DIVISION OF INTERNATIONAL FINANCE

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

H. 13
No. 252

June 15, 1966

CAPITAL MARKET DEVELOPMENTS ABROAD

I. Germany
II. Ten Charts on Financial Markets Abroad
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I. Germany: Capital Markets, March-May 1966

In the period under review, interest rates advanced steadily in Germany as a result of the combined upward pressure exerted by the continued tightening of the liquidity position of the banking system and the persistently strong demand for bank credit. As a result, the gap between money market rates and the Bundesbank's discount rate--which had remained at 4 per cent since August 1965--continued to widen, as did the gap between short- and long-term rates. (See Table 1.) In order to bring the interest rate structure into better balance the Bundesbank, in a widely anticipated move, raised its discount rate from 4 to 5 per cent and the rate on advances from 5 to 6-1/2 per cent with effect from May 27. Bank lending rates were increased following the discount rate increase and deposit rates are expected to go up shortly.

Table 1. Germany: Selected Financial Indicators
(per cent per annum and DM billions, monthly average)

	Jan.	Feb.	Mar.	Apr.	May 26	June 3
Discount rate 1/	4.00	4.00	4.00	4.00	4.00	5.00
Call money	4.12	4.49	5.12	5.36	4.94	6.00
3-month loans	4.99	5.24	5.56	6.02	6.13	6.50
6% Public authority bond yield	7.59	7.54	7.65	7.91	7.99	8.03
Discounts at the Bundesbank (DM billions)	5.75	5.57	7.43	7.25	a/ 7.03	b/ 7.33

1/ End of period.
a/ May 23.
b/ May 31.
Source: Deutsche Bundesbank; Frankfurter Allgemeine Zeitung.

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Prior to the discount rate action, which was virtually dictated by market conditions, the Bundesbank had relied on liquidity tightening policies to keep credit expansion in check. The deficit in the balance of payments was one of the most important factors in this connection. Reserve losses totaled $213 million in March and April and continued into the first half of May. The factors contributing to the deficit appear, however, to be changing somewhat. Last year, the shrinking trade surplus was the leading factor behind the payments deficit. This year, the trade balance is improving but a more than seasonal deterioration of the tourist account, and diminished private capital inflows have kept the balance of payments in deficit.

Over the past few months, the effects of the Bundesbank's restrictive policy have been increasingly felt. The bond market continues to be seriously affected and it once again became necessary to declare an issue pause for new public authority loans because the loss of investor confidence in the bond market kept funds from entering the market despite the high prevailing rates. The stock market has also been weak for months and has afforded little opportunity for fund raising. Consequently, increasing financing traffic has gone directly through banking and investment institutes. This led to an unusually large expansion of short and medium-term bank loans in the first quarter. Increasing demand has tightened conditions further in these ranges and borrowers have reportedly been offering more than 9 per cent interest on medium-term notes.

The instability in the bond market and the upward movement of yields on funds obtained outside the market are largely attributable to the persistent heavy financing needs of the public authorities which continue to seek funds regardless of cost. The Federal Government, in recognition of these facts, has prepared a "Conjuncture-Stabilizing" bill, which attempts to ensure that public spending flows will, as much as possible, affect the economy in a counter-cyclical manner. Under this bill, the Bundesbank's power to act effectively would also be expanded, partly through the ability to freeze funds of the public authorities and the social security funds, partly by an increase in the Bank's scope for open market operations and finally through new credit-limiting powers.

Conditions on money market tighten further

Monetary conditions tightened further during the first quarter and the process was apparently continued in April and May. As a result, money market rates rose steadily. In the second and third weeks of May, rates for day-to-day loans eased momentarily only because of heavier discounting by banks in anticipation of an increase in the discount rate.

The withdrawal of liquidity from the banking system took place as the Bundesbank allowed the February-April deficits in Germany's balance of payments and the collection of March tax payments to proceed without supplying any offsetting additions to bank liquidity. Consequently, the average rate for day-to-day loans rose to a level 1-3/8 per cent above the then prevailing discount rate of 4 per cent in the first week of May. The increased margin between the money market and discount rates, and the substantially expanded gap between long and short-term rates following a rise of bond yields to more than 8 per cent at the end of April, led to widespread anticipation of an upward adjustment of the discount rate. The initial failure of the Central Bank Council to take any discount action when market conditions appeared to dictate such an action led to considerable nervousness in financial markets. The money market consequently moved erratically from day-to-day in the first half of May as banks hedged against the awaited increase in the discount rate.

Bond market required another issue pause

Expectation of a discount action had been heightened by the rise of yields on public authority bonds to a high of 8.14 per cent at the end of April as the unabated pressure of public authority demands for financing led to a further demoralization of investor confidence. Banks, traditionally one of the largest investor groups, added virtually nothing at all to their portfolios during the first quarter. The bond market consequently weakened again from March through May following the brief consolidation in the first two months of the year.

The major capital market borrowers decided, therefore, at their May 5th meeting to close the bond market to new public authority issues through the end of June. This pause is the third issue stop on public authority bonds to have been declared in the past twelve months. But on this occasion public borrowers were also requested to refrain from taking up promissory loans (Schuldscheindarlehen) or other longer-term credits unless severe liquidity deficiencies made that absolutely unavoidable. This additional step was taken because the substantial growth of business in Schuldscheindarlehen during the bond market's weakness has itself contributed further to this weakness by drawing away loanable funds.

Although public authority borrowing averaged DM 314 million per month during the first quarter, a somewhat greater amount than that taken up a year ago, total gross borrowing on the bond market averaged only DM 1.2 billion per month, or DM 0.5 billion less than the average gross amount raised in the first quarter last year. (See Table 2.) Total bond flotations in April were sharply reduced from the first quarter average. The inability of the bond market to function orderly, even though the total issue volume was substantially reduced, reflects not simply the effects of the liquidity squeeze but suggests further the extent to which the weakness of the bond market has become a matter of confidence. This is also reflected in the growing use of Schuldscheindarlehen, (loans placed directly with banks and secured by promissory notes) by which capital flows by-pass the bond market. According to one of the leading German financial newspapers at least twelve such loans, totaling an estimated DM 250 million, were raised during the first quarter. So far this year these loans have carried coupons of 7 to 7.5 per cent, with effective yields of more than 8 per cent. Outside the banks and the bond market, finance-hungry borrowers are offering large insurance companies more than 9 per cent for the use of investment funds.

To encourage the public authorities in their restraint and to help brighten the mood of the bond market, the Federal Government announced that it would borrow no more on the bond market this year. The remaining DM 200 million which it still needs will be raised later in the year in the form of medium-term notes. By the end of 1966, furthermore, the Federal Government will have injected a net total of DM 447 million into the capital market; its total borrowing will be DM 550 million (including the resale of securities which it had acquired during last year's support operations), while scheduled redemptions will total DM 997 million.

Table 2. Germany: Gross Placements in Securities Markets, 1965-April 1966 1/
(millions of DM, month or monthly average)

	1965				1966	
	I	II	III	IV	I	Apr.
"Occasional" borrowers bonds:						
Industrial	86	90	--	16	--	n.a.
Public authorities	303	380	199	290	314	n.a.
Foreign issuers	193	43	37	171	102	n.a.
Other bonds 2/	333	181	833	141	215	n.a.
Total	915	694	1069	618	631	n.a.
Mortgage and communal bonds	853	570	628	522	571	n.a.
Total gross bond placements 3/	1768	1264	1697	1140	1202	554
Gross share placements	239	349	472	260	291	244
Total security placements at issue value	2007	1613	2169	1400	1493	798

1/ Market value.
2/ Mostly bonds of specialized credit institutions.
3/ Includes medium-term notes (Kassenobligationen).
Source: Deutsche Bundesbank.

Upward adjustment of discount rate

The need to realign the various interest rates and the uneasiness of financial markets put an end to the Bundesbank hesitation to take a discount rate action. On May 27, the Bundesbank raised its discount rate from 4 to 5 per cent and its rate on advances against securities (Lombard rate) from 5 to 6-1/4 per cent. The Bundesbank's selling rates for money market paper were adjusted accordingly: the rates for Treasury bills and storage agency bills were increased by 1 per cent each, while rates of non-interest-bearing bonds of all maturities were raised by 1/2 per cent.

The Bundesbank had apparently hesitated at first to raise the discount rate, despite the technical nature of the move, on the grounds that an upward adjustment of the interest rate structure was neither necessary nor desirable for either domestic or international reasons. Liquidity tightening measures were considered a more direct and efficient a means of damping domestic demand pressure than discount rate adjustment. Furthermore, it was feared that an upward adjustment of interest rates would lead to a further upward spiraling of rates on the bond market and to increased capital inflows. These hesitations appear to have been offset in the end, however, by the shrinking of private capital inflows in the first quarter of the year, by discount rate increases elsewhere, and by the need to quiet the nervousness of the German financial markets. Persistent price increases and recent signs that economic tensions were increasing again instead of easing off as indicated earlier undoubtedly helped firm the Bundesbank's decision.

The raising of the advances (Lombard) rate to 6-1/4 per cent increased the margin between the discount and Lombard rates from the traditional 1 per cent to 1-1/4 per cent. The sharper increase of the advances rate reflected the recent substantial expansion of Lombard credits. Many banks are approaching, or have already reached, their rediscount ceilings as rediscounting at the Bundesbank rose from DM 5.75 billion in December 1965 to DM 7.65 billion in the first part of May. As a result recourse to Lombard credit, which is not limited, increased from DM 163 million to DM 903 million during the period. Access to this form of credit has now become considerably more expensive.

Bank lending and deposit rates are now expected to advance further. The upward adjustment of the discount rate automatically raised the permissible level of interest which banks may charge on loans. Interest maxima have risen from 7 to 8 per cent for discountable paper and from 8-1/2 to 9-1/2 per cent for other paper and cash loans. Although bank lending rates to prime customers are known to have been below the previous maxima, they have reportedly been coming increasingly closer to them. Rates charged other customers are appropriately closer to the permissible maximum. Given the stringency of credit conditions and the demand for funds, some advance in rates is to be expected in this area.

Following the increase in the discount rate, the Federal Banking Supervisory Office recommended an increase in maximum bank deposit rates to become effective July 1st, if approved by the banks. Banks reportedly had already been paying more than the permissible maximum on some accounts. The increase in depositor rates will bring the basic savings rate (for accounts with an agreed period of notice of less than 12 months) from 3-3/4 to 4-1/2 per cent. Accounts with a period of notice of 12 months to 2-1/2 years will now receive interest of 5-1/2 rather than 5 per cent. The continued control of interest rates on accounts with notice periods of up to 2-1/2 years comes as a disappointment to banks, which had hoped that controls would be abolished for notice periods of over one year. Interest rates have been freed, however, on accounts of DM 100,000 or more having a minimum deposit period of three months. When banks meet with the Supervisory Council in June to discuss the proposed action, questions are anticipated on the freeing of interest rates on large deposits of over three months while interest controls are maintained on other time deposits of up to 2-1/2 years notice. On the whole, however, the Supervisory Office's recommendations are expected to be accepted as proposed.

The upward adjustment of the interest rate structure will place added pressures on mortgage and bond rates. Savings banks are expected to find it necessary to increase their rates on both new and outstanding mortgages and maintenance of the 7 per cent coupon rate on bonds may become even more difficult.

Fiscal developments

The German Parliament approved a 1966 budget of DM 68.9 billion, down from the initial DM 69.7 estimate, after a prolonged trimming process. This is an increase of 8 per cent over last year's estimates and of 4 per cent over last year's actual expenditures. In addition to cutting expenditures, the Budget Committee also shifted DM 900 million from the credit-financed extraordinary budget to the tax-financed ordinary budget.

The Government will shortly introduce a "Conjuncture-Stabilizing" law in Parliament, the core of which involves a commitment by the Federal and Laender Governments to coordinate their spending as much as possible in a counter-cyclical pattern to the developments in the economy. This is in part to be accomplished by having the Federal and Laender Governments establish special reserve accounts at the Bundesbank in times of high demand; these reserves would be drawn down in times of slack demand. The law further provides that the Federal Government formulate a five-year budget plan; Laender budgets are to take the expenditures of the municipalities into account and work towards the overall desired fiscal effect. Other provisions of the law would empower the Federal Government to limit the amount of borrowing of public authorities without seeking the approval of the Bundesrat (Upper House). to speed up tax payments, and to vary depreciation rates according to the economic climate.

The Bundesbank would be empowered to place ceilings on bank credit expansion which could be differentiated on the basis of the nature and the maturity of the credit granted and the type of lending institution. Such credit ceilings could be imposed for one year only with the possibility of an extension for another year. Violators would be obliged to put an interest-free deposit equal to the amount of overlending at the Bundesbank for the maximum of a year. In addition, the social security funds could be required to put a certain portion of their investible funds (depending upon their preceding year's investment level) into money market paper at the Bundesbank. Further, the Minister of Finance would be required to provide the Bundesbank with Treasury bills and bonds for open market operations under certain conditions; the amounts involved have not been specified as yet.

Continued tendency towards payments deficit

The tendency to deficit in the German balance of payments continued to contribute to the liquidity drain on the banking system throughout the period. In January the unwinding of window-dressing operations led to a large improvement of commercial banks' net foreign exchange positions. (See Table 3.) But in February, March, and April, combined foreign exchange losses of the commercial banks and the Bundesbank totaled $253 million and further losses were recorded through the first half of May.

Table 3. Germany: Changes in Reserve Position
(in millions of U.S. dollars)

	1965			1966			
	Jan.-Apr.	May-Aug.	Sept.-Dec.	Jan.-Apr.	Feb.	Mar.	Apr.e/
A. Bundesbank gold and foreign exchange							
Gold	- 5	138	28	- 8	- 4	- 4	---
Foreign exchange	-140	-752	114	-302	-47	- 14	-78
Total	-145	-614	142	-310	-51	- 18	-78
B. Drawing rights on IMF	- 35	186	12	34	---	10	10
C. Commercial banks net foreign exchange	502	-154	-310	324	11	-121	-16
Total A through C	322	-582	-156	48	-40	-129	-84

e/ Estimated.
Sources: Bundesbank Monthly Report and International Financial Statistics.

Although the overall picture has changed little, there are some indications that the factors behind the deficit are changing. The 1965 deficit arose almost entirely as a result of the large expansion of imports which led, in turn, to a marked deterioration of the trade balance. The slower growth of imports and the more rapid advance of exports in recent months have led, however, to an appreciable strengthening of the trade balance. The continued tendency toward deficit in the first quarter arose primarily from an unseasonally early and substantial weakening of the tourist account, from increased official payments (as compared to those of the first quarter 1965) and from a deterioration in the private capital balance. (See Table 4.) A substantial net outflow of short-term capital, the first in months, occurred in March and preliminary reports indicate there may have been a small outflow rather than the usual inflow of private capital in April.

Table 4. Germany: Balance of Payments, 1965-March 1966
(in millions of DM)

	1965 I	1965 II	1965 III	1965 IV	1966 Jan.	1966 Feb.	1966 Mar. 1/
1. Goods and Services							
Trade balance	1098	- 46	- 453	604	185	372	287
Services	- 2	- 789	- 852	45	-120	-148	- 80
Total	1096	- 835	-1305	649	65	224	207
2. Official Payments							
Donations	-1349	-1778	-1359	-1333	-461	-477	-492
Long-term capital	- 172	- 334	- 735	- 502	-215	- 15	80
Short-term capital	138	- 49	620	421	89	52	-168
Total	-1383	-2161	-1474	-1414	-587	-440	-580
3. Private Capital							
Long-term	410	522	514	540	429	-139	111
Short-term 2/	273	- 12	303	236	513	128	-269
Errors and omissions	1041	1358	527	- 715	796	125	- 80
Total	1724	1868	1344	61	1738	114	-238
Surplus or Deficit (-)	1437	-1128	-1435	- 704	1216	-102	-611

1/ Preliminary.
2/ Includes commercial bank capital other than net foreign exchange assets.
Sources: Basic data from Bundesbank and International Financial Statistics rearranged by author.

DM strengthens in exchange markets after discount increase

The foreign exchange quotation for the DM weakened generally after the beginning of the year as the deficit in Germany's balance of payments reemerged. Except for a brief strengthening in March, when banks pulled in funds to meet demands related to the tax date, the rate for the DM continued to slip downward on the foreign exchange market. (See Table 5.) This tendency continued through the first week of May. Anticipation and reaction to the discount rate increase caused the rate for the DM to strengthen during the rest of the month although it still remained below its par value.

Table 5. Germany: Exchange Rate and Forward Rate
(in U.S. cents per DM and per cent per annum)

Upper limit	25.188
Lower limit	24.875
Par value	25.00

	Spot Rate 1/	Forward Rate		Spot Rate 1/	Forward Rate
January	24.926	+0.28	May 6	24.878	+0.03
February	24.904	+0.22	13	24.891	-0.01
March	24.914	+0.04	20	24.897	-0.06
April	24.902	+0.03	27	24.916	-0.38

1/ Noon buying rate in New York.
Source: Federal Reserve Board.

Chart 1

NEW YORK, LONDON, MONTREAL:
YIELDS FOR U.S. DOLLAR INVESTORS ON 3-MONTH FUNDS

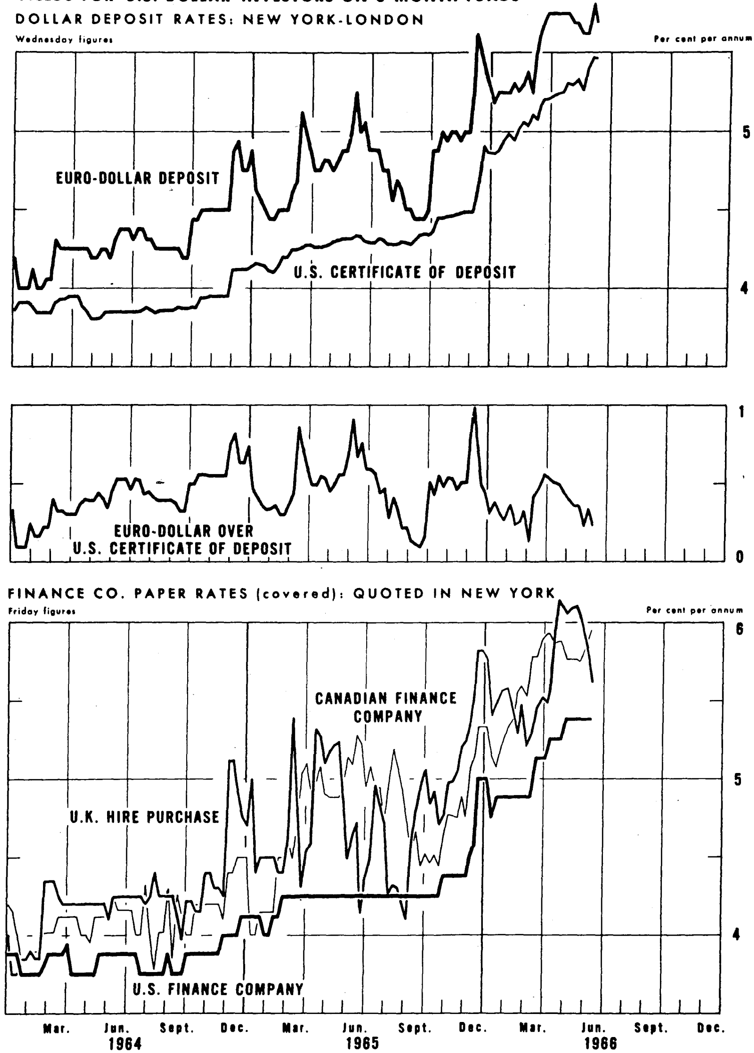
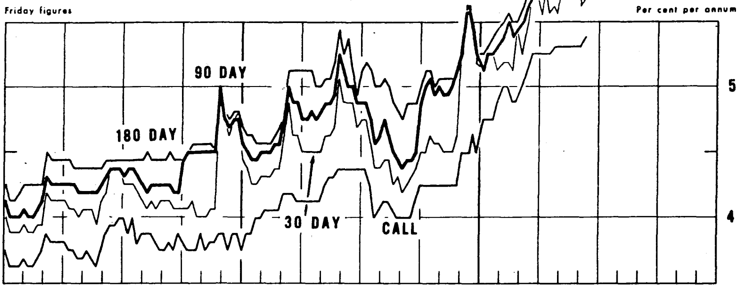


Chart 2

LONDON: YIELDS FOR U.S. DOLLAR INVESTORS ON 3-MONTH FUNDS

EURO-DOLLAR DEPOSIT RATES



HIRE PURCHASE AND LOCAL AUTHORITY DEPOSIT RATES (covered)

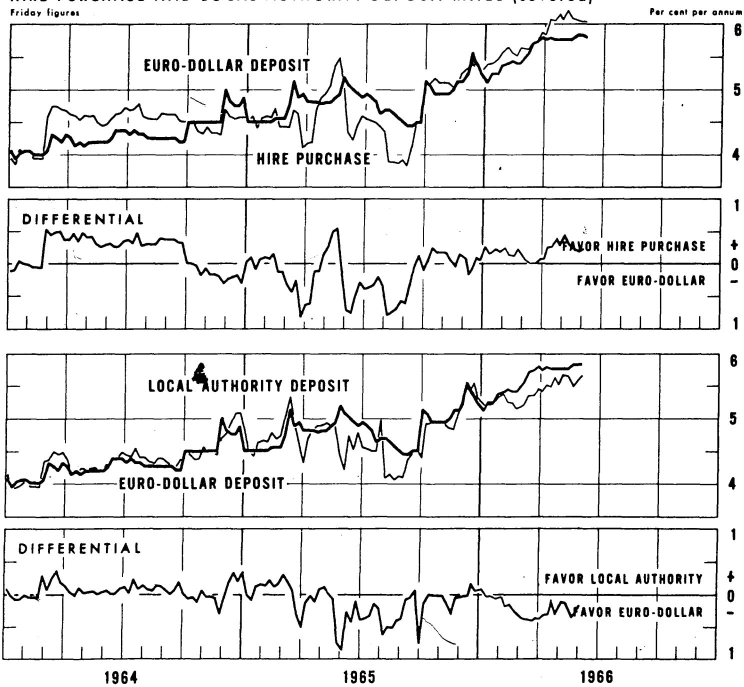


Chart 3

INTEREST ARBITRAGE: FRANKFURT/LONDON, ZURICH/LONDON

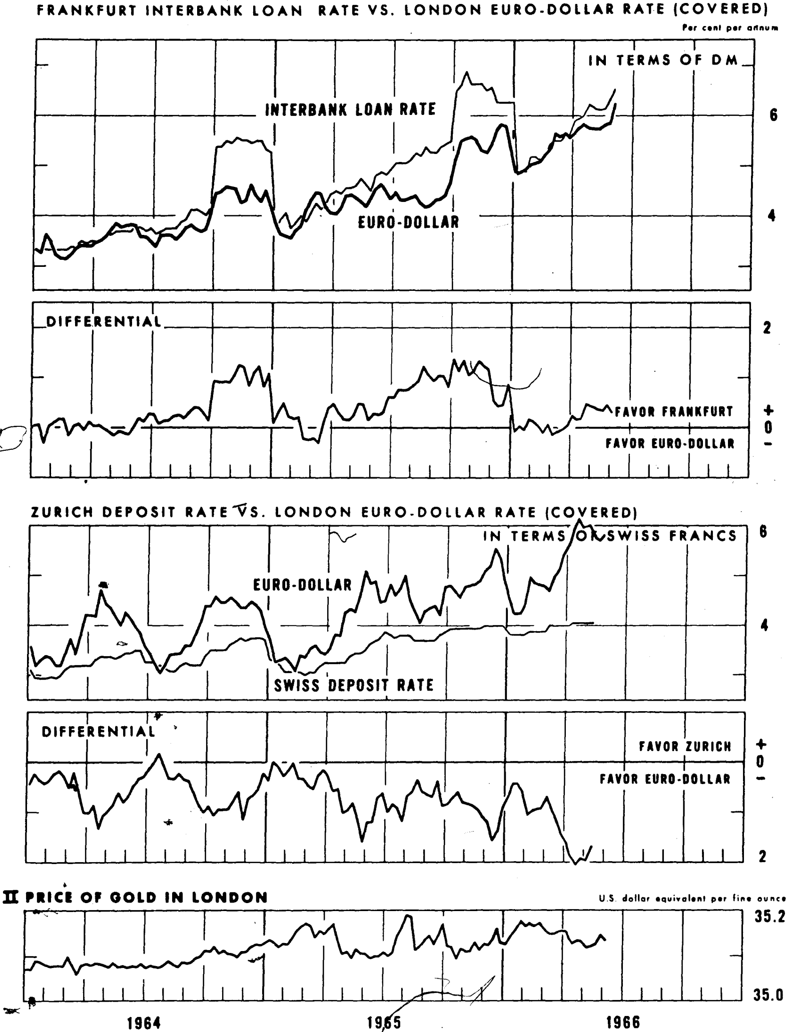


Chart 4

INTEREST ARBITRAGE, UNITED STATES/CANADA

Friday figures

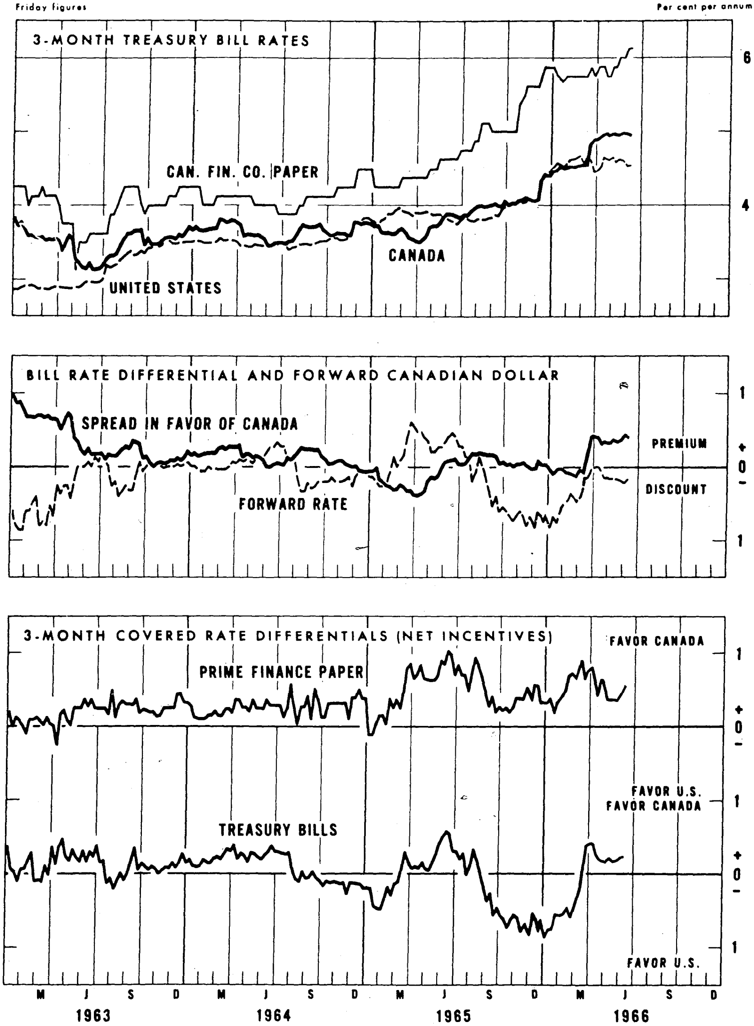


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Chart 5

INTEREST ARBITRAGE, NEW YORK/LONDON

Friday figures

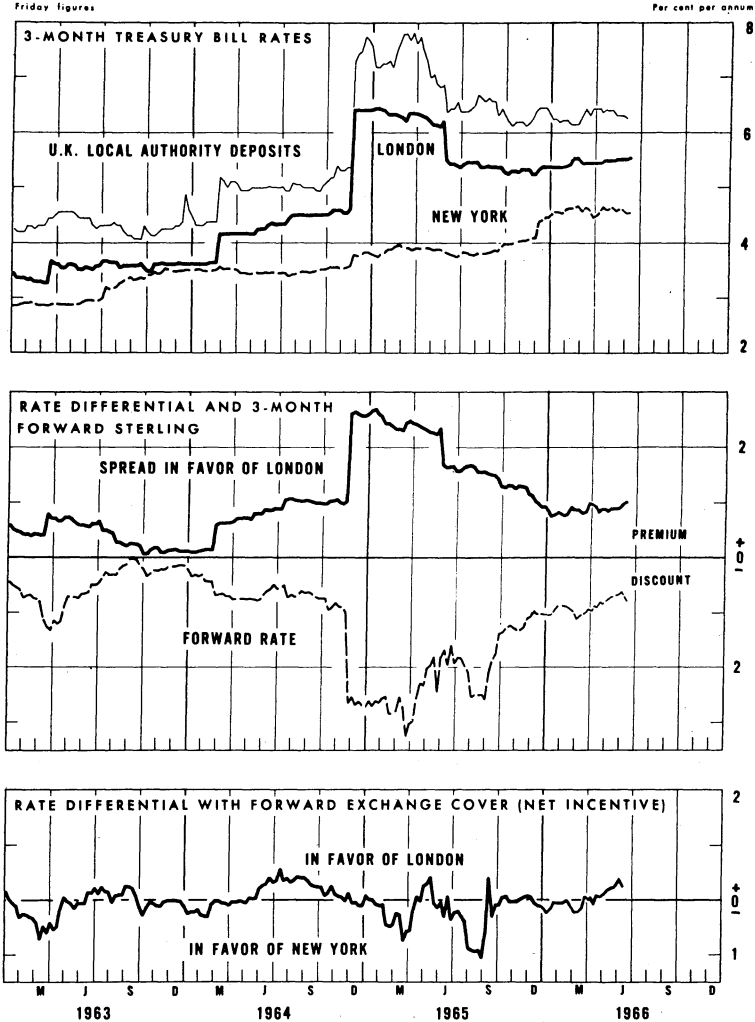
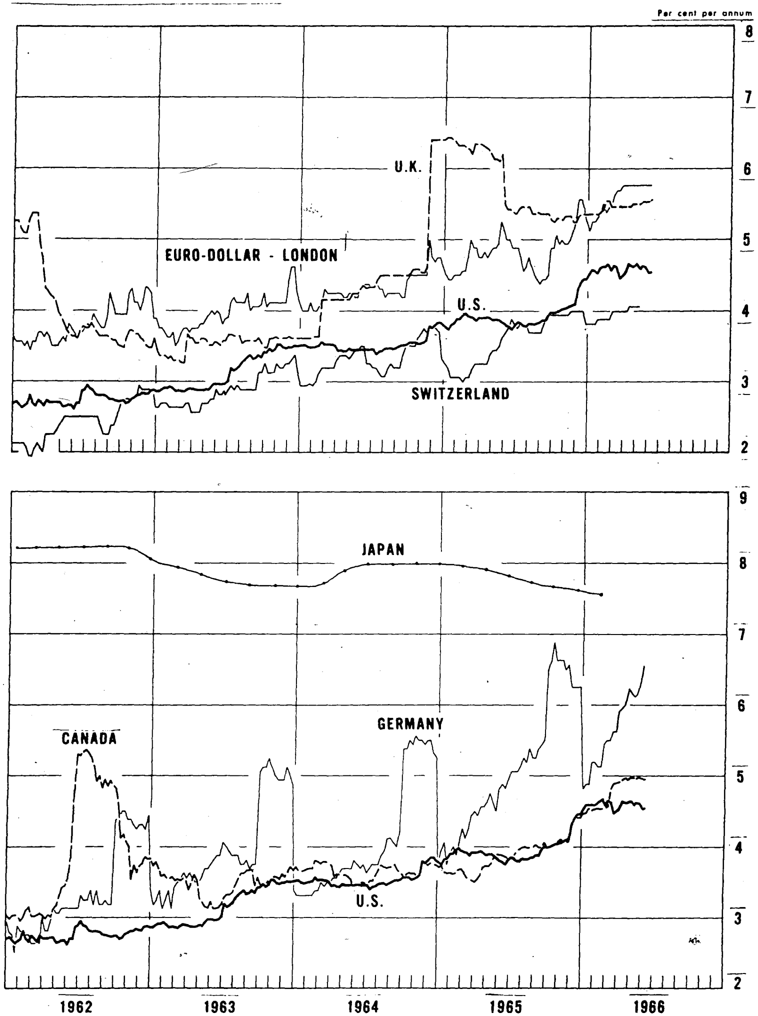


Chart 6

SHORT-TERM INTEREST RATES *



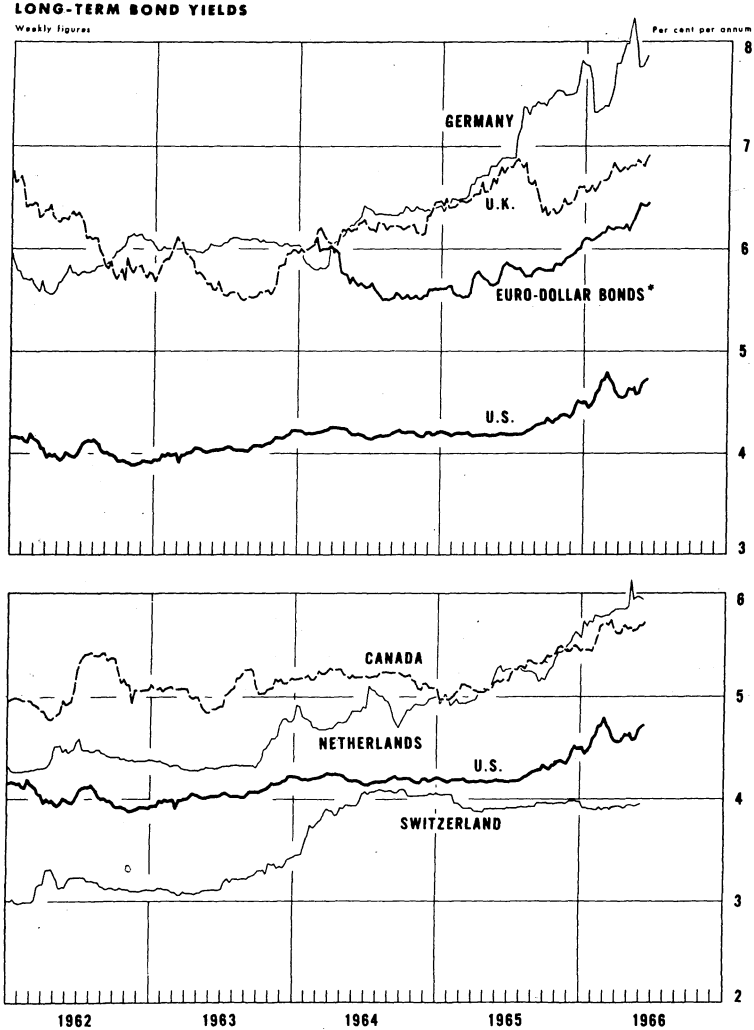
* 3-month treasury bill rates for all countries except Japan (Average rate on bank loans and discounts) Switzerland (3-month deposit rate) and Germany (Interbank Loan Rate)

† 3-month rate for U S dollar deposits in London

Chart 7

LONG-TERM BOND YIELDS

Weekly figures



*Average of yields for four foreign government dollar bonds quoted in London

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Chart 8

SPOT EXCHANGE RATES - MAJOR CURRENCIES AGAINST U.S. DOLLAR

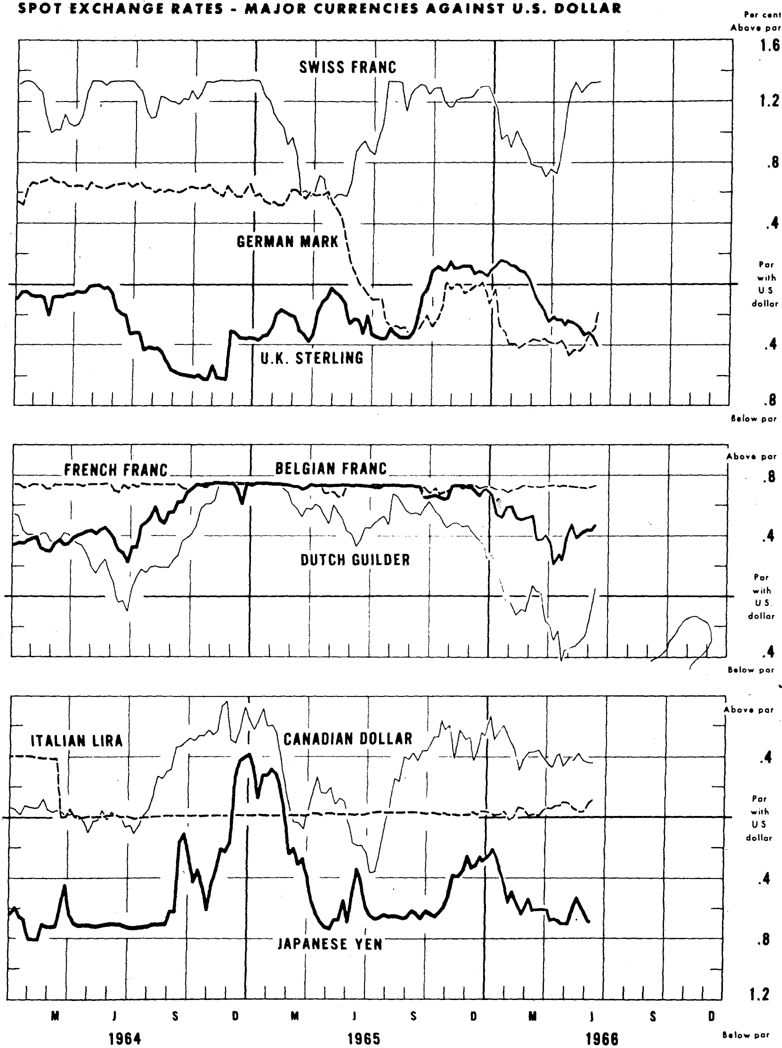


Chart 9

3-MONTH FORWARD EXCHANGE RATES

Friday figures

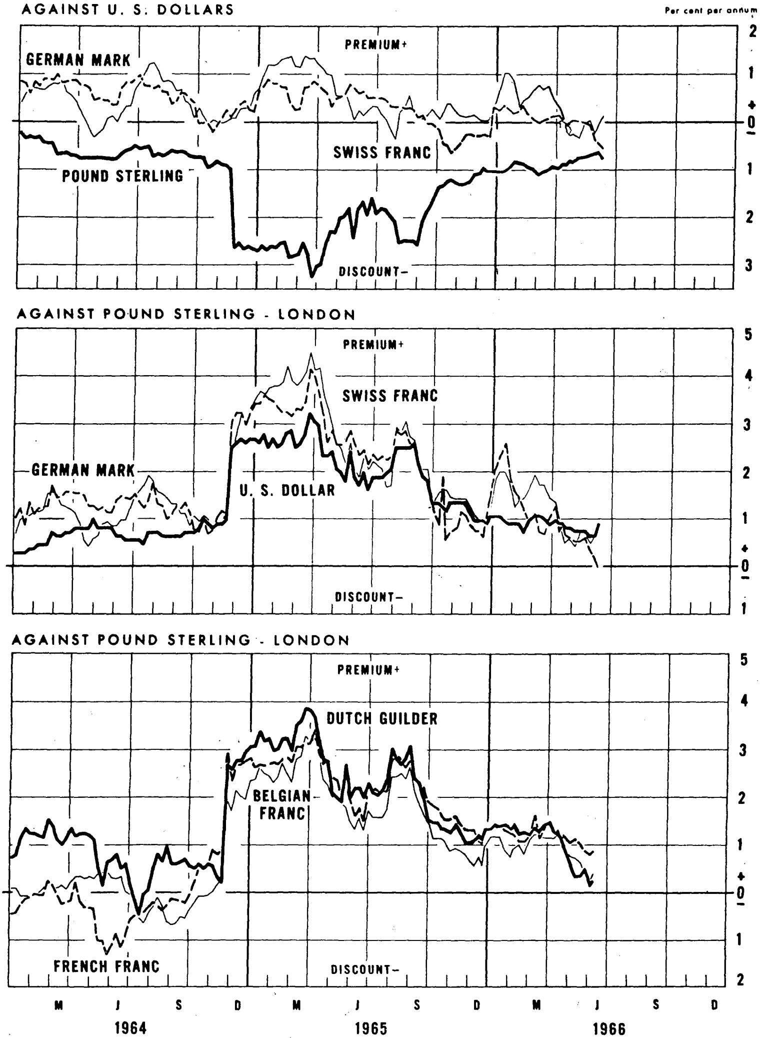
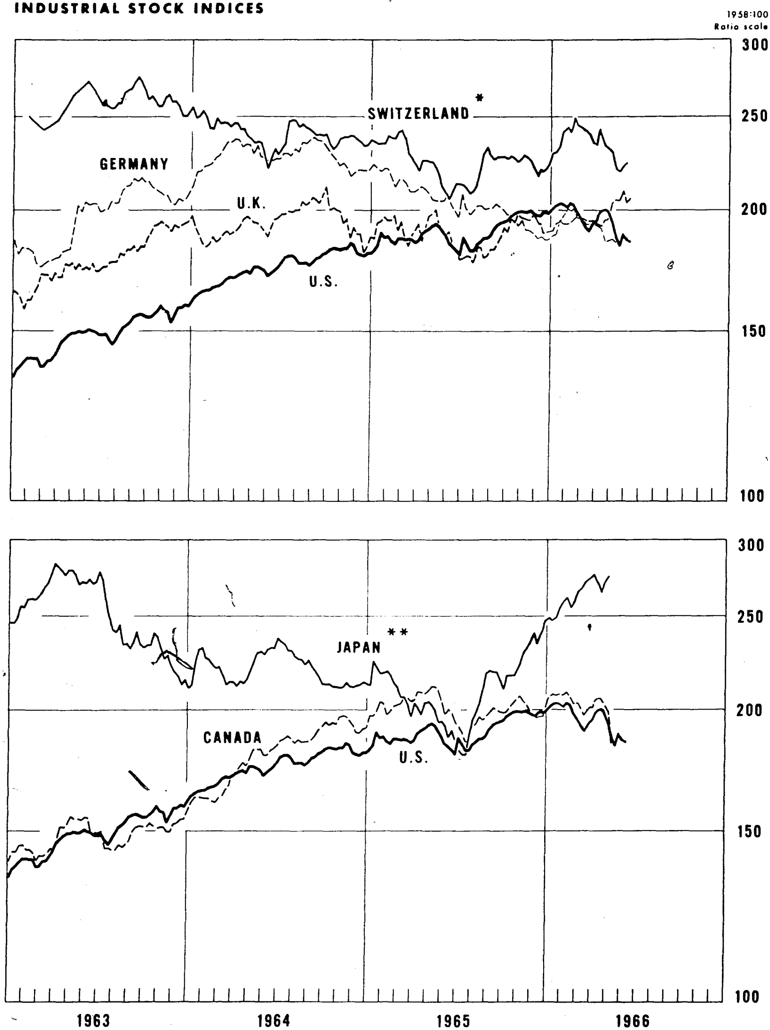


Chart 10
INDUSTRIAL STOCK INDICES



* Swiss Bank Corporation industrial stock index
** Japan: index of 225 industrial and other stocks traded on the Tokyo exchange

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III. Latest Figures Plotted in H.13 Chart Series, 1966
(all figures per cent per annum)

Chart 1

Upper Panel (Wednesday, June 8)

Euro-$ Deposit	5.69
U.S. certif. of deposit	5.46

Lower Panel (Friday, June 10)

Finance co. paper: U.S.	5.38
Canada	5.62
Hire-purchase paper, U.K.	5.95

Chart 2
(Friday, June 10)

Euro-$ deposits:

Call	5.38	90-day	5.75
7-day	5.56	180-day	5.94
30-day	5.69		

Hire-purchase paper (June 3)	6.03
Local-authority deposit (June 3)	5.65

Chart 3

Upper Panel (Period: June 1-7)

Interbank loan (mid-point)	6.55
Euro-$ deposit (average)	6.25

Lower Panel (Date: May 15)

Zurich 3-mo. deposit	4.06
Price of gold (Friday, June 3)	35.133

Chart 4
(Friday, June 10)

Treasury bills: Canada	4.94
U.S.	4.54
Spread favor Canada	+0.40
Forward Canadian $	-0.17
Net incentive (Canada +)	+0.23
Canadian finance paper	6.13

Chart 5
(Friday, June 10)

Treasury bills: U.K.	5.55
U.S.	4.54
Spread favor U.K.	+1.01
Forward pound	-0.79
Net incentive (U.K. +)	+0.22

Chart 6
(Friday, June 10)

Treasury bills: U.S.	4.54
U.K.	5.55
Canada	4.94
Interbank loan rate (German)	6.55
Euro-$ deposit (London)	5.75
Zurich 3-mo. deposit (Date: May 15)	4.06
Japan composit rate (Date: Feb. 28)	7.570

Chart 7

U.S. Gov't. (Wed., June 8)	4.73
U.K. War Loan (Thurs., June 9)	6.90
German Fed. (Fri., June 3)	7.87
Swiss Confed. (Fri., June 3)	3.95
Canadian Gov't. (Wed., June 8)	5.72
Netherlands Gov't perpetual 3% (Friday, June 3)	5.94
Euro-$ bonds (Fri., June 10)	6.45

For descriptions and sources of data, see special supplement to H.13, Number 239, March 16, 1966.