DIVISION OF INTERNATIONAL FINANCE

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

H. 13
No. 278

December 14, 1966.

CAPITAL MARKET DEVELOPMENTS ABROAD

I. Germany
II. Ten Charts on Financial Markets Abroad
III. Latest Figures Plotted in H.13 Chart Series, 1966

I. Germany: Money and Capital Market Developments, July-November 1966

There was a general easing in financial markets in Germany in the period under review. The upward trend in German interest rates reached a peak in mid-July and rates have since been declining. From mid-July to end-November, call money rates drifted down from 6.38 per cent to 4.88 per cent. For the first extended period during 1966, the call money rate was below the discount rate during most of the last half of November. Most of the 1966 rise in bond yields was also reversed during this period. During the same period, the average yield on 6 per cent public authority bonds fell from 8.62 per cent to 7.67 per cent on December 7.

Table 1. Germany: Selected Financial Indicators
(per cent per annum)

	Jan. 31	July 11	Sept. 30	Oct. 31	Nov. 30	Dec. 7
Discount rate	4.00	5.00	5.00	5.00	5.00	5.00
Call money	4.50	6.38	5.63	5.63	4.88	5.75
3-month loans	5.19	6.88	6.75	7.19	7.19	7.13
6% Public authority bond yield	7.55	8.62	8.12	8.07	7.79	7.67

Source: Bundesbank; Frankfurter Allgemeine Zeitung.

The factors behind the easing of rates have been a growing balance of payments surplus and public sector disbursements, which produced significant additions to bank liquidity, a slackening in the demand for loans and an unusually small expansion of required minimum reserves because of a shift in the structure of bank deposits.

OFFICIAL USE ONLY
(Decontrolled after six months)

Although the Bundesbank has allowed these additions to bank liquidity to occur, the central bank has so far limited the extent to which it was prepared to modify the restrictive emphasis of credit policy. The Bank announced in November, however, a 9 per cent reduction in minimum reserve requirements on time and sight deposits for the month of December as a temporary measure to ease heavy year-end strains on financial markets. In early December, the Bundesbank decided to extend the lower reserve requirements indefinitely to compensate for the loss of bank liquidity resulting from the removal of the privilege of using foreign assets to offset foreign liabilities in the calculation of banks' minimum reserve requirements. However, rough calculations suggest that for the big banks, the loss of this offset privilege may well outweigh the gain from the lower reserve requirement by as much as DM 700 million.

Money market eases as bank liquidity expands

After climbing rapidly during 1966 to a peak in July, money market rates then eased significantly. The easier condition of the German money market only partly reflected the easing in bank liquidity positions because banks placed a substantial portion of newly-acquired liquidity in short-term investments abroad. Banks' net foreign exchange positions improved an estimated DM 1.2 billion between July and November. Nonetheless, the call money rate declined from an average of 6.27 per cent in July to 4.95 per cent in the last week of November. The rate for three-month loans was slightly below the July peak in August and September, but rose again in October with the beginning of year-end positioning by banks. This seasonal rise, however, was much less marked this year than in previous years. (See Chart 6.)

The major source of liquidity additions has been the reappearance of balance of payment surpluses as of May this year; according to Bundesbank liquidity calculations, balance of payments inflows added DM 1.8 billion to the banking system in the third quarter alone and a total of DM 2.5 billion since May. In addition, the deterioration of public authorities net balances at the Bundesbank in July and August provided a net 928 million of liquid funds to the banking system in the third quarter as a whole. From these two and other factors, a net total of DM 1.4 billion became available to the banks in the third quarter. With one minor exception of a temporary character in late 1965, this is the first quarterly addition to bank liquidity which the monetary authorities have permitted since the first quarter of 1964.

An additional factor easing the banks' liquidity positions in the third quarter was a large-scale shift in bank liabilities from sight to time deposits. The reserve requirement against time deposits is 20 per cent compared with that of 30 per cent against sight deposits. As a result of the shifts, required reserves rose only about DM 100-200 million in August-October compared with the almost DM 500 million increase between May and July.

The shift in deposit structure followed the July 1, 1966 removal of interest ceilings on time deposits of three months or more of a minimum size of DM 100,000. As a result, time deposits jumped DM 2.3 billion in the third quarter in contrast to a decline of DM 1.0 billion a year ago, while sight deposits declined by DM 1.6 billion.

New Bundesbank measures

Thus far, the Bundesbank has declined to take any outright steps, such as a lowering of the discount rate, to loosen its tight monetary policy. The Bundesbank did, however, announce usual seasonal help to the domestic and international money markets in meeting heavy year-end cash demands. Minimum reserve requirements on domestic time and sight deposits were lowered by 9 per cent for the month of December, freeing an estimated DM 900 million to meet cash demands and window-dressing requirements.

Then, at the beginning of December the Bundesbank extended the lower minimum reserve requirements indefinitely; at the same time, the Bank made the gross (rather than the net) foreign exchange liabilities of banks subject to minimum reserve requirements, effective January 1, 1967. The Bank's statement implied that the effects of these two measures would offset each other. However, it appears that in the case of large banks which have significantly built up their foreign asset positions in response to the incentive offered by the liability offset possibility, the overall effect of these measures may be restrictive because the loss of the offset priviledge may outweigh the gain from the lowered reserve requirements.

The Bundesbank did not explain its reasons for taking these two measures. There is considerable speculation in financial circles, however, that the Bundesbank was encouraging the reflow of bank funds in order to prime the market for the placement of DM 1.5 billion of Treasury obligations at the beginning of 1967. The proceeds are earmarked for military offset payments to the United States.

Credit expansion continues to slow

The net expansion of credit to the non-bank sector continued to slow during the third quarter. Credit expansion to private borrowers was off most noticeably, rising only DM 3.7 billion or DM 2.2 billion less than in the third quarter of 1965. (See Table 2.) Part of the smaller expansion of credit to the private sector reflects the decline in industrial investment plans rather than a stringency of funds. Private industrial investment in 1966 is now not expected to exceed the 1965 level. The latest IFO Institute survey indicates furthermore that gross fixed investment by manufacturing industries in 1967 will be 8 to 10 per cent lower than in 1966.

The expansion of bank credit to the public sector was also smaller in the third quarter this year than last. Slower expansion of long-term credit extensions more than offset rises in short- and medium-term credits. The persistently more rapid growth of shorter-term credits to the public sector over the past year reflects the attempts of the public authorities to obtain interim financing in the face of long-term financing difficulties.

Thanks apparently to easing liquidity strains, banks again became net purchasers of securities--both stocks and bonds--in September, although they were net sellers in the third quarter as a whole. The continued firmness in bond prices in the past few weeks suggests that banks may have continued these purchases in October and November.

Table 2. Germany: Bank Credit Expansion to the Domestic Non-Bank Sector
(DM millions)

	January-September	I	II	III
Total Credit Expansion 1/				
1966	+19,924 p/	+6,876	+7,839	+5,209 p/
1965	+23,542	+6,781	+9,746	+7,015
Private Sector				
1966	+16,246 p/	+5,189	+7,327	+3,730 p/
1965	+18,188	+4,487	+7,731	+5,970
Public Sector				
1966	+ 3,359 p/	+1,453	+ 310	+1,596 p/
1965	+ 4,475	+1,618	+ 983	+1,874
Holdings of Securities 2/ and Syndicate Participants				
1966	+ 146 p/	+ 136	+ 160	- 150 p/
1965	+ 700	+ 597	+ 982	- 879

1/ Components do not add to total because of exclusion of "covering claims."
p/ Preliminary.
2/ After elimination of book losses arising from falling market values in 1965.
Source: Bundesbank, October Monthly Report.

Improvement in bond market

The bank market strengthened appreciably between July and early December thanks to the combined effects of the continuing issue pause in new public authority bonds, and some revival of buying interest by both bank and non-bank investors. Yields on 6 per cent public authority issues declined about 80 basis points from the July peak to the end of November, and a further 12 basis points in early December. (See Table 1 and Chart 7.) This latest firming of bond prices is partly attributable to a growing feeling in the market that the 25 per cent coupon tax might be rescinded by the new Government. The Bundesbank, however, remains firmly opposed to such a move.

The public authority issue stop, which has continued in effect since the end of May this year, has played a major role in relieving pressure on the bond market. In the second and third quarters, public authorities were almost entirely outside of the market as borrowers.1/ As a result of redemptions, the public sector actually injected a net total of DM 190 million into the capital market in the third quarter and DM 60 million in the second. The extremely weak state of the market generally discouraged all other "occasional" borrowers from raising funds. Total borrowing by occasional issuers in the second and third quarters was consequently five or six times smaller than last year levels. (See Table 3.) Even the mortgage and credit banks, which finance themselves regularly on the bond market, have raised less on the market this year than last, partly reflecting the slowdown in residential construction as well as the difficulties of raising capital on the bond market.

With greater stability in the market, private non-bank investors returned as buyers. Their net purchases amounted to DM 850 million in the third quarter, still considerably less than the almost DM 2 billion purchased in the third quarter last year, but substantially above the DM 540 million purchased in the second quarter of 1966. In the third quarter banks switched from being net sellers to being net purchasers and bought DM 193 million of domestic fixed-interest-bearing securities.

As a result of the improvement on the bond market, capital market issuers were able to move DM 300 million of securities from their own portfolios into the market in the third quarter. During the second quarter, borrowers had found it necessary to make support purchases of approximately DM 200 million.

It now appears likely that the ban on public authority issues, which has been maintained since May, may be cautiously relaxed beginning in January. The test issue is expected to be a DM 100 million loan of the city of Munich.

Budget outlook

The health of the bond market will continue to depend to a major extent upon expenditure and financing plans of the public authorities for 1967.

The Federal Government has experienced great difficulty in providing satisfactory financing for proposed 1967 expenditures despite painful budget cutting. The budget which the Government presented to the Bundesrat (Upper House) on October 28, was balanced on paper but it: (a) made insufficient provision for the DM 3.6 billion due to the United States Government under the terms of the military offset agreement; (b) assumed a Federal government corporate and income tax share of 39 per cent

---

1/ Very small amounts were raised on the bond market during this time by the Equalization of Burdens Fund. Flotations of this Fund are not considered standard public authority fund raising.

Table 3. Germany: Gross Placements in Securities Markets
(DM millions, market value, month or monthly average)

	1965			1966		
	I	II	III	I	II	III
"Occasional" borrowers bonds:						
Industrial	86	90	--	--	37	39
Public authorities	303	380	199	314	10	13
Foreign issuers	193	43	37	102	1	37
Other bonds[1]	333	181	833	215	60	118
Total	915	694	1,069	631	108	207
Mortgage and communal bonds	853	570	628	571	385	426
Total gross bond placements[2]	1,768	1,264	1,697	1,202	493	633
Gross share placements	239	349	472	291	250	177
Total security placements at issue value	2,007	1,613	2,169	1,493	743	810

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

rather than the 35 per cent to which it is normally entitled under the Constitution, despite clear indications that the Laender would insist upon a return to the 35:65 per cent apportioning of taxes at the end of this year;[1] (c) based its revenue calculations upon what is now considered to be an unreasonably high nominal GNP growth rate of 7 per cent for 1967. According to present trends, the growth rate is expected to be only 6 -- 6.3 per cent; this slower rate would imply a DM 1.09 billion smaller revenue intake.

1/ The German Constitution specifies that the Laender shall receive 65 per cent of total income and corporation tax receipts and the Federal Government 35 per cent. A change in the apportioning can be effected only by the mutual consent of the Federal and the Laender governments; this division is subject to review every two years.

After review, the Bundesrat called upon the Government to revise its budget estimates. Subsequent revisions led to a net increase in proposed expenditures of DM 1.36 billion, bringing the total to DM 75.28 billion. To provide the necessary additional revenues, the Government proposed to increase indirect taxes for an additional DM 1.95 billion and to raise the remaining DM 500 million on the bond market. However, the financing problem of the central government is further clouded by a projected DM 750 million shortfall in 1966 revenues which must be made up next year and which is not included in 1967 budget drafts.

The Erhard government broke up over the question of tax increases and it is not yet apparent in what way the new CDU-SPD Coalition Government will solve the budget problem. It seems clear, however, that the slowly reviving bond market cannot as yet bear the strain of large-scale central government financing, especially at this time when other public borrowers also have large pent-up financing demands.

Growing balance of payments surplus

Following a year and a half of payments deficits, consistent monthly surpluses re-emerged as of May and continued through November. The improvement of the German payments position resulted entirely from a sharp improvement in the trade balance: a marked slow-down in imports was accompanied by a growing expansion of exports. The trade balance has consequently improved steadily, moving from a small surplus of DM 845 million in the first quarter to one of DM 2.3 billion in the third quarter. This surplus contrasts sharply with a deficit of DM 453 million in the third quarter of 1965. (See Table 5.) The improvement in the trade balance was accompanied by continuing substantial inflows of private capital which amounted to DM 4.3 billion through the third quarter this year, slightly less than the DM 4.8 billion inflow of the first three quarters last year.

The second quarter surplus was reflected in an increase of Bundesbank reserves, chiefly in the form of increased drawing rights on the International Monetary Fund, following the increase in Germany's IMF quota in May from $788 million to $1,200 million. (See Table 6.) In the third quarter, however, there were substantial gains to both commercial bank and Bundesbank foreign exchange reserves and reserve gains continued in November.

The payments surplus caused the DM quotation to strengthen in foreign exchange markets. The rate for the mark moved steadily upward from an average of 24.894 U.S. cents in May to 25.150 U.S. cents in November. (See Chart 8.)

Table 5. Germany: Balance of Payments
(DM millions)

	1965 I	1965 II	1965 III	1966 I	1966 II	1966 III 1/
1. Goods and Services						
Trade balance	1,098	- 46	- 453	845	1,374	2,256
Services	10	- 769	- 821	- 309	- 468	- 785
Total	1,108	- 815	-1,274	536	906	1,471
2. Official Payments						
Donations	-1,341	-1,766	-1,344	-1,517	-1,350	-1,326
Long-term capital	- 172	- 334	- 735	- 149	-1,665	- 143
Short-term capital	138	- 49	619	- 82	1,677	13
Total	-1,375	-2,149	-1,460	-1,748	-1,338	-1,456
3. Private Capital						
Long-term capital	478	584	493	528	487	326
Short-term capital 2/	232	- 10	344	497	397	796
Errors and omissions	994	1,262	462	690	353	268
Total	1,704	1,836	1,299	1,715	1,237	1,390
Surplus or Deficit (-)	1,437	-1,128	-1,435	503	805	1,405

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.

Table 6. Germany: Changes in Reserve Position
(in millions of dollars)

	1965	1966 I	II	III	Oct.	Nov.
1. Bundesbank gold and foreign exchange						
Gold	162	- 8	- 93	- 14	- 6	1
Foreign exchange	-778	-195	136	275	168	36
Total	-616	-203	43	261	162	37
2. Drawing rights on IMF	163	24	118	--	5	--
3. Commercial banks' net foreign exchange	38	348	- 2	118	26	159e/
4. Total 1 through 3	-415	169	161	379	193	196e/

e/ Estimated.
Source: Bundesbank; International Financial Statistics.

Prepared by:
Rosemary A. Darlington, Economist
Europe and British Commonwealth Section
Division of International Finance

Chart 1

NEW YORK, LONDON, MONTREAL:

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

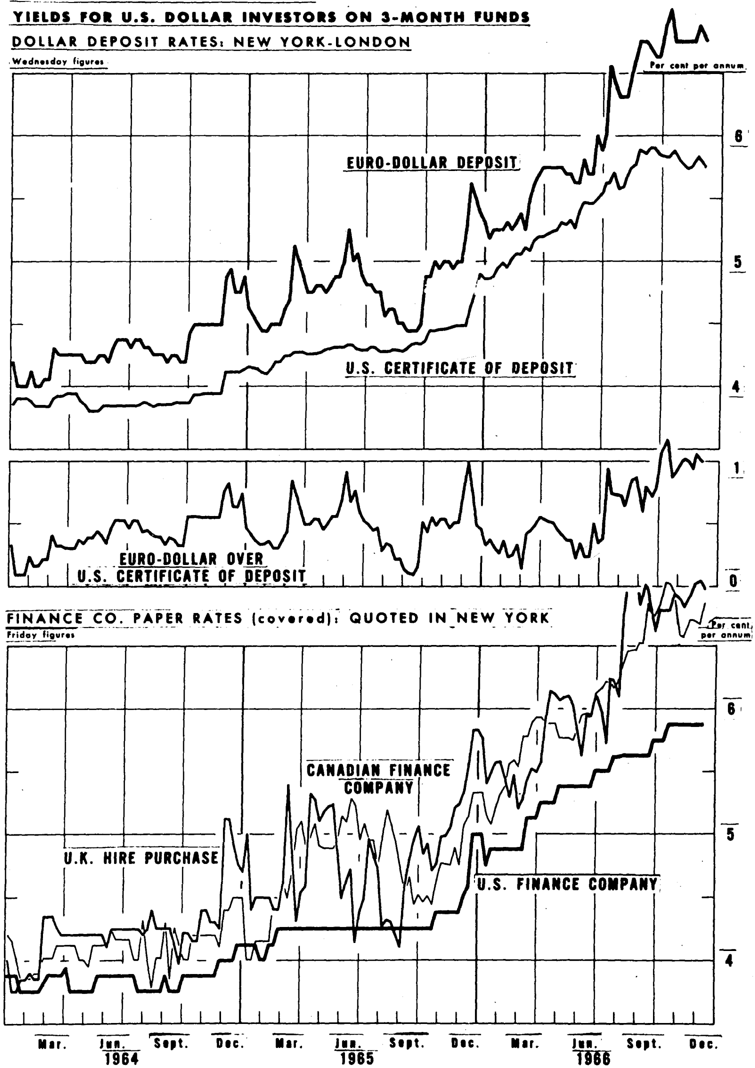


Chart 2

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

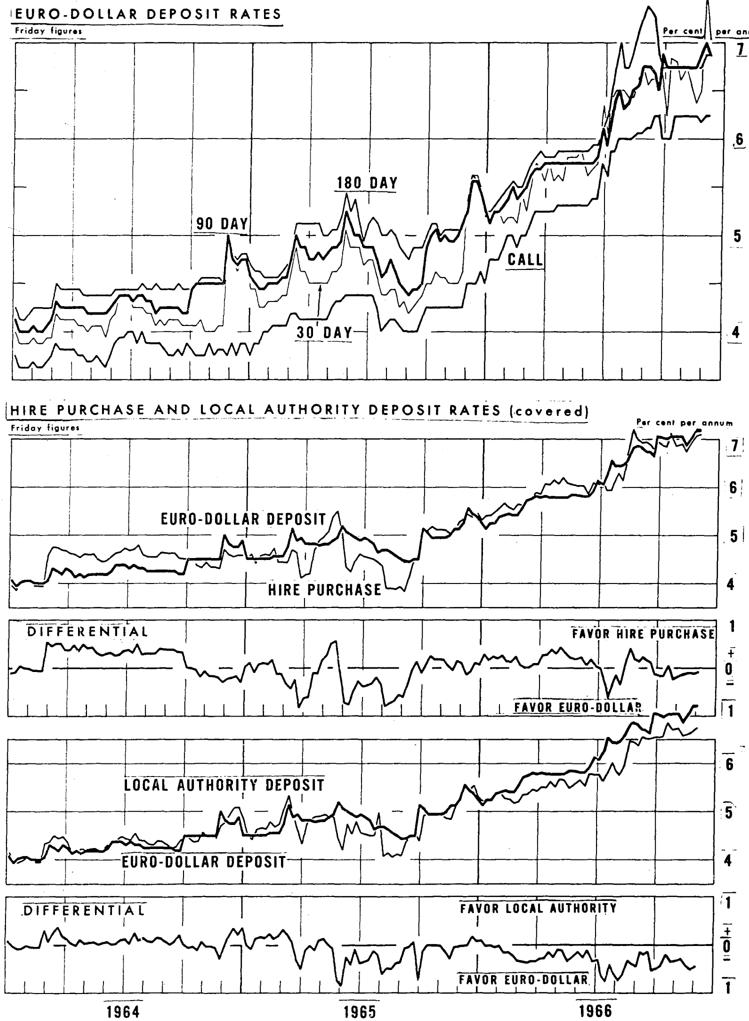


Chart 3

INTEREST ARBITRAGE: FRANKFURT/LONDON, ZURICH/LONDON

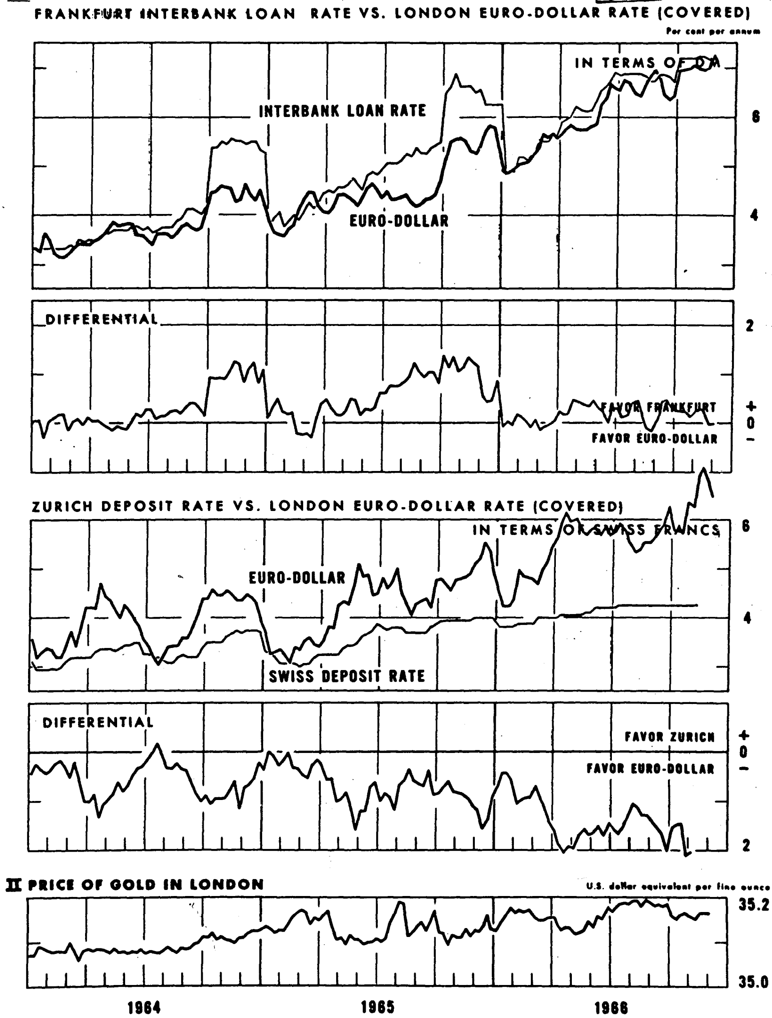
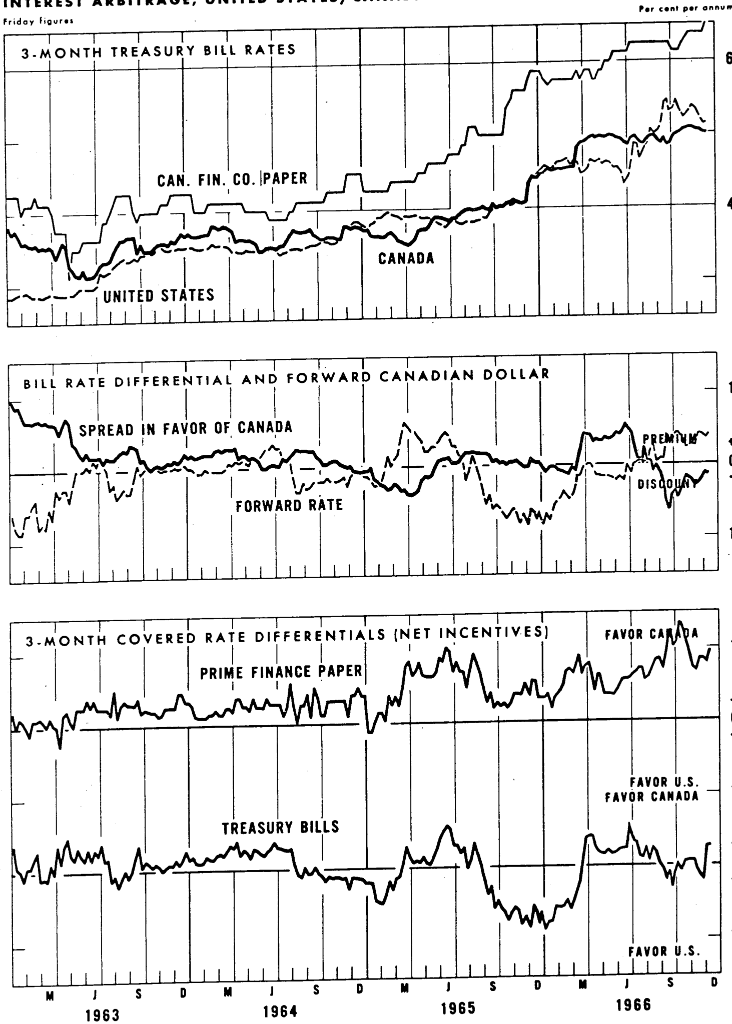


Chart 4

INTEREST ARBITRAGE, UNITED STATES/CANADA

Friday figures



14

Chart 5

INTEREST ARBITRAGE, NEW YORK/LONDON

Friday figures

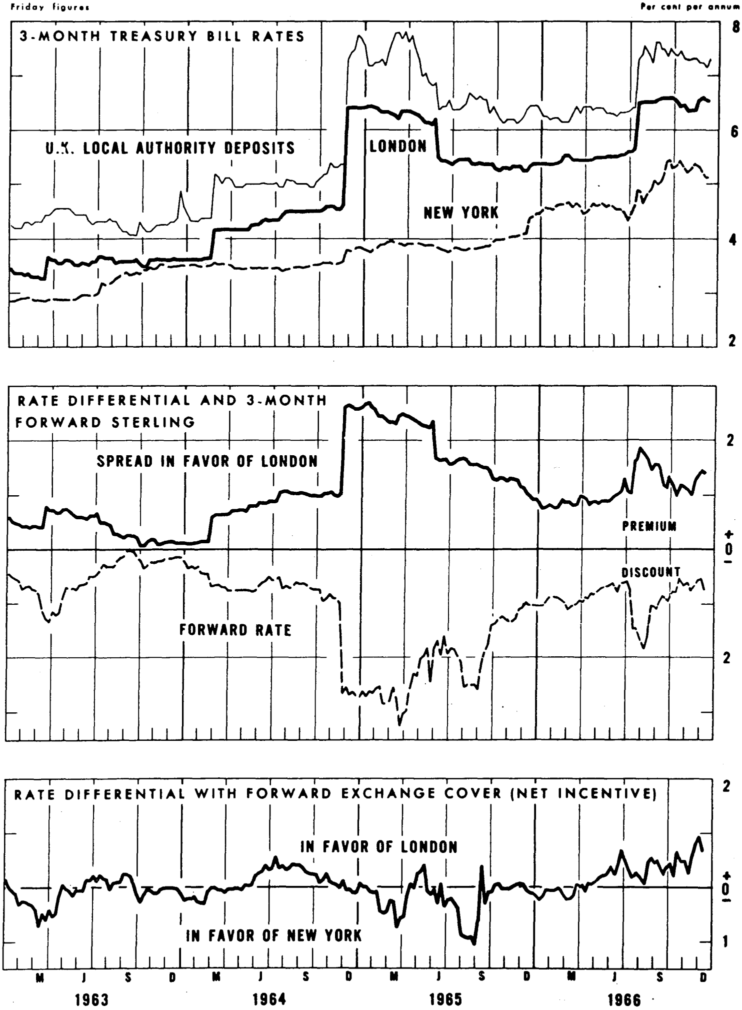
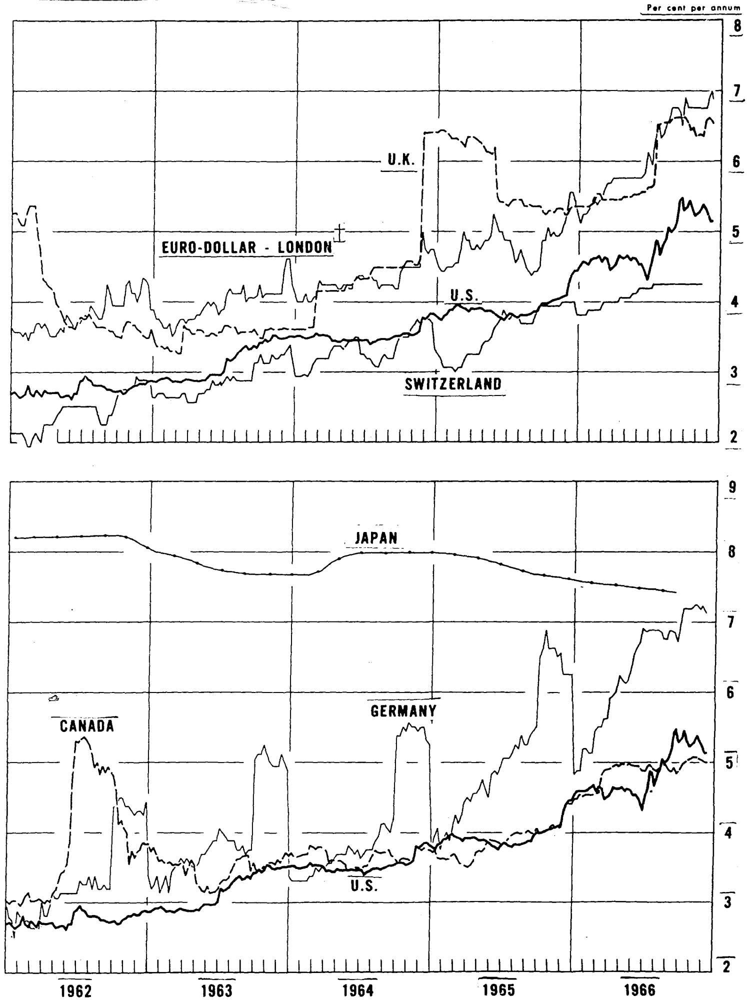


Chart 6

SHORT-TERM INTEREST RATES*

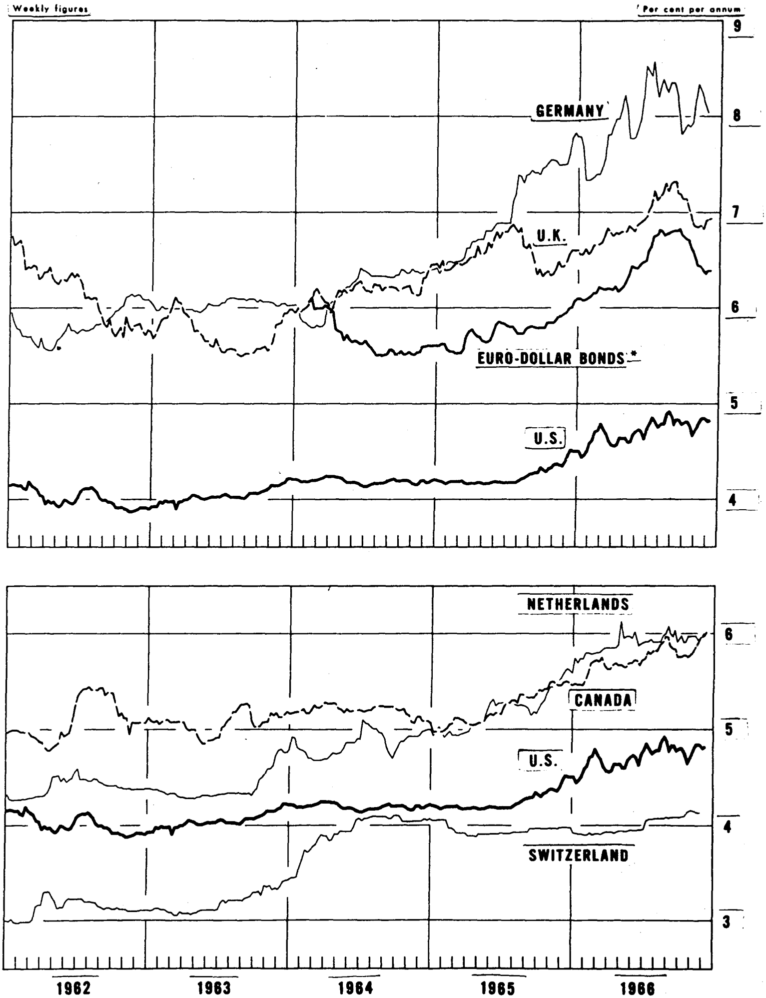


* 3-month treasury bill rates for all countries except Japan (Average rate on bank loans and discounts), Switzerland (3-month deposit rate) and Germany (Interbank Loan Rate)

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

16

LONG-TERM BOND YIELDS



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

Chart 8

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

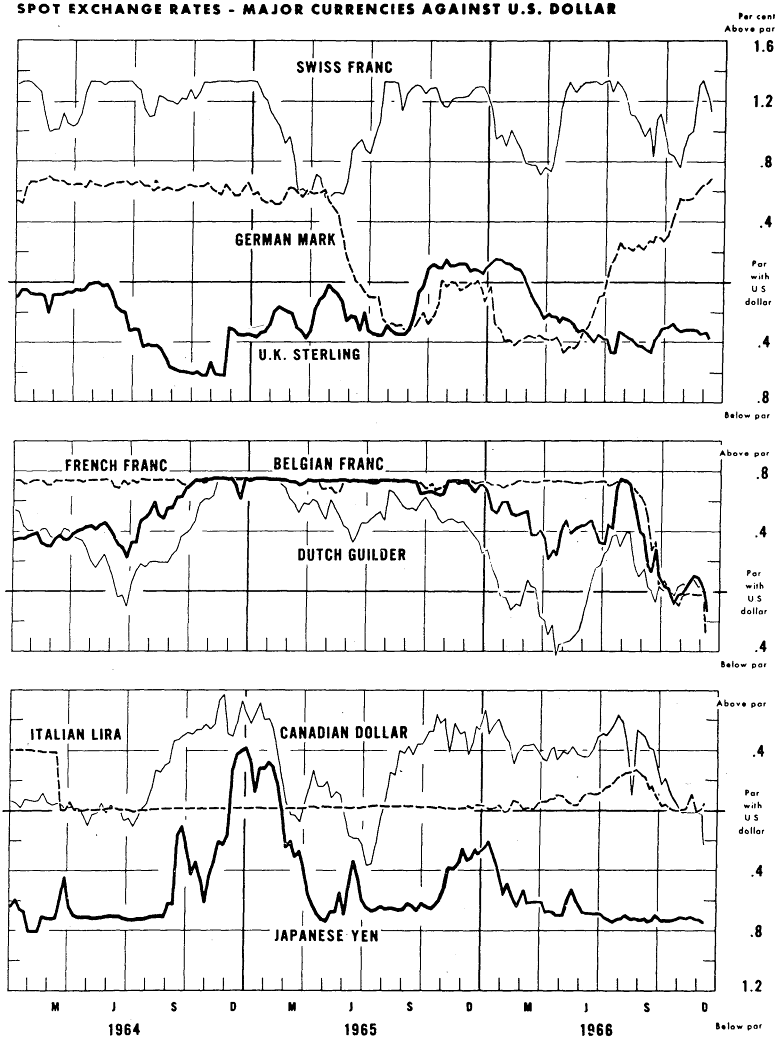
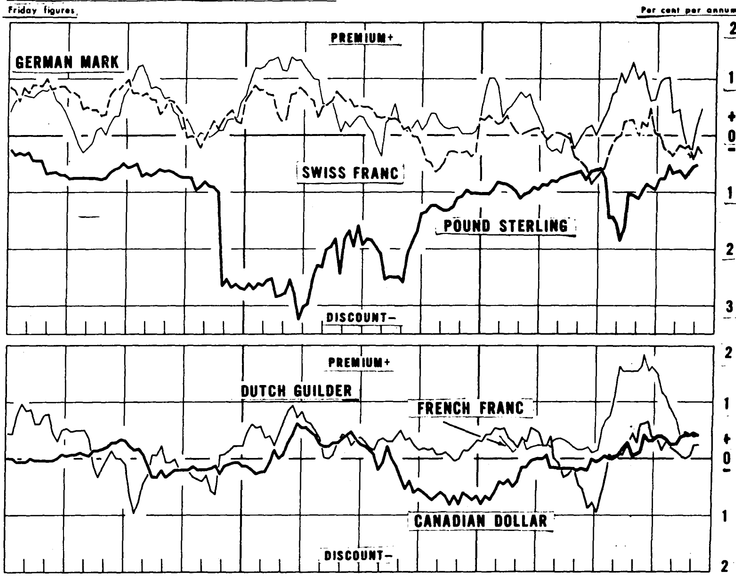


Chart 9

3-MONTH FORWARD EXCHANGE RATES

AGAINST U.S. DOLLARS—NEW YORK



AGAINST POUND STERLING—LONDON

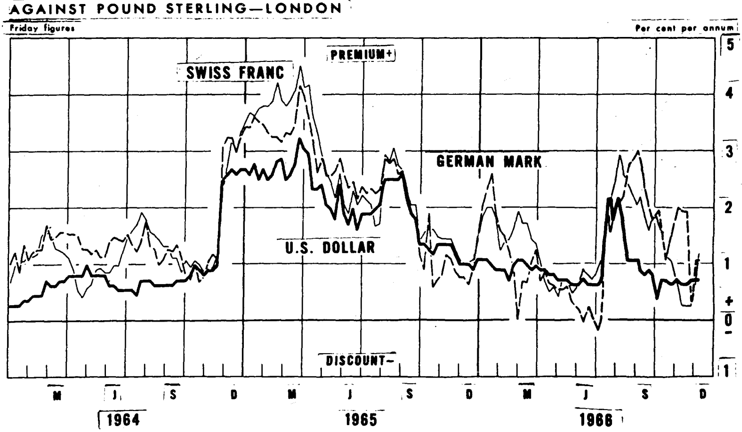
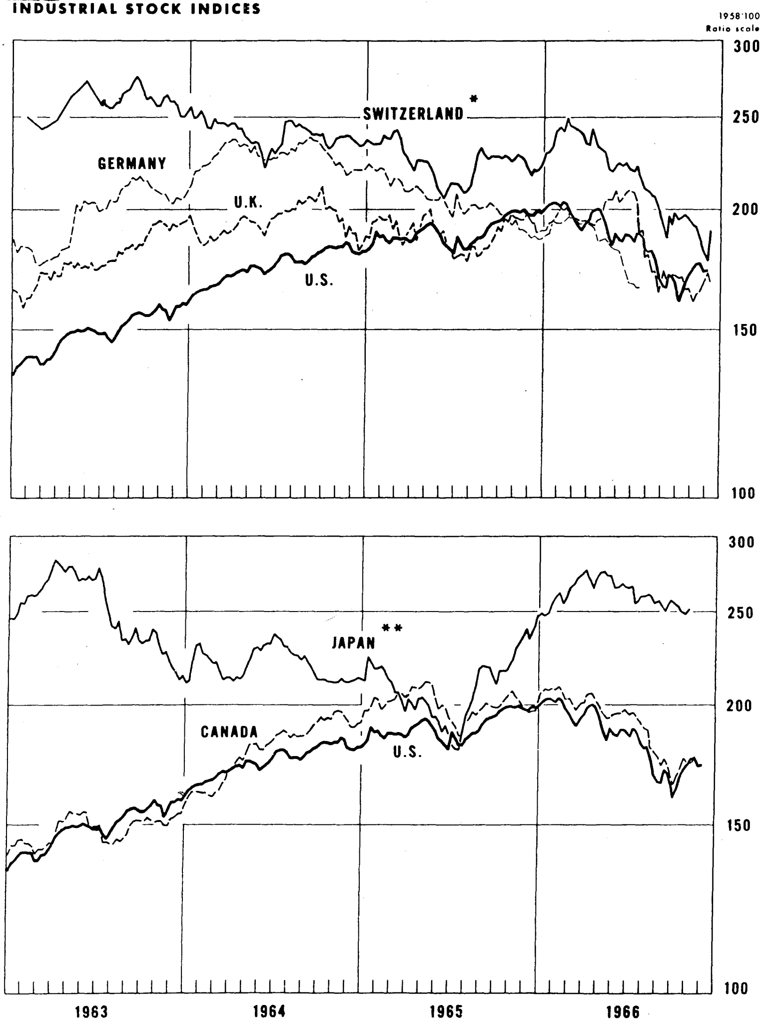


Chart 10

INDUSTRIAL STOCK INDICES



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

December 14, 1966

H.13
No. 278

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

Chart 1

Upper Panel (Wednesday, Dec. 7)

Euro-$ Deposit	6.75
U.S. certif. of deposit	5.75

Lower Panel (Friday, Dec. 9)

Finance co. paper:	U.S.	5.88
	Canada	6.84
Hire-purchase paper, U.K.		6.96

Chart 2
(Friday, Dec. 9)

Euro-$ deposits:

Call	6.25	90-day	6.88
7-day	6.50	180-day	6.88
30-day	7.06		

Hire-purchase paper	7.10
Local-authority deposit	6.75

Chart 3

Upper Panel (Period: Dec. 1-7)

Interbank loan (mid-point)	7.12
Euro-$ deposit (average)	7.13

Lower Panel (Date: Nov. 15)

Zurich 3-mo. deposit	4.25
Price of gold (Friday, Dec. 2)	35.164

Chart 4
(Friday, Dec. 9)

Treasury bills:	Canada	5.14
	U.S.	5.00
Spread favor Canada		-0.14
Forward Canadian $		+0.41
Net incentive (Canada +)		+0.27
Canadian finance paper		6.50

Chart 5
(Friday, Dec. 9)

Treasury bills:	U.K.	6.53
	U.S.	5.14
Spread favor U.K.		+1.39
Forward pound		-0.73
Net incentive (U.K. +)		+0.66

Chart 6
(Friday, Dec. 9)

Treasury bills:	U.S.	5.14
	U.K.	6.53
	Canada	5.00
Interbank loan rate (German) (Dec. 1-7)		7.12
Euro-$ deposit (London)		6.88
Zurich 3-mo. deposit (Date: Nov. 15)		4.25
Japan composit rate (Date: Sept. 30)		7.42

Chart 7

U.S. Gov't. (Wed., Dec. 7)	4.80
U.K. War Loan (Thurs., Dec. 8)	6.94
German Fed. (Fri., Dec. 2)	7.80
Swiss Confed. (Fri., Nov. 25)	4.13
Canadian Gov't. (Wed., Dec. 7)	6.01
Netherlands Gov't perpetual 3% (Friday, Dec. 2)	6.00
Euro-$ bonds (Fri., Dec. 9)	6.38

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