift downward; by mid-March, a new price of about 96 per cent of par became established. Even at this lower price, the Bundesbank had to continue to make support purchases of public authority bonds although there was a brief pause in new issues. Yields rose significantly: a representative 6 per cent railway bond yielded 6.63 per cent in March 1965 as compared with 6.42 per cent at the end of 1964 and 6.07 per cent in March 1964.

Money market rates also were under upward pressure, but the dominant feature in the market was the seasonal tightness in preparation for the mid-March tax date. However, the general trend towards tightness, and reactions to the President's balance-of-payments message which brought about a tightening of money markets throughout Europe, contributed to a more than seasonal stiffening of money market rates in Frankfurt.

Demand pressures continue

The trend towards increasingly full capacity utilization evident towards the end of 1964 continued into early 1965. At the current high level of activity, it is apparently becoming increasingly difficult to accomodate the continued high level of demand.

Demand, as measured by the inflow of new orders to industry, grew only moderately during most of 1964; in fact, September-October (1964) new orders were only fractionally above the level of the preceding spring. In January 1965, the order inflow was the lowest of any month since August 1964. (See Table 1.) But momentary spurts in order inflows, such as occurred at the end of 1964, have prevented any reduction in order backlogs. In fact over-all orders on hand have increased as export order books have been lengthening.

Table 1. Germany: New orders received by industry, 1963-January, 1965
(Index numbers, 1954 turnover = 100, seasonally adjusted)

	All industries 1/	Domestic orders	Foreign orders	Basic industries	Capital goods	Consumer goods
1963						
Jan.-Feb.	202	191	257	178	250	171
May-June	213	199	279	192	267	167
Sept.-Oct.	228	215	292	204	281	184
Nov.-Dec.	224	208	298	204	274	177
1964						
Jan.-Feb.	244	226	326	222	300	193
Mar.-Apr.	248	233	322	225	304	195
May-June	239	227	298	211	307	180
July-Aug.	245	233	302	224	299	200
Sept.-Oct.	249	234	317	228	303	192
Nov.-Dec.	258	241	332	226	333	195
Dec.	273	254	348	235	359	200
1965						
Jan. 2/	241	229	293	220	300	188

1/ Excludes mining, construction, food and power
2/ Preliminary
Source: Bundesbank, Monthly Report

Export order backlogs in 1964 grew steadily despite a flattening out of the upward trend of foreign demand during the summer and autumn of 1964. The Economics Ministry attributed the lengthening of foreign order books in part to the apparently greater willingness of foreign customers to accept longer delivery periods as compared with domestic customers. Thus domestic order backlogs could be reduced somewhat, although orders on hand remain very high; in some cases, they are continuing to grow, such as in the producer goods sectors. A slowdown in domestic demand in basic industries in recent months (although growth rates remain appreciable) is seen in a steady excess of deliveries over new orders. This development probably primarily reflects the tapering off of the inventory build-up.

Domestic demand for consumer goods continued at about the level reached in the third quarter of 1964. The acceleration of consumption demand which occurred towards the end of the year did not carry through into the first two months of 1965. However, the results achieved at the spring trade fairs would indicate that consumption demand is about to resume a faster rate of growth.

The build-up of demand pressures has continually been moderated by the greater-than-expected ability of industry to mobilize productive reserves. Thus, industrial output continued to expand steadily, even though a degree of capacity utilization had been reached in November 1964, which was described by the IFO-Institut as exceeding that reached at any previous cyclical peak.

Despite this high level of capacity utilization, industrial production in January (1965) exceeded the November-December (1964) level by 3.5 per cent (after seasonal adjustment) and the previous year's level by 10 per cent. (See Table 2.) There was a particularly vigorous expansion of output in the basic producer goods and capital goods sectors. Output of the consumer goods and building sectors, on the other hand, has remained comparatively stable since mid-1964; in the former case because of the calm development of demand, and in the latter because of capacity limitations.

The continued growth in output was made possible by the large additions to capacity which came into use during the year and which were accompanied by a marked improvement in labor productivity. Capital expenditures for equipment rose by 12 per cent in 1964 over 1963 as compared with an increase of only 2.3 per cent in 1963 over 1962. The high proportion of investment for capital deepening purposes made possible the continued large increase in productivity--amounting to a year-to-year rate of over 8 per cent in the fourth quarter of 1964--in the industrial sector.

Labor market continues tight

With the high level of investment assuring further growth of industrial capacity, the continuing labor tightness is the main limiting factor to output expansion. Unemployment in January (1965) was considerably less than at any time since the very low levels of early 1962. (See Table 3.) At the same time, job vacancies continued to rise and in January (after seasonal adjustment) there were five job openings for every person unemployed.

Table 2. Germany: Industrial Production, 1963-January, 1965
(Index numbers, 1950 = 100, seasonally adjusted)

	All industries	Basic producer goods	Capital goods	Consumer goods	Food, beverages, and tobacco	Building
1963						
Jan.-Feb.	268	276	362	225	237	148
Mar.-Apr.	282	299	381	234	240	275
May-June	288	312	384	238	248	314
July-Aug.	290	314	385	241	249	313
Sept.-Oct.	295	322	393	245	248	308
Nov.-Dec.	297	327	394	243	250	296
1964						
Jan.-Feb.	299	325	400	245	255	258
Mar.-Apr.	304	338	406	252	246	277
May-June	310	348	415	253	260	317
July-Aug.	314	355	416	259	258	307
Sept.-Oct.	318	362	421	262	255	314
Nov.-Dec.	318	362	424	256	256	314
Dec.	319	364	421	255	265	325
1965 1/						
Jan.	329	371	443	260	274	303

1/ Preliminary
Source: Bundesbank, *Monthly Report*

Table 3. Germany: Labor Market
I Quarter 1963 - January 1965
(thousands, seasonally adjusted, monthly averages)

	Unemployment	Vacancies	Ratio of vacancies to unemployment
1963			
I	196	501	2.6
II	170	520	3.1
III	170	547	3.2
IV	164	572	3.5
1964			
I	156	568	3.6
II	171	578	3.4
III	165	601	3.6
IV	151	634	4.2
1965			
January	123	637	5.2

Source: OECD.

With unemployment down to practically the structural minimum level and the labor force decreasing because of demographic trends, any alleviation of the labor situation would have to come from further increases in foreign labor and more efficient employment of those already in the labor force. Towards the end of 1964, there were about 1 million foreign workers in Germany, an increase of 150,000 over 1963. This increase was larger than expected and occurred in the face of the growing competition among European countries for the diminishing supply of labor reserves in Southern Europe.

For 1965 it is expected that the foreign labor force will increase by approximately another 100,000. Recruitment this year may well be higher now that Switzerland will be releasing foreign labor and unemployment in Italy still is well above 1963/1964 levels. But the influx of foreign labor at these levels may be no more than sufficient to compensate for the shrinkage of the domestic labor force and the anticipated reduction in working hours.

During 1964 continuing increases in labor mobility helped to raise labor productivity considerably. But, as the expansion broadens, slower-growing branches of industry are becoming more reluctant to release labor to the faster-growing industries. The Council of Economic Experts in its first Annual Report to Parliament cited the necessity for a wage-setting mechanism which would result in a degree of wage differentiation between branches of industry sufficient to attract labor to those industries where it is most needed. However, in the current situation it would appear to be difficult to achieve a much higher rate of re-distribution of labor.

Wage pressures intensify

With economic activity continuing to expand and no relaxation of strains in the labor market in sight, recent wage negotiations have resulted in rather larger pay awards than in 1963 and early 1964. Negotiated wage increases are estimated to have averaged 7-9 per cent in the second half of 1964 (about in line with the productivity increase in the industrial sector) as compared with 5-7 per cent during the first half.

The pattern for new wage contracts to be concluded for about 4 million workers this spring may well be indicated by the recent agreement reached for the important construction industry. This provides for an 8.4 per cent increase in wage rates, a partial deferment of a previously agreed upon reduction in working hours, and included the first "personal assets formation" scheme to be incorporated in a collective labor agreement in Germany. Under this scheme a worker can formally request that 2 pfennigs per hour worked be set aside for purposes of asset formation, in which case the employer will add 9 pfennigs to be used for the same purpose. The funds so accumulated would be tax-exempt under a draft amendment to the "DM 312 Law" and would have to be invested for a minimum period of five years in assets to be designated by the employee.

Union drives recently have focussed more and more on equitable income distribution rather than on criticism of the Government's price policies. Such criticism induced the Government to rescind rate increases for telephone service late in 1964; this move meant that the use of fiscal policy to contain private spending power (by reducing the deficits of public enterprises) will be less effective. Recent substantial wage increases in labor intensive industries and their effects on the price level may have played a role in the unions' shift from the price issue to that of "excessive employers' profits."

Price trends continue up

The continuing dimunition of productive reserves and the recent acceleration of wage increases are putting further pressures on the German cost and price levels. According to a Bundesbank estimate, effective hourly earnings in the first quarter of 1965 will show a year-to-year increase of about 10 per cent as compared with an expected rise in productivity in all sectors of the economy [2/] of around 5 per cent. Numerous price increases which are being announced currently cite rising wage costs as the major reason. For example, coal producers announced a compensatory 4 per cent price increase after agreeing to a 10.5 per cent wage rise. These developments appear to be putting an end to the slight decrease in the tempo of price rises which had occurred towards the close of 1964.

In January, producer prices for industrial products rose by 0.3 per cent after having declined slightly in December. (See Table 4.) Price increases for finished investment and consumption goods, in addition to the price rise for coal, were mainly responsible for the renewed upward movement.

Consumer prices rose more than seasonally but the main increases were concentrated in the service sector, primarily in rents. Both industrial and consumer prices in January were about 2.3 per cent above the preceding year's level.

2/ The year-to-year increase in productivity for 1964 on a GNP basis was 6 per cent.

Table 4. Germany: Prices and Wages, January 1963 - January 1965
(index numbers, 1958 = 100)

	1963 Jan.	1963 Oct.	1964 Jan.	1964 July	1964 Oct.	1964 Nov.	1964 Dec.	1965 Jan. a/
Producer Prices								
Total industrial products	103.5	103.9	104.3	104.8	106.2	106.6	106.5	106.8
Investment goods b/	107.3	107.4	107.5	108.4	109.8	110.6	110.7	111.1
Consumer goods b/	106.0	107.5	108.5	109.2	110.3	110.4	110.4	110.8
Consumer Prices								
General index	111.1	112.1	114.0	115.3	115.2	115.7	116.0	116.6 c/
Food	111.0	110.1	113.6	115.0	113.6	114.7	115.5	116.2
Export Prices								
General index	100.4	100.8	102.2	104.6	105.3	105.5	105.6	106.1
Investment goods b/	107.0	108.0	110.2	111.2	112.1	112.6	112.9	e/
Consumer goods b/	101.2	101.5	101.7	103.1	103.8	104.0	104.1	e/
Import Prices								
General index	95.6	96.2	96.9	97.5	98.0	98.8	98.7	98.0
Investment goods b/	97.4	98.3	101.5	101.4	101.6	101.7	101.7	e/
Consumer goods b/	94.5	94.5	94.3	94.0	94.0	94.0	94.0	e/
Earnings								
Average hourly earnings in industry d/	147.2	156.4	158.1	166.9	171.5	e/	e/	e/

a/ Preliminary.
b/ Grouped according to end-use of goods.
c/ February 1965: 116.7
d/ February, May, August, and November for 1963.
e/ Not available.

Source: Statistisches Bundesamt, Wirtschaft und Statistik.

Some of the pressures on the internal price level are currently being alleviated by the fall in import prices which largely reflects the turn-around in price movements for raw materials. Export prices, on the other hand, currently moving in close correspondence with the internal price level, resumed their rise and in January were 0.5 per cent above December 1964 and 3.8 per cent above January 1964.

Foreign trade continues to expand

Current developments on the foreign trade side continue to lend support to official statements that the danger of "imported inflation" has passed. The strong upward trend of imports evident since mid-1964 intensified towards the end of the year and is helping to alleviate some of the pressure on domestic capacity. The upsurge of imports, reportedly, is particularly strong for those industrial goods for which domestic delivery periods have been lengthening.

In January-February (1965) import values were 19 per cent above both May-June and January-February, 1964. (See Table 5.) Imports advanced broadly in all major sectors. Since the inventory build-up is tapering off and raw material prices have stopped rising, increases in finished goods imports have gained in importance in the general rise. In the fourth quarter of 1964, finished goods constituted 41.4 per cent of total imports as compared with 38.9 per cent in the corresponding period of 1963. A rise in foreign deliveries of military goods contributed to this uptrend, but the major upward impetus was undoubtedly provided by private demand.

Table 5. Germany: Merchandise Trade 1963-February, 1965
(seasonally adjusted monthly averages, in billions of DM)

	Exports	Imports	Industrial goods imports	Trade balance
1963				
Jan.-Feb.	4.32	4.06	3.03	.26
March-Apr.	4.76	4.45	3.33	.31
May-June	4.85	4.35	3.29	.50
July-Aug.	5.02	4.54	3.38	.48
Sept.-Oct.	5.07	4.56	3.43	.51
Nov.-Dec.	5.02	4.20	3.13	.82
1964				
Jan.-Feb.	5.53	4.60	3.44	.93
March-Apr.	5.30	4.69	3.53	.61
May-June	5.29	4.59	3.35	.70
July-Aug.	5.24	4.99	3.78	.25
Sept.-Oct.	5.49	5.23	3.97	.26
Nov.-Dec.	5.49	5.41	4.19	.08
Dec.	5.59	5.41	4.23	.18
1965				
January	5.85	5.68	n.a.	.17
Feb. 1/	5.73	5.26	n.a.	.47

1/ Preliminary
n.a. not available
Source: Bundesbank, Monthly Report

In order to reduce the effect of domestic price increases, the Federal Government is proposing a reduction of German external tariffs on certain agricultural items to the level of the Common External Tariff. In addition, it is hoped that the improvement in the German terms of trade will have salutary effects on the internal price level.

With the growth in imports outstripping that of exports, the net effect of external trade has been one of diminishing pressures. However, exports are continuing to show a rising trend and the trade surplus remains substantial, although it is well below the 1964 rate of DM 5.7 billion ($1.4 billion). For January-February it amounted to DM 3.8 billion (annual rate, seasonally adjusted), somewhat above the DM 3 billion ($0.75 billion) level which was recorded during the second half of 1964. Based on the inflow of foreign orders of the past months and the rise in order backlogs, it is expected that exports will continue at present high levels for some time to come.

Shifts in demand pattern

The current development of aggregate demand in Germany appears to follow that of previous expansions relatively closely. In 1951, 1954, and 1959 an upsurge of foreign demand triggered off large increases in gross investment--to some extent attributable to inventory investment--in the following year. The shift of expansionary factors was from external to internal demand: the investment booms which followed in 1952, 1955, and 1960 were then succeeded--as the third stage of this pattern--in 1953, 1956, and 1961 by major increases in private consumption demand. (See Table 6.)

Table 6. Germany: Change in Aggregate Final Demand (including exports) and Contribution of Selected Components to Total Change, 1951 - 1965

(Percentage change and percentages)

	Change from preceding year	Contribution to change		
		Exports	Gross Investment	Private Consumption
1951	23.1	$\boxed{29.1}$	16.6	40.6
1952	14.3	17.5	$\boxed{23.9}$	41.7
1953	7.5	27.8	2.7	$\boxed{66.3}$
1954	9.8	$\boxed{33.0}$	$\boxed{28.0}$	33.8
1955	16.0	19.9	$\boxed{36.3}$	37.7
1956	10.9	32.4	11.2	$\boxed{49.8}$
1957	10.0	$\boxed{35.3}$	12.5	43.9
1958	6.5	10.0	13.6	$\boxed{56.8}$
1959	9.5	$\boxed{24.5}$	$\boxed{30.8}$	33.5
1960	12.8	$\boxed{23.7}$	$\boxed{33.3}$	32.1
1961	9.3	8.9	22.6	$\boxed{51.2}$
1962	9.0	9.2	20.5	49.7
1963 a/	6.4	$\boxed{22.5}$	13.1	41.6
1964 a/	11.0	18.7	$\boxed{36.1}$	39.1
1965 First-half b/	8.5	23.5	11.2	$\boxed{51.0}$

a/ Preliminary.

b/ Based on estimate by Council of Experts.

Source: 1964 Report of the Council of Experts for the Assessment of Economic Trends p.17; Bundesbank *Monthly Report*.

In the current expansion, the export boom of 1963 was followed by an upsurge in investment demand in 1964. This rise in investment demand provided more than one-third of the 11 per cent increase in aggregate demand in 1964 over 1963.

It would appear that investment is about to give way to private consumption demand as the main dynamic factor in 1965. The Council of Economic Experts has estimated that aggregate demand in the first half of 1965 is likely to be 8.5 per cent above the first half of 1964. Slightly over half of this increase is expected to be provided by a rise in private consumption demand. In view of the large increase in disposable incomes--because of the acceleration in the rise of wage incomes and the tax cut which became effective at the beginning of the year--it would be reasonable to expect a sizable acceleration in the rise of consumption expenditures. However, the trend of retail sales so far has not supported this assumption. It would thus appear that the already very high rate of savings, which rose from 9.7 per cent in the second half of 1963 to 10.9 per cent in the second half of 1964, is rising still further.

Balance of payments moving towards equilibrium

The shift in emphasis in German economic growth from external to internal demand was reflected in the much diminished trade balance in the second half of 1964. But because of the huge surplus recorded during the first half of the year, the trade surplus for 1964 as a whole, at DM 5.7 billion ($1.4 billion), was only fractionally below that of 1963. (See Table 7.) However, the current account balance at

Table 7. Germany: Balance of Payments, 1963-January, 1965
(in millions of DM)

	Year		1964			1965
	1963	1964	Jan.-June	July-Sept.	Oct.-Dec.	Jan. a/
1. Goods and Services						
Trade balance	5,875	5,684	4,198	568	918	131
Services	-38	-454	-1	-439	-14	-60
Total	5,837	5,230	4,197	129	904	71
2. Official Payments						
Donations 1/	-4,956	-4,820	-2,538	-1,163	-1,119	-415
Long-term capital	-1,016	-1,101	-479	-158	-464	-58
Short-term capital	-318	-706	-366	74	-414	-288
Total	-6,290	-6,627	-3,383	-1,247	-1,997	-761
3. Private Capital						
Securities transactions						
Foreign purchases 2/	2,859	399	-45	305	139	136
German purchases 3/	-475	-833	-615	-116	-102	-119
Other long-term	752	618	307	-37	348	67
Short-term 4/	1,012	697	-427	46	1,078	-426
Errors and omissions	-528	1,882	1,368	760	-246	1,038
Total	3,620	2,763	588	958	1,217	696
Surplus or Deficit (-)	3,167	1,366	1,402	-160	124	6
Financed by						
1. Commercial banks						
Foreign exchange assets (increase-)	-287	-474	-654	-165	345	-1,587
2. Reserve Movements						
Drawing rights on IMF (increase-)	-140	-1,442	-587	4	-859	160
Bundesbank liabilities	-117	20	72	-83	31	-41
Gold and foreign exchange (increase-)	-2,623	530	-233	404	359	1,462
Total	2,880	-892	-748	325	-469	1,581
Total Financing	-3,167	-1,366	-1,402	160	-124	-6

a/ Preliminary.
1/ Also includes foreign workers' remittances.
2/ Net foreign purchases of German securities.
3/ Net German purchases of foreign securities.
4/ Includes commercial bank capital other than foreign exchange assets.
Source: Basic data from Bundesbank and International Financial Statistics, rearranged by author.

DM 5.2 billion ($1.3 billion) was DM 0.6 billion below 1963 because of a growing deficit on service account. The DM 0.5 billion deterioration in the service account was largely due to an increase in interest and dividend payments by German companies to foreign investors, reflecting both the growth of foreign investment in Germany and the improvement in the earnings position of German companies during 1964.

Private capital inflows into Germany rose again during the second half of 1964. Net sales by foreigners of German fixed interest securities (which had been substantial after the announcement of the 25 per cent withholding tax on dividends accruing to foreigners from such investments) have again been exceeded by purchases--though only by small amounts--since the fall of 1964. The stoppage of the non-resident capital outflow, substantial foreign borrowings by German subsidiaries of foreign companies, and increases in foreign short-term liabilities of German commercial banks generated a net inflow of DM 2.2 billion ($0.6 billion) on private capital account during the second half of 1964. For the year as a whole, the inflow of private capital amounted to DM 2.8 billion ($0.7 billion), which was DM 0.8 billion below the 1963 inflow.

Official capital outflows in 1964 were DM 0.3 billion above 1963 mainly because of an increase in prepayments for military purchases.3/ The slight increase in official payments combined with the reductions

3/ Official capital includes foreign workers' remittances. These have remained stable during 1964 despite the rise in the foreign labor force. This is generally taken as an indication that many foreign workers are taking up permanent residence in Germany.

in the current and private capital balances resulted in a reduction by more than 50 per cent in the balance of payments surplus between 1963 and 1964. At DM 1.4 billion ($0.35 billion) the 1964 surplus was still substantial, but the entire inflow was concentrated in the first half of the year. During the second half the German balance of payments was in virtual equilibrium as it was in January 1965.

Reserve accruals diminish

The large reduction in the German balance of payments surplus between 1963 and 1964 was reflected in a reduction in reserve accruals from $766 million in 1963 to $351 million in 1964. (See Table 8.) Official holdings of foreign exchange decreased by $534 million, but gold holdings of the Bundesbank rose by $405 million during the year. As a result total official holdings of gold and foreign exchange fell by $129 million. This decrease was, however, more than offset by an increase in the German reserve position in the IMF of $361 million. The commercial banks increased their foreign exchange assets by $119 million.

Reserve movements in early 1965 were dominated by the unwinding of year-end window dressing operations and by the commercial banks' preparations for the March tax date. Thus Bundesbank holdings of foreign exchange were reduced substantially in January as commercial banks put about equivalent amounts abroad. In February and March official foreign exchange holdings increased as banks were repatriating funds.

Table 8. Germany: Changes in Reserve Position 1963-February 1965
(in millions of U.S. dollars)

	Year		1964			1965	
	1963	1964	Jan.-June	July-Sept.	Oct.-Dec.	Jan.	Feb.
A. Bundesbank gold and foreign exchange							
Gold	164	405	238	68	99	2	1
Foreign exchange	495	-534	-178	-167	-189	-369	97
Total	659	-129	60	- 99	- 90	-367	98
B. Reserve position in IMF	35	361	147	- 1	215	- 40	- 4
C. Commercial banks							
Foreign exchange	72	119	164	41	- 86	397	-24
Total A through C	766	351	371	- 59	39	- 10	70

Source: International Financial Statistics: Bundesbank Monthly Report.

The balance of payments equilibrium and the money exports by commercial banks during the first six weeks of 1965 were reflected in a slight decline in D-mark quotations in foreign exchange markets. The rate moved from 25.149 U.S. cents in early January to 25.130 U.S. cents in mid-February. (See Table 9.) Subsequently, demand for the D-mark strengthened somewhat as commercial banks began to repatriate funds. Quotations reached a peak of 25.156 U.S. cents towards the end of February and declined slightly after that date. The premium on three-month forward D-marks mirrored the changes in the spot rate, widening with the rate declines. However, the movements were rather sharper than indicated by changes in the spot rate.

In March, with yields on Euro-dollars rising sharply after the President's balance of payments message, banks apparently began putting funds into the Euro-dollar market in preference to availing themselves of the preferential forward cover provided by the Bundesbank for investments in U.S. Treasury bills.

Continuing restrictive policy

The danger of imported inflation is no longer considered an issue in Germany, according to recent statements of German officials. Dr. Emminger, a director of the Bundesbank, in a recent speech said that "in the monetary sense we are not importing inflation from abroad and it does not appear likely that substantial and persistent balance of payments surpluses will reappear very rapidly."

However, the upward trend of domestic prices and costs and the continuing rise in pressures on resources have led the German

Table 9. Germany: Exchange Rate and Forward Rate in U.S. Cents per DM and per cent per Annum, 1964-March 1965

Par Value	25.00
Upper Limit	25.188
Lower Limit	24.875

			Spot Rate 1/	Forward Rate 2/				Spot Rate	Forward Rate
1964 -	Jan.-March		25.160	+0.9%	1965 -	Jan.	8	25.149	+0.8%
	April-June		25.161	+0.6%			15	25.136	+0.9%
	June-Sept.		25.155	+0.6%			22	25.131	+0.8%
	Oct.-Dec.		25.151	+0.3%			29	25.135	+0.8%
	Oct.	2	25.158	-0.0%		Feb.	5	25.129	+0.7%
		16	25.158	-0.0%			12	b/25.130	+0.7%
		30	25.152	-0.0%			19	25.140	+0.4%
							26	25.156	+0.3%
	Nov.	13	25.143	+0.3%					
		27	25.151	+0.3%		March	5	25.155	+0.3%
	Dec.	11	25.143	+0.4%			12	25.146	+0.7%
		24	25.165	a/+0.2%			19	25.140	+0.8%
		31	25.144	+0.6%					

1/ Noon buying rates.
2/ Quarterly and monthly data averages of Friday quotations.
a/ December 23.
b/ February 11.
Source: Federal Reserve Board.

authorities to voice increasing concern over a worrying build-up of domestic inflationary pressures. Thus it was not surprising that the Bundesbank, on January 22, 1965, raised its discount rate from 3 to 3.5 per cent. Bundesbank officials had made it known at various times since September 1964 that higher interest rates abroad and the reduced balance of payments surpluses gave them a greater measure of freedom to move toward monetary restraint than they had earlier in the year and that they would not hesitate to move accordingly if such restraint should prove necessary.

The decision to raise the discount rate came after a number of restrictive measures had been taken which had been aimed in early 1964 to reduce capital inflows from abroad and later in the year to reduce the liquidity position of the commercial banks.[4/] These actions, combined with the reduction of the huge trade surpluses during the second half of 1964, had the desired effect of a considerable tightening of bank liquidity. The latest Bundesbank action was seen as a further step in that direction. The timing appeared propitious on technical grounds: January usually is a month of fairly easy money market conditions as year-end window dressing operations are unwound and foreign exchange markets appeared somewhat more settled than they had been for some time. In addition, coming on the heels of the January 1 tax cut, it also served notice that the authorities were prepared to move against any increase in inflationary pressure.

4/ See "Recent Economic Developments in Germany, June-September, 1964," dated October 15, 1964.

Public concern about inflationary pressures emanating from the Government sector itself has been growing. Formally, Federal expenditures for 1965 are budgeted to rise approximately in line with the expected increase in real national product (about 5 per cent). However, expenditures in the farm sector arising from the unified grain price agreement reached within EEC late last year and certain other expenditures, mainly in the social sphere, not originally included in the budget proposal, had to be accomodated. This was achieved by certain cuts within the budget mainly affecting defense expenditures and by an increased authorization to finance expenditures outside the budget.

Criticism of these revisions centers on these two points. First, cuts in defense expenditures in favor of civil expenditures are thought to shift demand pressures from external to internal sources (because of the high proportion of military procurement from abroad). Secondly, the prospective rise of financing outside the budget from DM 1 billion in 1964 to DM 2.1 billion in 1965 lends support to the Bundesbank's feeling that there is ". . . reason to fear that, despite the intended limitation of the rise in expenditure to the prospective growth rate of the real national product, the Federal budget would contribute towards strengthening the expansive tendencies in the economy."[5/] In addition, the Laender budgets passed so far, show a rise in expenditures (other than for pure financing transactions) of roughly 9 per cent for 1965 as compared with 1964. The shortfall of

5/ Bundesbank, Monthly Report, January 1965, page 24.

receipts from expenditures is expected to widen between 1964 and 1965 and cash deficits are estimated to rise DM 0.7 billion to about DM 3 billion.

The large financing requirements of the public authorities added to the expansion of the private sector, are expected to put further pressure on the interest rate level despite the large volume of savings currently being generated.

Interest rates under upward pressure

The pressure put upon bank liquidity by previous official actions and by autonomous market forces had kept money market rates in Frankfurt well above the 3 per cent rate through most of 1964. The immediate effect of the January increase in the discount rate to 3.5 per cent was thus slight, mainly also because of the seasonal easing in the money market. In addition, easy conditions in the money market were further encouraged by the fact that the Bundesbank decided to temporarily suspend the sale of money market paper. This was interpreted as a move to encourage commercial banks to put excess funds abroad, but also as a show of displeasure at the heavy rediscounting and sales of money market paper by banks in anticipation of the discount rate increase.

Money rates remained relatively easy until the last week in February when rates moved up from around 3 per cent to fluctuate between 3-3/4 to 4-1/8 per cent. While the mid-March tax date dominated money market conditions, some of the tightening was also attributed to a withdrawal of U.S. funds from Germany in response to the President's balance of payments message. This in turn was said to have caused subsidiaries of U.S. firms to seek alternative sources of financing and thus to add to the demand for funds in Germany as well as elsewhere in Europe.

Long-term rates, which had stabilized towards the end of 1964, started to move upward again in early January. Yields on bonds with a 6 per cent coupon moved from 6.38 per cent in December 1964 to 6.44 per cent on January 21, before the discount rate action. The upward drift probably was related to two factors: the certainty that the withholding tax on nonresident income from fixed interest securities would be enacted and the view that borrowing requirements of public authorities would add more pressure on bond prices.

As it turned out, conditions in the bond market became so uneasy, despite the seasonal ease in the money market, that the Central Capital Market Committee recommended an issue pause to "occasional" borrowers; at this time, public authorities also voluntarily postponed a number of planned issues. Nevertheless, bond prices continued to drift lower and by mid-March yields had risen to 6.56 per cent.

Prices of 6 per cent Government bonds, which had been supported at 98 per cent of par, were allowed to fall to about 96 per cent. Even at this lower level, reportedly substantial support purchases were undertaken by the Bundesbank. The yield of a representative 6 per cent Railway bond rose from 6.42 per cent at the end of 1964 to 6.63 per cent on March 19, 1965. Under these conditions, the Capital Market Committee decided on March 17 to continue to ration access to the capital market in order to maintain the 6 per cent coupon rate.

The first of four impending public loans, totaling about DM 650 million, was announced on March 24; it is a DM 210 million of the Postal Authorities to be issued at 96 per cent of par with a maturity of only 8 years; the effective yield amounts to 6.8 per cent. With yields rising towards 7 per cent nonresidents could still earn about 5.25 per cent despite the 25 per cent tax deduction at source which will become effective mid-1965.[6/] But these yields would still be somewhat below those obtainable on foreign loans floated in Germany which are exempt from the tax.

Some further upward pressure on interest rates is expected to come from the revised rules regulating interest payments which became effective March 1. Under the new rules, the deposit periods for which rates are regulated are reduced from 4 years to 30 months and maximum rates for savings and time deposits are raised with increases ranging from 1/4 of one per cent to 1/2 of one per cent.[7/] Following this change, rates for longer-term deposits are expected to move closer to yields obtainable in the capital market. The Bundesbank in its January Monthly Report states that upward pressure on commercial banks' long-term lending rates--which are not officially regulated--following the increase in deposit costs would be welcome since it would tend to re-enforce the restrictive credit policy.

The general developments in the financial sphere also spread to the stock market. Share prices have weakened virtually continually since the beginning of the year, and the F.A.Z. stock index declined by

6/ Under double taxation treaties this tax is refunded to investors declaring income from these investments in their home countries. While, of course, not all such investments are made for tax-evasion purposes, the taxation issue appears, so far, to continue to make tax-exempt bonds more attractive to foreign investors than domestic bonds.

7/ Rules pertaining to rates of interest chargeable by credit institutions on loans of up to 4 years maturity were also changed.

7 per cent between January 1 and March 22, 1965. The weakness in the stock market was attributed to political uncertainties, internationally as well as nationally, the withdrawal of American investment funds and the general stringency of liquid fund supplies.