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October 25, 1965

Economic Developments in Germany,  
June-August 1965

17 pages

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Recent Economic Developments in Germany, June-August 1965

Summary

The German economy continued to expand during the period under review, but the pace of expansion appeared to be moderating slightly.<sup>1/</sup> But as before, a situation of overall demand in excess of supply capabilities was reflected in persistent upward price pressures. Some easing in the building sector, a further running down of inventories and somewhat slower growth of export demand helped to move supply and demand in the economy as a whole into somewhat better balance. On the other hand, continued strong investment activity, increased consumer spending and public demand continued to press upon capacities.

The possibilities of supply continuing to accommodate the demands made upon it are becoming more limited. As capacities are being more and more fully utilized, productivity increases are slowing down. This development, in view of the acute labor shortages, is reducing the elasticity of supply. This situation is reflected in the continuing upward movement of wages and prices. The gap between wage rates and effective hourly earnings has again begun to widen and unit labor costs are increasing rapidly. This increase, however, has so far not been fully reflected in price rises. The upward price movements to a large extent resulted from unusually high food prices connected with bad weather conditions. The more moderate rise in the price of industrial products was probably influenced by lower raw material prices in world markets.

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<sup>1/</sup> See "Recent Economic Developments in Germany, March-June 1965" dated June 24, 1965.

The rise in the internal price level and the continuing strong demand pressures are pulling imports into Germany in increasing volume. As a result, imported goods have become a considerable factor in easing pressures on domestic capacities. Although exports continue to grow steadily, the rapid rise in imports combined with a rise in the deficit on the service balance has caused the German balance of payments to return to a sizable deficit--totalling \$499 million--in April-July 1965.

The balance of payments deficit and market factors have continued to tighten the liquidity position of the commercial banks substantially. As a result, interest rates have been under continual upward pressure. Despite the higher costs of credit, public authorities continued to place heavy financing demands on the capital market and by the end of July long-term public authority bond yields had risen to 7.6 per cent. To restore order to the market, the Cabinet declared a freeze on the issue of new licenses for bearer bonds; public authority bond issues, which are not subject to the licensing requirement were suspended for the duration of the licensing freeze. Discussions were inaugurated between the government and the public borrowers to work out a method of tailoring public financing demands to proportions in line with the supply capabilities of the bond market. Discussions to this end are continuing, and it does appear that public authorities have now been impressed with the necessity of their cooperating in such an effort in the interest of their own future borrowing.

The rise of long-term bond yields to the neighborhood of 7.6 per cent widened further an already substantial gap between long- and short-term rates. Consequently on August 13, the Bundesbank raised its discount rate from 3-1/2 to 4 per cent and its rate on advances against securities from 4-1/2 to 5 per cent in order to realign long- and short-term rates. At the same time, the Bundesbank announced that the rediscount quotas of commercial banks would be reduced at the beginning of October by 12-1/2 per cent instead of the 25 per cent originally planned. The Bundesbank firmly asserted on this occasion and in its latest Report that it will continue its restrictive policies until inflationary pressures--particularly public authority spending--are brought under control.

#### Continued growth of demand

Total demand remained at a high level in the second quarter. Continuing vigorous investment activity and rapid growth of private consumption and public expenditures were given balance to a certain extent by the more moderate development of activity in the areas of construction, stock building and export expansion.

The continued strong demand situation was reflected in a rise of new orders to industry of 1.9 per cent from the first to the second quarter. But during the second quarter, order inflows remained relatively stable. (See Table 1.)

Industrial production expanded further in the second quarter in response to the continued growth of demand. The production of investment goods and of consumer goods expanded most rapidly, each

Table 1. Germany: New Orders Received by Industry  
1964 - July 1965  
 (1954 = 100, month or monthly average, seasonally adjusted)

|                    | All <sup>1/</sup><br>Industries | Domestic<br>Orders | Foreign<br>Orders | Basic<br>Industries | Capital<br>Goods | Consumer<br>Goods |
|--------------------|---------------------------------|--------------------|-------------------|---------------------|------------------|-------------------|
| <u>1964</u>        |                                 |                    |                   |                     |                  |                   |
| I                  | 239                             | 223                | 314               | 216                 | 295              | 189               |
| II                 | 248                             | 233                | 314               | 221                 | 310              | 191               |
| III                | 248                             | 235                | 310               | 224                 | 305              | 196               |
| IV                 | 253                             | 238                | 323               | 226                 | 319              | 195               |
| <u>1965</u>        |                                 |                    |                   |                     |                  |                   |
| I                  | 258                             | 243                | 332               | 223                 | 330              | 203               |
| II                 | 263                             | 248                | 330               | 228                 | 337              | 203               |
| April              | 264                             | 249                | 327               | 224                 | 341              | 202               |
| May                | 263                             | 249                | 330               | 225                 | 340              | 208               |
| June               | 261                             | 245                | 335               | 235                 | 329              | 197               |
| July <sup>2/</sup> | 254                             | 236                | 344               | 224                 | 323              | 199               |

<sup>1/</sup> Excluding mining, construction and power.

<sup>2/</sup> Preliminary.

Source: Bundesbank, Monthly Report.

rising about 1 per cent above production levels of the preceding quarter. (See Table 2.) Production in most other sectors was maintained at previous levels; construction, however, registered a decline for the second consecutive quarter as persistent rainfall continued to hinder building activity. On the whole, therefore, industrial production grew slightly more slowly in the second quarter than it had in the preceding three quarters, rising only 1.3 per cent as compared with 2.0 per cent.

Despite the continued growth of industrial production, therefore, order backlogs in industry were not reduced since the inflow of new orders grew apace. Consequently, deliveries fell short of new order inflows by 3 per cent in the second quarter, as they had in the first. The shift in importance from foreign to domestic demand as main source of continued growth in this phase of the business expansion was reflected in the development of industry order books. Foreign order books were shortened in the second quarter as deliveries caught up with the slower growth of new orders but domestic order books lengthened again as domestic demand continued to expand. The particularly strong growth of consumer demand was marked by a lengthening of order books in this industry as deliveries fell 11 per cent behind new order inflows.

#### Extremely tight labor market

The long-standing tightness of the labor market became even more pronounced during the course of the second quarter and by July

Table 2. Germany: Industrial Production, 1964-July 1965  
(1958=100, month or monthly average, seasonally adjusted)

|                    | <u>All Industries</u> | <u>Basic &amp; Producers Goods</u> | <u>Capital Goods</u> | <u>Consumer Goods</u> | <u>Food beverages &amp; tobacco</u> | <u>Building</u> |
|--------------------|-----------------------|------------------------------------|----------------------|-----------------------|-------------------------------------|-----------------|
| <u>1964</u>        |                       |                                    |                      |                       |                                     |                 |
| I                  | 146                   | 161                                | 150                  | 143                   | 128                                 | 157             |
| II                 | 147                   | 165                                | 153                  | 144                   | 127                                 | 152             |
| III                | 150                   | 169                                | 154                  | 146                   | 128                                 | 154             |
| IV                 | 153                   | 174                                | 157                  | 147                   | 129                                 | 173             |
| <u>1965</u>        |                       |                                    |                      |                       |                                     |                 |
| I                  | 156                   | 177                                | 164                  | 154                   | 132                                 | 156             |
| II                 | 158                   | 176                                | 166                  | 155                   | 132                                 | 148             |
| April              | 159                   | 176                                | 166                  | 157                   | 134                                 | 157             |
| May                | 157                   | 175                                | 166                  | 153                   | 129                                 | 147             |
| June               | 156                   | 176                                | 166                  | 155                   | 132                                 | 141             |
| July <sup>1/</sup> | 154                   | 174                                | 160                  | 156                   | 129                                 | 155             |

<sup>1/</sup> Preliminary.

Source: Bundesbank, Monthly Report.

the number of unfilled vacancies for every person unemployed rose on a seasonally-adjusted basis to 4.6 from an average of 4.1 in the first quarter. (See Table 3.) Unsatisfied demand continued to grow despite the shifting of labor from the slower growing mining and food industries and the addition of 230,000 foreign workers to the labor force between June of this year and last.

Industry, as a whole, managed to increase its labor force more rapidly this year than in 1964 and by mid-year industrial employment was 2.2 per cent above the preceding year. Approximately 75 per cent of the total increase in industrial employment was absorbed by the investment goods industries. Labor shortages currently, as reflected in the increase in the number of unfilled vacancies, appear to be most acute in the consumer goods industries and in the service sector.

The limits imposed upon the expansion of output by the continuing labor shortage are being felt the more severely because increases in output per man-hour have slackened recently. In the second quarter of 1965 labor productivity rose by 5.3 per cent over the second quarter of 1964 as compared with year-to-year increases of approximately 8 per cent in the preceding three quarters. Over the past year these large rates of productivity have helped to make the rapid growth in output possible despite the acute labor shortages. But as capacity limits are being approached in wide sectors of industry, output per man-hour is increasing less rapidly. The large investment outlays of the past year are adding to capacity but results are felt only after a time lag. The Deutsches Institut fuer

Table 3. Germany: Labor Market, 1964 - July 1965  
(thousands, seasonally adjusted, monthly averages)

| <u>1964</u>        | <u>Unemployment</u> | <u>Vacancies</u> | <u>Ratio of<br/>vacancies to<br/>unemployment</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   |
| II                 | 147                 | 645              | 4.4   |
| April              | 148                 | 642              | 4.3   |
| May                | 146                 | 648              | 4.4   |
| June               | 147                 | 644              | 4.4   |
| July <sup>p/</sup> | 143                 | 660              | 4.6   |

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<sup>p/</sup> Preliminary.

Source: OECD.

Wirtschaftsforschung, therefore, foresees a continuation of the lower annual rate of productivity increases--of about 5 per cent--for the remainder of this year.

The strong competition for labor gave greater impetus to wage increases and although contract hourly wage rates rose no more rapidly in the second quarter than they had in the two preceding quarters, the rate of growth of effective earnings increased. Whereas hourly contract rates rose 1.2 per cent from the first to second quarter to a level 7 per cent above a year ago, average earnings in industry rose to a level 10.1 per cent above the second quarter of 1964 as compared with 8.3 per cent in the first quarter. Since productivity grew only 5.3 per cent over this same period, the increase in earnings was almost twice as great. On the whole, the strong growth of wages, the January tax cut and substantial increases in transfer incomes have brought the total volume of net private income to a level 11 per cent higher in the first quarter of this year than a year earlier.

#### Prices continue to rise

Prices continued to rise in the second quarter, however, some moderation in the rate of increase was noted in various sectors, particularly on the wholesale level.

The increase in unit labor costs arising from the disparate growth rates of earnings and productivity have apparently not been fully reflected in price increases. Prices for industrial products rose 0.3 per cent in the second quarter following an increase of 0.8 per cent in the first. (See Table 4.) The more moderate growth of

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

|                                     | 1964        |              |             |             | 1965        |              |             |                           |
|-------------------------------------|-------------|--------------|-------------|-------------|-------------|--------------|-------------|---------------------------|
|                                     | <u>Jan.</u> | <u>April</u> | <u>July</u> | <u>Oct.</u> | <u>Jan.</u> | <u>April</u> | <u>June</u> | <u>July</u> <sup>a/</sup> |
| <u>Producer Prices</u>              |             |              |             |             |             |              |             |                           |
| Total industrial products           | 100.9       | 101.2        | 101.2       | 102.4       | 103.0       | 103.8        | 104.0       | 104.1                     |
| Investment goods <sup>b/</sup>      | 101.7       | 102.2        | 102.6       | 103.9       | 105.3       | 105.6        | 105.9       | 106.1                     |
| Consumer goods <sup>b/</sup>        | 101.6       | 101.8        | 101.7       | 102.3       | 103.2       | 103.9        | 104.4       | 104.6                     |
| <u>Consumer Prices</u>              |             |              |             |             |             |              |             |                           |
| General index                       | 104.6       | 105.1        | 105.7       | 105.7       | 107.0       | 107.8        | 109.5       | 110.1                     |
| Food                                | 104.6       | 105.0        | 105.8       | 104.5       | 106.4       | 107.3        | 110.6       | 111.8                     |
| <u>Export Prices</u>                |             |              |             |             |             |              |             |                           |
| General index                       | 101.7       | 103.3        | 104.1       | 104.8       | 105.8       | 106.1        | 106.1       | 106.1                     |
| Investment goods <sup>b/</sup>      | 103.2       | 103.6        | 104.1       | 105.0       | 106.5       | 106.9        | 107.2       | <u>c/</u>                 |
| Consumer goods <sup>b/</sup>        | 100.9       | 101.2        | 102.3       | 103.0       | 104.0       | 104.6        | 104.8       | <u>c/</u>                 |
| <u>Import Prices</u>                |             |              |             |             |             |              |             |                           |
| General index                       | 103.5       | 105.3        | 104.2       | 104.7       | 104.6       | 107.3        | 107.4       | 107.2                     |
| Investment goods <sup>b/</sup>      | 104.1       | 104.2        | 104.0       | 104.2       | 104.3       | 104.3        | 104.4       | <u>c/</u>                 |
| Consumer goods <sup>b/</sup>        | 100.1       | 99.5         | 99.8        | 99.8        | 99.8        | 100.1        | 100.1       | <u>c/</u>                 |
| <u>Earnings</u>                     |             |              |             |             |             |              |             |                           |
| Average hourly earnings in industry | 111.6       | 115.5        | 117.8       | 121.0       | 123.2       | 126.5        | <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.

prices in this sector was largely brought about by a lowering of prices in the non-ferrous metals industry following substantial reductions in the cost of raw materials in world markets. Steel prices were also reduced in some instances although this was not reflected in the index since price reductions were given in the form of an increase in rebates to purchasers.

The price of finished consumer goods rose steadily realizing another quarterly increase of 0.7 per cent. The greatest part of the rise in the consumer price index reflected, however, unseasonally high food prices caused by poor summer crops and increases in rents.

Public authority deficits add to inflationary pressures

Inflationary tendencies in Germany were reinforced by growing public authority deficits. The combined deficits of the Federal Government and the Laender alone were DM 3.3 billion higher in the first eight months than they were in the corresponding period last year. As a consequence, total borrowing of the Federal, State and local authorities rose almost DM 4.1 billion between January and June in contrast to an increase of DM 2.3 billion in January-June 1964.

The flow of new funds to the German capital market has, on the other hand, been appreciably reduced since the inflow of foreign funds to the German bond market was effectively discouraged in March 1964. The rapid increase in the financing demands of the public authorities, therefore, was accompanied by the drying up of a major source of loanable funds. As a result, a serious strain developed on the bond market and long-term bond yields rose steadily from 6.43 per cent at the end of December 1964 to 7.21 per cent by the end of May and on July 27 reached 7.61 per cent. The average yield on 6 per cent public

authority bonds rose 29 basis points from the beginning of July to the 27th as a record total of new financing demands flooded the market. On July 28, in order to halt the further deterioration of the market, the Cabinet suspended the issue of licenses for all bearer bonds and temporarily halted the issue of federal and state bonds which did not fall under the licensing provision. The major capital market borrowers were summoned to Bonn to determine measures to control the heavy borrowing demands of the public authorities. The Economics Ministry announced it would gradually resume the issues of licenses at the beginning of September; licenses are apparently to be meted out on the basis of the average demand for long-term capital of issuing institutions and on the extent to which institutions have already been authorized to issue 7 per cent bonds. At the beginning of September, the Federal Railways announced its intention of placing a large loan during the month. This loan was subsequently postponed indefinitely, however, following the weakening of the market immediately upon its announcement. To calm the market, the Capital Market Committee announced that the situation on the bond market still required issue restraint and that no applications for new issues lay before it.

These most recent developments may have succeeded in convincing the public authorities of the necessity of common cooperative efforts to adjust the size of their financing demands to more reasonable proportions. Most public borrowers have taken some steps to reduce or

postpone their planned borrowings and in their September 10th meeting agreed not to borrow above an effective interest level of approximately 7.6 per cent. However, more definite or conclusive remedies are yet to be worked out.

Trade balance further diminished

Although the strong increase in consumer incomes and in public spending continued to press upon supply capacities these pressures were eased somewhat by the overflow of demand into imports. The growth of imports continued to exceed considerably a substantial expansion of exports and the trade balance dwindled further from a seasonally-adjusted monthly average of DM 280 million in January-April to one of DM 70 million for May-August. (See Table 5.) The German trade balance has therefore been reduced by almost three-fourths from a total of DM 5.1 billion in the first 8 months of 1964 to a total of DM 1.4 billion for the same period of 1965.

Imports rose 6.8 per cent from January-April to May-August when they reached a level 22 per cent above the preceding year. The import composition reflected the areas of demand concentration within Germany. The growing importance of consumer demand as a leading source of continued expansion was emphasized by the particularly strong growth of fully-finished manufactures which rose to almost 29 per cent of total imports in the second quarter. (See Table 6.)

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

|                           | <u>Exports</u> | <u>Imports</u> | <u>Industrial<br/>goods<br/>Imports</u> | <u>Trade<br/>Balance</u> |
|---------------------------|----------------|----------------|---|--------------------------|
| <u>1963</u>               |                |                |   |                          |
| July-August               | 5.05           | 4.52           | 3.36                                    | .53                      |
| September-October         | 5.04           | 4.55           | 3.43                                    | .49                      |
| November-December         | 5.04           | 4.18           | 3.10                                    | .86                      |
| <u>1964</u>               |                |                |   |                          |
| January-February          | 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-August               | 5.28           | 4.99           | 3.76                                    | .29                      |
| September-October         | 5.46           | 5.21           | 3.96                                    | .25                      |
| November-December         | 5.51           | 5.39           | 4.13                                    | .12                      |
| <u>1965</u>               |                |                |   |                          |
| January-February          | 5.79           | 5.47           | 4.30                                    | .32                      |
| March-April               | 5.76           | 5.53           | 4.25                                    | .23                      |
| May-June                  | 5.95           | 5.86           | 4.45                                    | .09                      |
| July-August <sup>1/</sup> | 5.94           | 5.89           | n.a.                                    | .05                      |
| April                     | 5.36           | 5.43           | 4.18                                    | -.07                     |
| May                       | 6.14           | 5.85           | 4.49                                    | .29                      |
| June                      | 5.77           | 5.87           | 4.41                                    | -.10                     |
| July                      | 6.16           | 5.78           | n.a.                                    | .37                      |
| August <sup>1/</sup>      | 5.72           | 6.02           | n.a.                                    | -.30                     |

<sup>1/</sup> Preliminary.

n.a. Not available.

Source: Bundesbank, Monthly Report.

Table 6. Germany: The Composition of Foreign Trade  
(per cent of total imports or exports)

|                                    | 1964          |               | 1965          |               |       |
|------------------------------------|---------------|---------------|---------------|---------------|-------|
|                                    | Jan.-<br>June | July-<br>Dec. | Jan.-<br>Mar. | Apr.-<br>June | July  |
| Total Exports                      | 100.0         | 100.0         | 100.0         | 100.0         | 100.0 |
| Industrial exports                 | 97.2          | 97.2          | 96.7          | 96.9          | 97.1  |
| Raw materials                      | 4.4           | 3.7           | 3.3           | 3.6           | 3.5   |
| Semi-manufactures                  | 9.4           | 8.8           | 9.1           | 8.4           | 8.3   |
| Finished manufactures              | 83.5          | 84.7          | 84.3          | 84.9          | 85.3  |
| Products for<br>further processing | 18.0          | 18.1          | 18.7          | 18.5          | 18.0  |
| Fully-finished<br>products         | 65.4          | 66.6          | 65.6          | 66.4          | 67.3  |
| Total Imports                      | 100.0         | 100.0         | 100.0         | 100.0         | 100.0 |
| Industrial imports                 | 75.2          | 75.5          | 77.4          | 76.0          | 75.7  |
| Raw materials                      | 18.8          | 17.8          | 17.4          | 16.5          | 15.4  |
| Semi-manufactures                  | 15.4          | 17.0          | 16.2          | 15.6          | 15.8  |
| Finished manufactures              | 41.1          | 40.8          | 43.7          | 44.0          | 44.6  |
| Products for<br>further processing | 13.8          | 14.8          | 15.2          | 15.2          | 15.4  |
| Fully-finished<br>products         | 27.3          | 26.0          | 28.5          | 28.8          | 29.1  |

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

On the other hand, stock building in industry, which had been a major expansionary factor until the end of last year, has apparently not resumed. Stocks were probably allowed to run down further during the second quarter since imports of raw materials and intermediate goods rose only slightly.

Exports grew a bit more slowly in May-August than they had in the first four months of the year, rising about 3 per cent over the preceding quarter in comparison to earlier growth rates of 5.3 per cent. To a certain extent, however, this development was conditioned by special factors. The reduction of intra-E.E.C. tariffs at the beginning of the year made it advantageous for exporters to delay shipments until after that date. As a result, there was a bunching of exports in January and February which boosted first quarter results. However, the slower growth of exports in the second quarter may also reflect an increased absorption of output by domestic users.

With German imports from the Common Market rising particularly strongly--by 35 per cent as compared with the second quarter of 1964-- exports remaining virtually unchanged Germany's trade balance with the E.E.C. closed for the first time with a deficit of DM 536 million. Germany's exports to the United Kingdom and Switzerland, because of the effects of those countries' anti-inflationary policies, remained at about last year's level, but exports to other EFTA countries expanded vigorously as did those to North America and the Eastern European Countries.

Balance of payments returns to deficits

Germany's balance of payments returned to deficit in April-July after special circumstances in the first quarter had caused a momentary surplus. However, in contrast to earlier periods in 1964 when the overall deficit was caused by the combination of private capital outflows and reduced surpluses on current account, the deficit in April-July was caused entirely by a deterioration in the current account. A sharp swing in the goods and services balance from a surplus of DM 1,149 million in January-March to a deficit of DM 978 million in April-July caused Germany's overall balance to shift by DM 3,433 million (\$858 million) to a deficit of DM 1,996 million (\$499 million) in April-July.

As a result of the continued rapid expansion of imports, the trade surplus disappeared almost entirely in April-July 1965. (See Table 7.) This development was accompanied by a mainly seasonal shift in the services account from a small inflow in the first quarter to an outflow of DM 1,053 million in April-July. A leading factor in this deterioration was the steep rise in German tourist expenditures abroad which led to a net outflow of DM 1,063 million in April-July 1965. This was DM 313 million more than in the same period of 1964. However the withdrawal of investment income from Germany by foreigners was responsible to an almost equal degree for the large deterioration of the services account. The net outflow of investment income reached DM 1,054 million in April-July and was more than double the size of that of a year earlier. According to the

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

|  | 1 9 6 4               |              |              |              | 1 9 6 5       |                             |
|--|-----------------------|--------------|--------------|--------------|---------------|-----------------------------|
|  | I                     | II           | III          | IV           | Jan.<br>March | April<br>July <sup>a/</sup> |
|  | 1. Goods and Services |              |              |              |               |                             |
| Trade balance                          | 2389                  | 1973         | 685          | 1034         | 1096          | 75                          |
| Services                               | 83                    | 44           | -416         | - 40         | 53            | -1053                       |
| Total                                  | <u>2472</u>           | <u>2017</u>  | <u>269</u>   | <u>994</u>   | <u>1149</u>   | <u>-978</u>                 |
| 2. Official Payments                   |                       |              |              |              |               |                             |
| Donations <sup>1/</sup>                | -1147                 | -1469        | -1228        | -1101        | -1357         | -2181                       |
| Long-term capital                      | -249                  | -230         | -158         | -464         | -174          | -979                        |
| Short-term capital                     | -393                  | 13           | 70           | -415         | 68            | 167                         |
| Total                                  | <u>-1789</u>          | <u>-1686</u> | <u>-1316</u> | <u>-1980</u> | <u>-1463</u>  | <u>-2993</u>                |
| 3. Private Capital                     |                       |              |              |              |               |                             |
| Securities transactions                |                       |              |              |              |               |                             |
| Foreign purchases <sup>2/</sup>        | 646                   | -635         | 304          | 197          | 65            | 203                         |
| German purchases <sup>3/</sup>         | -299                  | -316         | -116         | -102         | -624          | -156                        |
| Other long-term                        | 144                   | 164          | 68           | 390          | 930           | 459                         |
| Short-term <sup>4/</sup>               | 664                   | 57           | -297         | -251         | 273           | 217                         |
| Errors and omissions                   | 778                   | 333          | 584          | -453         | 1107          | 1252                        |
| Total                                  | <u>1933</u>           | <u>-397</u>  | <u>543</u>   | <u>-219</u>  | <u>1751</u>   | <u>1975</u>                 |
| Surplus or deficit (-)                 | <u>2616</u>           | <u>- 66</u>  | <u>-504</u>  | <u>-1205</u> | <u>1437</u>   | <u>-1996</u>                |
| <u>Financed by:</u>                    |                       |              |              |              |               |                             |
| 1. Commercial banks                    |                       |              |              |              |               |                             |
| Foreign exchange assets (increase -)   | -2224                 | 422          | 179          | 1674         | -2069         | 520                         |
| 2. Reserve movements                   |                       |              |              |              |               |                             |
| Drawing rights on IMF (increase -)     | -368                  | -219         | 4            | -859         | 132           | -742                        |
| Bundesbank liabilities                 | 34                    | 38           | -83          | 31           | 63            | - 45                        |
| Gold and foreign exchange (increase -) | - 58                  | -175         | 404          | 359          | 437           | 2263                        |
| Total                                  | <u>-392</u>           | <u>-356</u>  | <u>325</u>   | <u>-469</u>  | <u>632</u>    | <u>1476</u>                 |
| Total financing                        | <u>-2616</u>          | <u>66</u>    | <u>504</u>   | <u>1205</u>  | <u>-1437</u>  | <u>1996</u>                 |

- <sup>1/</sup> Also includes foreign workers' remittances.  
<sup>2/</sup> Net foreign purchases of German securities.  
<sup>3/</sup> Net German purchases of foreign securities.  
<sup>4/</sup> Excludes total net commercial bank foreign exchange holdings.  
<sup>a/</sup> Preliminary.

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

Bundesbank, this big increase arose primarily in connection with the larger distribution of profits by German subsidiaries to American automobile and office machine parent firms.

To some extent, this transfer of profits had no net effect upon the German balance of payments insofar as it was immediately reinvested in the German subsidiary. This apparently occurred in a number of instances. Direct investment was also affected by conversions of short-term credits into long-term assets and by an increase in the net worth of subsidiaries through the transfer of funds from unpublished to published reserves. These transactions and others produced a recorded net inflow of direct investment capital to Germany of DM 459 million in April-July, and DM 1,389 million in the first seven months of the year, in contrast to a total of only DM 766 million for 1964 as a whole.

There was furthermore, a net inflow of private short-term capital to Germany as firms--many of them American subsidiaries--continued to borrow abroad. According to the Bundesbank, these firms were able to satisfy their financing needs with little difficulty in markets outside the United States. Security transactions also led to a small net inflow of capital; foreign security purchases by Germans were reduced from the rather high first quarter level and there was a net addition to the amount of German securities held on foreigners. (See Table 8.)

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

|   | <u>1964</u> |             |            |            | <u>1965</u>           |                                     |
|---|-------------|-------------|------------|------------|-----------------------|-------------------------------------|
|   | <u>I</u>    | <u>II</u>   | <u>III</u> | <u>IV</u>  | <u>Jan.-<br/>Mar.</u> | <u>Apr.-<br/>July</u> <sup>p/</sup> |
| <u>Transactions in</u><br><u>German securities</u>            |             |             |            |            |                       |                                     |
| Net foreign purchases (+)                                     |             |             |            |            |                       |                                     |
| of: Fixed-interest  |             |             |            |            |                       |                                     |
| bearing securities  | 443         | -519        | 65         | 16         | -13                   | 116                                 |
| Stocks  | <u>203</u>  | <u>-116</u> | <u>239</u> | <u>181</u> | <u>78</u>             | <u>87</u>                           |
| Total   | 646         | -635        | 304        | 197        | 65                    | 203                                 |
| <u>Transactions in</u><br><u>Foreign securities</u>           |             |             |            |            |                       |                                     |
| Net German purchases (-)                                      |             |             |            |            |                       |                                     |
| of: Fixed-interest  |             |             |            |            |                       |                                     |
| bearing securities  | -189        | -257        | -36        | -7         | -339                  | -11                                 |
| Stocks  | <u>-110</u> | <u>-59</u>  | <u>-80</u> | <u>-95</u> | <u>-285</u>           | <u>-145</u>                         |
| Total   | -299        | -316        | -116       | -102       | -624                  | -156                                |
| Total net transactions in<br>foreign & domestic<br>securities | <u>347</u>  | <u>-951</u> | <u>188</u> | <u>95</u>  | <u>-559</u>           | <u>47</u>                           |

<sup>p/</sup> Preliminary.

Source: Bundesbank, Monthly Report.

Foreign exchange position

The shifts in Germany's balance of payments were mirrored by changes in its foreign exchange position. After rising \$389 million in the first quarter, German foreign exchange holdings fell \$510 million in April-July. The greater part of this decline took place in June and July but particularly in July. (See Table 9.) In July, commercial banks substantially reduced their foreign exchange assets in order to shore up their liquidity positions and Bundesbank reserves fell \$98 million. The decline in Bundesbank reserves was caused largely by the transfer of \$116 million to a frozen U.K. account in connection with Germany's agreement to share the cost of British Rhine forces. This was effected through a purchase of U.K. Treasury bills--representing a prepayment on this agreement--and a sale of an equivalent amount of U.S. Treasury bills. The exclusion of this transaction from reserve movements would have produced a total reserve decline of only \$105 million after adjustment for Germany's IMF position. In August, Bundesbank reserves declined by a further \$85 million.

As a result of the continuing balance of payments deficit the exchange rate for the DM declined from an average of 25.003 U.S. cents in June to 24.961 cents in July and to 24.923 cents in August. (See Table 10.) However, the movement in the rate reversed itself in September and moved up strongly as commercial banks reportedly pulled back foreign exchange assets in volume when the approach of the major September tax date brought the tightness on the German money market to a high pitch.

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

|  | 1 9 6 4               |                       | 1 9 6 5                |                        |             |             |             |
|--|-----------------------|-----------------------|------------------------|------------------------|-------------|-------------|-------------|
|  | <u>Jan.-<br/>June</u> | <u>July-<br/>Dec.</u> | <u>Jan.-<br/>March</u> | <u>April-<br/>July</u> | <u>June</u> | <u>July</u> | <u>Aug.</u> |
| A. Bundesbank gold & foreign exchange            |                       |                       |                        |                        |             |             |             |
| Gold   | 238                   | 167                   | 11                     | 139                    | --          | 5           | - 2         |
| Foreign exchange                                 | -178                  | -356                  | -106                   | -705                   | -93         | -103        | -83         |
| Total  | <u>60</u>             | <u>-189</u>           | <u>-95</u>             | <u>-566</u>            | <u>-93</u>  | <u>-98</u>  | <u>-85</u>  |
| B. Reserve position in IMF                       | <u>147</u>            | <u>214</u>            | <u>-33</u>             | <u>186</u>             | <u>--</u>   | <u>6</u>    | <u>6</u>    |
| C. Commercial banks' Net foreign exchange assets | <u>164</u>            | <u>-87</u>            | <u>517</u>             | <u>-130</u>            | <u>- 9</u>  | <u>-129</u> | n.a.        |
| Total A through C                                | 371                   | -62                   | 389                    | -510                   | -102        | -221        | n.a.        |

n.a. Not available.

Source: International Financial Statistics; Bundesbank Monthly Report.

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

|        |                         | Par value    |        |                         | 25.00        |        |
|--------|-------------------------|--------------|--------|-------------------------|--------------|--------|
|        |                         | Upper limit  |        |                         | 25.188       |        |
|        |                         | Lower limit  |        |                         | 24.875       |        |
|        | Spot Rate <sup>1/</sup> | Forward Rate |        | Spot Rate <sup>1/</sup> | Forward Rate |        |
| May    | 25.097                  | +0.66%       | July   | 16                      | 24.963       | +0.45% |
| June   | 25.003                  | +0.57%       |        | 23                      | 24.939       | +0.32% |
| July   | 24.961                  | +0.42%       |        | 30                      | 24.931       | +0.31% |
| August | 24.923                  | +0.29%       | August | 6                       | 24.932       | +0.33% |
| June 4 | 25.020                  | +0.60%       |        | 13                      | 24.928       | +0.28% |
| 11     | 25.001                  | +0.64%       |        | 20                      | 24.931       | +0.30% |
| 18     | 24.995                  | +0.50%       |        | 27                      | 24.919       | +0.25% |
| 25     | 24.983                  | +0.52%       | Sept.  | 3                       | 24.915       | +0.10% |
| July 2 | 24.975                  | +0.50%       |        | 10                      | 24.926       | +0.15% |
| 9      | 24.976                  | +0.50%       |        | 17                      | 24.938       | -0.03% |
|        |                         |              |        | 24                      | 24.950       |        |

<sup>1/</sup> Noon buying rate.

Source: Federal Reserve Board.

Domestic liquidity tightens sharply

The influence of the Bundesbank's restrictive policies, the balance of payments deficit and the financing requirements of the strongly expanding economy continued to cause a tightening of bank liquidity during the second quarter. However, these influences were intensified by the exceptionally strong cash demands of the public as vacation approached. As a result, commercial bank liquid assets were cut back by DM 1774 million in the second quarter and DM 1592 million in the month of July, a total almost twice as high as that experienced during the April-July period last year. (See Table 11.)

Market factors continued to exert the main contractive influence affecting commercial banks' liquidity. The strong expansion of money in circulation by DM 1787 million in April-July, which was very largely connected with the approach of the prime vacation months, also offered evidence of the rise in private incomes. In addition, the balance of payments deficit continued to drain liquidity from the banking system, withdrawing a total of DM 1542 million in the April-July period. Public authority spending, on the other hand, injected an unseasonally large volume of funds into the system during this time, partly offsetting the drain on liquidity.

Throughout the first quarter, the banks had continued to rely chiefly on the resale of money market paper and borrowing at the Bundesbank to replenish their liquidity positions. However, in

Table 11. Factors Increasing (+) or Decreasing (-) Commercial Bank  
Liquidity, 1964-July 1965  
(change during period, in billions of DM)

|   | 1964        |              |              |             | 1965        |              |              |
|---|-------------|--------------|--------------|-------------|-------------|--------------|--------------|
|   | <u>I</u>    | <u>II</u>    | <u>III</u>   | <u>IV</u>   | <u>I</u>    | <u>II</u>    | <u>July</u>  |
| Money in circulation  | +1065       | -675         | -589         | -1585       | +520        | -1173        | -614         |
| Public authority<br>deposits  | -1515       | -456         | -14          | +2375       | -1006       | +921         | +415         |
| Foreign exchange<br>assets  | +569        | -178         | -210         | +225        | -16         | -1011        | -531         |
| Other   | -365        | +492         | -147         | -86         | -212        | -44          | -657         |
| Total   | -246        | -817         | -960         | +929        | -714        | -1307        | -1387        |
| Additions (-) or reductions<br>(+) in reserves with<br>Bundesbank*  | +635        | -403         | -1385        | -1069       | +356        | -467         | -205         |
| Total increase (+) or<br>decrease (-) in liquid<br>assets           | <u>+389</u> | <u>-1220</u> | <u>-2345</u> | <u>-140</u> | <u>-356</u> | <u>-1774</u> | <u>-1592</u> |
| <u>Liquidity provisions</u>   |             |              |              |             |             |              |              |
| 1. Purchase (-) or resale<br>(+) of money-market<br>paper           | -439        | +863         | +1285        | +521        | -8          | +970         | +783         |
| 2. Increase (-) or<br>decrease (+) of<br>foreign exchange<br>assets | -461        | -134         | -58          | -234        | -333        | +206         | +525         |
| 3. Borrowing (+) or<br>repayment (-) at<br>Bundesbank               | +511        | +491         | +1118        | -147        | +699        | +598         | +284         |
| Total (1-3)   | <u>-389</u> | <u>+1220</u> | <u>+2345</u> | <u>+140</u> | <u>+358</u> | <u>+1774</u> | <u>+1592</u> |
| * Note: due to increase<br>(+) in required minimum<br>reserves      | +355        | +400         | +1435        | +362        | +303        | +484         | +192         |

Source: Bundesbank, Monthly Report.

July, as in September, large sales of money market paper were not sufficient to supply the banks with the necessary liquidity and the banks were led to repatriate a volume of foreign exchange assets almost as large as their sales of money market paper, despite the advantages connected with holding funds abroad.<sup>1/</sup>

Further increases in interest rates

The increased tightness of the liquidity situation and the large volume of financing demands, particularly those of the public sector, placed mounting pressure on interest rates and long-term bond yields rose steadily throughout the period.

The bond market failed to consolidate more than momentarily following the establishment of the 7 per cent long-term rate in May and large volumes of financing demands continued to be brought to the market despite the high cost of credit. The persistent pressure placed upon the market by the apparently interest-insensitive public sector caused considerable concern particularly in the ranks of small investors. As a result, funds which might have flowed into the bond market under other circumstances were placed elsewhere, in savings accounts especially, and the consequently slower growth of investible funds added to the tightness of liquidity on the capital market.

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<sup>1/</sup> See "Recent Economic Developments in Germany, March-June 1965" dated June 24, 1965, p. 23.

The rise of long-term bond yields discussed earlier widened the gap between long- and short-term rates considerably. On August 13, the Bundesbank moved to bring long- and short-term interest rates into better alignment and raised the discount rate from 3-1/2 to 4 per cent and the rate on advances against securities from 4-1/2 to 45 per cent. With an eye to avoiding an increase in its already strained relations with the commercial banks, the Bundesbank at the same time announced that rediscount quotas of the banks would be reduced at the beginning of October by only 12-1/2 per cent instead of by 25 per cent as originally planned. This decision appears to be of mainly psychological value, since banks have underutilized their rediscount quotas at the Bundesbank by more than 25 per cent.

A rise in the discount rate had been expected as far back as May, when the 7 per cent rate was established. Until the action of August 13, however, the Bundesbank declined to raise discount rate on the grounds that the current state of the economy called for no further tightening of credit and that a technical adjustment of the rate would cause a further increase in interest rates. The increased disparity between short- and long-term rates, however, appeared to have become too large by the end of July to go uncorrected.

The continued tendency of prices in Germany to rise between May and August may also have played a role in overcoming the hesitancy of the Bundesbank to take this step. At the time of the discount rate increase, the Bundesbank stated emphatically, but perhaps rhetorically, that the current economic situation in Germany would allow no relaxation of its restrictive policies.