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Germany's Balance-of-Payments Surplus

The great strengthening of the international economic position of West Germany has been one of the most striking aspects of that country's remarkable postwar recovery.[1] By 1951, the country's exports had surpassed those of an undivided prewar Germany. Since then, they have more than trebled, making Germany the largest exporting nation in the Free World after the United States. This sharp rise in exports has occurred while other special supports (developed when there was still concern over German weakness) have also gone on increasing. The most notable among these special factors have been foreign exchange receipts from the United States and other NATO forces stationed in Germany. Recently, Germany's trade earnings and special receipts have also been supplemented by short-term capital inflows, enlarging Germany's balance-of-payments surplus during January-September 1960, to a record annual rate of about $2 billion. The German Federal Bank's gold and net foreign exchange holdings have risen almost uninterruptedly for the last ten years, reaching $7½ billion at the beginning of November—the largest international currency reserve of any single Free World country except the United States. In the current year, the German surplus represents the counterpart of roughly half of the very large United States dollar deficit.

Although this strong balance-of-payments position has helped make the German mark one of the world's hardest currencies, the continued large-scale accumulation of reserves has posed a serious dilemma for German monetary policy in recent years. This dilemma—which a number of other countries also have faced—is the problem of pursuing a policy of monetary restraint at home, while at the same time attempting to avert the foreign exchange gains that are the frequent by-product of this policy and which add to domestic liquidity. The Federal Bank has been well aware that further exchange inflows eventually could not be offset effectively by monetary restraint alone. In its 1959 annual report, the bank declared that, if these inflows continued, it would be forced to continue to offset them "in order to make its credit policy effective. . . . Clearly, however, it would be easy to expect too much of the bank in connection with such a more or less permanent stiffening of the measures affecting liquidity."

The sustained flow of gold and foreign exchange to Germany has also been of concern to its trade partners. The persistent gravitation of reserves to one country involves a heavy drain on other countries' reserve holdings, and if left unchecked would seriously unbalance the entire international payments mechanism. During the mid-fifties, the European Payments Union nearly collapsed under the weight of Germany's large surpluses, and only substantial German credits to the EPU kept the latter functioning. As the dollar position of European countries improved and convertibility of European currencies into dollars (for nonresident holders) was restored at the end of 1958, the German surplus ceased to be a threat to the payments mechanism in Europe. At the same time, however, the increased use of dollar earnings by European countries to cover their deficits with Germany transferred the burden of the German surplus more fully onto the United States dollar.

Against this background, the present article, after examining the factors underlying the German balance-of-payments surplus, describes the measures that have already been taken to correct the payments imbalance and indicates some of the possibilities for further action in the future.

HE BALANCE-OF-PAYMENTS SURPLUS

During the first three quarters of 1960, the over-all German balance-of-payments surplus was running at an annual rate of about $2 billion (see table). Aside from short-term capital inflows, the two major elements in this surplus were the trade surplus of over $1 billion and the receipts from the United States and other NATO troops stationed in Germany, also about $1 billion annually.

Germany's trade surplus rose progressively from 1955 to 1959, as a result of a 60 per cent rise in exports and only a 46 per cent increase in imports (see Chart I). During the first ten months of 1960, however, imports rose faster than exports, partly because of sharply increased imports of military goods, and the trade surplus has consequently remained about 10 per cent below last year's level.

A number of factors, some of a structural nature, underlie the trade imbalance. One of the most influential has been Germany's relatively low import demand as com-

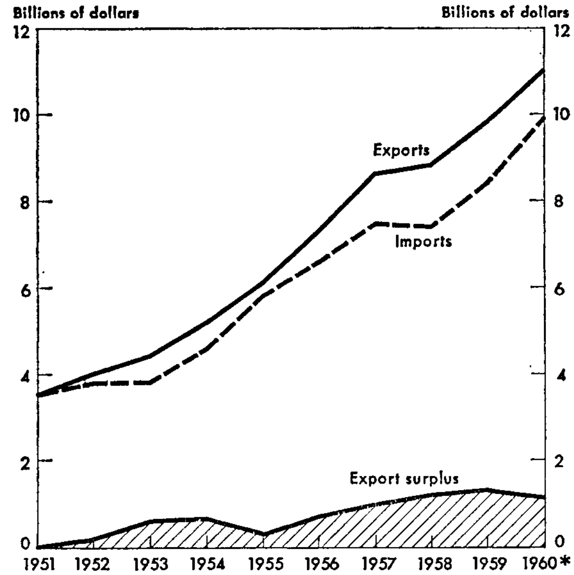
[1] For a discussion of Germany's postwar recovery, see "Growth and Price Stability: The German Experience", *Monthly Review*, February 1960, p. 29.

pared with prewar years. Decades of tariff protection and especially the attempts at self-sufficiency during the 1930's appear to have conditioned the German economy to import-saving and to have encouraged efficient exploitation of the country's own material and human resources. Moreover, there has been an enormous expansion since the war in the production of capital goods, which in Germany have a relatively low content of imported raw materials. From 1955 to 1959, while industrial production climbed by 26 per cent, imports of raw materials rose only 6 per cent. Similarly, the proportion of raw material imports to total imports declined steadily from 36 per cent in 1951 to 22 per cent in 1959.

On the export side, the conspicuous increase in German exports—from $1.9 billion in 1950 to $9.8 billion in 1959—has reflected both strong foreign demand for German goods and the German ability to meet this demand. During the postwar period, the generally high level of economic activity throughout the world and, for most of these years, the inflationary pressures in competing countries created a sellers' market for such German products as machinery, cars, and other highly specialized finished products. Moreover, until fairly recently many countries discriminated against imports from the United States and thus had to look for other sources of supply. Germany offered such a source, especially for capital equipment, the more so since during the years immediately following the Korean war the country did not have to devote a large part of its resources to a defense establishment of its own. Even now, when German rearmament is under way, defense outlays amount only to about 4 per cent of the gross national product as compared with 9

Chart I

GERMAN FOREIGN TRADE



* January-October at annual rate.

Source: International Monetary Fund.

per cent for the United States. Moreover, German fiscal and monetary policies have both been almost consistently on the restrictive side. They have kept aggregate internal demand within limits that have left an increasing margin of productive capacity for exports, while at the same time limiting price increases and keeping them within a highly competitive range.

Another important element in Germany's export performance has been the official export-promotion program. Throughout the past decade, the government has supported a large export-credit insurance system, under which export guarantees covering both economic and political risks have been made available to German exporters. In addition, the government has granted tax advantages to exporters by refunding turnover and other taxes on goods sold abroad; it has been calculated that such tax rebates have allowed exports to be priced as much as 12 per cent below the prices listed at home. This policy of active encouragement of exports contrasts with the imposition of a 4-6 per cent turnover equalization tax on most imports in order to equal the turnover taxes borne by similar domestic products; furthermore, little progress has been made in liberalizing agricultural imports.

Receipts from the United States and other NATO forces have been about as important as the trade surplus in contributing to the over-all payments surplus. In 1959, such receipts amounted to $981 million, or more than

Germany's Balance of Payments
In millions of dollars

Item	1957	1958	1959	1960*
Current account:				
Balance of trade	+ 972	+1,179	+1,276	+1,091
Balance of services	+ 183	− 227	− 549	− 462
Surplus on trade and services	+1,155	+ 952	+ 727	+ 629
Receipts from NATO troops	+ 633	+ 923	+ 981	+1,010
Balance on current account	+1,788	+1,875	+1,708	+1,639
Unilateral payments†	− 392	− 392	− 627	− 603
Capital account:				
Long term	− 173	− 446	− 895	− 373
Short term	− 408	− 122	− 565	+ 529
Balance on capital account	− 581	− 568	−1,460	+ 156
Balance on current account, unilateral payments, and capital account	+ 815	+ 915	− 379	+1,192
Errors and omissions	+ 403	− 156	− 120	+ 857
Changes in official gold and foreign exchange reserves	+1,218	+ 759	− 499	+2,049

* January-September at an annual rate.
† Primarily indemnification payments to Israel and to victims of Nazi persecution resident in other countries.
Source: Adapted from the German Federal Bank October 1960 *Monthly Report*.

three times as much as in 1955; so far this year, there has been a further small rise. Of these receipts, about 80 per cent comes from United States troops and the remainder from British and other NATO forces. In order to assist Britain on this score, Germany agreed early last year to pay a lump sum of $100 million in support of British troops in Germany; the third and final instalment was paid this spring.

Some offset to the trade surplus and the foreign exchange receipts from NATO forces has in recent years been provided by sizable net deficits on service transactions, on so-called unilateral payments, and on long-term capital account. As regards services, sharply rising German tourist expenditures and net outpayments of income on foreign investments in Germany have been instrumental in changing the service account of the balance of payments from a $183 million surplus in 1957 to a $549 million deficit in 1959. "Unilateral payments", consisting mainly of indemnification payments to Israel and to victims of Nazi persecution resident in other countries, have increased markedly and stood at an annual rate of $603 million in the first nine months of this year, although these are not necessarily a continuing flow. There has also been a deficit in Germany's long-term capital account, particularly because the German Government must make annual repayments on its external debt and German residents generally have been net purchasers of foreign securities. The total of these various net payments during January-September 1960 was equivalent to an annual rate of nearly $1.5 billion and thus exceeded the trade surplus by a substantial margin, although still far short of the combined trade surplus and NATO troop receipts.

Over the past fifteen months, moreover, the inflow of short-term capital has aggravated the German external surplus considerably. After the current boom began to develop in the summer of 1959 and the Federal Bank tightened credit substantially by a series of measures, German banks repatriated the bulk of their foreign short-term assets. From August 31, 1959, just before these measures were adopted, to September 30, 1960, banks drew down these assets by $530 million to around $240 million (about the level at which they had stood before the Federal Bank started to encourage the outflow of short-term funds at the end of 1958—as noted below). During the same period, German banks also increased their short-term borrowing abroad at an accelerated pace and outstanding borrowings rose from $67 million to $257 million. Even more important, a large volume of short-term funds moved into Germany, as German industry directly borrowed from abroad and as payments for imports were delayed and payments for exports speeded up. No official statistical record is kept of such short-term movements, and these movements accordingly are included in the balance of payments under "errors and omissions". This latter item accounted for about $610 million, or about 42 per cent of official reserve gains during the second and third quarters of this year.

IN SEARCH OF BALANCE-OF-PAYMENTS EQUILIBRIUM

The German authorities, concerned about the huge and persistent external surplus, have taken a number of corrective measures during the last few years. In a move to curb domestic inflationary pressures as well as to reduce the trade surplus, they lowered tariffs on most industrial products by nearly 50 per cent in 1956-57. Partly as a consequence, imports of finished products rose by 138 per cent from 1955 to 1959, and their share in total imports increased from only 19 per cent to 31 per cent. However, in view of the sluggish rise in imports of raw materials and food products and the very sharp rise in exports, these tariff cuts failed to prevent the trade surplus from almost doubling from 1956 to 1959.

In the first eight months of 1959, the German authorities sought to moderate Germany's foreign exchange gains by stimulating the outflow of short-term funds. During almost this entire period the Federal Bank kept its discount rate at 2¾ per cent, the lowest in the history of German central banking, and also extended forward cover at below market rates or at no cost at all to commercial banks desiring to increase their short-term dollar assets. The banks responded well to these efforts, and increased their net foreign exchange position by $570 million during January-August 1959. At the same time, the German Government made substantial advance payments on military purchases abroad as well as on its external debt. However, although these efforts were effective in reducing official reserves and easing the upward pressure on the mark, they could not provide a lasting solution to Germany's payments problem. As noted above, the Federal Bank in the fall of 1959 deemed it essential to tighten credit in order to curb excessive internal demand. The German banks thereupon started to repatriate the foreign short-term assets they had built up in early 1959, thus swelling the official reserve inflow to very large proportions.

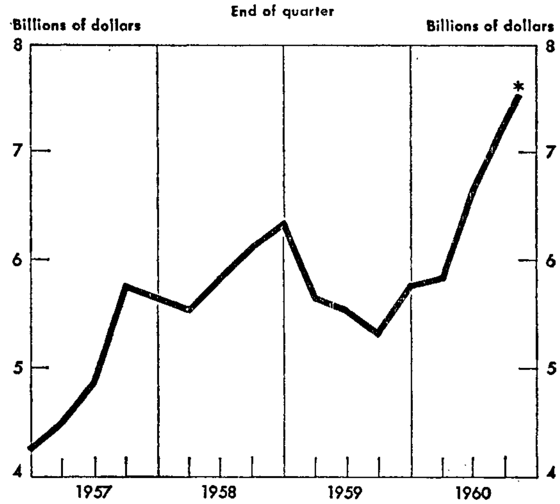
While the Federal Bank accepted the repatriation of German short-term funds as an unpleasant, though unavoidable, consequence of its restraint policy, it took a series of measures to limit the inflow of foreign short-term funds that were attracted by the rising German interest rates. As of last January 1, the bank raised to the legal maxima the reserve requirements against increases in foreign-owned sight, time, and savings deposits above their November 30, 1959 levels. Effective July 1, German credit institutions were prohibited from paying interest on foreign-owned sight and time deposits (but not on savings deposits), as well as from selling money market paper to nonresidents. At the same time, the bank withdrew an earlier regulation under which the German banks' foreign-owned deposits, if offset by foreign-currency assets, had been exempt from reserve requirements—a move that probably has particularly discouraged the acceptance of Continental dollars by German banks.[2]

Judging from the decline in foreign deposits with German banks since the end of May, these steps appear to have had some effect. However, the measures did not prohibit German banks from paying interest on foreign-owned savings deposits and did not prevent nonresidents from buying German stocks and bonds, purchases of which appear to have risen sharply during the last five months. Moreover, the measures did not affect short-term borrowing abroad by German banks and corporations, which, as noted, has gained momentum in recent months, particularly as regards the financing of import credits. Such short-term borrowing abroad continued despite the Federal Bank's willingness, since the end of August, to enter into dollar-swap transactions with German banks, for periods of up to six months, under which it would buy forward dollars at a premium of 1 per cent per annum above the rate for the spot sale—a premium that was raised to 1½ per cent at the end of September. Finally, since all these efforts had focused on the short-term capital inflow, which is largely a symptomatic and aggravating factor in the surplus problem, they proved inadequate to dispel rumors of a German mark revaluation—rumors that further raised Germany's foreign exchange gains during recent months, despite the clear determination of the German authorities to take no action of this kind.

Chart II

GERMAN OFFICIAL GOLD AND FOREIGN EXCHANGE RESERVES

End of quarter



Note: Official reserves include the German Federal Bank's holdings of gold, foreign exchange, bonds and notes of the International Bank for Reconstruction and Development, and Germany's net bilateral claims arising from the liquidation of the European Payments Union.

*As of November 7.

Source: International Monetary Fund.

A NEW POLICY APPROACH

By the fall of 1960, it became obvious that the various policy measures, largely undertaken by the Federal Bank alone, had been insufficient to prevent the flow of foreign exchange into Germany from mounting to alarming proportions (see Chart II). In the first ten months of the year, the reserve gains averaged almost $40 million a week and even exceeded $100 million in some weeks. The German Government itself has therefore announced its intention to make a start toward cutting down the German payments surplus by more fundamental measures.

In reaction to a growing body of opinion that Germany should assume a larger share of economic-development assistance, the government now has in process several plans for increasing Germany's foreign aid contributions. Under a draft bill just submitted to parliament, the government will make available during the next five years $360 million for long-term loans to less developed countries. These funds are to be derived from interest on loans financed by former Marshall Plan counterpart funds, about $50 million annually, and from the sale of the Federal Government's interests in the Volkswagen works, about $120 million. Further, German industry, banks, and insurance companies will subscribe to a fifteen-year 5 per cent $360 million special Federal Government loan, the proceeds of which also are to be used for long-term foreign aid. Also, the German States, which recently have accumulated large budget surpluses as a result of high tax revenues, have agreed to make some funds—perhaps $140 million—available to the Federal Government for the purpose of financing foreign aid. Finally, a small amount may come from the Federal Government budget itself, depending on whether some budgetary economies

[2] See Alan R. Holmes and Fred H. Klopstock, "The Market for Dollar Deposits in Europe", *Monthy Review,* November 1960, p. 197.

can be realized. In total, these proposals could provide about $800 million of German capital for prospective foreign aid projects. However, actual outlays might be spread out over several years, so that the capital outflow each year might be relatively small as compared with the current annual balance-of-payments surplus of $2 billion.

Most of these funds would be made available to the Reconstruction Loan Corporation (Kreditanstalt für Wiederaufbau), which is widely favored in Germany as the most appropriate institution to administer an expanded foreign aid program. The corporation, owned half by the Federal Government and half by the States, was set up in 1948 primarily for the purpose of channeling, on a loan basis, part of the European Recovery Program funds to German industry. In addition, the corporation's charter authorizes it to raise funds on the capital market, which it has done increasingly during recent years. Since 1958 it also has engaged increasingly in foreign lending, using both ERP funds and funds raised on the market. In 1959, it made several foreign commitments totaling some $153 million—about 25 per cent of its total credits extended last year—in connection with long-term credits granted to foreign companies for specific projects or to various foreign governments. Earlier this year, the German authorities indicated that the corporation would be given a leading role in German economic development loans—a view that has found wide support since it has been operating for more than ten years and possesses large and diversified assets.

These steps, once implemented, would represent a promising start toward closing the gap of recent years. In addition, the German Government has expressed its willingness to increase its contributions to NATO. A semiofficial publication of the German foreign ministry recently stated that: "If the justified concern of the United States Government meets with a common acceptance and a common solution by the NATO allies, the Federal Government is willing to make a suitable contribution within this framework". Such an increased contribution to NATO, together with President Eisenhower's new directives to reduce official United States dollar outlays abroad —of which Germany has been a major beneficiary—may go considerably further toward reducing or offsetting that part of Germany's large foreign exchange receipts that arise from the presence of NATO troops in Germany.

The authorities are reportedly hoping to make a further contribution toward a narrowing of the external surplus by putting more emphasis on fiscal and other restraints, in order to relieve monetary policy of some of its present heavy responsibility for checking excessive demand. Funds made available for foreign aid should help not only to reduce the payments surplus, but also to mop up domestic liquidity. The Federal Bank has welcomed this prospect, and on November 11 felt able to reduce its discount rate to 4 per cent from 5 "exclusively with a view to the external monetary situation" (see also page 219 of this *Review*). Thus, the bank's insistence on greater reliance on fiscal and other nonmonetary types of restraint to curb domestic liquidity finally seems to be bearing fruit. In its October *Monthly Report,* the bank underscored once more the need for such a shift, stating that the recent heavy foreign exchange inflow "has paralyzed to a considerable extent the effects of the credit restraint policy and has more clearly than ever demonstrated the conflict between the domestic and external aspects of this policy".

CONCLUDING COMMENTS

During the past year, the distorting influence of a continuation of Germany's unusual balance-of-payments surplus has become clearly recognized, both inside and outside Germany. The responsibilities of a "good creditor" country are now being defined, within the context of the various unique aspects of the German situation. The German authorities seem agreed that special action is necessary.

There is much to be done purely in terms of normal trading relationships, both to avoid serious raising of tariff barriers as the Common Market comes into force and to reduce present impediments to imports—not only imports from the United States and other industrialized countries, but also those from the struggling newer countries that need markets if their growth is to be balanced and sustainable. Much has already been done by the Federal Bank with a view to slowing capital inflows, but these efforts have not prevented a continued inflow of short-term capital, nor could they have been expected to bring about by themselves the more fundamental balance-of-payments adjustments that are required. Thus, much more remains to be done in the areas that are closely dependent upon the stimulation or encouragement, or even direct participation, of the German Federal Government itself.

While the United States Treasury-State Department mission of consultation in late November did not yield specific results, there is no doubt that the nature of the problem has been brought more clearly into focus, both in the United States and in Germany. The start already made by the German authorities on many fronts and the broad range of their further proposals suggest that a comprehensive program of remedial action is in the making.

The Business Situation

The economy has continued in a state of "high-level stagnation" through November. While general demand has been slack, there has been no pervasive cumulative decline in either production or distribution. What stands out instead is the failure of the economy as a whole to expand, while the labor force and productive capacity have continued to grow throughout the year.

One of the most disturbing consequences of the economy's performance has been the rise in unemployment. The usual sample survey indicated that 6.4 per cent of the civilian labor force was unemployed in October, and no improvement was implied by the volume of new unemployment compensation claims filed in November. A more reassuring development was the sharp rise of total retail sales in October, mainly in durable goods, and the continuation of seasonally adjusted industrial production in October at almost the September level. However, fragmentary data suggested the possibility that both sales and production might have declined slightly during November. The mixture of contrasting early indicators of November performance included a growth of bank loans to business that was about in line with the average for the month over recent years, and a somewhat stronger rise in bank loans to consumers. The gentleness of the present adjustment to date is also suggested by the recently published McGraw-Hill survey of businessmen's capital spending plans for 1961, which points to only a small decline from the 1960 level.

THE THIRD-QUARTER DIP

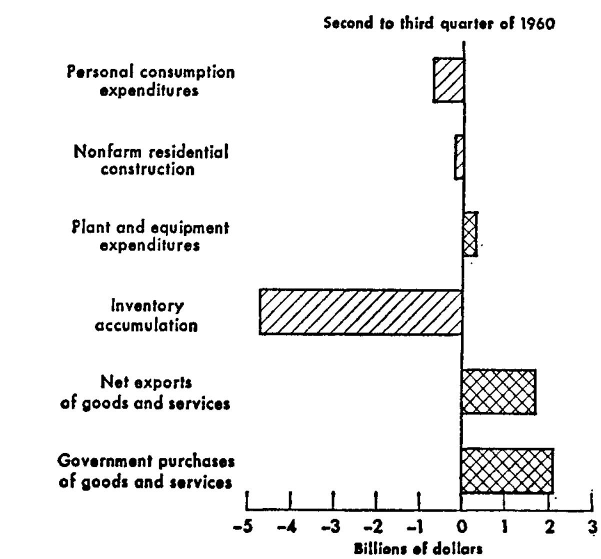
While, statistically, reduced accumulation of inventory was the major factor in the $1.5 billion (current dollar) decline of GNP in the third quarter of this year, perhaps the most disappointing feature was the failure of the consumer to exert his usual upward pull (see Chart I). The decline in total personal consumption spending was just $0.7 billion, seasonally adjusted annual rate, but in only three other quarters since the end of the Korean war has consumption failed to rise, and these were all recession periods. Outlays for both durable and nondurable goods were down, and the rise in spending for services was smaller than usual. Some of the decline in consumer outlays no doubt reflected lower incomes for the unemployed. In addition, however, the ratio of consumption to disposable income dropped to the lowest level since the end of the last recession, suggesting that consumers have also been slowing their expenditures for other reasons.

Gross private domestic investment was again pulled down by a reduction in the rate of inventory accumulation and by a slight further sag in residential construction. The fall in the rate of inventory accumulation, which has been a major drag since early this year, was smaller, however, than it had been in the second quarter of 1960. Indeed, final demand (GNP minus inventory accumulation) was up again although by much less than in the second quarter. Producers' outlays for plant and equipment edged up at the relatively slow rate of $0.3 billion, following strong advances earlier in the year. The government sector, however, boosted its demand over the second-quarter level by a substantial $2.1 billion, about twice the increase in each of the two previous quarters. The rise reflected primarily higher Federal pay scales, increased employment by State and local governments, and heavier outlays for highway construction. Strong

Chart I

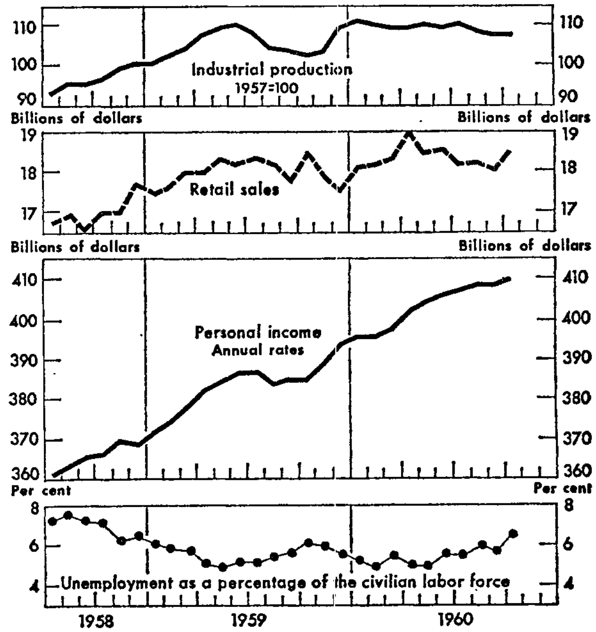
CHANGES IN GROSS NATIONAL PRODUCT COMPONENTS

Seasonally adjusted annual rates



Source: United States Department of Commerce.

support for the domestic economy also came from a $0.9 billion increase in exports. A fall in imports of about the same magnitude pushed net exports of goods and services up by $1.7 billion to the highest level in three years and thereby provided some encouragement on the balance-of-payments situation.



Note: Alaska and Hawaii included in the unemployment rate and in retail sales since January 1960.

Sources: Board of Governors of the Federal Reserve System; United States Departments of Commerce and Labor.

MORE RECENT PATTERNS

The limited data thus far available on developments since the third quarter place demand in a slightly more favorable light. As noted before there was a sizable boost in retail sales in October, to the highest level since June (see Chart II). Automobile sales were particularly strong, setting a record for the month. There were also widespread—albeit small—gains in other retail fields, including a 4 per cent rise in seasonally adjusted department store sales. In November, department store sales apparently declined substantially (on an adjusted basis). However, if automobile sales in the latter part of the month continued the relatively good performance of the first twenty days, they will have contributed much to maintaining total retail sales.

An indirect reflection of consumer demand—outlays for home building—rose slightly in November, seasonally adjusted, after a five-month decline. This series lags behind the new housing starts series, which increased substantially in October, seasonally adjusted, from the disappointing September pace. This latter series, however, has been highly erratic since it was redesigned last May and should be interpreted with caution.

Backing up the consumers' more favorable showing in October, personal income registered a further gain of $0.8 billion in that month to a seasonally adjusted annual rate of $409.6 billion (see Chart II). Wage and salary payments rose somewhat, more than offsetting September's small decline. This advance took place despite a rise in unemployment because of increases in the government wage bill. The dip in total wage payments in manufacturing was cushioned by a rise in average hours worked and by a small gain in hourly earnings. Government transfer payments rose again, by $0.3 billion, largely reflecting the increased flow of unemployment benefits.

Turning to the production side, although the Federal Reserve's index of industrial production did in fact fall slightly in October, the decline was too small to show up in the rounded figures, which remained unchanged at 107 per cent of the 1957 base period, seasonally adjusted (see Chart II). Output of consumer goods was up a little, due mainly to the high automobile production but also reflecting small rises in staples. These increases more than offset moderate declines in appliances and in rugs and furniture. There was also a rather sharp drop in television and radio output, in part the result of labor disputes. Business equipment production was up insignificantly. While output of most materials was down, iron and steel production was unchanged after allowing for seasonal factors. A decline in manufacturers' new orders in October was attributable mainly to reductions in defense orders (which had accounted for most of the rise in the two preceding months), but it nevertheless pointed to the possibility of a further decline in industrial production in November. Available November data for iron and steel production, as well as for automobile production, indicate more-than-seasonal declines.

The normally sensitive business spending for plant and equipment seems to have been only moderately dampened by the recent sluggish course of business. Domestic machine tool orders appear to have risen in October after a sharp drop-off in September, and construction contract awards in October for manufacturing plants recouped part of the September loss. Some encouragement on capital spending by business is also offered by the October McGraw-Hill survey. While it is estimated that outlays for 1960 will be 5 per cent below the level planned last

April, the level now planned for 1961 is only 3 per cent below the present estimates for 1960 outlays. A similar survey in October 1957 showed planned spending for 1958 down considerably more (7 per cent) from the estimated 1957 level.

Perhaps the most unsatisfactory element in the recent business news was the information that unemployment in October had climbed to a seasonally adjusted level of 4.5 million persons or 6.4 per cent of the civilian labor force, the highest percentage since December 1958 (see Chart II). Early November reports on unemployment insurance claims suggest some further deterioration. A major part of the employment decline in October (seasonally adjusted) was in farm jobs, largely reflecting an early harvest.

The wholesale price index rose 0.4 per cent in October, contrary to both normal seasonal expectations and the generally downward trend of recent months. Abnormally short supplies of various farm products caused most of the advance. The consumer price index also moved up in October by 0.4 per cent. The increase, the largest since April, was primarily seasonal. Service prices continued to climb, but the biggest advances occurred in automobile and food prices.

Money Market in November

Aggregate member bank reserves rose more than seasonally during November, as seasonal and other drains of funds were more than offset by sizable Federal Reserve open market operations in the first part of the month and by the release of reserves through full liberalization of vault cash regulations toward the month's close. During the first half of November, the three-month bill rate rose ½ per cent from the 2 per cent level to which it had declined in late October. During the second half, however, bill rates moved moderately downward.

Excess reserves remained concentrated at country banks over most of the month. The New York City banks reported a sharp rise in loans early in the month, and the ensuing deposit drains kept the reserve positions of the money market banks under some pressure. During the first half of the month, their large net purchases of Federal funds kept the effective rate for funds at the 3 per cent ceiling on almost every day. In the latter part of the month, with the reflux of funds from country banks and the increased eligibility of vault cash for meeting reserve requirements, the position of the money market banks improved and Federal funds generally traded at rates of 2 per cent or lower. Correspondingly, rates posted by New York City banks on loans to Government securities dealers were in a 3¾-4¼ per cent range over the early part of the month and then moved progressively lower to 2¾-4 per cent at the month's close.

The rise in Treasury bill rates in the first half of the month reflected several factors. Among them was the view in some quarters that the easing of vault cash and reserve requirements (announced October 26) might bring a smaller net demand for bills than would have occurred if seasonal reserve needs had been met through System open market purchases. Subsequently, with the greater attractiveness of yields, there was some pickup in demand and rates moved lower again. In the markets for longer term Treasury and corporate obligations, investor psychology remained particularly hesitant as political, economic, and balance-of-payments uncertainties found no clear resolution. The Treasury bond market was affected also by congestion in the corporate market and the resultant markup in corporate bond yields, which prompted some switching out of Governments as the spread between corporate and Government yields widened. Consequently, prices for Treasury bonds drifted downward with few interruptions over the month.

BANK RESERVES AND BANK CREDIT

During the first two statement weeks ended in November, reserve drains resulting from declines in float, heavy gold outflows, and the preholiday expansion of currency in circulation were offset by System open market operations, which supplied $1,255 million in reserves through both outright purchases and increases in the repurchase account. Some $276.5 million of the System's outright purchases in these weeks consisted of certificates and short-term notes and bonds. Operating factors first absorbed and then released reserves during the following two weeks, with both movements moderated by System open market operations.

In the final statement week of the month, reserves absorbed by various market factors, a rise in required reserves, and a runoff of System holdings under repurchase agreements were more than offset by the liberalization of

Changes in Factors Tending to Increase or Decrease Member Bank Reserves, November 1960
In millions of dollars; (+) denotes increase, (−) decrease in excess reserves

Factor	Daily averages—week ended Nov. 2	Nov. 9	Nov. 16	Nov. 23	Nov. 30	Net changes
Operating transactions						
Treasury operations*	+ 106	+ 33	− 103	+ 46	—	+ 82
Federal Reserve float	− 259	− 113	+ 323	+ 224	− 300	− 125
Currency in circulation	+ 18	− 196	− 229	− 5	− 106	− 518
Gold and foreign account	− 144	− 277	− 36	− 63	− 76	− 596
Other deposits, etc.	− 84	+ 5	− 338	+ 193	− 1	− 225
Total	− 362	− 548	− 385	+ 395	− 482	−1,382
Direct Federal Reserve credit transactions						
Government securities:						
Direct market purchases or sales	+ 265	+ 493	+ 149	+ 90	− 71	+ 926
Held under repurchase agreements	+ 288	+ 209	− 59	− 364	− 137	− 63
Loans, discounts, and advances:						
Member bank borrowings	− 51	− 53	+ 32	− 69	+ 14	− 127
Other	—	—	—	—	− 14	− 14
Bankers' acceptances:						
Bought outright	+ 2	+ 4	—	+ 3	+ 2	+ 11
Under repurchase agreements	—	+ 9	+ 1	+ 2	− 12	—
Total	+ 504	+ 662	+ 124	− 340	− 216	+ 734
Member bank reserves						
With Federal Reserve Banks	+ 142	+ 114	− 261	+ 55	− 698	− 648
Cash allowed as reserves†	+ 3	− 189	+ 194	− 31	+1,494	+1,471
Total reserves†	+ 145	− 75	− 67	+ 24	+ 796	+ 823
Effect of change in required reserves†	− 109	+ 119	+ 70	− 32	− 288	− 240
Excess reserves†	+ 36	+ 44	+ 3	− 8	+ 508	+ 583
Daily average level of member bank:						
Borrowings from Reserve Banks	189	136	168	99	113	141‡
Excess reserves†	563	607	610	602	1,110	698‡
Free reserves†	374	471	442	503	997	557‡

Note: Because of rounding, figures do not necessarily add to totals.
* Includes changes in Treasury currency and cash.
† These figures are estimated.
‡ Average for five weeks ended November 30, 1960.

Regulation D, effective November 24, permitting member banks to count all, rather than only a part, of their vault cash toward satisfying reserve requirements. Part of the rise in required reserves in that week reflected the increase from 11 to 12 per cent, on November 24, in reserve requirements for country banks, the largest holders of vault cash. These banks gained about $500 million in available reserves on balance from the changes in Regulation D.

The reserve positions of New York City banks were considerably tightened by a sharp expansion of loans early in the month. This expansion, along with an increase of almost $500 million in Government securities holdings in late October and a further slight rise in early November, was accompanied by a high level of borrowings by the New York City banks, both at the "discount window" and through the Federal funds market. By the middle of the month reserve positions began to ease again, and total borrowings of New York banks were sharply reduced. Over the country, bank loans to business were up sharply in the four weeks ended November 23, about in line with the usual expansion at this season, while bank loans to consumers were relatively strong as compared with other years. Total bank credit at all reporting banks declined during the period, but by about $100 million less than in the corresponding weeks of 1959.

System Account holdings of Government securities increased by $536 million over the period October 26 to November 30. Average total reserves for this period were $201 million higher than in October, and average free reserves rose to $557 million from $510 million.

GOVERNMENT SECURITIES MARKET

A cautious tone characterized the Government securities market over most of the month. Early in the month, $10.3 billion of certificates and bonds maturing November 15 was exchanged for $9.1 billion of 15-month 3¼ per cent notes and $1.2 billion of 5½-year 3¾ per cent bonds. An additional $0.5 billion of the maturing issues was redeemed for cash. It had been initially expected in some market quarters that the 15-month maturity on the notes might discourage exchanges by corporations primarily interested in maturities of a year or less. But the relatively attractive 3¼ per cent coupon on the notes and the scarcity of shorter issues in the market built up a substantial demand. A modest premium was maintained both on rights to the exchange and on the "when-issued" securities.

Later in the month, the Treasury announced an additional offering of 4 per cent bonds of 1969 ($1.3 billion of these was issued in 1957) to holders of approximately $750 million of Series F and G Savings bonds maturing in 1961, at a price of 100½. Subscription books for the exchange were open from November 21 through 29, with delivery scheduled for December 15.

In the Treasury bill market, rates rose steadily from their end-of-October lows through the first half of November, as several factors which had contributed to the earlier rate decline were reassessed or failed to develop as expected. The announced changes in Regulation D, which were first interpreted as an easing influence and exerted downward pressure on rates, later came to be viewed by some observers as a possible restraint on total demand for bills. Reserves supplied to meet seasonal needs in this way, rather than through System bill purchases, it was felt, might or might not reach the bill market. At the same time, the expectation that a strong demand for bills would arise on swaps out of rights to the Treasury's refunding offer did not materialize. In these circumstances, the sale of bills by banks facing increased money market demand pressures, and the seasonal letdown in corporate purchases, brought an upward movement in rates which carried the average issuing rate on three-month bills to 2.624 per cent in the November 14 auction, from 2.127 per cent on October 31.

Later the entire market strengthened, as the more attractive yields sparked a pickup in demand while the development of greater ease in the money market caused banks to switch to the buyers' side of the market. The narrowing spread between these rates and declining rates in Europe (the British bank rate had been reduced from 6 to 5½ per cent on October 27 and the German discount rate from 5 to 4 per cent on November 11) was also a factor. Prospective and actual bank demand for the investment of reserves released through changes in Regulation D on November 24 and on December 1 (when reserve requirements for central reserve city banks were reduced from 17½ per cent to 16½ per cent) contributed to aggressive bidding which brought average issuing rates to 2.396 and 2.749 per cent on the 91- and 182-day bills, respectively, in the November 21 auction and to 2.326 and 2.640 per cent on November 28. Over the month as a whole, market yields on three-month bills were up by 28 basis points, closing at 2.40 per cent. Issues maturing through December were down in rate, however, reflecting strong demand on most days during the month.

In the bond market, demand remained hesitant through most of the month and prices drifted downward with few interruptions. Contributing to this hesitancy were continuing uncertainties over the economic picture, accompanied first by strength in the stock market and then by press speculation that the cyclical low of interest rates may already have been reached. Another factor making for hesitancy was the balance-of-payments deficit and its possible implications for pursuing easier credit policies, though the President's November 17 announcement of measures to reduce the deficit contributed to a brief rally at that time. While pre-election doubts added to investor hesitancy before November 8, the election itself seemed to bring no resolution of uncertainties—after an initial flurry of price increases—and had little obvious sustained impact on the market. Finally, there was the continuing congestion in the corporate bond market where the heavy schedule of new offerings met investor reluctance, at least at what was judged to be the close pricing of a number of the new issues. The consequent markups in rates produced relatively large yield differentials in favor of corporates and led to some switching from Treasury to corporate issues. Over the month as a whole, prices of long-term Treasury bonds were down by ⅝ to 2 points, while intermediates were off by ½ to 1¾ points.

OTHER SECURITIES MARKETS

An atmosphere of investor hesitancy, as noted, pervaded the corporate bond market over most of the month, and a substantial supply of new and recent issues remained unsold, although some progress was made in distributing unsold bonds following the termination of a number of offering syndicates late in the month. Prices of seasoned bonds fluctuated irregularly in a narrow range until midmonth and drifted downward thereafter until the closing days, while prices of recent issues declined markedly.

This congestion continued through the end of the month despite the excellent reception accorded a $75 million Aa-rated utility bond, due 1990 and nonrefundable for five years. Reoffered on November 22 to yield 4.87 per cent—roughly ¼ per cent above similar recent offerings—it was quickly sold out. Over the month as a whole corporate bond offerings aggregated approximately $460 million, above the level of last November but well below the $644 million total of October 1960, which included the $250 million American Telephone and Telegraph issue.

In contrast, the market for tax-exempt bonds displayed a firmer tone and prices of seasoned issues moved generally higher over the month. New offerings totaled $434 million—compared with $287 million last month and $369 million in November 1959—and met mixed receptions. Also during the month, the first new Tennessee Valley Authority bonds, exempt from State but not Federal taxes, reached the market. This $50 million issue, not included in the above totals, was reoffered on November 15 to yield 4.40 per cent and is due in 1985; it met a fair reception. Over the month, Moody's average yield indexes of seasoned Aaa bonds rose from 4.30 to 4.33 per cent for corporates and declined from 3.17 to 3.14 per cent on tax-exempts.

Reflecting the upward movements in Treasury bill yields, rates on commercial paper were raised by ⅛ per cent on November 10 and again on November 16, making the offered rate on prime 4- to 6-month paper 3⅜ per cent. Also, on November 16, major finance companies increased their rates on directly placed paper maturing in more than 60 days by ⅛ to ⅜ of a percentage point—to 2⅞ per cent on 60- to 89-day paper—though cutting rates on some shorter maturities, and the Federal National Mortgage Association increased the offered rate on its directly placed discount paper by 10 basis points to 2.80 per cent on 60- to 89-day paper.

Foreign Economic and Financial Developments

Economic activity continued vigorous in most of the major industrial countries of the world during the third quarter of 1960. Conditions ranged from continued boom in Japan and a number of Western European countries to a leveling-off of expansion in several others. Canada provided the exception by undergoing a mild decline. While generally restrictive monetary policy continued to play an important role in imparting an orderly stability to the expansion process throughout much of the world, the rather widespread abating of earlier expansionist fever permitted more freedom of central bank action.

BUSINESS CONDITIONS ABROAD

The long-sustained business expansion led in several countries to pressure on productive capacity during the third quarter, which was reflected in slower over-all growth of industrial output but also provided the incentive for substantial new investment and strengthened activity in the capital goods industries. Indeed, this investment surge provided a major impetus to continued expansion in a few countries, while in the United Kingdom—where there was a marked decline in exports and in the output of consumer durable goods—it was primarily responsible for the maintenance of industrial production at a high level. The over-all situation has become spotty in Scandinavia, however, with activity in some industries now slowed markedly. Although there were additional wage increases in a number of countries during the summer, prices generally have remained stable through the early fall months even in those countries that have had boom conditions a year or more.

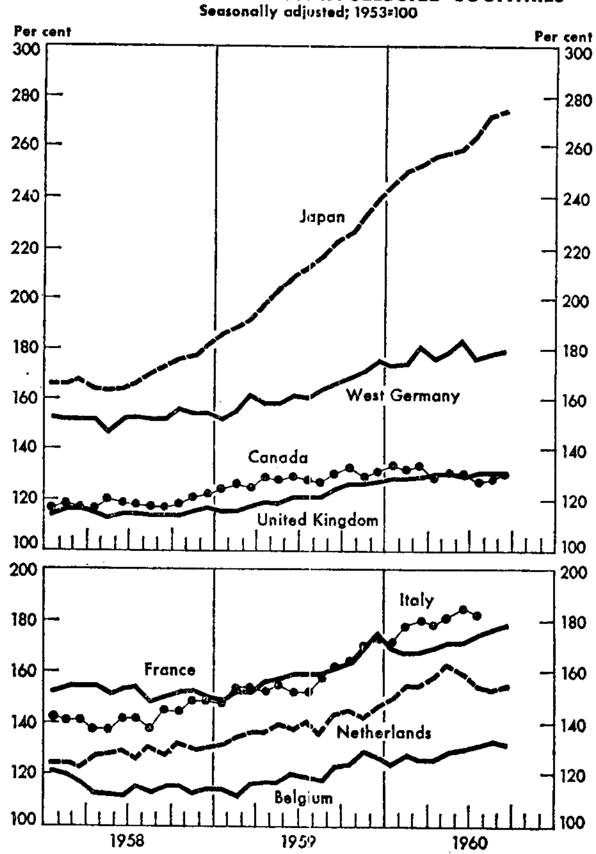
The very rapid expansion of industrial production that characterized the boom in Western Europe and Japan during the latter part of 1959 had already slowed somewhat in the first half of 1960. During the summer and early fall the expansion virtually ceased in several countries, notably the United Kingdom (see Chart I). In some cases, however, such a change was made almost inevitable by the pressure on capacity, noted above, and may not reflect any real moderation of expansionary pressures. For example, there has been no significant relaxation of demand pressures in Germany and the Netherlands in spite of a leveling of the industrial production index in these two countries. While there has been some easing in German inventory demand for consumer goods, capital goods orders continue to run 20 per cent higher than sales. French expansion, meanwhile, has been renewed after a slowdown in the first half of the year; industrial production reached a record high in September. In some other countries, such as the United Kingdom and Sweden, however, the expansion now is concentrated in a few industries. Somewhat similar divergencies are appearing in Japan, in spite of a fairly rapid rate of expansion of industrial production following a temporary leveling off during the second quarter. Canadian third-quarter industrial production was 3-4 per cent below the January peak and the decline was evident throughout primary and secondary manufacturing industries, although durables were most affected.

A substantial capital equipment investment boom

Chart I

INDUSTRIAL PRODUCTION IN SELECTED COUNTRIES

Seasonally adjusted; 1953=100



Note: Latest 1960 data partially estimated.

Sources: Organization for European Economic Cooperation, General Statistics; national statistics.

apparently took firm hold in an increasing number of countries, even as the demand for consumer durables began to ease in a few instances. In some countries—Germany, Italy, and Japan, for example—the investment boom had started as early as last year and has continued largely unabated. More recently, investment outlays have taken on additional importance for Italy and Japan, since they have become the major force in sustaining the high level of general economic activity. In the United Kingdom, furthermore, the strong revival in the capital goods industries continued in the third quarter in spite of tighter credit restrictions and declining consumer durables demand. The investment intentions of business, according to a survey of the Board of Trade, suggest the possibility of a 25 per cent increase in 1960 over 1959 in private outlays on fixed capital in manufacturing industries. A further 20 per cent rise is anticipated for 1961. In addition, government investment plans call for somewhat increased spending in the fiscal year ending March 31, 1962. In France, after a fairly considerable delay and a number of government measures to stimulate investment, a boom in capital goods production got under way during the summer and carried over into the fall months. In Denmark, a 30 per cent increase in fixed investment is expected for 1960 as a whole.

Investment in new construction presents a varied picture. Credit restrictions have somewhat dampened demand for house building in Germany, but nonresidential construction demand continues to rise sharply. Actual building has remained on a high plateau and is straining the supplies of labor and materials. In Canada, reduced demand for houses resulting from generally slack economic conditions and an easing of the postwar housing shortage has not been offset by a rise in industrial construction. The Netherlands building boom has been slowed somewhat by labor shortages and rising construction costs; French construction industries remain weak despite the developing investment boom. In Scandinavia and Switzerland, however, construction activity increased during the third quarter, although primarily in industrial building.

As capital investment was the major expansionary force in the increase of industrial output, advances have taken place mainly in such producers' goods industries as steel and other metals, machine tools and industrial equipment, and chemicals. In Belgium, for example, January-October steel output was up 18 per cent over a year earlier; and it rose further in Germany, France, and Sweden. Moreover, new orders continued high. Output in paper, glass, rubber, and certain industrial raw materials also showed considerable strength in a number of countries.

Trends in consumer goods industries, however, differed widely. Textile production, for example, slowed substantially in Sweden and slightly in France but continued relatively high in Belgium and the United Kingdom. Automobile production was fairly low throughout the summer and fall in the United Kingdom, and declined sharply in October in France as exports to the United States fell off. In both countries, layoffs and shorter hours in this industry have become increasingly common in recent months. As for Germany, on the other hand, declining sales to the United States were offset by increases in domestic and in other foreign sales, and in Japan motor vehicle production has also continued high.

Consumer demand for other durables eased during the summer, and has remained generally slack in Italy, Canada, and the United Kingdom while easing somewhat further in Japan. In the Netherlands, where consumer purchases rose strongly in July after easing in the late spring, the government tightened the instalment-credit regulations for consumer durables by imposing higher downpayments and shorter repayment periods. Demand for soft goods has continued to expand in most industrial countries, and in Germany rising wages have stimulated consumer sales. In the United Kingdom, the April instalment-credit restrictions were reflected in a decline in hire-purchase debt in August and September, the first such decline in two and one-half years. Retail sales, however, recovered to their spring peak during the early fall.

Employment continues very high and labor shortages are spreading in most industrial countries except Canada, Japan, and Italy. Even in the latter two, which have had serious unemployment problems for some time, substantial progress has been made in cutting down the number of unemployed and shortages have developed in some skilled trades. In Canada, on the other hand, unemployment is now over 7 per cent (seasonally adjusted) and has become the country's most serious economic problem. Elsewhere, the increasing tightness of the labor markets has led to a pronounced upward drift in wages and to the more widespread use of foreign laborers on a temporary basis, especially from Italy, Spain, and Greece. Such workers have gone principally to Switzerland, Germany, and the Netherlands, but their movement has not been sufficient to achieve a significant reduction of job vacancies there and their number is expected to decrease toward the year end.

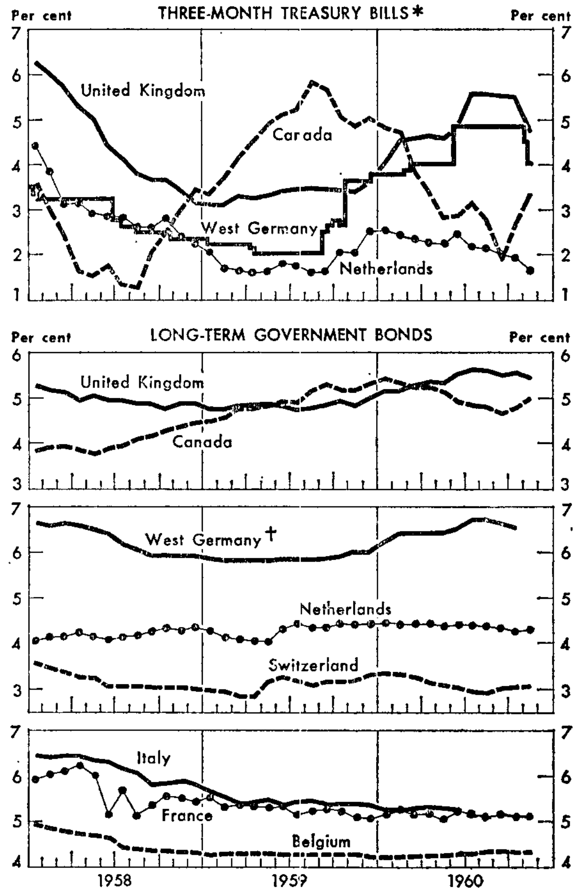
Against the background of long-sustained expansion in most of the major foreign industrialized countries, the continued maintenance of substantial price stability must be judged a remarkable achievement. To be sure, many of these countries have been aided by stable or weakening prices of imported raw materials. In addition, the rise in productivity and industrial capacity, due to earlier investments, combined with progressive import liberalization, has paid off handsomely in terms of the ability to meet demand pressures.

MONETARY TRENDS AND POLICIES

The maintenance of price stability in the face of strong demand pressures has recently enabled the authorities in foreign industrial countries to gear their monetary policies more closely to international financial considerations. While the persistent strength of business has in most cases continued to dictate a fair degree of restraint, several major Western European countries were able in the past three months to permit some decline in interest rates from the levels that were reached last summer after a year of continued and aggressive monetary restraint (see Chart II). In certain countries such action was warranted to some degree by changes in the domestic economic climate. In others, however, the move toward lower interest rates largely reflected external considerations, especially the desire to reduce the inflow of short-term capital.

The first major European country to move in the direction of lower interest rates this fall was France, where a highly satisfactory balance-of-payments position and the continued absence of inflationary pressures encouraged the authorities to adopt a bolder policy of expansion. Effective October 6, the Bank of France reduced its basic discount rate to 3½ per cent from 4, apparently in an effort to stimulate private investment. Cheaper credit has been a major objective of French Government policy, and earlier this year had already led to several measures aimed at cutting the lending charges of commercial banks and other financial institutions. On October 6, too, the French National Credit Council relaxed the terms of instalment purchases of automobiles and other consumer durables. Simultaneously with these various credit-easing measures, however, France adopted a new commercial bank reserve requirement device that will henceforth be available to the Bank of France on a stand-by basis. Under this new measure, commercial banks may be required to hold a minimum percentage of their deposits in specified liquid assets, including in particular medium-term paper that might otherwise be rediscounted. This new device can be used to supplement the prevailing commercial bank minimum reserve requirements (in the form of Treasury bills) and the ceilings on the rediscounting of short-term paper, and is reportedly designed primarily to guard against an excessive monetization of the large amounts of medium-term paper currently held by the French banking system.

Chart II
INTEREST RATES IN SELECTED COUNTRIES



Note: November 1960 data partially estimated.

* Treasury bills: Canada and United Kingdom, average tender rates for three-month bills; West Germany, central bank selling rates for 60- to 90-day bills; Netherlands, market rates for three-month bills.

† Rates on mortgage bonds.

Sources: International Monetary Fund, International Financial Statistics; national statistics.

In the United Kingdom, where a series of credit-restraint measures had culminated last summer in a hike in the bank rate to 6 per cent, the authorities continued during the fall to keep a tight rein on liquidity. However, largely in response to a sizable inflow of foreign short-term funds since midsummer, the Bank of England lowered its discount rate to 5½ per cent on October 27. In explaining this action, a bank spokesman stated that "in today's conditions and having regard especially to the level of rates in other centers, we have concluded that 6 per cent is unduly high and gives no advantages to us as against 5½ per cent". On the other hand, the British monetary authorities have stressed their intention not to permit any substantial relaxation of credit at the present time, since the threat of excessive domestic pressures is not yet considered past and the basic external position is still viewed as less than satisfactory. However, long-term interest rates have eased somewhat in recent months, and the Treasury bill rate continued to drop sharply even after the short-term market had made its usual adjustment to a discount rate change.

An end to the year-old climb of interest rates may similarly be in sight in West Germany, where relatively greater reliance may be placed henceforth on fiscal measures to contain domestic demand. Since midyear the Federal Bank has attempted to curb the inflow of foreign-owned funds by limiting the payment of interest on, and the investment of, such funds. The policy of domestic restraint continued in the late summer and early fall to be frustrated to a considerable extent by the expansion of German bank and business borrowing abroad. In a new attempt to stem such borrowing, the Federal Bank in late September increased from 1 per cent per annum to 1½ the premium that it introduced in August on dollar swap transactions with commercial banks. (In such operations, the Federal Bank sold spot dollars to the banks and repurchased these dollars forward from them at the above-mentioned premium. In this manner, the banks in effect earned interest over and above what they could obtain by using the dollars for investment in foreign short-term money market paper or for financing imports into Germany.) In the beginning of November, however, the premium was abolished as regards import financing, although it is being maintained with respect to transactions involving investments abroad.

More recently, in view of the discount rate reductions abroad, a drop in the Federal Bank's own rate was deemed "unavoidable" and was effected on November 11. Since domestic economic conditions remain under considerable strain, the lowering of the rate to 4 per cent from 5 was carried out entirely in response to the external situation. As pointed out by the bank, the reduction, if it is successful in this respect, may actually curb domestic liquidity. Meanwhile, the German authorities are also mapping a more basic attack on the country's sustained external surplus, as already described in this *Review*.

The twofold problem of domestic inflationary pressures and large inflows of foreign exchange also continued to confront a number of other Western European economies. In Switzerland, where restrictions on foreign-owned deposits were also adopted last summer, the central bank absorbed some of the excess liquidity resulting from earlier inflows by placing in late September a special Fr.400 million issue of Treasury certificates with some of the more liquid commercial banks. The Swiss National Bank also renewed its warnings against the dangers of overexpansion, and urged both employers and wage earners to exercise moderation in setting prices and wages. The national bank, furthermore, has continued to apply its traditional policy of relying on the export of long-term capital (the timing and amount of which it controls) to keep domestic inflationary pressures at bay.

In the Netherlands, where the repatriation of funds by the banking system continued in September and October when unusually heavy corporate-tax payments fell due, no further general restraint measures were taken following last July's reserve requirement increase, and interest rates dropped somewhat. However, the continued buoyancy of consumer demand led the authorities to tighten instalment credit in October. In Belgium, where the international position weakened in midsummer because of the Congo crisis but has strengthened again in the past three months, the national bank lowered to 4 per cent from 5 its discount rate on bank acceptances representing exports. The move, which leaves the basic discount rate unchanged, was presumably aimed at stimulating exports, upon which the country is highly dependent for continued domestic expansion.

In Canada, credit conditions continued relatively easy, in spite of a more-than-seasonal autumn rise in interest rates that was largely attributable to both domestic and international economic uncertainties. In Japan, credit conditions showed little change following the discount rate reduction that was made last August to maintain economic expansion.

In general, the monetary authorities of the major industrial countries have continued, as in recent years, to identify and to react promptly to "pressure points" emerging in their domestic economies. Recent developments have re-emphasized as well the importance of a prompt recognition of "pressure points" in the international payments mechanism in a world of convertible currencies.