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Development of the German Money Market

by Dr Johannes Völling, Düsseldorf *

Those whose duty it is to deal in the money market business at the German banks have been facing an unusual, one might even say unprecedented, situation for weeks and months: daily money is being sought for and offered at high rates of interest, generally in excess of 10 p.c. p.a. (even 12 p.c. was offered at the end of the year). Loans for periods of one and three months have, in similar fashion, reached rates of interest such as have not been noted on the German money market since the end of the war. This means that the rates on the money market at this time not only exceed the Central Bank's official discount rate of 7.5 p.c., a situation which has also arisen on previous occasions in the past when money was tight and which is by no means something to cause wonderment considering the structure of the German money market itself, the methods employed by participants in that money market and the possibilities open to them for obtaining other sources of financial assistance from outside—but that, in addition, they stood, and still stand from time to time, at more than (the 1 p.c. above the lombard rate for advances on security), now at 9.5 p.c. which was generally regarded hitherto as the absolute ceiling for yield on the money market.

Explaining Factors

This is a phenomenon in the true sense of the word which well deserves to be explained and interpreted. We do, it is true, get to the heart of the matter by pointing to the big outflow of speculative money (which had come in from abroad) following the revaluation of the Deutsche Mark on October 27, 1969. This outflow, however, is not sufficient in itself to provide the sole explanation for the continuing market squeeze and the strain on the liquidity of the banking system and the consequent narrowness of the market, all of which have hitherto found their clearest expression in the high level of interest rates.

Other factors which play a similarly significant role are the following: the light structural shifts in the money market position of individual Ger-

man bank groupings; the credit policy adopted by the Central Bank and its effects on the money market; the development of the German balance of payments and its effects both on the Federal Bank's currency reserves and on the liquidity of the credit institutes; and, more especially, the growing engagement in, and dependence on, foreign money markets following convertibility.

Special Role of Euro-money Market

This last point, indeed, has become more and more important. The Federal Republic has, of all the Western States, the freest movement of capital and the least number of restrictions on movements of capital—a fact, however, which exposes the home market to especially strong pressure from international movements of money and capital which have been induced by interest rates. This applies with all the more validity because of the Euro-money market which has infiltrated between the individual national markets during the last few years and, registering the slightest fluctuations in interest rates with the sensitivity of a seismograph, has been prepared to either borrow or dispose of money as the case might be. It acts as a reservoir of equalisation for the divergencies in international liquidity and considerably accelerates the flow of such liquidity, especially when the large international banks are joined by private enterprises of world reputation in the Euro-market transactions. When speculative streams of liquidity—caused by expectations of changes in the rates of exchange—are added to movements of money induced by interest rates the effects on the domestic money market can assume the quite extreme and undesirable forms which have become evident these last months.

Determining Economic Factors

The position of individual banking groups on the market, conditioned, as it is, to a greater or lesser degree by their business structure and policy proves less decisive for the makeup of the money market in the long run than the state of liquidity of the banking system as a whole. The latter again, depends on whether there is

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an influx of liquidity into the system as a whole or whether it is deprived thereof. These streams of liquidity are determined by exogenous factors which the banking system, as a general rule, cannot influence. Among the most important of these exogenous factors are the following: the development of the Federal Bank's currency reserves; the deposit policy of Non-banks; certain measures of credit policy introduced by the Federal Bank; and, especially, the deposit policy of the public authorities.

Development of Currency Reserves

The first of these three determining factors has tended to increase liquidity throughout the whole of the German banking system for years because of the continued high surpluses in the balance of payments. A figure of almost DM 9,000 mn net alone has flowed in between 1966 and the end of 1969, the influx of currency rising from DM 4,600 mn at the first wave of speculation in November 1968 to DM 12,700 mn during the second wave of speculation in May 1969. The significance of these components of national banking liquidity—which are, to a certain extent, international as well—and, bound up therewith, the dependence of the domestic money market on interest and exchange-rate speculations has grown in the train of the increasing interlocking of capital markets in the world's economic system (which is becoming stronger and stronger) on the one hand and the efforts towards a gradual reduction of all barriers on movements of capital on the other. Jumps in interest rates induced additionally to the "normal" seasonal fluctuations on the money market are undesirable in the interests of a steady and continuous state of the money market. The German money market—to use a simplified and generalised formulation—has had to pay the piper for the currency speculation over the last 18 months in the form of extremely low money rates during the waves of speculation and a continuously tight money market during the following period of repatriation. Thus it was that more than DM 8,000 mn flowed out in November 1969 after the revaluation of the DM and a good DM 7,000 mn followed in December. Efforts by the Central Bank to exert a "quietening" influence on movements of currency by means of favourable exchange rate guarantee costs and, in that way, to influence currency rates themselves in the money market cannot be crowned with success in the long run in view of the great mobility of capital and existing expectations of exchange rate alterations. Such measures, in fact, usually only bring a fresh influx of money in their train. The German Federal Bank recognised this merry-go-

round and, consequently, abandoned exchange rate guarantees during the second wave of speculation in May 1969.

Interdependence between Capital Markets

German dealers in money, relieved of this "absorption of money" caused by speculation on the German market will also have to keep a very close watch for the future on happenings on the supranational and capital markets—especially on the Euro-markets—at least if the Federal Republic desires to keep its "open frontiers" in movements of capital. You cannot have your cake and eat it at the same time. Put in another way: those who want to maintain freedom of movement for capital cannot, at one and the same time, guarantee the independence of the home money market from international money movements. The advantage of free capital movement, namely the ability to invest wherever the highest relative returns are available may, in certain circumstances, embody possible national disadvantages like variations of interest rates or higher levels of interest. This situation will not alter very much when the present worldwide restriction policies of the Central Banks and the currency authorities are gradually relaxed and when the balance of payments situation in the USA and Great Britain has been normalised. The American money market and the Euro-market—whose volume rose from \$30,000 mn to \$40,000 mn within a year—exhibit a certain life and dynamic of their own from which the (by comparison) relatively small German market cannot isolate itself, whether it wants to or not.

Deposit Policy of the Non-banks

An influence tending to cause tightness of liquidity was exerted, generally speaking, by the deposit policy of the non-banks since 1966 and, especially, during the last few months which primarily stemmed from the development of credit balances belonging to the Federal Government and the Lands in the Central Bank. Since the Government of the Federal Republic has to lodge two of its special assets in the Federal Bank current accounts and—in certain circumstances—the Lands must act similarly with regard to their cash resources, every surplus in tax revenue expenditures effected internally by these public law entities means a corresponding loss of liquidity for the banking system. This surplus actually arises because of the differences in timing between the dates taxes become due and the dates when current expenditures are made. But they have, in fact, become more and more the result of a consciously pursued economic policy on the part of the public authori-

ties and especially on the part of the Federal Government. This policy of purposely creating cash surpluses will continue, at least, for the first six months of 1970 and will thus persist in tending to act as a brake on liquidity and a spur to increased interest rates.

Generally speaking, the determining factors of credit policy also had the effect of contracting bank liquidity (that is to say, especially the minimum reserves) and the rediscount policy of the Central Bank. Taken as a whole these measures of credit policy effected a decrease of bank liquidity amounting to DM 3,600 mn since 1966. Mainly responsible for this development were the following measures: the minimum reserve ratios on deposits by non-residents and the reduction of the rediscount quotas designed to prevent the banks obtaining the necessary Central Bank funds for credit by discounting bills at the Central Bank.

Reduction in Bank Liquidity

These three exogenous and some other not so important determining factors, taken as a whole, cause the reduction in bank liquidity since 1966 which amounted to DM 2,200 mn. But the decline can be exclusively traced to developments in 1966. The following table shows that the bank liquidity went down last year by more than DM 14,500 mn. It became clear, at the same time, how the banking system "financed" this efflux of liquidity. While divergencies in liquidity between one or several groups of banks can be cleared among themselves, this is not possible where losses of liquidity by the whole

system are concerned. In this case they can only fall back on the Central Bank whether by means of a reduction in excess funds, through a greater recourse to Central Bank funds, by returning money market papers to the Central Bank when due for, or before, their maturity or the liquidation of investments on the money market abroad. The banks, for the greater part, have waived this last possibility. On the contrary, they have considerably stockpiled their short term investments abroad because of the high foreign levels of interest—particularly in the USA—and, in this way, have still further increased the "liquidity squeeze" on the domestic market or their drawings on other sources or outside covering credit as the case might be. The liquidity efflux was mainly financed, in the first place, by the discounting of bills of exchange and the using of bonds as security for advances by the Central Bank. The discounting of bills at the Central Bank rose by more than DM 8,000 mn and the rediscount quotas, especially in the case of smaller banks, have been largely exhausted. Advanced for short term loans against pledged securities, therefore, a method of which the banks only avail themselves with reluctance, were called for much more frequently than in former periods of restriction. Despite the lombard rate which amounted to 9.5 p.c.—the highest ever demanded in the Federal Republic—the borrowing of loans against pledged securities of the Federal Bank amounted at times to more than DM 6,000 mn.

The second important source for offsetting their loss of liquidity was found by the banks in their domestic money market investments. This was,

Development of Bank Liquidity and its Components

(in Millions of DM)

— Changes based on Averages from the Four Weekly Bank Return Dates of Months at the end of a Quarter or Months respectively —

Period	Bank Liquidity as a Whole (Increase: +)	Surplus Reserves (Increase: +)	Domestic Money Market Papers (Increase: +)	Money Market Investments abroad (Increase: +)	Unused Redis- count Quotas (Increase: +)	Advances against Security (Lombard Credits) (Increase: —)
1968 1st Quarter	+ 1,485	— 924	+2,023	+ 266	— 71	+ 191
2nd Quarter	+ 739	+ 210	+ 154	+ 29	+ 312	+ 34
3rd Quarter	+ 455	— 190	+ 386	+ 608	— 228	— 121
4th Quarter	+ 2,522	+1,272	+ 108	— 166	+1,436	— 128
1969 1st Quarter	— 5,832	—1,315	—1,484	+1,871	—4,421	— 483
2nd Quarter	+ 4,396	— 569	—1,013	+2,885	+2,942	+ 151
3rd Quarter	— 4,555	+1,059	—1,037	—1,930	—3,284	+ 637
4th Quarter	— 8,554	+ 518	—3,929	+ 504	—3,428	—2,219
1969 April	— 1,849	+ 341	— 955	—2,175	+ 211	+ 729
May	+10,931	+5,103	+ 346	+1,957	+3,433	+ 92
June	— 4,686	—6,013	— 404	+3,103	— 702	— 670
July	— 3,282	+ 712	— 864	+ 328	—3,347	— 111
August	— 2,531	+ 225	— 471	—2,086	+ 19	— 218
September	+ 1,258	+ 122	+ 298	— 172	+ 44	+ 966
October	+ 1,492	— 690	— 503	+1,962	+1,053	— 330
November	— 5,701	+ 200	—1,173	+ 373	—2,314	—2,792
December	— 4,345	+1,008	—2,253	—1,831	—2,172	+ 903

Source: Monthly Reports of the German Federal Bank, February 1970.

however, less a result of consciously pursued policy than the maturing of non-interest bearing treasury bonds of the Federal Government of which about DM 4,600 mn were paid back in 1969.

Conclusions

This fairly long term review of those factors which govern the economy as a whole does not give rise, as yet, to any hopes of a speedy, lasting and fundamental easing of the position on the German money market in the near future. Speculation on exchange rates has come to an end and an influx of currency from this source is, therefore, very improbable. One must, on the contrary, reckon with further effluxes even if they are on a smaller scale if German enterprises have to repay foreign credits borrowed when

currency was in full flood. Differences in interest rates between the German, the foreign and Euro-markets have, it is true, been reduced but as long as the policy of contraction continues—and this particularly applies to the USA—we need not reckon with pressure on the German interest levels emanating from pressure exerted through international interest developments. Conversely, one cannot force down the whole interest level by a one-sided domestic policy of interest reduction. The restrictive financial policy with its tendency to create surpluses on Federal Bank Accounts will make its own contribution to keeping bank liquidity short and, in that way, to keeping the money market tight.

Taken all in all: dealers on the German money market will have to reckon with high rates for daily money during the coming months.

Money and Banking under the New System

by Dr J. Wilczynski, Canberra *

Monetary policy under central planning of the Socialist type is much more intimately integrated than under Capitalism with wage and fiscal policies, and these are further reinforced by direct controls where necessary. The overall objective of the monetary policy is to provide a financial basis conducive to plan fulfilment and monetary equilibrium in the economy. Before the recent reforms, the scope for monetary policy was pretty limited, as money performed a passive function.

Under the new system, basic proportions in the economy are still centrally determined, but otherwise enterprises have a good deal of freedom in deciding on the details and methods of fulfilling the plan. Directives and prohibitions have been largely replaced with financial incentives and disincentives administered flexibly by monetary authorities. The new system is accentuating inflationary pressure, which provides a new challenge to monetary policy.

Monetary Policy

One of the principles adopted in the reforms is the rule of self-financing. This means that enterprises, even in the sphere of investment, have

to rely basically on their own resources instead of central allocations from the State budget. This has produced a change in payment flows in the economy. Grants to enterprises are now smaller, and so are their payments to the State budget. Instead, deliveries are now financed mostly "horizontally" on the enterprises' own initiative. In this process, banks have assumed an active role.

The increasing importance being attached to monetary policy is indicated by the growing number of publications on the role of money, credit and banks. In these discussions Western achievements in the sphere of monetary theory and policy are also analysed with a view to possible adaptations to modern Socialist economic conditions. Two British economists, T. Wilson and G. R. Denton, who made a thorough on-the-spot study of the Yugoslav economy in 1967 concluded that "Yugoslavia is relying more upon banking policy than is Britain". Meditating on the modern trends in Socialist countries, a Polish monetary expert Z. Grabowski concluded: "... who knows, if in the light of these developments the theoretical assumption of the withering away of money with the transition to Full Com-

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