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Economic Developments in Germany:
March-June 1965

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Helen B. Junz

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Recent Economic Developments in Germany, March-June 1965

Summary

Business activity continued to expand in Germany during the spring of 1965 as expectations of a slowdown in the rate of growth so far have not been confirmed by fact. The shift in the pattern of demand apparent earlier has become more pronounced in recent months.^{1/} The main expansionary factors operating in 1964--exports and inventory demand--have lost force; but their upward impetus has been replaced by a faster growth in private consumption demand, and investment demand continues to grow steadily. Some signs that demand in the overheated building sector may be easing off have appeared, but this easing could well be only temporary.

The main limiting factor to the expansion of output still remains on the supply side. But the emphasis currently seems to be shifting from factory capacity to labor as the major bottleneck. Heavy industrial investment in 1964 and the continuing high outlays being made for industrial equipment apparently have resulted in a growth of productive capacities more or less in line with the growth in demand.

By contrast, the domestic labor force has grown only slightly and additions to industrial employment have come entirely from the growth in the foreign labor force. Under current conditions of expanding demand

^{1/} See "Recent Economic Developments in Germany, January-March 1965", dated April 2, 1965.

and increasing labor shortage, the upward trend in wage payments has accelerated. However, effective hourly earnings, which rose 8.5 per cent between the first quarter of 1964 and the first quarter of 1965, increased somewhat less than anticipated and the gap between contract rates and effective earnings actually appears to be narrowing.

Nevertheless, unit labor costs have been increasing and a renewed rise in raw material costs added to upward pressure on the price level. Despite these developments, there was a perceptible moderation in the pace of price increases during March and April. Part of the slowdown in the upward price trends can probably be attributed to the sharpening competition of imports in the German market.

Imports, particularly of finished goods, have continued to grow vigorously. Although German exports appear to have lost none of their competitiveness in foreign markets, the advance of imports continues to outstrip that of exports. As a result, in January-April 1965, the huge trade surpluses of early 1964 were reduced by about two-thirds, to an annual rate of \$0.8 billion.

The reduction in the trade balance and the shift from long-term private capital inflows to outflows, following the announcement of the 25 per cent withholding tax on non-resident income from German fixed interest bearing securities, resulted in balance-of-payments deficits during the last three quarters of 1964 and again in March-May 1965.

The reversal in Germany's international payments position, the restrictive policy measures of the Bundesbank, and the continuing rapid expansion of the economy brought about a severe tightening of domestic liquidity. Continuing large financing demands of the private sector and the growing borrowing needs of the public authorities put further upward pressure on the interest rate level.

These developments finally led to the establishment of a 7 per cent long-term interest rate in May, when public authorities decided to yield to market pressures and to halt support purchases of their bonds which had been undertaken in an attempt to keep yields at around 6.7 per cent. Yields since have stabilized at about 7.3 per cent and new 7 per cent coupon bonds issued at these rates have been absorbed readily. Nevertheless, there remains some question whether public authorities will be able to find all the financing necessary for their projected expenditures this year and whether some projects will not have to be postponed. Such a development, in so far as projects involving domestic investment are affected, would fit within the current framework of economic policy.

Since the spread between long-term and short-term rates has been widening and short-term rates have consistently remained above the discount rate for about three months, the question has arisen whether the current discount rate of 3.5 per cent would be maintained. The Bundesbank has gone on record that even a purely technical increase of the discount rate would inevitably have further upward repercussions on the rate structure--a development which the authorities do not consider desirable at this point. However, the Bundesbank has also stated that it will not move to counteract upward pressures on money rates emanating from market forces.

Business activity continues to expand

Over-all demand continued to increase during the first four months of 1965, although perhaps at a somewhat slower pace than in the fourth quarter of 1964. The shift in the pattern of demand, which became apparent earlier, has become more pronounced in recent months. Foreign demand, which was the mainspring in the 1963-64 upswing, is currently expanding only moderately, and the upward impetus from stockbuilding--a major expansionary factor in 1964--also appears to have worked itself out. But the slowing down in these sectors of demand is offset by an acceleration in the expansion of private consumption demand and a continued vigorous growth of investment demand.

The continued growth of demand was reflected in the inflow of new orders to industry, which averaged 2.1 per cent higher during the first four months of 1965 than in the last four months of 1964 after seasonal adjustment. (See Table 1.) Domestic orders grew somewhat faster than foreign orders, reversing the pattern which had prevailed during most of 1964. During the first four months of 1965, domestic orders advanced by 2.2 per cent as compared with the last four months of 1964, while foreign orders were up 1.7 per cent. The order inflow to the capital goods industries continued to expand vigorously and that to the consumer goods industries accelerated appreciably. In the basic industries, on the other hand, the inflow of new orders in early 1965 remained below the rate established in the second half of 1964, possibly reflecting some slowing in the rate of expansion in the construction sector.

Table 1. Germany: New Orders Received by Industry, 1964-April 1965
(Index numbers, 1954 turnover = 100, seasonally adjusted)

	<u>All industries</u>	<u>Domestic orders</u> ^{1/}	<u>Foreign orders</u>	<u>Basic industries</u>	<u>Capital goods</u>	<u>Consumer goods</u>
<u>1964</u>						
Jan.-Feb.	240	224	319	222	300	193
March-April	246	231	318	225	304	195
May-June	243	229	305	211	307	180
July-Aug.	245	233	302	224	299	200
Sept.-Oct.	250	236	317	228	303	192
Nov.-Dec.	256	239	332	226	333	195
<u>1965</u>						
Jan.-Feb.	251	236	316	220	320	195
March-April ^{2/}	266	249	344	223	344	211
January	245	232	305	220	311	186
February	256	245	332	221	338	203
March	270	251	362	222	352	219
April ^{2/}	261	247	327	224	336	201

^{1/} Excluding mining, construction, food and power.

^{2/} Preliminary.

Source: Bundesbank, Monthly Report.

The growth in industrial output during the first four months of 1965 more or less kept pace with the expansion of demand. Industrial production during the period averaged 2.6 per cent higher than in September-October, 1964. (See Table 2.) The various sectors of production (if month-to-month variations are excluded) mirrored the developments in the order situation rather closely. Output of the capital and consumer goods sectors during the first four months of 1965 was appreciably higher than during the last four months of 1964, while that of basic producer goods grew slowly.

Despite the parallel movements of order inflows and output, order backlogs continued to increase in most sectors. During the

first four months of 1965, deliveries fell short of new order inflows by 3 per cent: foreign deliveries fell behind by about 8 per cent and domestic deliveries by about 2 per cent. The stronger tendency for foreign order books to lengthen, despite a slowdown in the growth of export order inflows, apparently indicates a continuing shift towards accommodation of domestic customers in preference to foreign customers.

Table 2. Germany: Industrial Production, 1964-April 1965
(Index numbers, 1958=100, seasonally adjusted)

	<u>All industries</u>	<u>Basic producer goods</u>	<u>Capital goods</u>	<u>Consumer goods</u>	<u>Food beverages & tobacco</u>	<u>Building</u>
<u>1964</u>						
Jan.-Feb.	146	162	149	142	128	157
March-April	146	163	149	144	127	153
May-June	149	165	154	146	129	154
July-Aug.	150	168	155	146	128	154
Sept.-Oct.	151	171	156	147	127	158
Nov.-Dec.	153	175	157	145	129	180
<u>1965</u>						
Jan.-Feb.	159	179	166	156	135	164
March-April	153	171	160	151	130	145
January	162	182	168	158	136	188
February	156	175	165	155	133	140
March	149	168	154	151	129	138
April	157	175	166	152	131	153

Labor shortage continues acute

The continuing labor shortage appears to be the main limiting factor to the expansion of output. Productive capacities have been growing rapidly due to the heavy investment outlays of the past year, and investment activity continues to expand unabated. As a result, additions to capacity have kept pace with the over-all growth in

demand, and in some instances have grown even faster. A recent survey conducted by the IFO-Institute found that the rate of capacity utilization in April 1965, though higher than in the preceding year, did not quite reach the record rate recorded in the fall of 1964. Thus, the potential for further expansion of output, although smaller than in early 1964, appears to be limited primarily on the side of labor rather than of plant capacity.

Unemployment has moved down continually, except in February when bad weather conditions caused a momentary rise. (See Table 3.) The rate of unemployment currently hovers around 0.5 per cent of the labor force, which appears to be very close to the structural minimum. At the same time, the seasonally adjusted level of unfilled vacancies, appears to have reached the maximum at which employers still think it worthwhile to register vacancies. The ratio of job offers to the number of unemployed (after adjustment for seasonal variations) at 4.3 in April (1965) was unchanged from the fourth quarter (1964) level.

Employment in industry at the end of March (1965) was 2.5 per cent higher than in the previous March. The growth in the industrial labor force was mainly due to the influx of foreign labor during the year. With little expansion in the domestic labor force, foreign labor, currently numbering more than 1 million, constitutes 5 per cent of the total labor force. A faster growth of the industrial labor force, according to the May Report of the Bundesbank, would be possible only at the expense of other sectors of the economy which also are facing acute labor shortages.

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

	<u>Unemployment</u>	<u>Vacancies</u>	<u>Ratio of vacancies to unemployment</u>
<u>1963</u>			
I	220	526	2.4
II	171	545	3.2
III	172	569	3.3
IV	169	585	3.5
<u>1964</u>			
I	172	588	3.4
II	173	599	3.5
III	168	618	3.7
IV	151	646	4.3
<u>1965</u>			
I	155	633	4.1
April	148	642	4.3

Source: OECD.

Under conditions of expanding demand and continuing labor shortages, wage pressures are accelerating. Increases in weekly wage rates coming into force since the fourth quarter of 1964 have averaged 5.2 per cent as compared with increases of 3 per cent during the first half of 1964. In addition, current settlements appear to include more liberal fringe benefits--such as higher vacation pay, rent allowances and some form of profit sharing--than in 1963-64. On average, hourly wage rates during the first four months of 1965 were 7.5 per cent above the January-April, 1964 level.

Because the pressures on the labor supply encourage payments of above-contract rates, bonuses and overtime work, effective hourly earnings increased even faster than contract rates. During the first quarter of 1965 they averaged 8.5 per cent higher than in the first quarter of 1964. However, the Bundesbank estimated that currently the differential rate of increase between contract and effective hourly earnings is diminishing slightly.

Price movements moderate

While the upward trend of hourly earnings is becoming more pronounced, the rate of productivity increases is slackening. Consequently, labor costs per unit of output have been increasing. Renewed rises in raw material costs, particularly for non-ferrous metals, have added to pressures on the price level in recent months.

Nevertheless, the rate of price increases in March and April appears to have been somewhat slower than that of the first two months of the year. Industrial producer prices in March-April rose by 0.4 per cent as compared with 0.7 per cent in January-February. (See Table 4.) The upward price movement of finished investment and consumption goods also was somewhat more moderate in recent months than in late 1964 and early 1965.

Expectations are that these developments will continue during the next few months. A recent survey conducted by the IFO-Institute found that the proportion of firms expecting higher prices in the investment goods sector was appreciably smaller in April (1965) than in the fall of 1964.

Table 4. Germany: Prices and Wages, January 1964-April 1965
(index numbers, 1962 = 100)

	1964				1965			
	Jan.	April	July	Oct.	Jan.	Feb.	March	April ^{a/}
<u>Producer Prices</u>								
Total industrial products	100.9	101.2	101.2	102.4	103.0	103.4	103.5	103.8
Investment goods ^{b/}	101.7	102.2	102.6	103.9	105.3	105.2	105.3	105.6
Consumer goods ^{b/}	101.6	101.8	101.7	102.3	103.2	103.4	103.6	103.9
<u>Consumer Prices</u>								
General index	104.6	105.1	105.7	105.7	107.0	107.1	107.5	107.8
Food	104.6	105.0	105.8	104.5	106.4	106.2	106.9	107.3
<u>Export Prices</u>								
General index	101.7	103.3	104.1	104.8	105.8	105.9	106.1	106.1
Investment goods ^{b/}	103.2	103.6	104.1	105.0	106.5	106.6	106.7	<u>c/</u>
Consumer goods ^{b/}	100.9	101.2	102.3	103.0	104.0	104.1	104.2	<u>c/</u>
<u>Import Prices</u>								
General index	103.5	105.3	104.2	104.7	104.6	106.1	106.6	107.3
Investment goods ^{b/}	104.1	104.2	104.0	104.2	104.3	104.3	104.4	<u>c/</u>
Consumer goods ^{b/}	100.1	99.5	99.8	99.8	99.8	100.0	100.1	<u>c/</u>
<u>Earnings</u>								
Average hourly earnings in industry	111.6	115.5	117.8	121.0	123.8	<u>c/</u>	<u>c/</u>	<u>c/</u>

a/ Preliminary

b/ Grouped according to end-use of goods.

c/ Not available.

Source: Statistisches Bundesamt, Wirtschaft und Statistik.

The Bundesbank attributed the moderation of price tendencies in the investment goods (as well as in the consumer goods) sector to the increasing share of the domestic market supplied by imports. Import prices for finished goods, in contrast to domestic producer prices, have remained relatively stable through most of 1964 and the early months of 1965. German export prices have also reflected the calmer price climate.

Moderate trade surplus

The moderating influence exercised by imports on the domestic price level has caused Government officials to state not only that the danger of "imported inflation" has passed, but actually that the external sector currently can be viewed as a stabilizing factor. The strong upward trend of imports, despite continued growth of exports, has eroded a major part of the huge trade surpluses of early 1964. During January-April (1965), the seasonally-adjusted trade surplus ran at an annual rate of \$0.8 billion or only about one-third of the \$2.3 billion rate registered during the first four months of 1964. (See Table 5.)

In March-April (1965) imports, which had been rising steadily since mid-1964, were 19.5 per cent above March-April, 1964 and 2.5 per cent above November-December, 1964. The pattern of import expansion reflected the shift in the domestic pattern of demand. The rise in imports of fully finished goods for final consumption has gained in importance in recent months, and in the

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

	<u>Exports</u>	<u>Imports</u>	<u>Industrial goods imports</u>	<u>Trade balance</u>
<u>1963</u>				
July-Aug.	5.05	4.52	3.36	.53
Sept.-Oct.	5.04	4.55	3.43	.49
Nov.-Dec.	5.04	4.18	3.10	.86
<u>1964</u>				
Jan.-Feb.	5.41	4.54	3.40	.87
March-April	5.30	4.62	3.49	.68
May-June	5.31	4.62	3.44	.69
July-Aug.	5.28	4.99	3.76	.29
Sept.-Oct.	5.46	5.21	3.96	.25
Nov.-Dec.	5.51	5.39	4.13	.12
<u>1965</u>				
Jan.-Feb.	5.79	5.47	4.30	.32
March-April	5.76	5.52	n.a.	.24
January	5.85	5.68	4.44	.17
February	5.73	5.26	4.16	.47
March	6.15	5.61	4.31	.54
April 1/ May 1/	5.36 6.14	5.43 5.85	4.18 n.a.	-.07 .29

1/ Preliminary.

n.a. Not available.

Source: Bundesbank, Monthly Report.

first quarter of 1965 these goods led the advance in imports with a year-to-year increase of 40.6 per cent. (See Table 6.) Imports of finished products for industrial consumption and of semi-manufactures also continued to expand strongly. In contrast, imports of raw materials grew less rapidly than previously since producers' stocks of these materials, which were built to high levels by the end of last year, are reportedly sufficient for current requirements.

Table 6. Germany: Growth in Major Sectors of Germany's Foreign Trade
(percentage change from the previous year)

	1 9 6 4			1965
	Jan.- March	March- Oct.	Oct.- Dec.	Jan.- March
Total Exports	+20.5	+ 8.8	+ 8.7	+11.6
Industrial exports	+19.9	+ 8.5	+ 8.8	+11.3
Raw materials	+19.6	- 5.7	- 0.8	-11.8
Semi-manufactures	+12.8	+ 0.9	+ 7.2	+11.8
Finished				
manufactures	+20.8	+10.1	+ 9.5	+12.4
Products for further processing	+23.3	+12.1	+ 7.9	+12.4
Fully-finished products	+20.1	+ 9.5	+ 9.9	+12.5
Total Imports	+ 8.4	+ 8.7	+24.0	+23.6
Industrial imports	+ 8.9	+ 5.7	+28.0	+28.1
Raw materials	+21.6	+13.6	+18.1	+ 7.9
Semi-manufactures	+13.5	+20.8	+29.8	+27.1
Finished				
manufactures	+ 1.8	+ 1.8	+31.9	+38.9
Products for further processing	+ 9.3	+17.9	+32.9	+35.9
Fully-finished products	- 2.0	- 5.8	+31.4	+40.6

Source: Statistisches Bundesamt, Aussenhandel, Reihe 1; Bundesminister fuer Wirtschaft, Die Wirtschaftliche Lage.

While import competition in the German market has become increasingly sharper during the past year, German exports so far appear not to have lost their competitiveness in foreign markets. In fact, the near stability of export prices during the first four months of 1965 would indicate that German exports currently may even be gaining in over-all price competitiveness.

Exports resumed their upward trend in the fall of 1964 and March-April export values (after seasonal adjustment) were 9 per cent

above both July-August, 1964 and March-April, 1964. Exports of semi-manufactures and of finished manufactured products appear to be accelerating, and during the first quarter of 1965 both categories registered increases of roughly 12 per cent as compared with the first quarter of 1964.

As a result of these large increases, the German share in the total value of exports of manufactured goods of major industrial countries (which declined in the second and third quarters of 1964) has been rising since the fourth quarter of 1964. The National Institute for Economic and Social Research estimated that the German share in exports of manufactures (after seasonal adjustment) fell from 20.6 per cent in the first quarter of 1964 to 19.3 per cent in the third quarter of the year and subsequently rose again to reach 21.1 per cent in the first quarter of 1965. This rise was the more remarkable since German exports to the other Common Market countries were only little changed between the first quarters of 1964 and 1965 because Italian import demand dropped sharply after anti-inflationary measures were taken by the Italian authorities last year.

By contrast to the relative stability in German exports to the Common Market over the year, sharp increases occurred in exports to the EFTA countries (other than the United Kingdom, where the imposition of import surcharges had a dampening effect on import deliveries early this year), the United States, the lesser developed countries and Eastern Europe. As a result, total German exports

rose faster than the average of world exports. Since German export deliveries are increasingly falling behind the rate of inflow of new orders, a continuation of these recent trends may be expected.

Balance of payments surplus in January-April 1965

After having been in deficit for the last three quarters of 1964, the German balance of payments again recorded a surplus in January-February. However, this surplus was largely due to special capital inflows, in part connected with pressures on sterling and in part with anticipatory positioning to the United States' balance of payments measures.

In March and April, Germany's payments position reverted to a deficit and preliminary figures indicate a further deficit in May. During the first four months of 1965, the balance-of-payments surplus amounted to DM 1,315 million (\$329 million) as compared with a surplus of DM 2,319 million (\$580 million) recorded in the corresponding period of 1964. (See Table 7.)

The reduction in the German payments surplus between early 1964 and early 1965 resulted largely from the deterioration in the current-account balance. The strong rise in imports, which outstripped the growth in exports, caused the trade balance to fall by DM 2 billion (\$0.5 billion) between January-April, 1964 and January-April, 1965. The small improvement in the service account registered over the period, in contrast to the change in the trade account, does not appear to constitute a structural shift. On the contrary, indications are that the tendency towards growing deficits on travel account has been resumed and that the deterioration on this account will probably

Table 7. Germany: Balance of Payments, 1964-April 1965
(in millions of DM)

	<u>Jan.-April</u>		<u>1964</u>		<u>1965</u>	
	<u>1964</u>	<u>1965a/</u>	<u>III</u>	<u>IV</u>	<u>Jan. - Feb.</u>	<u>Mar. a/ Apr.</u>
1. Goods and Services						
Trade balance	3157	1100	685	1034	557	543
Services	-115	-43	-556	-130	-8	-35
Total	<u>3042</u>	<u>b/1057</u>	<u>129</u>	<u>904</u>	<u>549</u>	<u>b/ 508</u>
2. Official Payments						
Donations <u>1/</u>	-1774	-2157	-1163	-1119	-867	-1290
Long-term capital	-381	-288	-158	-464	-106	-182
Short-term capital	-376	143	74	-414	-124	267
Total	<u>-2531</u>	<u>-2302</u>	<u>-1247</u>	<u>-1997</u>	<u>-1097</u>	<u>-1205</u>
3. Private Capital						
Securities transactions						
Foreign purchases <u>2/</u>	382	35	305	139	147	-112
German purchases <u>3/</u>	-367	-588	-116	-102	-310	-278
Other long-term	234	1030	-37	348	872	158
Short-term <u>4/</u>	698	335	-298	-251	334	1
Errors and omissions	861	1742	760	-246	1265	477
Total	<u>1808</u>	<u>2554</u>	<u>614</u>	<u>-112</u>	<u>2308</u>	<u>246</u>
Surplus or deficit (-)	<u>2319</u>	<u>1315</u>	<u>-504</u>	<u>-1205</u>	<u>1760</u>	<u>-445</u>
<u>Financed by:</u>						
1. Commercial banks						
Foreign exchange assets (increase -)	-2557	-2007	179	1674	-2944	937
2. Reserve movements						
Drawing rights on IMF (increase -)	-344	140	4	-859	176	-36
Bundesbank liabilities	54	-29	-83	31	-61	32
Gold and foreign exchange (increase -)	528	581	404	359	1069	-488
Total	<u>238</u>	<u>692</u>	<u>325</u>	<u>-469</u>	<u>1184</u>	<u>492</u>
Total financing	<u>-2319</u>	<u>-1315</u>	<u>504</u>	<u>1205</u>	<u>-1760</u>	<u>445</u>

1/ Also includes foreign workers' remittances.

2/ Net foreign purchases of German securities.

3/ Net German purchases of foreign securities.

4/ Excludes total net commercial bank foreign exchange holdings.

a/ Preliminary.

b/ Does not add due to statistical discrepancy of DM 6 million in May Reports of the Bundesbank.

Source: Basic data from Bundesbank and International Financial Statistics, rearranged by author.

more than offset improvements in interest payments abroad stemming from the recent reduction in foreigners' holdings of German fixed-interest securities.

Private capital inflows into Germany during the first four months of 1965 exceeded the previous year's inflow considerably, even though foreigners continued to reduce their net holdings of German fixed-interest securities slightly in 1965 after increasing these holdings substantially in the first few months of 1964. (See Table 8.) The DM 2,554 million (\$638 million) inflow of private capital in early 1965 was caused to a large extent by short-term flows reflecting substantial foreign borrowings by German subsidiaries of foreign companies as well as by German-owned firms.

Table 8. Germany: Private Security Transactions with Foreigners,
1964 - April 1965
(in millions of DM)

	<u>Jan.-April</u>		<u>1964</u>	<u>1 9 6 5</u>				
	<u>1964</u>	<u>1965</u>		<u>p/</u>	<u>IV</u>	<u>Jan.</u>	<u>Feb.</u>	<u>March</u>
<u>Transactions in</u>								
<u>German securities</u>								
Net foreign purchases (+)								
of: Fixed-interest								
bearing securities	254	-10	16	104	-34	-281	2	
Stocks	<u>128</u>	<u>45</u>	<u>123</u>	<u>32</u>	<u>45</u>	<u>1</u>	<u>-34</u>	
Total	382	35	139	136	11	-80	-32	
<u>Transactions in</u>								
<u>Foreign securities</u>								
Net German purchases (-)								
of: Fixed-interest								
bearing securities	-234	-284	-7	-55	-67	-217	55	
Stocks	<u>-133</u>	<u>-304</u>	<u>-95</u>	<u>-53</u>	<u>-135</u>	<u>-97</u>	<u>-19</u>	
Total	-367	-588	-102	-108	-202	-314	36	
Total net transactions in foreign & domestic securities	<u>15</u>	<u>-553</u>	<u>+37</u>	<u>28</u>	<u>-191</u>	<u>-394</u>	<u>4</u>	

p/ Preliminary.

Source: Monthly Report of the Deutsche Bundesbank.

The net-inflow of DM 180 million (\$45 million) on long-term private capital account during January-April 1965 resulted from the conversion of short-term credits into long-term assets by a German subsidiary of a foreign company. Without this transaction there would have been a private long-term capital outflow of about DM 320 million (\$80 million) mainly because of net purchases of foreign securities by German residents. These purchases arose partly in connection with the increased number of DM-denominated issues floated by foreigners in the German market. During the first four months, DM 550 million worth of these issues were floated: it is estimated that DM 250 million were taken up by German investors. However, some of these purchases probably represent residual holdings of the issuing banks which may be placed abroad later.

Reserve changes

The changes in the balance-of-payments accounts were reflected in a rise in total German foreign exchange holdings of \$424 million in January and February and a subsequent fall of \$104 million in March and April. (See Table 9.) Preliminary figures indicate a further decline in May.

The reduction in overall foreign exchange holdings in March resulted from the drawing down of foreign balances in the amount of \$219 million by commercial banks in response to the tight liquidity situation in German financial markets and in preparation for the major mid-March tax date. The Bundesbank's reserve position, on the other hand, improved by \$169 million. Combined holdings of the Bundesbank

and the commercial banks declined by a further \$54 million in April and an estimated \$71 million in May.

Table 9. Germany: Changes in Reserve Position, 1964-April 1965
(in millions of U.S. dollars)

	<u>1 9 6 4</u>		<u>1 9 6 5</u>				
	<u>Jan.- June</u>	<u>July- Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>March</u>	<u>April</u>	<u>May</u>
A. Bundesbank gold & foreign exchange							
Gold	238	167	2	1	-8	--	134
Foreign exchange	-178	-356	-368	97	166	-36	-473
Total	<u>60</u>	<u>-189</u>	<u>-366</u>	<u>98</u>	<u>158</u>	<u>-36</u>	<u>-339</u>
B. Reserve position in IMF	<u>147</u>	<u>214</u>	<u>- 40</u>	<u>-4</u>	<u>11</u>	<u>- 2</u>	<u>182</u>
C. Commercial banks							
Net foreign exchange assets	<u>164</u>	<u>-87</u>	<u>638</u>	<u>98</u>	<u>-219</u>	<u>-16</u>	<u>a/ 86</u>
Total A through C	<u>371</u>	<u>-62</u>	<u>232</u>	<u>192</u>	<u>-50</u>	<u>-54</u>	<u>a/ -71</u>

a/ Estimated.

Source: International Financial Statistics; Bundesbank Monthly Report.

In May, the Bundesbank made available an additional \$168 million to the IMF under the General Agreements to Borrow. Bundesbank gross gold and foreign exchange reserves adjusted for IMF transactions fell by \$157 million during May, reflecting a continuing balance of payments deficit and the movement of commercial bank funds abroad.

The German reserve losses were reflected in a weakening of the D-mark in foreign exchange markets. The spot rate for the D-mark slipped almost continuously from a high of 25.161 U.S. cents at the beginning of April to 25.132 cents at the end of the month. (See Table 10.) During May the rate began to decline more rapidly, partly

because commercial banks again began to move funds abroad. But when the movement of commercial banks' funds was reversed in June in anticipation of the June tax date, the dollar continued to strengthen against the D-mark and by mid-June quotations at 24.995 U.S. cents were slightly below the D-mark's par value of 25.000 U.S. cents.

Table 10. Germany: Exchange Rate and Forward Rate in U.S. Cents per DM and per cent per annum, January-June 1965

		Par value			25.00		
		Upper limit			25.188		
		Lower limit			24.875		
		<u>Spot Rate</u> ^{1/}	<u>Forward Rate</u>		<u>Spot Rate</u>	<u>Forward Rate</u>	
Jan.	8	25.149	+0.8%	April	2	25.161	+0.8%
	15	25.136	+0.9%		9	25.147	+0.7%
	22	25.131	+0.8%		16	25.148	+0.6%
	29	25.135	+0.8%		23	25.153	+0.3%
Feb.	5	25.129	+0.7%		30	25.132	+0.5%
	11	25.130	+0.6%	May	7	25.122	+0.5%
	19	25.140	+0.4%		14	25.110	+0.6%
	26	25.156	+0.3%		21	25.075	+0.8%
March	5	25.155	+0.3%		28	25.038	+0.7%
	12	25.146	+0.7%	June	4	25.020	+0.6%
	19	25.140	+0.8%		11	25.001	+0.6%
	26	25.151	+0.8%		18	24.995	+0.5%

^{1/} Noon buying rates.

Source: Federal Reserve Board.

Since the revaluation of the D-mark in 1961, the rate for the D-mark has fallen below par only during and immediately after the Cuba crisis of October 1962. German financial circles are attributing the strength of the dollar to shortages in the German exchange market connected with the success of the U.S. balance of payments measures. These shortages are reportedly accentuated by speculators holding back dollar balances.

Domestic liquidity tightens

The reversal in Germany's international payments position-- from large surpluses to actual deficits in the last three quarters of 1964 and again in the period March through May 1965, combined with the continued rapid expansion of the economy and the restrictive policy of the Bundesbank, brought about a severe tightening of domestic liquidity. The liquid assets position of commercial banks, after rising substantially during 1963 and the first quarter of 1964, has been decreasing steadily since. Between the second quarter of 1964 and April 1965 the reduction amounted to DM 4.3 billion. (See Table 11.)

In recent months, the tightening of bank liquidity has been due mainly to market factors. Since February, money supply has been increasing rapidly--by DM 1.3 billion between February and April 1965. The Bundesbank estimated that money in circulation in May (1965) exceeded the preceding year's level by roughly 10 per cent.

In contrast to the preceding year, transactions on external account served to further tighten the commercial banks' liquidity position during the first four months of 1965. The influence of public authorities' cash movements, on the other hand, which usually is seasonally restrictive during the first part of the year, was less so in 1965 than in the preceding year. During the first quarter of 1965, the banks' liquidity position was tightened by DM 358 million, while it had increased by DM 389 million in the

Table 11. Factors Increasing (+) or Decreasing (-) Commercial Bank Liquidity, 1963-April 1965
(change during period, in billions of DM)

	1963	1964				1965	
		I	II	III	IV	I	April
Money supply	-1607	+1065	-675	-589	-1585	+520	-433
Public authority deposits	+1588	-1515	-456	-14	+2375	-1006	+652
Foreign exchange assets	+2796	+569	-178	-210	+225	-16	-295
Other	-279	-365	+492	-147	-86	-212	-162
Total	+2498	-246	-817	-960	+929	-714	-238
Additions (-) or reductions (+) in reserves with Bundesbank *	-1222	+635	-403	-1385	-1069	+356	+22
Total increase (+) or decrease (-) in liquid assets	<u>+1276</u>	<u>+389</u>	<u>-1220</u>	<u>-2345</u>	<u>-140</u>	<u>358</u>	<u>-216</u>
<u>Liquidity provisions</u>							
1. Purchase (-) or resale (+) of money-market paper	-704	-439	+863	+1285	+522	-8	+232
2. Increase (-) or decrease (+) of foreign exchange assets	-376	-461	-134	-58	-235	-333	+303
3. Borrowing (+) or repayment (-) at Bundesbank	-196	+511	+491	+1118	-147	+699	-319
Total (1-3)	<u>-1276</u>	<u>-389</u>	<u>+1220</u>	<u>+2345</u>	<u>+140</u>	<u>+358</u>	<u>+216</u>
* Note: due to increase (+) in required minimum reserves	+1059	+355	+400	+1435	+362	+303	+46

Source: Bundesbank Monthly Report for May 1965 and Report of the Deutsche Bundesbank for the Year 1964.

preceding year. And there was a further substantial tightening in April and May. Because of various official actions, ^{2/} commercial banks refrained from providing for their needs for liquid assets through the drawing down of their foreign short-term balances.

Instead they met their needs primarily through the sale of money-market paper--to the amount of DM 2.2 billion in 1964 and a further DM 0.2 billion so far in 1965--and through borrowings at the Bundesbank--to the amount of DM 2.2 billion in 1964 and DM 0.4 billion in the first four months of 1965.

Interest rates move up

The severe tightening of the banks' liquidity position, the rapid expansion of the economy and the growing borrowing needs of the public authorities put continuing pressure on the interest level. These factors finally led in May to what appears to be a firm establishment of a 7 per cent long-term rate.

Public authorities' attempts to keep prices for their 6 per cent bonds stable at 96 per cent of par (giving an effective yield of about 6.7 per cent) by directing the Bundesbank to undertake support purchases at this level finally had to yield to market pressures. On May 5, the Bundesbank withdrew support from public authorities issues and yields moved up to 7.3 per cent where they appear to be stabilizing.

The first public authority loan carrying a 7 per cent coupon--a DM 100 million issue of the Land Rheinland-Pfalz--priced to yield 7.2 per cent was placed successfully at the beginning of June. Since

^{2/} Since March, 1964 the Bundesbank has been providing preferential forward cover for commercial banks' investment in U.S. Treasury bills. In addition, minimum reserve requirements against foreign deposits were increased, but foreign liabilities may be offset against foreign assets.

then a second such loan, a DM 150 million issue of the Land Hessen, has reportedly been oversubscribed.

The success of these loans has led the market to anticipate the placement of about DM 1 billion of 7 per cent public authority loans in June and July. These yields apparently are sufficiently attractive to interest both domestic and foreign investors.

However, part of the funds moving into the new issues appears to be coming from switching out of older issues: issuers still had to undertake support purchases of older bonds; in addition, foreign DM-denominated issues (which had been attractive to foreign investors because they are exempt from the 25 per cent withholding tax) have recently come under selling pressure reportedly because of switching of funds into the new 7 per cent bonds.

At current yields, German authorities appear not to be concerned about a possible resumption of large inflows of foreign capital into public authorities's bonds. Interest rates have moved up also in other financial centers. The authorities seem prepared to accept the risk of renewed foreign capital inflows under current conditions because they feel that the higher cost of credit is needed to put effective limits to the borrowings of German public authorities. In the area of private investment, the higher costs are partly offset by interest and capital subsidies, especially in mortgage finance. The Bundesbank estimated recently that in 1964 about one-third of total borrowing requirements of the German economy were provided at non-market rates.^{3/}

^{3/} Report of the Deutsche Bundesbank for the Year 1964, p.6.

With the long-term rate settling around 7.3 per cent, the question has arisen whether the current discount rate level of 3.5 per cent will be maintained. Tightness in the money market has kept call money rates between $3/4$ to 1 percentage point above the discount rate almost continually since the beginning of March. Because of the growing spread between long- and short-term rates and the fact that call money rates have consistently been above the discount rate, banking circles widely expected an upward change in the discount rate in May.

However, the Central Bank Council apparently decided that monetary conditions currently are sufficiently restrictive not to warrant further action. The Bundesbank, in its recently issued Report for May, stated that it was questionable whether a discount rate change merely for technical reasons would be advisable. Particularly, the psychological effects would be such as to push interest rates up further if no counter-measures were taken. The Bank considers that current conditions warrant no further restrictive action; on the other hand, it also sees no need for a reversal of its policy with a view towards counteracting the market forces which are tightening liquidity.