

MONETARY POLICY AND THE POST-WAR ECONOMIC
RECOVERY OF THE FEDERAL GERMAN REPUBLIC

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INTRODUCTION

The purpose of this thesis is to analyze and evaluate the role played by monetary policy in the economic recovery of the Federal German Republic between 1945 and 1958. The rapid resurgence of the West German economy has made it, in the opinion of many, a classic example of economic recovery occurring in the setting of a free market economy. The fact that this nation has passed from virtual total destruction to the position of being a leading industrial power would seem to justify a detailed study of the factors contributing to this achievement. Many prominent students of the German economic scene consider monetary policy to be one of the most significant factors contributing to the economic recovery. Therefore, this report shall attempt to provide a comprehensive chronological account of the monetary policies carried out in the Federal German Republic, and of the post-war evolution of the West German banking system.

Most studies of German monetary policy are to be found in the economic periodical literature. The few texts that are available, in English, on the German economic recovery, in most instances allude only indirectly to monetary policy. The periodical studies that have been carried out are, on the whole, fragmentary and deal usually with only a relatively narrow period. The bulk of these studies,

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as will be noted from the bibliography, are restricted, in general, to the period between 1948 and 1953. There has been a noticeable lack of study devoted to the period between 1953 and 1958. In consideration of the fragmentary nature of previous studies, and of the fact that no comprehensive synthesis of the entire fourteen year period has as yet been undertaken, it is hoped that this thesis will be able to make some contribution to an understanding of German monetary policy as it occurred during the post-war era.

It is the intention of this report to provide an historical approach to the subject, while at the same time co-ordinating, where possible, the various divergent theoretical evaluations. This thesis has been written exclusively from English language research material. For this reason, the bulk of the reference material, particularly in the case of non-official data, has had to be acquired from American and British sources. In order to verify and fortify these sources, considerable recourse has been made to the official publications of the German Central Bank, which fortunately have been made available in officially sanctioned English translations. The monthly and annual reports of the Central Bank have proven invaluable in the preparation of this report, and their comprehensiveness is a tribute to the competence of the monetary authorities. It is hoped that, by utilizing a varied selection of sources, a high degree

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of objectivity and accuracy has been achieved.

The first chapter of this thesis traces the events of monetary significance which occurred between May 1945 and December 1948. The chaotic conditions prevalent immediately following the war, as evidenced by black market activity and bilateral trade, are examined along with the measures taken by the Allies to decentralize both the large commercial banks and the old Central Bank, the Reichsbank. Of particular significance is the section devoted to the re-establishment of the banking system along the lines of the U.S. Federal Reserve System, and the creation of the regional Land Central Banks, in addition to the new Central Bank, the Bank Deutscher Laender. The currency reform of mid-1948, which contracted the money supply and established a new currency, is described and evaluated at considerable length, for many economists consider this event to have contributed more to the economic recovery than any other single factor. The remainder of the chapter is devoted to a description of the post-reform inflation, and the measures of monetary restriction undertaken by the Central Bank.

The second chapter considers the period between January 1949 and June 1951. A description and evaluation of the relaxation of monetary restriction by the Central Bank draws attention to the relative economic stagnation which prevailed during the first fifteen months of this period.

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Mention is also made of the currency devaluation of September 1949, and of the liberalization of O.E.E.C. imports, both of which intensified the balance of payments difficulties. It is noted that, throughout this period, the Bank continued to give precedence to the maintenance of currency stability and balance of payments equilibrium over the achievement of full employment. The second half of the chapter describes the inflationary pressures and economic boom which were brought about by the outbreak of the Korean War in mid-1950. A detailed examination is made of the West German entry into the E.P.U., and the serious balance of payments deficits which prompted the monetary authorities to carry out a series of anti-inflationary measures. The remainder of the chapter deals with the return, between January and June 1951, to relative economic stability, and evaluates the measures taken to achieve this.

The third chapter describes and analyzes the monetary events occurring between July 1951 and December 1954. This period was characterized by general internal stability, continued economic growth, and a beginning of balance of payments surpluses with the E.P.U., which increased commercial bank liquidity substantially. Fortunately, as is indicated, inflationary pressures were held in check and, to a large extent, neutralized by both the increased propensity to save and the large persistent public budget surpluses. Of parti-

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cular significance is the fact that during this period the monetary policy of the Central Bank remained largely neutral, while it permitted internal financial stability to be maintained by existing forces. Attention is drawn to two important monetary occurrences. Particularly notable was the establishment of rediscount ceilings which were intended to control more effectively commercial bank recourse to the Central Bank. It is also noteworthy that, commencing in September 1952, gradual progress was made toward the reconcentration of the commercial banking system.

The final chapter deals with the period between January 1955 and December 1958. This chapter presents a year-by-year account of the economic events which occurred, and evaluates the monetary measures which they prompted. Attention is directed to the means used by the monetary authorities to restrain inflation, while at the same time maintaining continued economic growth, in spite of a worldwide recession which began in 1957. Several monetary achievements of this period are emphasized. First, an explanation is provided of how open-market operations succeeded, for the first time, in becoming an effective weapon of monetary control. Secondly, the events surrounding the final reconcentration of the majority of the large commercial banks are described. Thirdly, a detailed description is provided of the events leading up to the establishment of the new Central

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Bank, the Deutsche Bundesbank, along with an evaluation of the significance of this achievement.

A brief summary and conclusion outlining the objectives of monetary policy throughout this period completes the thesis.

CHAPTER I

THE GERMAN MONETARY SITUATION: 1945-1948

The period between May 1945 and December 1948 was a crucial one in the recovery of the war-devastated German nation. The break-down of the monetary system following defeat, and its eventual reorganization in 1948, provided a significant example of the importance of money to the well-being of the economy. It is the purpose of this chapter to survey and evaluate the conditions prevailing at the end of the war, the various Allied Occupation attempts to reorganize the monetary system, and the actual measures undertaken. A study will be made of the new banking organization, and of the immensely important currency reform, along with their repercussions on the economy.

I. THE PRE-CURRENCY REFORM PERIOD

1. The Period of Economic Chaos

The end of World War Two found Germany in a state of general destruction and economic disorder. The chaotic situation on the monetary plane was a serious obstacle to any important revival of German industry. The Third Reich had financed the war preparations and the war itself by means of constantly increasing inflation. The early post-war interna

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monetary situation in Germany was, thus, characterized by an abnormal over-supply of money in relation to goods. The volume of currency and bank deposits was many times that of the pre-war level, at substantially unchanged official prices. The situation was one of excessive money circulation, exhausted stocks, and an enormous decrease in production. Due to the extension of war-time controls official prices and wages rose only moderately. However, the Reichsmark, for the most part, finally ceased to serve as a standard of value and medium of exchange. Owners and producers of goods and services increasingly exchanged them only for other goods rather than for money. The system of control and distribution gradually collapsed, and the whole national economy reverted by degrees to primitive methods of trade.

2. Black Markets and Bilateral Trade

Black market operations were relatively insignificant during the first year of the occupation. They were held in check by the extraordinarily rigid pattern of prices and wages that had existed previously. During the latter part of 1946, the black markets gradually increased in importance because firms found that if they sold all their output through legal channels they could not replace their stocks of raw materials nor hold their labor. Virtually all firms, at one time or another, entered into black market dealings, but the majority

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of firms and households refrained from intensive use of such dealings for they considered them immoral and distasteful.¹ Nevertheless, the small sector of the community which did actively participate in such activities made a substantial impact on the economy.

One interesting aspect of the black market trade was that even one small transaction of this type had the effect of absorbing a large amount of purchasing power due to the excessive level of black market prices, which in some instances were one hundred times as high as the legal price. In this manner the black market absorbed a significant portion of the excess money supply.² Thus, the artificially inflated prices of very scarce goods served to control, to an extent, the inflationary consequences of the oversupply of money. Inflation was also counteracted by the decline in the velocity of circulation compared with pre-war, which resulted from the decrease in financial transactions and the official sterilization policies.

By the end of the first year of occupation the public had generally lost faith in the Reichsmark. This repudiation

¹ F.H. Klopstock, "Monetary Reform in Western Germany", Journal of Political Economy, Vol. 57, (August, 1949), p.280.

² H. Mendershausen, "Prices, Money, and the Distribution of Goods in Post-War Germany", American Economic Review, Vol. 39, (June, 1949), p. 654.

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of the currency was brought about by, among other factors, public knowledge that the occupation authorities were considering various methods to reduce the money supply.³ This expectation was reflected in the substantial change in the pattern of consumer and business transactions.⁴ In legal transactions money became of secondary importance compared to the ration coupons that went with it. "To most people, money did not lose value by way of depreciation but it lost significance through an increasing limitation of its usefulness."⁵ In black market dealings, where fears of currency reform and of tax collection made large money hoards unwanted, barter became the prime form of operation. The general objective of business was to buy as much and sell as little as possible in order to build up physical assets, and insure against loss by not selling against paper money.

The black market was, in many respects, an unsatisfactory and unreliable source of supply. For this reason, a great portion of trade became centered around bilateral exchange, "compensation trade", distributions to workers, and direct barter. These transactions were illegal, but were so

³ "Monetary Reform in Germany", Monthly Review of the Federal Reserve Bank of New York, (September, 1948), p. 94.

⁴ Klopstock, op. cit., p. 278.

⁵ Mendershausen, op. cit., p. 655.

widespread as to make their eradication by the authorities impossible.⁶ It was estimated that by early 1947, about one-half of the value of all commercial trade was transacted on a barter or "compensation" basis.⁷ The widespread acceptance of bilateral trade had at its origin two basic factors. First, the occupation authorities themselves had originated the procedure by engaging in direct barter. Second, the people considered bilateral trade much less immoral than black marketing.⁸

Probably the most important form of bilateral trade was the widespread growth of so-called "compensation trading". This was the practice, engaged in by industrial firms, of exchanging their products with other firms for raw materials or other supplies, or for consumers' goods which were distributed to the labor force. A substantial part of the output of certain types of products was disposed of in this manner. It resulted from the unwillingness of firms to hold money, and the increasing inability to purchase needed supplies with money.⁹ A side effect of this was the tendency towards hoarding of stocks.

⁶ Mendershausen, loc. cit., p. 655.

⁷ M. Stamp, "Germany Without Incentives", Lloyds Bank Review, (July, 1947), p. 23.

⁸ Mendershausen, op. cit., pp. 655-56.

⁹ F.A. Lutz, "The German Currency Reform and the Revival of the German Economy", Economica, Vol. 16, (May, 1949), p. 122.

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The role played by cigarettes as money in the precurrency reform period is a factor worthy of note. Not until August 1946, when the Allies opened up barter stores which quoted prices in barter units, did cigarettes play a significant role as money. These barter stores caused cigarettes to be regarded, to a certain extent, as a standard of value and medium of exchange, but they were insufficient to make their use general. Only in September 1946, when the Anglo-American authorities made illegal the conversion of Reichsmarks into dollars or pounds in an attempt to curtail black marketing, did the cigarette play any significant role as a monetary unit. Cigarettes from that time onward until the currency reform did, in varying degrees, serve as a means of payment and measure of value. In doing so they rejected the essential characteristic of money that it should be durable. In spite of certain views to the contrary,¹⁰ it should be realized that the cigarette, while useful as a barter commodity for small transactions, never played a really significant role in the German economy. Its use took place primarily between Allied nationals and a relatively small number of Germans. For all practical purposes, it was eliminated by the currency reform of 1948.¹¹

¹⁰ "How the Miracle Came About", Economist, (October 18, 1952), p. 211.

¹¹ P.R. Senn, "Cigarettes as Currency", Journal of Finance, Vol. 6, (September, 1951), pp. 329-32.

While the disadvantages of bilateral and "compensation" trade were numerous, certain advantages were evident. Despite the fact that the system was inefficient and costly, it did help to avoid a complete break-down of industrial activity as a result of scarcity and prohibitions.¹² In the absence of such activities there is no doubt that many firms would have been driven out of business had they relied on the official allocation mechanism. Producers expanded output when they were certain that they would be able to dispose of their products in return for goods which they required. Thus, the barter transactions enabled some production and employment to take place that otherwise would not have.¹³ It should be emphasized, however, that in spite of any benefits which were derived from barter, the waste and misallocation of resources which came about through the break-down of the monetary mechanism served as one of the key factors in retarding the recovery of the economy. The social waste caused by this primitive mechanism made absolutely essential a reform of the monetary system.

3. The Decentralization of the Banking System

The post-war German central banking system owes its character to Allied measures of decentralization which were

¹² Mendershausen, op. cit., p. 655.

¹³ Klopstock, op. cit., p. 279.

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undertaken in accordance with the provisions of the Potsdam Agreement, and is modelled on a federal principle. The Potsdam Agreement intended that the German economy should be decentralized in order to prevent a reoccurrence of the concentration which had aided the Nazi war cause. Under it, all monetary and banking policy was to be carried through equally in all four zones.

It was the aim of the United States Military Government to bring about a decentralization of the German banking system in adherence to the spirit of Potsdam. Their interpretation of the Agreement involved five fundamental objectives.¹⁴

1. The decentralization of the banks in each "Land" or province.
2. The establishment of a Land Central Bank to serve the needs of the decentralized banks.
3. The establishment of joint Allied and Land Central Bank machinery to control and co-ordinate banking and the monetary policies of the Land Central Banks.
4. The dissolution of the old central bank, the Reichsbank, and of the central control of the six largest German banks, the so-called "Grossbanken".

¹⁴ H.A. Adler, "The Post-War Reorganization of the German Banking System", Quarterly Journal of Economics, Vol. 63, (August, 1949), pp. 322-24.

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5. The removal of the excessive power of the German banks over economic activity.

The United States first introduced its plan for monetary decentralization in November 1945. The initial opposition to it came primarily from the British, who felt that decentralization was unnecessary and would make more difficult both the occupation and the recovery of the German economy. At the preliminary discussions both the Soviet and French delegates seemed strongly in favor of decentralization. By late 1946, however, while the British and French agreed, in general, to the U.S. plan on condition that a central bank be established, the Soviets completely rejected the establishment of a central bank with control over all four zones.¹⁵

As negotiations progressed, relations between the Western Allies and the Soviets grew noticeably cooler. The Soviet delegation did everything it could to impede progress by making such impossible demands as the requirement that the printing of bank notes be placed under the control of the separate zone commanders. This was obviously unacceptable for it placed no limitation on the note issue of a particular zone. The Western Allies' trust in the Soviets had been further undermined by their previous printing of Allied Military Marks immediately following the end of the war. In this instance the Soviets had printed billions of these marks with reckless

¹⁵ *Ibid.*, p. 325.

abandon, and had used them to legally remove almost anything saleable in Germany. This action resulted in a loss of much valuable German property without compensation, and cost the Western Allies many millions of dollars when they were redeemed in the Western Zones at par.¹⁶ Numerous attempts were made at securing Soviet co-operation in arriving at a Four Power monetary agreement, but Soviet unwillingness destroyed all hopes of such an achievement. Whatever the Soviet motivation, they were successful in delaying the badly needed monetary reform for many months.

In their zone the U.S. authorities had received no co-operation from the Land governments in accepting the banking reorganization. In fact, the German banks were attempting to regain their former positions of centralized control. Because of this German opposition, in March 1946, banks in the U.S. Zone were ordered to stop accepting instructions from outside the zone. The continuing lack of German co-operation forced the U.S. Military Government to order decentralization of the three largest of the Grossbanken - the Deutsche Bank, Dresdner Bank, and Commerz-Bank.¹⁷

¹⁶ Jack Bennett, "The German Currency Reform", Annals of the American Academy of Political and Social Science, Vol. 267, (January, 1950), pp. 43-44.

¹⁷ "The German Banking Reorganization", Economist, (October 29, 1949), p. 976.

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The decentralization of the banks was opposed by the German authorities on the grounds that it would undermine the confidence of the German people and weaken seriously the structure of the banking system. Later events proved these arguments to be without justification. The German authorities sought to prevent the replacement of the Reichsbank by the central banks in each Land. The German and U.S. positions differed also, in that while the German authorities wanted the banks owned and controlled by the state, the U.S. wanted them owned by the member banks and controlled by representatives of the government. The American viewpoint, however, prevailed.¹⁸

The old powerful central bank, the Reichsbank, had its branches decentralized in each Land of the U.S. Zone. Each of these "Landeszentralbanken" took over the liquid assets of the Reichsbank branches in their individual Land.¹⁹ The ownership of these central banks, while at first in the hands of the Land governments, was to be shifted to private banks operating in the Land within two years. The Landeszentralbanken assumed the main functions of the old Reichsbank. Unlike the older institution, which itself had competed with the commercial banks, the new central banks were restricted basically to the role of being the bank for the commercial

¹⁸ Adler, op. cit., pp. 325-27.

¹⁹ Bennett, op. cit., p. 47.

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banks. Their functions included the keeping of reserve deposits, the engagement in open-market operations, and the granting of short-term credits to public institutions. They were given the right to regulate the money supply but were not allowed to issue currency. Their policies were regulated by an Advisory Council of their own representatives and those of the Land governments, until early 1948.²⁰

The authorities in the French Zone followed a policy almost identical to that of the U.S. Zone. Land Central Banks were established in the French Zone but, unlike the U.S. Zone, had their ownership left at the option of the Land governments. As in the U.S. Zone the Grossbanken were decentralized.²¹

The British had opposed decentralization of the banking system for they felt it unnecessary and a violation of the principle of economic unity spelled out in the Potsdam Agreement. For this reason, centralized control over the banks was carried out by the British Military Government itself. Although the British rejected the principle of decentralization, the actions of the other three zones had the effect of decentralizing the British Zone banking system at a zonal level whether they liked it or not. In late 1947, there was an economic fusion of the U.S. and British Zones.

²⁰ Adler, op. cit., p. 328.

²¹ Adler, loc. cit., p. 328.

Thus, the term "Trizone", which had formerly been applied collectively to the U.S., British, and French Zones, was replaced by the term "Bizone". Due in part to this event, the British agreed to the decentralization of the Reichsbank and Grossbanken, and to the establishment of Land Central Banks on condition that a central bank be established to supervise the activities of the zonal Land Central Banks.²²

The authorities in the Soviet Zone undertook a program of monetary reorganization which was much more severe than that of the other zones. At the end of hostilities the Soviets had closed all banks and permitted depositor withdrawals of only RM. 300 from accounts of less than RM. 3000. Those with larger accounts were prevented from withdrawing anything on the grounds that they were capitalist exploiters. The private banks were replaced by a state owned bank in each of the five provinces. These new state banks received all assets of the commercial banks but gave no consideration to their liabilities. Following the establishment of Land Central Banks in the western zones, the Soviets, in May 1947, established "Emissions-und Girobanken" which were similar in their operations to the western Land Central Banks. They differed from the latter by the fact that their capital was provided by the provincial governments and they were under direct state control, in contrast to the Land Central Banks which were to be

²² Ibid., pp. 329-30.

controlled largely by private interests.²³

4. The Creation of the Bank Deutscher Laender

The new German central banking structure was modelled closely on the Federal Reserve System of the United States. Nevertheless, it retained many characteristics of the old Reichsbank.²⁴ The Bank Deutscher Laender was founded on March 1, 1948, by the military governments of the three Western Zones. It was to perform its functions through the eleven Land Central Banks. The Land Central Banks subscribed the share capital of the Bank Deutscher Laender in proportion to the volume of their deposits. The Bank was to be independent of the Federal Government, and was designed to enjoy considerable influence with both the Government and public. The Board of Directors of the Bank was to be the authority determining the monetary policy. Its membership consisted of the presidents of the eleven Land Central Banks, and the President and Chairman of the Board who were chosen by the eleven. The Bank's powers were initially subject to the veto of the Allied Bank Commission.²⁵

²³ Ibid., pp. 333-35.

²⁴ "Germany's Capital Needs", Banker, (July, 1949), pp. 17-18.

²⁵ Bennett, op. cit., p. 48.

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The basic functions assigned to the Bank Deutscher Laender were as follows.²⁶

1. To be the sole authority with the right of issuing currency.
2. To control the volume of credit and money by means of the discount rate, the fixing of minimum reserve ratios which the commercial banks are required to maintain, undertaking open-market operations, and the establishment of qualitative and quantitative limits on credit extended by the commercial banks.
3. To act as the banker for the Federal Government. The Government was to be permitted to cover temporary budget deficits by borrowing from the Bank.
4. To maintain gold and foreign exchange reserves and be responsible for controls or transactions in foreign exchange. Foreign exchange policy was to be laid down by the Bank as agent of the Federal Government, but the execution of foreign exchange regulations was to be performed mainly by the commercial banks licensed to act as foreign trade banks and responsible to the Land Central Banks.
5. Unlike the old Reichsbank, the Bank Deutscher Laender was forbidden to undertake commercial banking transactions.

The Bank Deutscher Laender was largely the result of

²⁶ Bank for International Settlements, Establishment of Bank Deutscher Laender, Law No. 60, (Basle, March 1, 1948), pp. 1-8.

British insistence that there be a central bank to co-ordinate Bizone monetary policy. It was to deal primarily with the Land Central Banks, foreign central banks, and the Bizonal Economic Administration. It was not to exercise its monetary control by exerting pressure on the reserves of the Land Central Banks. Its control was to be invoked by its ability to regulate the transactions carried out between the Land Central Banks and the regional commercial banks.²⁷ The Land Central Banks were obligated to put into effect the policies and decisions of the Bank.

The creation of the Bank Deutscher Laender meant that there were then three layers of banks in the Bizone. Although the banking system was patterned after the U.S. Federal Reserve System, the addition of the new Bank introduced an institution lacking in the U.S. system. It has been suggested that with the introduction of the Bank Deutscher Laender the Land Central Banks could have been dispensed with, and the commercial banks allowed to deal directly with the one Central Bank. The abolition of the Land Central Banks was opposed, especially by the U.S. Zone authorities, because it would have created a banking system resembling too closely the old monopolistic one that they were seeking to eradicate. The British Zone authorities appear to have been the only members of the Bizone

²⁷ R.E. Emmer, "West German Monetary Policy", Journal of Political Economy, Vol. 63, (February, 1955), p. 53.

to have recognized the greater efficiency and lower cost that one central Bank would have afforded. At the time of the creation of the Bank Deutscher Laender, it was felt by many that the Land Central Banks would eventually disappear.²⁸

II. THE CURRENCY REFORM

1. Introduction

The prevalence in post-war Germany of an over-supply of currency, severe shortages of consumers' goods, and an active black market, caused the price mechanism to lose all significance as a directing force in the economy. As a result, the currency had ceased to be a store of value, and as a standard of exchange it served only for a limited range of rationed commodities. It was obvious that as long as these conditions persisted reconstruction both economically and politically would be impossible. "Remedial measures had to be taken promptly in order to avoid further chaos".²⁹

While the delaying tactics of the Soviets undoubtedly prolonged and intensified the chaos resulting from the monetary disorder, the delay did have the effect of affording the Western Allies an interval in which they could better plan

²⁸ Lutz, op. cit., p. 125.

²⁹ M. Albery, "Post-War Internal Currency Stabilization", Review of Social Economy, Vol. 8, (September, 1950), p. 92.

their action. It was their intention that the currency reform should "re-establish money incentives and the free market mechanism as the decisive determinants of economic life".³⁰ The reform was opposed by many Germans on the grounds that it was lacking in social justice.

The currency reform has often been regarded, and not unjustly, as a turning point in the recovery of the West German economy. Nevertheless, it should be recognized that the first signs of an economic recovery were already perceptible before the reform. In this regard, however, production had increased only gradually and the population had in general derived little benefit from it. The currency reform replaced the old valueless Reichsmark with a new more realistically supported Deutsche Mark. The contraction of the money supply and the introduction of the new currency, through their severity, were highly successful in curbing the evils of inflation, and in restoring confidence and vitality to the economy.³¹

2. The Currency Reform Measures

The currency reform took effect on June 20, 1948. In order to prevent speculators and profiteers from disposing of their old Reichsmarks in a manner contrary to the spirit of

³⁰ Klopstock, *op. cit.*, p. 281.

³¹ G. Soloveytchik, "How Sound is German Recovery?", *Banker*, Vol. 103, (November, 1954), p. 290.

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the reform it was carried out in a series of stages.³² The first, the Currency Law, introduced the new currency, the Deutsche Mark, and provided for the conversion of the old currency at a ratio of ten Reichsmarks to one Deutsche Mark. The second, the Issue Law, named the Bank Deutsche Laender as the exclusive bank of issue, and established commercial bank reserve requirements. The third stage, the Conversion Law, set the conversion rate for bank accounts at RM. 10 : DM. 1.³³ In addition, half of the amount resulting from this conversion was placed in a blocked account. A later currency law on October 31, 1948, cancelled seventy per cent of these blocked accounts, provided that a further ten per cent could only be used for investment in government bonds, and freed twenty per cent.

The most significant features of the reform were the contraction of the money supply and the reorganization of the public and private debt structure. It had been felt that the best way to close the gap between the money supply and quantity of goods was to cut the money supply to fit the volume of goods at existing prices. The alternative method of letting prices rise to fit the money supply, which the British seemed

³² Bennett, op. cit., p. 49.

³³ S. Schattmann, "The German Currency Reform", Banker, (August, 1948), pp. 73-74.

to favor, found few supporters elsewhere.³⁴ The reform was mainly an expression of Allied views but did contain some German contributions.

The contraction of the money supply was the most conspicuous element of the reform. All currency and bank deposits owned by individuals and firms had to be registered. They were converted at the above-mentioned ratio which, in effect, reduced the money supply by approximately ninety-three per cent.³⁵ This severe scaling down applied to savings deposits as well as to demand and time deposits,^{35a} a fact that caused much bitterness and social unrest. To provide people with cash during the conversion period a per capita allowance of DM. 60 was given each individual, of which DM. 40 was made available on the day of the reform, and DM. 20 two months later. The allowance could be obtained against old Reichsmarks at a ratio of 1 : 1, but beyond RM. 60 the DM. allowance was charged at a ratio of 10 : 1. Unknown at the beginning of the reform but made public by the end was the fact that for each RM. 60 that was exchanged for Deutsche Marks by each member of the family, RM. 600 had to be deducted from the family currency and bank deposit held at the beginning of the reform. This meant that the first 540 marks of the old

³⁴ T. Balogh, Germany: An Experiment in 'Planning' by the 'Free' Price Mechanism, (Oxford, 1950), p. 16.

³⁵ Menderhausen, op. cit., p. 658.

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^{35a} Savings deposits are characterized by the issue of a savings book and by the fact that withdrawals without notice are limited to DM. 1,000 per month.

deposits and bank notes in excess of 60 marks belonging to people who had already obtained their initial quota of the new currency was entirely wiped out. Consequently, the actual conversion ratio was 1 : 1 for persons holding less than RM. 60, and between 10 : 1 and 15.3 : 1 for persons holding over RM. 600.³⁶ The result was that only those profited who had no bank account amounting to RM. 600 or more. This provision was instrumental in eradicating most personal savings deposits. From these facts one can conclude that the original listing of the ratio as 10 : 1 was by the end of the reform decidedly incorrect.³⁷

The sharp reduction in liquidity made necessary a debt reorganization. People whose cash holdings had been drastically scaled down could not be expected to meet their short-term obligations at par. All debts were, therefore, devalued in the ratio of 10 : 1.³⁸ Long-term debtors, particularly in the case of mortgages, would have benefited immensely from such a virtual elimination of their debt. To prevent enrichment of this kind the potential profit which would have resulted was absorbed into a fund from which war damage compensation payments were to be made later.

The bank deposits of all German governmental agencies

36 Balogh, op. cit., p. 23.

37 Lutz, op. cit., p. 123.

38 Balogh, op. cit., p. 23.

and of the occupying powers were cancelled. They were, however, partially replaced by cash allotments to permit continuation of their operations.³⁹ In a similar manner the reserves or cash balances of all credit institutions were cancelled. The reform had, at the outset, reduced the deposit liabilities of the commercial banks by ninety per cent. In addition, the most important portion of their assets, their investment in securities of the Nazi Reich, had been wiped out in its entirety.⁴⁰ To restore their solvency the banks were given new government obligations or "Ausgleichsforderungen" in order to bring their assets to the level of their liabilities with an additional small allowance for capital. These "Equalization Claims" or successors to the old Reich debt bore interest at three per cent, which was below any market rate likely to establish itself. This, in effect, made them non-negotiable.⁴¹ These claims could be lodged by any bank as security for overdraft facilities with the Land Central Banks. To restore liquidity the banks were given reserves equal to fifteen per cent of their demand deposits and seven and one-half per cent of their time and savings deposits arising out of the conversion.⁴² The reserves took the form of deposits with the

³⁹ Lutz, op. cit., p. 124.

⁴⁰ Schattmann, op. cit., p. 76.

⁴¹ "Banking in Trizonia", Economist, (April 23, 1949), p. 758.

⁴² Schattmann, op. cit., p. 76.

central banking system and were fifty per cent above the minimum reserve requirements fixed by the system. The resulting excess liquidity was to prove a source of trouble, for the commercial banks were able to acquire substantial excess reserves unencumbered by any indebtedness to the Land Central Banks. These excess reserves contributed to future inflationary pressures.⁴³

The reform was complemented by a series of decontrol measures which went into effect shortly afterwards and resulted in the removal of price, allocation, and rationing regulations. Although not planned as an integral part of the reform, they were probably responsible for a good part of its success. In addition, in order to strengthen production incentives, a tax reform law was introduced at the time of the currency reform which reduced income taxes by one-third. Property taxes were cut by over one-half and corporate taxes were made more favorable.⁴⁴

3. Evaluation of the Reform

No other financial undertaking in German history had such an immediate and significant impact. The reform proved immensely successful in getting the German economy back into

⁴³ Emmer, op. cit., p. 55.

⁴⁴ "Monetary Reform in Germany", Monthly Review of the Federal Reserve Bank of New York, (September, 1948), p. 95.

operation. During the first week, RM. 13.5 millions were paid in, in addition to RM. 109 millions of bank deposits. Not all Reichsmarks were declared because of the fear of many that the unusually large amount would direct attention to their former black market activities.⁴⁵ The volume of Deutsche Marks introduced by the reform is outlined in Table I. The reform transformed the economic scene from one day to the next. Goods which had been hoarded and hidden for months suddenly appeared in the stores.⁴⁶ Money resumed its normal function, black markets reverted to a minor role, and output and labor productivity surged upward. The spirit of the country changed overnight.

The main feature of the reform was its severity. For this reason it has been criticized on the grounds that it was socially unjust. It has been argued, with justification, that those who had substantial bank accounts were heavily discriminated against in contrast to those who held real assets or who possessed little cash. This discrimination had been caused by the previously noted exchange methods.⁴⁷ The treatment of savings deposits as money instead of as debts was harsh as was the 10 : 1 cut in the value of debts. Those who had held

⁴⁵ Lutz, op. cit., p. 124.

⁴⁶ Klopstock, op. cit., pp. 284-85.

⁴⁷ Lutz, op. cit., p. 127.

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Table I
Volume of Deutsche Marks Created
by the Currency Reform

Sector	Millions of DM.
"Kopfgeld" ^a	2,850.
Initial amount received by Laender and municipalities	2,360.
Initial amount received by business, the Railway, and Post Office	810.
Military Governments Allotment	770.
"Free Accounts" ^b including the 20 per cent released in October 1948 from blocked accounts	5,500.
Total	12,290.

F. A. Lutz, "The German Currency Reform and the Revival of the German Economy", Economica, Vol. 16, (May, 1949), p. 124.

a. "Kopfgeld" was the per capita allocation of DM. 40 received immediately and DM. 20 received later.

b. "Free Accounts" were the 50 per cent of the individuals new DM. balance which he could dispose of, the other 50 per cent being blocked.

claims against the Reich which had been invalidated were even more seriously affected. Total deposits were reduced to approximately DM. 12 millions from about RM. 120 millions. This drastic scaling down of notes and deposits caused heavy losses to those who had invested their savings in deposits, insurance, and bonds.⁴⁸ It was felt most painfully by the weaker more unproductive sector of the population. Entrepreneurs, businessmen, and debtors were favored at the expense of fixed income receivers and creditors.⁴⁹ Only the extremely comprehensive social security system kept the reform from being completely unbearable for the weaker groups. Despite the validity of this social injustice argument, it must be conceded that no matter what measures had been taken, social injustice would still have prevailed.

The reform has been criticized on the grounds that the initial Deutsche Mark quotas allowed to individuals, businesses, and public authorities appear, in retrospect when added to the new Deutsche Marks arising from the conversion of the Reichsmark, to have been rather excessive. The continuing increase in the money supply and bank reserves which resulted from the gradual release of blocked balances seemed

⁴⁸ Per Jacobsson, "The Recovery of Western Germany", Skandinaviska Banken Quarterly Review, Vol. 32, (July, 1951) p. 53.

⁴⁹ Balogh, op. cit., pp. 24-26.

to defy central bank control. The Land Central Banks were unable to sell securities and in that way absorb some of the "free accounts" that were being released, because the claims which they held against the Laender and the Bizone were non-negotiable. The unexpectedly rapid expansion of credit was further brought about by the fact that the initial quotas were all in the form of central bank money and they added to the already high liquidity of the banks as soon as they were deposited. These factors created inflationary pressures which had not been anticipated.⁵⁰

In spite of the fact that subsequent events revealed numerous errors in judgment, it must be recognized that many of the technical decisions were difficult, and on the whole the reform achieved its desired objectives. There is little doubt that the missing factor necessary for the achievement of a free economy had been supplied — a medium of exchange acceptable at face value by all for goods, services, and property alike.⁵¹

⁵⁰ Lutz, op. cit., pp. 129-30.

⁵¹ Bennett, op. cit., p. 51.

III. THE POST-REFORM INFLATION

1. The Inflationary Pressures

At the time of the currency reform many economists expected a definite deflationary tendency to arise. Events proved, however, that the six month period following the reform was to be characterized by a distinct boom which possessed serious inflationary tendencies. The creation of money connected with the currency reform led to a significant expansion of consumer demand, to increases in prices and production, and to high profits. For monetary policy, therefore, the period was one of intense struggle against inflation.

The currency reform had provided the public with sufficient cash to bring about a spending spree which lasted until about the end of September. The initial per capita quotas and the later release of blocked balances were supplemented with new money creation by the commercial banks. Consumer purchases were so heavy that withdrawals from savings accounts exceeded deposits.⁵² Both the money supply and velocity of circulation increased significantly. The two basic reasons for the increased velocity of money were, first, the desire among consumers to purchase articles which hitherto had been unavailable, and, secondly, the widespread distrust of the currency which had resulted from previous inflations and

⁵² Klopstock, *op. cit.*, p. 286.

losses. In spite of substantial dishoardings of stocks, consumer purchases were substantially in excess of current production even though production had increased rapidly. The inevitable result of the supply of purchasing power being in excess of the supply of commodities was a substantial rise in prices. Between June and December, the consumers' price index rose in excess of ten per cent, even though production had increased by almost fifty per cent.⁵³ The price increases created a serious situation for they caused added doubts about the soundness of the currency, which increased dissaving and velocity of circulation, and in turn reinforced the upward price tendency.⁵⁴ The situation could have become extremely serious had not the labor unions exercised restraint in pressing for higher wages. This union restraint was due to fear of inflation and the desire to avoid interfering with the recovery. To these factors must be added the impoverishment of the unions as a result of the reform, and the growth of unemployment caused by the refugee influx.⁵⁵

In the last quarter of 1948, the inflation was intensified by a return to hoarding on the part of many producers

53 Lutz, op. cit., pp. 132-34.

54 R. Stucken, "Monetary Policy in Western Germany since the Currency Reform", Proceedings of the First International Credit Conference, Vol. 2, (Rome, 1953), pp. 123-24.

55 Balogh, op. cit., p. 35.

and distributors. This arose from the expectation of still higher future prices, and from the fear that the expected "Lastenausgleich" or equalization of the war burden legislation would result in heavy taxation of profits and turnover. There was, thus, a desire to hoard valuables which could be concealed for tax purposes.⁵⁶ Until the end of September, the monetary authorities had been virtually powerless to influence business and credit conditions. This had been due to the high liquidity of business and of the commercial banks which had not had to borrow from the central banking system. During the fourth quarter of 1948, the possibility of Central Bank control was enhanced by increased borrowing by the commercial banks necessitated by the need to obtain additional notes and coins which the public demanded.⁵⁷ The inflationary pressures had by this time reached the point where they threatened to jeopardize the ultimate success of the currency reform. For this reason the Central Bank undertook positive corrective measures.

2. Measures Taken by the Bank Deutscher Laender

The Central Bank carried out four major measures of credit restriction in November and December 1948.⁵⁸

⁵⁶ Lutz, op. cit., pp. 137-38.

⁵⁷ Stucken, op. cit., pp. 124-25.

⁵⁸ Otto Veit, Changes in Monetary Policy and Their Consequences, (Frankfurt, 1957), pp. 126-27, quoting Annual Report of the Bundesverband des Privaten Bankgewerbes, (1951), p. 36.

There was, in effect, a dual rediscount rate. The rediscount rate proper applied only to commercial bills having a maximum maturity of three months. The so-called "rate on loans against security" applied to transactions having a maturity in excess of three months. On November 3, 1948, the Bank refused to rediscount commercial bills and bank acceptances, the main vehicles for credit, unless they were based on the financing of foreign trade or essential goods ordered by the public authorities. This action was designed to force the commercial banks to maintain their reserves by borrowing against security, a method where the interest rate always exceeded the rediscount rate by one per cent. This measure, however, affected only those small banks which depended on Central Bank borrowing because they had no other commercial paper to offer. Banks with adequate investment portfolios were not unduly inconvenienced.

On November 24, 1948, the commercial banks were requested not to increase their total credit outstanding beyond the level of October 31, except in cases vital to the national well-being. Each exception was to be approved by the local Land Central Bank. This measure was interpreted in a flexible manner for if narrowly adhered to it could have seriously affected the industrial recovery.⁵⁹ It was significant for two reasons. First, despite the fact that the

⁵⁹ Stucken, op. cit., p. 126.

Bank Deutscher Laender had no legal right to impose such a credit ceiling, nevertheless it was accepted, thereby indicating that the traditional authority of the Central Bank was still strong. Secondly, this measure, which was similar to former Reichsbank actions, established a precedent for future unorthodox measures by the Bank Deutscher Laender. The result of the action was that the commercial banks gradually allowed their short-term credits to expire while refusing to grant new credit. The banks did, however, find it impossible to reduce their total credit to the October 31 level because of difficulty in reducing their existing credit outstanding. The actual slowing down of credit expansion which did take place, nevertheless, indicated that the banks were showing restraint in lending.⁶⁰

On December 1, 1948, the Bank Deutscher Laender raised the minimum reserve requirements on demand deposits from ten per cent to fifteen per cent. Of the measures taken, this was the only one which was a general credit control action as contrasted with the others which tended to be selective in nature. This measure did not have much effect for the banks, in general, possessed more than adequate reserves to offset it.

Any effectiveness the minimum reserve ratio might

⁶⁰ Otto Veit, Changes in Monetary Policy and Their Consequences, (Frankfurt) 1957, p. 127.

have had would depend on rigid adherence to it. For this reason, on December 10, 1948, the Bank Deutscher Laender raised the penalty rate of interest for falling below the required reserve from one per cent to three per cent above their rate for advances.

3. Evaluation of the Period

During the last several weeks of 1948, there was a noticeable slackening of the inflationary pressures. The role played by monetary restraint in achieving this was uncertain for there were a number of other contributing factors. There had been a widening gap between prices and consumer purchasing power created by wage stability, the influx of converted balances had ended, and world markets in general had turned downwards. The volume of currency was still increasing but at a slower rate, while the velocity of circulation had declined substantially. Purchases slackened not only because of declining purchasing power but also because of the expectation of lower future prices fostered by statements made by the authorities.⁶¹ These factors coupled with the monetary restrictions curtailed the inflation.

The measures taken by the Bank Deutsche Laender have been criticized on the grounds that they came too late and

⁶¹ "Western Germany and European Integration", Rotterdamsche Bank Quarterly Review, No. 4, (1949), p. 10.

were not stringent enough.⁶² The first criticism is based on the fact that within two months after the reform the consumers' price index had risen by ten points. The second is based on the lack of any attempt by the Bank Deutscher Laender to curtail the excessive commercial bank liquidity either by increasing the rediscount rate or the rate on loans against security. It had also failed to increase the reserve requirements to the legal maximum. The Bank rejected these criticisms by arguing that it did not wish to interfere with the economic reconstruction by raising the cost of Central Bank credit. Despite claims by the Bank that an increase in interest rates would have done little to discourage borrowing because of rising prices, some economists doubted whether the demand for short-term credit was as interest inelastic as the Bank believed. Those who held this view felt that an increase in interest rates would likely have substantially reduced the volume of short-term credit.

To the extent that the decrease in this component of the volume of money reduced aggregate demand and the rate of increase of prices, the real rate of interest would have been further increased, causing a secondary reduction in the volume of short-term credit. This ricochet effect would have been cumulative and, although its strength cannot be assessed a priori, would certainly have offset to some extent the forces shifting the demand curve for short-term credit to the right during this period.⁶³

62 Emmer, op. cit., pp. 56-58.

63 Ibid., p. 57.

It would seem, therefore, that the Bank Deutscher Laender acted more slowly and less strongly in mitigating the inflationary tendencies than the rapidly increasing prices would have justified. For the recovery and further growth of West Germany the six months of the currency reform boom were of extraordinary importance. Many Allied and German financial experts felt, however, that the monetary authorities placed too much emphasis on providing excessive liquidity for the banks and business, and too little emphasis on retarding inflationary pressures.⁶⁴

64 Klopstock, op. cit., p. 290.

CHAPTER II

ECONOMIC STAGNATION AND THE KOREAN WAR BOOM

The currency reform boom which lasted approximately six months was followed by a two and one-half year period characterized by two contrasting situations. The fifteen month period commencing in January 1949 was one of relative stagnation of output, falling prices, and increasing unemployment. The recovery from this situation, which became apparent by April 1950, was transformed into another dynamic boom with the outbreak of the Korean War. This second boom within two years lasted until about the middle of 1951. It is the purpose of this chapter to trace the events which occurred during this period, and to evaluate the policies of the monetary authorities in regard to their effect on the economic recovery.

I. DECLINING RATE OF GROWTH AND RISING UNEMPLOYMENT

1. Economic Conditions

The period between January 1949 and March 1950 may be described as one of relative economic stability with some elements of stagnation present. In the first months of 1949, both free market and black market prices for non-essentials fell sharply. Consumers and businessmen showed greater restraint in their purchasing as commodities which had

formerly been in short supply became available in adequate and in some instances excessive quantities. Productive capacity had expanded considerably and, with only a slight increase in wages, production tended to increase more than effective demand. The result was that prices fell slowly and continuously, but not enough to cause any really serious interruption in output.¹ Nevertheless, the February production peak became virtually a plateau for the next six months. Also, during this period there was no significant rise in exports. In the absence of long-term credit facilities, investment slackened and unemployment became more serious. At the end of June 1949, unemployment had risen to 1.3 millions, or about nine per cent of the labor force, as compared with 760,000 at the end of 1948. The monetary authorities attributed the bulk of this rise to the heavy influx of refugee labor.² In addition, numerous other symptoms of a deflationary nature had appeared. Bankruptcies tripled in the first three months of 1949, and continued at a high rate through August.³ The value of commercial bills protested tripled between January

¹ E. Preiser, and W. Krelle, "Analysis of Economic Developments in Western Germany since the Currency Reform of 1948", in E. Lundberg, ed., The Business Cycle in the Post-War World, (London, 1955), p. 148

² Bank Deutscher Laender, Report for the Years 1948-1949, p. 7.

³ W.W. Heller, "The Role of Fiscal-Monetary Policy in German Economic Recovery", American Economic Review, Vol. 40, (May, 1950), p. 536.

and May, and by summer had stabilized at about twice the January rate.⁴ The events of the first half of 1949 clearly indicated a potentially serious contractive situation.

The extent of Central Bank blame for the recessionary tendencies which had arisen was the subject of much controversy. There is no doubt that the Bank did contribute in some degree to the deflation, but in all fairness to it, it must be recognized that numerous other factors existed. Opponents of the Central Bank action overlooked the fact that after the end of 1948, the creation of money as a result of the currency reform had ceased to have any great significance. In addition, the increase in Marshall Aid deliveries, which expanded greatly raw material stocks formerly in short supply, was responsible, to a large extent, for the drop in commodity prices. With the cessation of the rise in prices, the public began to divert its excess currency holdings into savings rather than into consumption. There is no doubt that this public reaction played a significant role in reducing market demand.⁵ Claims of unduly severe credit restriction must, in large part, be dismissed. Between October 1948 and

⁴ A commercial bill is considered to be protested when on the date of its maturity it is presented for payment and acceptance, such payment and acceptance is refused. In other words, the draft is dishonored.

⁵ R. Stucken, "Monetary Policy in Western Germany since the Currency Reform", Proceedings of the First International Credit Conference, Vol. 2, (Rome, 1953), pp. 127-28.

March 1949, supposedly the period of excessive restriction, commercial bank credit increased by nearly DM. 1,800 millions, while Central Bank credit increased by approximately DM. 839 millions.⁶ This could hardly be considered undue restriction.

The business community, in general, felt that the economic decline had been brought about by what they considered to be a restrictive credit policy on the part of the commercial banks. The banks, however, defended their actions on three grounds.⁷ They argued first, that, by mitigating the inflationary boom and in turn lowering prices, they had relieved business, to some extent, from the pressure of higher wage demands. Secondly, the prevention of over-expansion of the new currency had raised the esteem for it in foreign countries. Thirdly, the banks maintained that their resources would not have allowed them to extend credit any further. They felt that by attempting to direct credit away from producers of non-essentials, in order to satisfy essential investment, they had served better the interests of the economic recovery.

2. Central Bank Measures: March - December 1949

When it became clear that the currency reform boom

⁶ Bank Deutsche Laender, Report for the Years 1948-1949, p. 8.

⁷ "Germany's Capital Needs", Banker, (July, 1949), p. 14.

had spent itself and inflationary dangers had passed, the Bank Deutscher Laender relaxed some of its credit restrictions of late 1948. In March 1949, the commercial banks were released from the requirement that they should keep their credit to the level of October 31, 1948, a restriction which in practice had not been fulfilled. In May 1949, the rediscount rate at which the Land Central Banks accepted bills was lowered from five per cent to four and one-half per cent.⁸ In June 1949, the legal reserve requirements on demand deposits were lowered from fifteen per cent to twelve per cent. Because the lowering of the rediscount rate in May had not been too effective, it was again lowered in July by an additional one-half per cent. Finally, on September 1, 1949, the Bank further lowered the reserve requirements on demand deposits from twelve per cent to ten per cent, and on time and savings deposits from five per cent to four per cent.⁹ In addition, the minimum reserves which the Land Central Banks were required to maintain at the Bank Deutscher Laender were reduced from twenty per cent to twelve per cent. This final action marked the end of changes in the discount rate and

⁸ Although at the time of the currency reform the rediscount rate was fixed at five per cent, the Central Bank was, in fact, empowered to set the rate at any level which it considered justified by economic conditions.

⁹ The legally permissible minimum and maximum reserve requirements were eight to twenty per cent against sight deposits, and four to ten per cent against time and savings deposits.

minimum reserve ratios until mid-1950. The measures undertaken by the Central Bank indicated that it was willing to use the discount rate and minimum reserve ratios to stimulate economic activity, "even though this was not done with any excessive vigour".¹⁰

This credit liberalization was taken full advantage of by the public and the commercial banks. Between March 1949 and June 1950, the volume of short-term bank credit extended by the banks almost doubled. Despite this, the industrial price index fell by eleven points, and the cost-of-living index fell by sixteen points to its level just prior to the currency reform. It was this continued fall of prices that justified the easy-money policy and credit liberalization.¹¹

It was evident that the basic economic problem facing West Germany was the need for sufficient capital to reconstruct its industrial potential. The economic stagnation which occurred in 1949 could, to a large extent, be attributed to inadequate long-term investment. Net investment had fallen almost one-third short of the investment goal of DM. 3,000 millions set for the third quarter of 1949.¹² The

¹⁰ Stucken, op. cit., p. 128.

¹¹ R.E. Emmer, "West German Monetary Policy", Journal of Political Economy, Vol. 63, (February, 1955), pp. 58-59.

¹² Heller, op. cit., p. 538.

commercial banks had sacrificed long-term credit by their emphasis on the promotion of short-term business.¹³ The shortage of long-term credit fell most heavily on new business enterprises, and on the provision of urgently needed new housing. A state sponsored Reconstruction Loan Corporation had been established in late 1948 for the financing of long-term projects as a lender of last resort. This agency remained inactive, however, until April 1949 when it was put on a sounder financial basis.¹⁴ Its contribution to the acceleration of investment was not too great, for it granted loans of only DM. 277 millions by the end of September, out of a possible DM. 445 millions.¹⁵ Many felt it could have been more successful had it been equipped to handle transactions in a more rapid manner. Its effectiveness was further limited by the fact that it provided no funds for housing.

The volume of available savings fell far short of the needs for essential capital investment. This occurred in spite of a significant increase in savings, and largely as a result of the relatively low level of real incomes. In addition, both the general public and business still preferred a high degree of liquidity as a result of their fear of

¹³ K.F. Maier, "Has Western Germany a Liberal Market Economy?", Banca Nazionale del Lavoro Quarterly Review, (Rome, March, 1952), p. 42.

¹⁴ H. Mendershausen, "Prices, Money, and the Distribution of Goods in Post-War Germany", American Economic Review, Vol. 39, (June, 1949), pp. 661-62.

¹⁵ Heller, op. cit., p. 539.

locking up resources for a long period. The volume of savings was further reduced by the fact that a large part of incomes which would have gone into savings was absorbed by heavy taxes and, as public revenue, tended to be held in liquid form by the authorities themselves. The situation was aggravated by the lack of any great success on the part of large public corporations in selling their securities. Even the June 1949 release of blocked funds from the Investment Account, in order to meet such loan requirements, did little to rectify the difficulty. The excessive liquidity preference which hampered investment was slightly counteracted by the easy-money policy of the Bank. The Central Bank further acted by granting special rediscount credit facilities to encourage long-term capital investment. This policy aided the so-called "drive for investment" which was carried out by the public authorities who sought to use a large part of their liquid funds to increase investment substantially from mid-1949 on.¹⁶

The Bank Deutscher Laender did not engage in large open-market operations to offset the shortage of long-term capital. One major reason for this was the fact that there was virtually no open-market for securities. The Bank felt that if it made any large injection of credit it would make the commercial banks almost independent of the central banking

¹⁶ Bank Deutscher Laender, Report for the Years 1948-1949, p. 9.

system once again. The foreign trade and payments position also made it cautious in this direction. Nevertheless, the Bank did act in August 1949 by granting the commercial banks special refinancing facilities to enable them to grant long-term industrial credits in anticipation of future capital accumulation.¹⁷ The Central Bank agreed to purchase Equalization Claims which the commercial banks would repurchase out of their future holdings of funds available for investment. The result was rather disappointing for the banks made only modest use of this provision in financing investment and exports. This reaction may have been due, in part, to the fact that the banks had become so relatively illiquid from mid-1949 onward that they hesitated to exchange the liquid Equalization Claims for more illiquid credits.¹⁸

The events of September 1949 seemed to justify the Central Bank's caution in injecting credit into the economy. On September 19, 1949, the United Kingdom devalued the pound by 30.5 per cent, and its action was followed in the same degree by most other European countries. West Germany had to act similarly in order to avoid an overvaluation of its currency and the detrimental effect on the volume of trade. German devaluation was not as drastic, however, and amounted

¹⁷ Stucken, op. cit., p. 129.

¹⁸ Bank Deutscher Laender, Report for the Years 1948-1949, p. 10.

to only 20.6 per cent.¹⁹ The devaluation had relatively insignificant internal effects due to government subsidies which prevented food prices from rising, and to the fact that the money supply was not unduly inflated as it would have been if Central Bank credit expansion had been excessive. The relatively small German devaluation forced many exporting industries to lower prices substantially in order to be able to compete. Lower prices outside Germany led to a strong demand for imports.²⁰ This occurrence was, in part, responsible for the deficits which developed in the autumn of 1949, and which continued until the first quarter of 1950. These deficits could be tolerated only because of the surpluses which had been accumulated during the first six months of the year.

The situation was further complicated in September 1949, when West Germany took action in liberalizing her imports by withdrawing import restrictions from one-half of her imports from O.E.E.C. countries. This was done in conjunction with the program for the liberalization of intra-European trade.²¹ In fact, West Germany liberalized its import trade more rapidly and to a greater extent than most other European countries. The result was that its imports rose much more

¹⁹ Emmer, op. cit., p. 59.

²⁰ Bank Deutscher Laender, Report for the Years 1948-1949, p. 11.

²¹ A.K. Cairncross, "The Economic Recovery of Western Germany", Lloyds Bank Review, (October, 1951), p. 25.

rapidly than its exports, and serious balance of payments deficits occurred with the O.E.E.C. countries. The export position was also aggravated by the previously noted currency devaluation.²² The foreign trade liberalization had a significant impact on the internal economy. The sharp rise in imports led to a much greater demand for credit by importers during the second half of 1949, which the banks were generally able to satisfy. The result was a substantial increase in the volume of credit, especially in the last quarter of 1949. The banks, which were able to show net credit balances in mid-1949, were, by the end of 1949, showing a considerable net indebtedness to the central banking system. This greatly reduced their willingness and ability to grant further credit. The liberalization of imports and devaluation of the currency also had the effect of causing prices to fall in the autumn of 1949, probably as a result of the need to adjust prices to foreign levels. In addition, the diversion of demand to imports caused production, which had risen significantly between July and November, to fall again at the end of 1949. It also contributed, to some extent, to the rise in unemployment.²³

²² Emmer, op. cit., p. 59.

²³ Bank Deutscher Laender, Report for the Years 1948-1949, pp. 11-12.

3. Economic Transition: January - March 1950

At the beginning of 1950, the Central Bank was faced with the necessity of reconciling two conflicting objectives. It had to do something to alleviate the serious unemployment, while at the same time being careful not to endanger the balance of payments through an overly liberal internal credit policy. Unemployment, which had been about 450,000 in June 1948, had by February 1950 risen to more than two million, or fifteen per cent of the employed wage and salary earners.²⁴ While most of the unemployed were refugees from the Russian Zone, some, nevertheless, were previously employed workers. The industrial production index had not recovered from its seasonal drop in December 1949, and many felt this indicative of the beginning of a serious deflation. The Bank Deutscher Laender would, no doubt, have pursued a much more active policy had it not feared for the balance of payments.²⁵

The serious unemployment prompted the Federal Government to introduce a "Work Creation and Housing Program" in February 1950. The Central Bank announced that it would re-discount credits issued under the program should the banks require such additional liquidity. This offer was made in order to remove commercial bank anxiety about their liquidity,

²⁴ Bank Deutscher Laender, Report for the Year 1950, p. 2.

²⁵ Emmer, op. cit., p. 59.

which would likely have increased their hesitancy to lend. Even though the credits promised by the Central Bank provided adequate financing for the works projects, the program was slow in commencing due to administrative problems, and had a relatively small effect on the economy. Fortunately for the Bank Deutscher Laender, the economic decline was counteracted by a gradual improvement in exports. The slackening of domestic demand was offset by an increase in exports in the first quarter of 1950, which amounted to an annual rate of nearly DM. 4,000 millions. The substantial increase in exports caused the balance of payments deficit of the first quarter of 1950, to be transformed into a surplus of about DM. 11 millions in the second quarter of 1950.²⁶ By the end of March 1950, it was apparent that the economy was once again moving in an upward direction.

4. Evaluation and Conclusions

Throughout this period, the Bank Deutscher Laender had been under pressure from many sides to act more boldly and more quickly. Nevertheless, even when it was easing the credit situation, it did so in an atmosphere of restraint and financial conservatism. The Bank made quite clear its desire to give precedence to the maintenance of currency stability

²⁶ Bank Deutscher Laender, Report for the Year 1950, p. 6.

and balance of payments equilibrium over the achievement of full employment. It considered it, "out of the question to apply internal measures which might endanger the balance of payments".²⁷ There is no doubt that the Bank was relieved of what might have been an extremely difficult situation by the economic upswing in the spring of 1950, and the outbreak of the Korean War three months later. Its basic policy of putting stable money and external balance ahead of employment stimulation appears to have been justified by the strong position ultimately achieved by the German economy. The revival in the spring of 1950 seemed to indicate that the Central Bank was correct in trusting to the natural dynamics of the economy to raise output without greater monetary assistance. It should, however, be realized that had the Korean War not occurred, Central Bank conservatism would likely have appeared to have been excessive. The events following Korea made the previous policies extremely fortunate. With the Korean outbreak, activity in Germany as elsewhere rose sharply, but unlike most other countries, Germany had more adequate capacity which enabled her to avoid a serious domestic price inflation. The growing capacity had, to a large extent, been the result of monetary policies which had sought such an end. This was one more example of the combination of luck and good management which pervaded the German economy in the post-war era.

²⁷ Bank Deutscher Laender, Report for the Years 1948-1949, p. 12.

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II. ECONOMIC REVIVAL AND THE KOREAN WAR BOOM

1. The Economic Upswing: April - May 1950

By April 1950, the first real signs of economic recovery had appeared. Despite this fact, on April 29, 1950, a new tax reform bill came into force which reduced personal income taxes by an average of sixteen per cent, and which was retroactive to January 1, 1950. Subsequent events proved this move to be lacking in wisdom. Higher exports and reduced imports had resulted in a small overall foreign trade surplus. The German liberalization of trade with O.E.E.C. countries was by this time showing improved prospects. The foreign trade deficit in this sector, which in the last quarter of 1949 had been DM. 300 millions, had become a surplus of DM. 49 millions in the second quarter of 1950.²⁸ Employment in the export industries had increased from 425,000 in December 1949, to 600,000 in June 1950. The revival in the export industry was mainly responsible for the overall increase in production and employment. Industrial production had reached a post-war peak by June 1950. Employment also achieved a post-war record of nearly fourteen million, while unemployment had fallen from about two million in February, to 1.5 million in June.²⁹

²⁸ "Lessons of German Monetary Policy", Banker, (September, 1951), p. 173.

²⁹ Preiser and Krelle, op. cit., p. 150.

The substantial increase in industrial production would have been impossible without credit expansion. Bank notes in the hands of the public had been increased from DM. 7,610 millions in January, to DM. 8,160 millions in June. In addition, bank deposits had risen by DM. 5 millions, while short-term credits had increased by about thirty per cent. Much of this credit was used to finance domestic investment since the shortage of savings was still quite acute. The credit expansion had the effect of increasing domestic purchasing power noticeably, and raw material and food imports showed some increase. There is no doubt that the previous expansionary measures of the monetary authorities had contributed to a significant extent in bringing about the domestic boom.³⁰

2. The Korean War Boom

The outbreak of the Korean War in June 1950, found Germany confronted with its second boom in two years. The downward trend in prices was definitively reversed by the substantial increase in demand which resulted from the fear that the conflict would spread to Europe, and bring with it another wave of intense shortage.³¹ The main factor increasing demand was the rush to accumulate inventories. Prospects of rapid rearmament brought about a one-third increase in

³⁰ M.J. Bonn, "The German Payments Crisis", Banker, (February, 1951), p. 94.

³¹ Emmer, op. cit., p. 60.

producers' goods output between June and September 1950. The rapidity of the upswing, and the heavy rise in imports, were largely the result of the sensitiveness of German businessmen to the threat of inflation and shortages. Businessmen rushed into raw material markets to stock up, with the fortunate but unforeseen result that they generally bought earlier and more cheaply than their less nervous foreign competitors. The Central Bank felt that the substantial industrial production increase would have been impossible, due to lack of excess productive capacity, had it promoted too active a "full employment" policy previously. In addition, it maintained that such a policy would have led to much more substantial price rises than had, in fact, occurred.³² This justification would seem to be rather flimsy in light of the great social distress which the unemployment had caused.

Like businessmen, consumers started hoarding commodities in order to offset the shortages and restrictions that seemed imminent. Their action was reflected in a sudden drop in the rate of saving as shown by a slowing down of the growth of savings deposits. German authorities estimated that over DM. 1,600 millions was injected into increased retail consumption through savings withdrawals in the nine months following the Korean outbreak.³³ There is also

³² Bank Deutscher Laender, Report for the Year 1950, p. 9.

³³ "Lessons of German Monetary Policy", Banker, (September, 1951), p. 172.

evidence to indicate that hoards of notes and coin which had been accumulated during the first two years after the currency reform, as a result of tax evasion, were used to finance the consumer buying waves. During this period the turnover of retail trade increased more quickly than before, while the quantity of money increased more slowly. The velocity of circulation increase was supplemented by an injection of previously inactive money estimated at some DM. 750 millions. This utilization of hoarded balances for consumption may be considered as merely a variation of the dissaving caused by withdrawal of deposits.³⁴

The monetary and fiscal measures which had been undertaken prior to the Korean War in order to stimulate employment had the unfortunate tendency to make their effect felt at the time of the Korean boom, when a diametrically opposite policy would have been appropriate. Both the Works Creation Program and the April tax reduction, due to delays in implementation, had no effect until the second half of 1950, when they succeeded in worsening an already highly inflationary situation. The tax reductions, which had been retroactive, caused the Federal and Land governments to suffer a deficit of slightly more than one per cent of the Gross National Product. This deficit occurred because the tax revenue reductions had not been offset by any corresponding decline in

³⁴ Bank Deutscher Laender, Report for the Year 1950,
p. 7.

public expenditure.³⁵ The result was that the tax reductions and returns placed a substantial amount of disposable income in the hands of the people who, in turn, increased their consumption by an amount roughly equal to the amount they received.³⁶ The increased demand, which was not met by a correspondingly large increase in the supply of consumer goods and services, contributed further to the inflationary pressure. The earlier stimulation policies, coupled with consumer dissaving, financed a large part of the consumer buying spree, and in doing so placed the boom largely outside of the control of the Central Bank.

The sharp increase in domestic demand which had been triggered by the Korean outbreak was further reinforced by a substantial increase in credit expansion. In addition to a rapid rise in short-term credit granted to industry, an increase in medium and long-term loans considerably increased the money supply. The commercial banks felt obligated to grant these loans that had been promised in early 1950 on the basis of anticipated additions to savings accounts which had not materialized. The Bank Deutscher Laender estimated that the commercial banks had "created" approximately DM. 3,250 millions of credit during the second half of 1950.³⁷

³⁵ Emmer, op. cit., pp. 60-61.

³⁶ Bank Deutscher Laender, Report for the Year 1950, p. 7.

³⁷ Ibid., p. 8.

Credit demands made by trade and industry had become virtually insatiable. This demand could not be controlled by the Central Bank through a rise in interest rates because of the general expectation that prices would rise further, and shortages of goods would in future become more acute.³⁸

The increased demand for commodities had been accompanied by an increase in production which, to some extent, tended to retard the rise in prices. Nevertheless, as the intensity of the boom increased, many firms were approaching their production optimum, and were finding it increasingly difficult to obtain raw materials and fill orders on time.³⁹ Industry was further hampered by increasing trade union pressure for higher wages, an occurrence which could not be offset significantly by higher productivity. The rising wages, and increasing raw material prices in the world markets succeeded in turning the terms of trade against West Germany.

3. The E.P.U. Payments Crisis

On July 1, 1950, the Federal German Republic, together with all other O.E.E.C. countries, joined the European Payments Union. The E.P.U. was an intra-European monetary clearing union designed to reduce short-term balance of

³⁸ Stucken, op. cit., p. 133.

³⁹ Bank Deutscher Laender, Report for the Year 1950, p. 9.

payments fluctuations. The European countries were now able to ignore their balance of payments with individual nations and concentrate solely on their balance with the group as a whole. Each member was granted a credit quota on which it could draw, and each in turn granted drawing rights on itself. The member nations agreed to trade in the currency of any member of the group. The net balance of each country with the E.P.U. was to be calculated monthly in U.S. dollars. The surplus countries were to receive fifty per cent of their balance in gold or dollars, and were required to extend the remaining fifty per cent to deficit countries. The deficit countries which had not exceeded the credit portion of their quota were obligated to pay one-half of their deficit each month. On the basis of its turnover in trade and services with the other E.P.U. countries in 1949, West Germany received a basic quota of \$320 million.⁴⁰ Deficits in excess of its credit portion of \$192 million were to be met fully in gold or dollars. It soon became obvious that the quota had been too small, for the trade volume with the E.P.U. countries in 1949, on which it had been based, had in the meantime more than doubled.

The outbreak of the Korean War created an unprecedented demand for imports of raw materials and foodstuffs which

⁴⁰ Ludwig Erhard, Germany's Comeback in the World Market, (London, 1953), p. 106.

initially could not be paid for by a corresponding immediate expansion in exports. The main reason for the increase in imports was the immense rise in personal consumption, reinforced by the import liberalization which introduced many new consumers' goods that had been sought after for years. In addition, imports began to increase substantially partly as a result of importers trying to stock up before a possible sterling revaluation, and before commodity prices rose any further.⁴¹ The result was severe balance of payments difficulties which reduced gold reserves to a dangerously low level.

The deterioration in West Germany's balance of payments was concentrated in payments to and from the E.P.U. which accounted for nearly three-quarters of the external trade during the second half of 1950. This fact worsened the situation, for the E.P.U. sector was the only one where the strong import pressure could not be mitigated through the use of quantitative trade and exchange controls due to the former import liberalization arrangements. The net result was that West Germany showed a large deficit with the E.P.U. almost from the beginning.⁴²

⁴¹ "Lessons of German Monetary Policy", Banker, (September, 1951), p. 173.

⁴² Bank Deutscher Laender, Report for the Year 1950, p. 10.

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The deterioration of the German balance of payments is shown in Table II. It should be noted that throughout the crisis exports continued to rise. Unfortunately, foreign exchange receipts from the exports were reduced by two main factors. First, in the preceding months, certain countries had made large advance payments on exports for later delivery. This had been done in order to take advantage of the automatic credit drawing rights which had been set up by Germany for the benefit of the members of the old Intra-European Payments Plan, and which otherwise would have expired unused after June 30, 1950. Secondly, German exporters began holding their earnings abroad, for they felt that sterling might be revalued with the Deutsche Mark remaining⁴³ unchanged.

Within three months after the E.P.U. had come into existence, West Germany had acquired a debt of \$186 millions within her quota, while \$104 millions of dollar payments had become due in order to cover the balance of her deficit. It became clear that her deficit would soon exceed her quota and thus be payable in dollars. Such an eventuality was far beyond the capabilities of the small West German dollar reserves.⁴⁴ As the payments crisis became more critical the Bank Deutscher Laender moved to dampen the demand for imports

⁴³ "Lessons of German Monetary Policy", Banker, (September, 1951), p. 173.

⁴⁴ Bank Deutscher Laender, Report for the Year 1950, p. 11.

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Table II
 Germany's Foreign Trade by Quarters
 (Millions of Deutsche Marks)

Balance with:	1950				1951
	I	II	III	IV	I
Dollar Area	46	60	214	266	187
Sterling Area	-214	-201	-210	-429	-422
Other E.P.U.	-300	49	-172	-300	-60
Other countries	17	104	29	49	65
Total	-451	11	-140	-414	-230
Total Exports	1,507	1,789	2,176	2,891	2,975
Total Imports	1,958	1,778	2,316	3,305	3,205

"Lessons of German Monetary Policy", Banker,
 (September, 1951), p. 173.

by tightening the general supply of credit.

4. Central Bank Anti-Inflationary Measures

At the beginning of September 1950, the deterioration in the balance of payments caused the commercial banks to be driven to the Central Bank in order to raise funds. After almost four months of inaction the Bank Deutscher Laender adopted four major measures to retard the expansion of short-term credit. In September, effective October 1, 1950, the minimum legal reserve ratios of the commercial banks were increased by fifty per cent. On and after October 13, 1950, the Land Central Banks would rediscount bank acceptances only if they came from banks which did not increase the volume of their acceptance credits beyond the total outstanding on October 12, 1950. On October 26, 1950, the discount rate of the Land Central Banks was raised from four to six per cent, and the rate on loans against security from five to seven per cent. Finally, on November 2, 1950, effective January 31, 1951, the Land Central Banks were requested to reduce their rediscounts and advances granted to the commercial banks to no more than ninety per cent of the level of October 31, 1950.⁴⁵

On the initiative of the Bank Deutscher Laender the

⁴⁵ Otto Veit, Changes in Monetary Policy and Their Consequences, (Frankfurt, 1957), pp. 133-34.

Federal Government undertook several steps of import and exchange policy to help counteract the balance of payments difficulties. All import licenses that were not supported by firm import contracts became invalid. This was done to withhold foreign exchange desired by speculators. In addition, in order to discourage further hoarding of licenses, all new applications for a license had to be accompanied by a cash deposit of fifty per cent, to be held by the local Land Central Bank until the goods had arrived. The result of this action was a reduction of over \$500 millions in the block of old licenses which had amounted to \$1,114 millions in October 1950.⁴⁶

Despite the numerous measures undertaken by the monetary authorities, the foreign exchange situation remained serious enough to lead to consideration of suspension of the E.P.U. import liberalization. This was not carried out for, in November 1950, on the advice of Cairncross and Jacobsson, the E.P.U. granted a special credit of \$120 millions on which West Germany could draw to cover up to two-thirds of its deficit after exhausting its quota. The remaining third had to be paid monthly by earned dollars. The loan was repayable between June and November 1951, at a rate of interest of two and three-quarter per cent.⁴⁷ It was granted in conjunction

⁴⁶ Bank Deutscher Laender, Report for the Year 1950, p. 59.

⁴⁷ Bonn, op. cit., p. 97.

with a corrective plan submitted by the German Government to the E.P.U. In addition to the credit, the O.E.E.C. countries were advised to liberalize their import policy as much as they could in favor of German goods.

5. Evaluation of the Restrictive Action

The Bank Deutscher Laender's action, though severe by ordinary standards, was only moderately so under the prevailing conditions. Under normal circumstances the restrictive measures would undoubtedly have contracted commercial lendings sharply. In actual fact, however, bank lendings to business and individuals rose by approximately one-third in the fourth quarter of 1950. Despite the higher discount rates and the acceptance credits restrictions, the commercial banks continued furnishing loans through borrowing from the central banking system. This situation can be traced to two main factors. First, the commercial banks at the time of the credit restriction were generally in possession of enough eligible paper for discount to meet the higher reserve requirements. This was reinforced by the fact that the process of granting credits itself led to the creation of new paper for rediscount. The restrictions on acceptance credits did reduce this type of transaction, but the decrease was offset by an expansion of ordinary discount credits.⁴⁸ Secondly, the effective-

⁴⁸ Bank Deutscher Laender, Report for the Year 1950,

ness of the action was greatly reduced by the fact that the inventory hoarders and speculators were not greatly impressed with the rise in the cost of credit, for they anticipated further price rises. The commercial banks and business felt that the absence of fixed exchange rates, as found under the gold standard, meant that there was no longer any ultimate check on inflation. This was a key factor in causing the Central Bank to lose effective control over the volume of credit. As a result, the inflation and balance of payments deficits continued to worsen.⁴⁹

6. The Movement Back to Stability

By the end of 1950, the German E.P.U. deficit had been somewhat reduced. The situation was, however, worsened by the entry of China into the Korean War. Fear of shortages by the public caused them to dissave to effect purchases. This injection of money enabled business to increase imports without having to depend on commercial bank finance, and caused a corresponding run on import licenses.⁵⁰ Matters were aggravated by a decline in production due largely to a shortage of coal and steel. The ensuing substantial increase in the E.P.U. deficit meant that by February 1951, Germany's

⁴⁹ "Lessons of German Monetary Policy", Banker, (September, 1951), p. 175.

⁵⁰ Per Jacobsson, "The Recovery of Western Germany", Skandinaviska Banken Quarterly Review, Vol. 32, (July, 1951), pp. 55-56.

borrowing rights with the E.P.U. had run out, and the special November credit was virtually exhausted. On February 22, 1951, the liberalization of E.P.U. imports was suspended, and a more rigid system of import licensing was introduced.⁵¹ This action ended the external deficit, but sacrificed the liberal trade principles which had formerly been championed. In the months that followed, commercial imports dropped, while exports increased and closed the gap. By May 1951, West Germany had achieved a surplus with the E.P.U. of \$81 millions, and had paid back in full the special \$120 million credit. It has been pointed out that the change in the German position coincided with the down-turn of the world-wide raw materials boom. Considering the German sensitivity to world price movements, it was felt by some that falling world prices would have acted to discourage imports sufficiently without the need for deliberalization of imports, as a result of importers anticipating still lower prices.⁵² Whether this process in itself would have been sufficient is open to question.

Even though it had become necessary to utilize direct trade controls, in January and February 1951, the Bank Deutscher Laender continued its restrictive monetary policy with a series of new measures. The Central Bank requested the commercial banks to reduce their short-term credits

⁵¹ Bank Deutscher Laender, Report for the Year 1951, p. 3.

⁵² Jacobsson, op. cit., p. 56.

outstanding by May 31, 1951, to a level DM. 1,000 millions less than the amount as of January 31, 1951. Since the increase of the minimum reserve ratios had failed to secure the desired withdrawal of bank liquidity, it was decided to make them more effective by issuing a set of "guiding principles". These were designed to govern commercial bank ratios of total loans to their over-all position, in order to control the absolute volume of credits granted by the banks. According to the "guiding principles", the volume of short and medium-term lending by the commercial banks to business and the public was not to exceed a specified multiple of their net worth. In addition, their total liquid resources were not to fall below a specified percentage of their customers' deposits.⁵³ The intention of the "guiding principles" was to re-establish a firm tradition of banking policy. The Central Bank had no legal power to force these measures on the commercial banks, but it threatened to deny banks that refused to co-operate any recourse to the central banking system. As the commercial banks were heavily indebted to the central banking system, few desired to find themselves in this position of financial ostracism.⁵⁴

⁵³ Stucken, op. cit., pp. 134-35.

⁵⁴ Karl Klasen, "Relations between the German Central Banking System and the Commercial Banks", Lectures Delivered at the Tenth International Banking Summer School, (Frankfurt, 1957), p. 31.

The Bank Deutscher Laender gave two main reasons for its shift in policy. First, it felt that the traditional methods of credit control had failed. Secondly, it felt that administrative controls offered greater scope for selectivity in restricting credit. It is possible, however, that the Bank was too hasty in abandoning the classical reserve requirement control. It failed to raise this to the legal maximum of twenty per cent. Had this been done, there is little doubt that the commercial banks would have had to decrease their loans or increase their recourse to the central banking system which itself was not restricted by any legal maximum in charging for credit.⁵⁵

The Central Bank measures were effective in producing the first small reduction in short-term bank credit since the 1948 currency reform. This reduction occurred in March and April 1951, but in May there was again an increase although at a slower rate.⁵⁶ It was apparent that prices were leveling off, and in June the industrial price index fell for the first time since the outbreak of the Korean War. In addition, the cost-of-living index had stabilized by mid-year.⁵⁷ By June 1951, the economic indicators made it evident that the boom had on the whole run its course.

⁵⁵ Emmer, op. cit., pp. 62-63.

⁵⁶ Bank Deutscher Laender, Report for the Year 1951, p. 8.

⁵⁷ Ibid., pp. 14-15.

7. Conclusions

The positive accomplishments achieved by West Germany during this period were the substantial rise in output, the doubling of exports, and the emergence from the crisis with a relatively small increase in prices and wages.⁵⁸ The basic negative factor was the suspension of import liberalization. This action undid earlier progress which was not fully restored until early 1952. Monetary policy contributed significantly to the economic progress. Nevertheless, although credit restraint was successful in avoiding an extremely serious inflation, it was not as successful in correcting the external deficit as many felt it should have been. In this regard, however, it should be recognized that the Central Bank was probably correct in assuming that an over-tightening of credit could have done considerable damage to production and employment. In addition, the monetary policy of the Bank was undermined by the 1950 tax reduction. The Central Bank in introducing its second series of restrictions in early 1951 showed that it realized the direct import controls required a counteracting force to offset their inflationary potential.

⁵⁸ The cost-of-living index rose from 151 in June 1950, to 167 in June 1951.

CHAPTER III

MONETARY POLICY: JULY 1951 - DECEMBER 1954

The economic events in the Federal German Republic between mid-1951 and the end of 1954 may be divided into two separate periods. The economic boom following the outbreak of the Korean War was, like its predecessor of 1948, followed by a period of relative economic stability. This period of consolidation occurred between approximately July 1951 and June 1952, and was characterized by a decline in the rate of growth of consumption and output. By the middle of 1952, a resumption of the upward trend in activity had become apparent, and it carried through with minor interruptions to the end of 1954. Particularly noticeable during this period was the substantial increase in exports and the strong balance of payments surplus. It is the purpose of this chapter to examine the events which occurred during these periods along with the actions of the monetary authorities and their evident effectiveness.

I. CONSOLIDATION AFTER THE KOREAN WAR BOOM

1. The Economic Indicators

The basic economic indicators substantiated that this was a period of general stability. Prices which had been moving steeply upward, by mid-1951 began to stabilize,

and in some instances fell slightly. Between the second quarter of 1951 and the end of 1951, wholesale prices had risen by only two per cent, and the cost-of-living by only four per cent.¹ From this time on until about mid-1952, the cost-of-living remained virtually unchanged. Wage demands which threatened to upset the price stability were weakened by the summer 1951 decline in excess demand.² Slackening demand and falling retail sales, coupled with falling international raw material prices, created uncertainty about future price trends, and caused retailers to reduce their stocks. The result was that orders to manufacturers fell to a greater extent than the decrease in retail sales, with the effect that consumers' goods production remained at a comparatively low level during most of the one year period.³

In contrast to the decline in consumers' goods production, capital goods production had by the first quarter of 1952 risen by thirteen per cent over one year earlier. Nevertheless, during the summer of 1951, capital goods production had sustained a considerable interruption due mainly to

1 G.B. Grimwood, "Recent Changes in Germany's Foreign Trade Balance", Federal Reserve Bulletin, (March, 1952), p. 242.

2 Bank Deutscher Laender, Report for the Year 1951, pp. 15-16.

3 Bank Deutscher Laender, Report for the Year 1952, p. 10.

shortages of coal and steel.⁴ These serious production bottlenecks required correction, but this was hampered by the inadequate German capital market. A number of proposals and plans for the purpose of directing investment into bottleneck sectors were considered, but none were implemented at this time.⁵ Fortunately, despite the problem of inadequate financing, the bottlenecks eased by the end of 1951, and the capital goods sector remained a key one in sustaining economic activity.

2. Foreign Trade and the Balance of Payments

After June 1951, total exports remained at a level nearly twice as large as the quarterly average for 1950. The rise in total imports from this time onward, while at a level slightly higher than in the winter of 1950-51, was not sufficient to prevent an export surplus.⁶ At this time approximately seventy per cent of West German foreign trade took place with the countries of the E.P.U. bloc. The export surplus achieved with the E.P.U. continued throughout 1951, and was responsible for the overall surplus on current

⁴ B.D.L., 1951, op. cit., p. 17.

⁵ E. Preiser, and W. Krelle, "Analysis of Economic Developments in Western Germany since the Currency Reform of 1948", in E. Lundberg, ed., The Business Cycle in the Post-War World, (London, 1955), p. 153.

⁶ Grimwood, op. cit., p. 241.

account.⁷ The situation was, however, worsened in the autumn of 1951 by the growing deficit with the Dollar Area. This Dollar Area balance of payments deficit within the space of four months had cost the Bank Deutscher Laender approximately one-quarter of the entire dollar reserves which it had held at the end of September 1951.⁸ Despite this and other trade difficulties, by November 1951, the Federal Republic for the first time since the establishment of the E.P.U. had a credit balance in its cumulative account, and it used the dollar repayments to replenish its exchange reserves.⁹ As a result, it was decided to abolish as of January 1, 1952, most of the import quotas imposed on the E.P.U. members in February 1951. In spite of this restoration of the E.P.U. import liberalization, substantial surpluses continued to be obtained, and by mid-1952, West Germany had passed from being the largest debtor to being the largest creditor.¹⁰

3. Monetary Conditions

The period between July 1951 and June 1952 was, as has been seen, in many respects a reaction from the excesses

⁷ B.D.L., 1951, op. cit., p. 4.

⁸ Ibid., p. 18.

⁹ Ludwig Erhard, Germany's Comeback in the World Market, (London, 1953), pp. 113-14.

¹⁰ "The German Economy: Foreign Trade and Balance of Payments", Economist, (October 18, 1952), p. 209.

of the Korean War boom. Nevertheless, from mid-1951 on, the volume of short-term commercial bank lending to trade and industry began once again to expand considerably. This occurred as a result of the gradual expansion of exports, and the continuing relatively high level of capital investment.¹¹ The volume of short-term bank lending to business and the public continued well into 1952 to increase more rapidly than the monetary authorities considered desirable. This took place in spite of the higher interest rates and minimum reserve requirements that had been maintained since the E.P.U. crisis of the winter of 1950-51.¹²

The growth in the volume of money was accentuated by the balance of payments surpluses which had occurred since the suspension of the O.E.E.C. import liberalization. The favorable balance of payments meant that the central banking system and foreign trade banks put larger amounts of Deutsche Marks into the hands of businessmen in payment for foreign exchange bought than the businessmen paid in to purchase foreign exchange. This increase in the money supply may be contrasted with the balance of payments deficits of the Korean boom which had absorbed large amounts of money. Despite an increase in imports during the third quarter of 1951, exports had increased

¹¹ B.D.L., 1951, op. cit., p. 10.

¹² "Economic Developments in Germany", International Monetary Fund Financial News Survey, (April 18, 1952), p. 317, quoting Bank Deutscher Laender, Monthly Report, (Jan.-Feb., 1952).

to such an extent that the amount of money created through purchases of foreign exchange in excess of sales had continued at a high level. In fact, even during the first quarter of 1952, when the balance of payments surpluses were being reduced by dollar deficits, the foreign exchange transactions surplus still created extra money which amounted to DM. 464 millions. These tendencies coupled with the general expansion of credit meant that in the second half of 1951, the total volume of money increased by DM. 4,400 millions.¹³

During this period several factors had the effect of neutralizing the inflationary tendencies of the credit expansion, and in doing so contributed to the maintenance of economic stability. One of the most significant of these factors was the decrease in the propensity to spend. By mid-1951 there had been a noticeable slackening of tension in the international raw material markets which was accompanied by a decline in prices. This was reinforced by the Central Bank actions which had made it more difficult to obtain new credit. The gradual restoration of confidence in the currency led to a less strong desire to spend. Thus, despite the greater volume of money, the velocity of circulation slowed down, and the demand for goods increased only slightly.

¹³ B.D.L., 1951, op. cit., p. 11.

The decline in the propensity to spend was complemented by an increase in savings.¹⁴ During the first quarter of 1951, savings account out-payments had exceeded in-payments. By mid-1951, however, there was again a surplus of in-payments which continued to increase throughout the next twelve months. From June 1951 on, the supply of notes and coins had been increasing considerably more than personal income and retail sales. This was undoubtedly caused by a replenishment of cash hoards of notes and coins. Like the in-payments into savings accounts, it had the effect of sterilizing money through a decline in consumers' purchases, which in turn served to neutralize the increase in the money supply.¹⁵ It is interesting to note that private savings continued to by-pass the securities market because the rate of interest on securities carrying fixed interest rates was artificially kept down, thereby making them unattractive to investors.^{15a} This by-passing of the securities market meant that the greater part of savings which were held in deposits or in the form of notes and coins were readily available for use at short notice. In this way they were potentially able to contribute to cyclical fluctuations in a more effective manner than had they been in a more illiquid form.¹⁶

14 Ibid., p. 28.

15 Ibid., p. 12.

16 Ibid., p. 13.

15a UNIVERSITY OF OTTAWA SCHOOL OF GRADUATE STUDIES During the first five years after the currency reform the Government did not allow interest rates higher than five per cent on mortgage bonds and 6.5 per cent on industrial bonds.

The final factor contributing to the neutralization of the credit expansion was the appearance of public budget surpluses. The Federal Government and Land deficits of the first half of 1951, which had caused monetary expansion through the need for recourse to the banking system, were eradicated by the tax increases of mid-1951. The result was that from late summer 1951 to the second quarter of 1952, the budgets of both the Federal Government and Lands showed substantial cash surpluses. Public borrowings from the banks fell considerably, while cash holdings increased. Thus, the public budgets did not cause any additional flow of money into circulation, but tended to slow down the rate of expansion of the money supply.¹⁷

4. Central Bank Policy

Despite the fact that the former E.P.U. payments difficulties had been overcome, and that many of the economic indicators evidenced a growing internal stability, between mid-1951 and the second quarter of 1952, the Bank Deutscher Laender did not discard its restrictive credit policy, but instead prepared itself for the next inflation by taking precautionary measures. Several factors prompted this policy. It was realized that the balance of payments surpluses achieved in the second quarter of 1951 provided no evidence

¹⁷ I.M.F., (April 18, 1952), op. cit., p. 317.

that basic equilibrium had been re-established between the demand for imports and the demand for exports. These surpluses had, in reality, arisen not as the result of any voluntary lowering of imports, but as a result of the arbitrary import ceilings. In addition, it was apparent by mid-1951 that with the reduction of Marshall Aid the balance of payments with the Dollar Area would suffer, as in fact it did in the autumn.¹⁸ The increased liquidity of the public, which was largely held in check by its lower propensity to consume, made the stability of the price level seem uncertain in the eyes of the Central Bank. The Bank retained its restrictions because it feared that an increase in the domestic price level might prompt an unfavorable turn in the balance of payments.¹⁹

The credit policy pursued by the Central Bank was not overly rigid, and was characterized by a certain degree of administrative flexibility. This flexibility was evidenced especially by the easing of the February credit quotas from June 1951 onwards, which were lifted completely in October 1951. In addition, from about mid-1951 on, the Central Bank made credits available to the Reconstruction Loan Corporation in order to assist the basic materials industry, while at the same time it granted special assistance to facilitate export credits. Both of these actions served to ease, to some

¹⁸ B.D.L., 1951, op. cit., pp. 5-6.

¹⁹ R.E. Emmer, "West German Monetary Policy", Journal of Political Economy, Vol. 63, (February, 1955), p. 65.

extent, the prevailing credit situation. Finally, in September 1951, the fifty per cent deposit requirement for import license applications was removed, mainly because it had caused a distortion of the credit structure through its artificial restriction of liquidity.²⁰ The result of this action was the release of a large quantity of money which increased bank liquidity substantially, but which was only in part drawn off by an attempt to place Treasury Bonds on the market. This October 1951 attempt to curb the increase in liquidity by selling the commercial banks a substantial portion of its short-term Treasury paper was the first attempt by the Central Bank to reduce commercial bank liquidity through the sale of securities. The weakness of the German capital market which had prevented such action prior to this was still strongly evident.²¹ According to the Central Bank, the main reason for taking this action was its desire to rid itself of the various securities which it had acquired through the expansionary operations of 1949-50, and which it considered unsuited to its portfolio. The open-market impact of these operations was apparently regarded as of secondary importance.

During this period the methods of controlling credit in individual cases were modified in order to increase the ability to counter future inflationary tendencies through more

²⁰ B.D.L., 1951, op. cit., pp. 18-19.

²¹ Grimwood, op. cit., p. 242.

selective action.²² The first measure was the introduction of rediscount ceilings or quotas for individual banks. This was designed to enable each Land Central Bank to control more effectively the credit which it made available to specific credit institutions. At the time of implementation the quotas were far above the prevailing rate and as such had little effect on the banks. The second measure was the extension and hardening of the "guiding principles" which had been issued earlier. This was carried out in mid-1951, and later in March 1952, when the allowable maximum ratio of acceptance credits to net worth was reduced. This final action caused the Central Bank to rescind the obligation that the Land Central Banks rediscount acceptances only for banks that had not extended their credit outstanding beyond the level of October 12, 1950.²³ The immediate restrictive effect of these actions was undoubtedly minor for they left most banks with more than adequate scope for manoeuvre. Nevertheless, they seemed to provide a potential means for future credit restriction.

The Central Bank made no attempt to relax the rediscount rate and minimum reserve requirements until April 1952. Two reasons accounted for this. First, the policy change was mainly prompted by the decline of imports at the end of March

²² B.D.L., 1951, op. cit., pp. 19-20.

²³ Emmer, op. cit., p. 66.

which terminated the previous large expansion of short-term lending. Secondly, action was finally taken because by this time it had become apparent that the return to full O.E.E.C. import liberalization had not brought about any significant import pressure. Thus, from May 1, 1952, minimum reserve requirements were lowered with the result that total required reserves dropped by DM. 250 millions, mainly to the benefit of small credit institutions which had been favored by the new graduated method of reserve reduction based on the total amount of deposits possessed. The new schedule gave the smallest banks the largest reserve reductions. In addition, the rediscount rate of the Land Central Banks was reduced from six per cent to five per cent effective May 29, 1952, thereby lowering the rate of the commercial banks. This step was taken to ease the cost of borrowing for businessmen which had been kept high in order to inhibit inflationary pressures.²⁴

5. Evaluation of Monetary Policy

During this period of relative economic stability, some German observers felt that the economy was overly vulnerable to external happenings to which the upward trend was largely due. This group felt that an aggressive expansionary policy, coupled with a lifting of the restrictive monetary measures, was needed to exploit the economic growth possibil-

²⁴ B.D.L., 1951, op. cit., pp. 20-21.

ities and insure against a downswing.²⁵ As has been shown, this view was rejected by the monetary authorities who chose to adopt a cautious policy of conservatism.

The introduction of rediscount quotas, designed to force banks that had overextended their loans from the Central Bank to build up the necessary reserves by borrowing against security, was questioned by some on grounds of its effectiveness. As the rate charged by the Land Central Banks on such loans was only one per cent higher than the rediscount rate, the deterrent effect of such a small differential, it was argued, was open to question. Since the rate of interest charged by the commercial banks was higher than either the rediscount rate or the rate on loans against security, a strong inflationary demand would more than have offset any slight increase in the cost of credit. Despite the belief of the Central Bank that this measure would be a strong anti-inflationary weapon, some economists felt it doubtful that the effects of the rediscount quotas would be much different than that of a one per cent increase in the rediscount rate.²⁶

The conservative policy of the monetary authorities seemed to be justified by subsequent events. In spite of the fact that there had been little substantial monetary stimula-

²⁵ H.C. Wallich, Mainsprings of the German Revival, (New Haven, 1955), p. 97.

²⁶ Emmner, op. cit., p. 65.

tion, the trend of business activity picked up noticeably about the middle of 1952. This upswing had been caused by an increase in consumers' goods production after depletion of stocks, and by the continuing upward rise in exports. Nevertheless, the excess capacity reserve which had been built up meant that some labor and productive capacity remained idle. From this fact it can be concluded that the authorities had overdone, to a slight extent, their policy of retaining monetary stringency.²⁷

II. CONTINUED EXPANSION AND MONETARY NEUTRALITY

1. Economic Conditions

The period between July 1952 and December 1954 was characterized by a continuing upward trend in economic activity which was accompanied by relative internal stability. The real increase in Gross National Product had risen from 6.2 per cent in 1952, to about eight per cent in 1954.²⁸ The continuous rise in employment, which in 1953 represented the greatest increase since the currency reform, was accompanied by a noticeable decline in unemployment.²⁹ The general fall in international raw material prices from mid-1952 on, was

²⁷ Wallich, op. cit., p. 100.

²⁸ Bank Deutscher Laender, Report for the Year 1954, p. 4.

²⁹ Bank Deutscher Laender, Report for the Year 1953, p. 2.

reflected in a downward movement in prices of both consumers' and producers' goods, which continued until mid-1954 when slight increases appeared. This relative price stability occurred despite an upward trend in wages which became most marked in 1954.³⁰

Private consumption, which had fallen off somewhat in 1952, was stimulated in mid-1953 by the tax reductions of the "Minor Tax Reform".³¹ Despite some soft spots in capital investment activity, particularly in the consumers' goods industries during 1952 and 1953, capital investment in both fixed assets and stocks by 1954 was one of the main factors in stimulating economic activity.³² It was encouraged by both the increase in profits and the generally lower interest rates.

The Federal Government and Lands from 1952 on, continued to attain considerable budget surpluses, although because of somewhat higher public expenditures these diminished in 1954. The surpluses had the effect of counteracting inflationary tendencies through their ability to hold demand in check by means "forced saving".³³ Finally, throughout the entire period, the economic situation was dominated by the

30 B.D.L., 1954, op. cit., p. 6.

31 B.D.L., 1953, op. cit., p. 5.

32 B.D.L., 1954, op. cit., pp. 8-9.

33 Ibid., pp. 13-14.

continued rise of exports and the accompanying substantial enlargement of the balance of payments surpluses. This favorable position had been aided by the decline in the value of imports in 1953, which was due to the fact that while raw material imports generally declined in price, finished goods which comprised most of West Germany's exports remained stable in price.³⁴ In 1954, as a result of higher imports the balance of payments surpluses were reduced, but the situation remained, nevertheless, favorable.³⁵

2. The Monetary Situation

Throughout this period the continued economic expansion resulted in a substantial increase in lendings of which commercial bank lendings made up the largest part. Between 1952 and 1954, the annual rise in bank lendings amounted to about DM. 2,500 millions. The substantial growth of medium and long-term bank credit was due to the fact that, despite some improvement, the operations of the German securities market still remained quite narrow in scope.³⁶ This condition persisted because the people continued to mistrust illiquid investment, due to their desire to avoid a reoccurrence of the losses which resulted from the 1948 currency reform.

³⁴ B.D.L., 1953, op. cit., pp. 10-11.

³⁵ B.D.L., 1954, op. cit., pp. 29-30.

³⁶ Ibid., p. 16.

The continuous balance of payments surplus increased commercial bank liquidity through the Central Bank being forced to buy more foreign exchange than it was able to sell. Indeed, the foreign exchange purchases of the Bank amounted to more than one-third of the money created by credit expansion.³⁷

It is true, however, that this source of addition to the money supply was less important in 1954 than in the preceding two years. Due in large part to the balance of payments surplus and its contribution to increasing bank liquidity, the commercial banks were able to expand considerably their short-term credit, while at the same time being able to decrease their need to utilize the rediscounting facilities of the central banking system.³⁸ Between 1952 and 1954, the value of commercial bills held by the central banking system dropped considerably, while there was a considerable rise in commercial bank holdings of rediscountable bills with their expansionary potential.³⁹

Fortunately, the inflationary aspect of the expansion of the money supply was, to some extent, offset by a considerable increase in savings. The recovery in private savings demonstrated the improving public confidence in the currency.

³⁷ B.D.L., 1953, op. cit., pp. 12-13.

³⁸ Ibid., p. 15.

³⁹ Rediscountable bills include Federal Government Treasury Bills, in addition to bills of exchange backed by three parties known to be solvent, and payable within three months from date of purchase.

It should be noted, however, that the rise in savings was mainly due to the increase in incomes, and that it did not occur at the expense of consumption. In fact, private savings was actually exceeded by capital investment and, therefore, was incapable of inhibiting the expansion.⁴⁰ In addition, by 1953, business saving, or retained earnings, was adversely affected by rising wage costs and the levelling off of profits. It was the public sector, through its budget surpluses, that provided the greatest part of the increase in total saving which offset the inflationary pressures created by the balance of payments surplus and rising investment. This is shown by the fact that between 1951 and 1953, private saving rose by only DM. 2,500 millions, whereas public saving through its surpluses rose by over DM. 7,000 millions.⁴¹ There is much truth in the statement that, "internal financial stability in Western Germany was maintained because the effects of two major financial changes - the shifts from deficit to surplus on both foreign and government accounts - served as offsets to each other".⁴²

40 B.D.L., 1954, op. cit., p. 13.

41 H.K. Heuser, "Recent Financial Changes in Western Germany", Federal Reserve Bulletin, (October, 1954), pp. 1047-48.

42 Ibid., p. 1041.

3. A Change in the Banking System

Following World War Two, in order to eliminate excessive concentrations of economic power, the "Big Three Banks" had been decentralized into thirty unit banks confined basically to Land operations. In a reform carried out in September 1952, the thirty units were reduced to nine, each of which could have branches throughout one of the three banking areas in Germany.⁴³ These so-called "successor banks" were established in the hope that they would be able to correct some of the worst deficiencies of the original deconcentration without having to restore the former "Big Three". The new institutions were, however, direct descendants of the old "Big Three", and formed again into three separate banking groups each operating in their respective region with a reappearance of their traditional co-operation. This move towards reconcentration was carried out because the numerous small institutions which had formerly been created were unpopular because of their break with tradition, and were inefficient due to the restricted area of their operations.⁴⁴ This reform emphasized the wisdom of the original British opposition to decentralization on grounds of inefficiency. It proved to be only

⁴³ Bank Deutscher Laender, Report for the Year 1952, p. 56.

⁴⁴ "Full Circle in German Banking?", Economist International Banking Survey, (November 19, 1955), p. 23.

the first step in a move toward complete restoration of the old heavily concentrated system. During 1953 and 1954, the "successor banks" maintained close links with each other and followed uniform policies, even at times financing overseas investment projects as a group. The importance of these nine banks was indicated by the fact that in June 1954 they held thirty-seven per cent of all private bank deposits, and forty-two per cent of all trade bills in the hands of the commercial banks.⁴⁵ By 1954, it was apparent that few barriers existed to the reconstitution of the old "Big Three Banks", and that it would only be a matter of time before this end was accomplished.

4. Central Bank Policy

Throughout this period the monetary policy of the Central Bank remained largely neutral while it permitted internal financial stability to be maintained by existing forces. The Bank felt that there was no need to apply severe restrictions in the light of the price stability, increased savings, and balance of payments surpluses. Nevertheless, it found no reason for adopting an especially liberal credit policy since employment, production, and investment, in addition to bank liquidity, remained at normally high levels.

⁴⁵ U.K. Board of Trade, The Federal Republic of Germany, (London, 1955), p. 52.

Thus, the Central Bank followed a policy of prudence which entailed a gradual relaxation of the previous Korean boom restrictions.⁴⁶

Minimum legal reserve requirements were lowered on three occasions between mid-1952 and February 1953, from ten per cent to 7.3 per cent.⁴⁷ The resulting substantial improvement in commercial bank liquidity was used by the Central Bank to dispose of securities which it had previously acquired. Large open-market operations resulted in the disposal of a substantial part of the money-market securities held by the Bank Deutscher Laender and the Land Central Banks. Central Bank security holdings dropped from DM. 248 millions at the end of 1952, to DM. 116 millions at the end of 1954. The contractive effect of these operations was, however, in large part offset by the large Central Bank purchases of foreign exchange.⁴⁸ Beginning in mid-1952 the Central Bank rediscount rate, which had been six per cent, was lowered on several occasions until in May 1954 it reached the level of three per cent - the lowest rate occurring in Germany since the turn of the century.⁴⁹ These changes were accompanied by a corresponding lowering of other money market rates due to the high

46 B.D.L., 1952, op. cit., pp. 13-14.

47 Ibid., p. 15.

48 B.D.L., 1953, op. cit., p. 17.

49 B.D.L., 1954, op. cit., p. 20.

liquidity of the money market. It is interesting to note that the reduction of the rediscount rate in May 1954 was the only definite measure of credit policy carried out in that year. Thus, the Central Bank made less use of the instruments of credit policy in 1954 than in any other year since the 1948 currency reform. It can be concluded that the Bank Deutscher Laender during this period pursued an internal monetary policy which leaned slightly on the inflationary side in order to promote the continued economic growth of Western Germany.

5. Evaluation of Central Bank Policy

Monetary policy, particularly toward the end of this period when market forces were offsetting each other and creating internal equilibrium and external solvency, appears neither to have strongly enforced nor significantly weakened any specific financial trend. The decline in private consumption relative to disposable income cannot be directly attributed to monetary policy. Nevertheless, the previous intensive use of monetary policy made it clear to the people that this action would again be taken, if necessary, to safeguard the value of the Deutsche Mark. Thus, in this manner, monetary policy did contribute to the climate of financial confidence which proved essential in stimulating the increase in savings activity.⁵⁰

⁵⁰ Heuser, *op. cit.*, pp. 1045-46.

The sales of securities by the Bank Deutscher Laender and the Land Central Banks during 1952 and 1953 were of interest for, while they did reduce commercial bank reserves, they were not open-market operations of the typical type. The Central Bank stated that the reason for these sales was merely to unburden its portfolio of formerly acquired securities. It is likely that the Central Bank undertook these sales only in the belief that its otherwise liberal credit policy was sufficiently capable of offsetting any contractive pressure they may have had. Nevertheless, the reluctance of the Bank to admit that policy considerations led to what is normally considered to be an act of policy, seemed to indicate a failure on its part to use systematically its right to buy and sell securities on the open-market.⁵¹ It is true, however, that open-market operations were made difficult by the narrow scope of the securities market and the scarcity of marketable government debt. The fact that such a large block of securities was capable of being sold did point out the gradual improvement of the open-market as a potential tool of restriction. Notwithstanding this, the rather long sixteen month period required to carry out the operation indicated that an active open-market policy at that time would have been largely impossible.

⁵¹ Emmer, op. cit., p. 67.

Despite the generally favorable economic scene, there was, as in the immediately preceding period, a pressure from some quarters for a more expansionary monetary policy. This pressure, however, diminished as economic activity gained momentum toward the end of 1954. As in the previous period, the monetary authorities rejected most of the expansionary advice, for they remained confident that the economy would continue at high levels without extreme intervention on their part. Events fortunately proved this attitude to again be correct. When toward the latter part of 1954 the expectation of rearmament intensified the boom tendencies, it became apparent that the Central Bank policy of avoiding highly expansionary measures had proven wise.⁵²

⁵² Wallich, op. cit., p. 105.

CHAPTER IV

WEST GERMAN MONETARY POLICY: 1955-1958

The period between 1955 and 1958 was one of the most significant in the post-war development of the West German banking system. It was during this period that the Central Bank reached maturity in its ability to enforce monetary directives on the economic life of the community. The Central Bank throughout the period demonstrated its ability to curtail severe inflation, while at the same time preventing the development of any serious recessionary tendency. It is the purpose of this chapter to trace chronologically the actions of the monetary authorities, and to emphasize the major monetary developments which took place.

I. ECONOMIC EVENTS AND MONETARY POLICY

1. Economic Boom and Credit Restriction During 1955

West German monetary policy during 1955 represented a turning point. In 1955 the Bank Deutscher Laender was compelled to return to a more restrictive policy, and thus to abandon the relatively liberal attitude which it had held since the end of the Korean crisis. During the second half of 1955 especially, there appeared a general state of full employment which in some cases had taken on the character of

over-full employment. In addition, there was a noticeable tendency in some sectors for wage increases to exceed gains in productivity.¹ During 1955, domestic demand became more important than external demand as the main expansionary force. Considerable tension developed on the domestic market, but the country's external position and its currency continued to improve in spite of a sharp rise in imports. The persistent favorable balance of payments position caused Central Bank foreign exchange reserves to continue to rise substantially.² The investment boom, which provided the main stimulus, became one of the principal causes of Central Bank concern. Fixed investment in 1955 rose to DM. 3,800 millions, an increase of twenty-one per cent over 1954.³ As a result of higher employment and wages, private consumption rose considerably, and price rises became more frequent.

During the second half of 1955, there was a considerable increase in the public cash surpluses. This rather considerable withdrawal of money from circulation undoubtedly served as a brake on the expansionary tendencies. As a result, the commercial banks found it increasingly necessary to apply to the Central Bank for credit, and were thus made

¹ Bank Deutscher Laender, Report for the Year 1955, pp. 8-9.

² Ibid., p. 28.

³ Ibid., p. 6.

more sensitive to the restrictive measures of the Bank.⁴ On the other hand, the sterilization of money in public funds increased the need for borrowing from the banks. Taxes which were not put back into circulation in the form of public expenditures were put back in the form of new credits. The Bank was critical of the double effect of fiscal policy which, while it froze large funds in the central banking system, expanded investment activity by favorable depreciation rates, and stimulated exports by promotion measures. The Bank, therefore, could not rely upon the restrictive effect of the Government's surplus alone, but was compelled to take a number of restrictive measures of its own.⁵

The first step the Central Bank undertook was that from May 1955 onwards, it used open-market operations to neutralize the excess liquidity caused by the large balance of payments surpluses. Earlier disposals of securities had not had this aim specifically in mind.⁶ With virtually no holdings of marketable securities the Bank, in order to carry out open-market operations, found it necessary in May 1955 to exchange with the Federal Minister of Finance a part of its Equalization Claims, which represented a claim of

⁴ Ibid., p. 14.

⁵ Otto Veit, Changes in Monetary Policy and their Consequences, (Frankfurt, 1957), p. 144.

⁶ B.D.L., 1955, op. cit., p. 15.

indefinite duration on the Federal Government, for money-market securities in the form of Treasury Bills and Treasury Bonds. By the end of July 1955, nearly DM. 1,500 millions of this so-called "mobilization paper" was circulating. The effect of these open-market operations was soon felt, and despite the fact that the balance of payments surpluses were large, the measures created a counteracting force which tightened liquidity. Money-market rates which had been below the Central Bank rediscount rate rose above it, and the commercial banks for the first time in years were forced to take Central Bank credit.⁷

A second and more pronounced warning was given in August 1955, when the Bank raised its rediscount rate from three per cent to three and one-half per cent, a measure which was accompanied by an increase of one per cent in the minimum reserve requirements. This action was taken in order to indicate that the Central Bank considered the economic trend had become crucial, and intended keeping the expansion within bounds in order to maintain prosperity.⁸ The tendency toward wage increases, the persistent pressure of demand, and indications of a large volume of public expenditures were among the reasons which caused the Bank to raise the rediscount rate.

⁷ Ibid., pp. 16-17.

⁸ Ibid., p. 17.

Up until the end of 1955, the monetary braking effect which the Central Bank had desired occurred rather slowly and, as was subsequently found, only temporarily.⁹ Despite the open-market operations, the banking system was able to maintain a high rate of lending by reselling part of these securities, and by sharply reducing the volume of their new purchases in late 1955. While the total lending of the Bank Deutscher Laender was greater in 1955 than in 1954 by almost twenty per cent, short-term credits, which were more immediately affected by the restrictive measures, increased less than in 1954, especially toward the end of the year.¹⁰ It should be noted that the open-market operations of the Bank were aided by the rediscount quotas which restricted the possibilities of recourse to the Central Bank that normally would have been available without limit.¹¹ Despite the need for some qualification, it can be stated that in general, the commercial banks and the economy began to feel the impact of the restrictive measures toward the latter part of the year, especially since, at the same time, there was a temporary decrease in foreign exchange receipts and a considerable rise in public funds.

The measures of the Central Bank were opposed by

⁹ Veit, op. cit., pp. 144-45.

¹⁰ B.D.L., 1955, op. cit., pp. 22-23.

¹¹ Ibid., pp. 19-20.

both Dr. Erhard, the Minister of Economics, and by Chancellor Adenauer who feared that severe quantitative restriction of credit could have disastrous social and economic consequences without perhaps even achieving its ends. The politicians felt that the capital structure of much of Germany's industry was still at that time fundamentally unsound, and that bank credits had become a vital source of long-term industrial investment. They feared that a severe credit squeeze could seriously endanger the solvency of many small and medium-sized firms, while at the same time having little influence on the main sources of pressure on the capital goods industries - the Government itself, and the larger firms. It was their belief, therefore, that the weakness of the capital structure of German industry made it difficult and unpleasant to use the traditional weapons of monetary policy to maintain stability in times of boom.¹² This difference of opinion between the Central Bank and the Federal Government pointed out the importance of maintaining the monetary authority independent of political pressures which were more concerned with short-run political benefits than with the long-run overall stability of the economy.

¹² C.W. Layton, "The Coming Test of the D-Mark", Banker, (April, 1956), pp. 211-12.

2. 1956 and More Effective Monetary Restriction

During the first half of 1956, the boom tendencies of 1955 continued to prevail. Economic strain continued as a result of wages tending to exceed the rise in productivity. The decline in the propensity to save persisted as a result of the large rise in private consumption. Savings during the first half of 1956 were no larger than one year earlier, despite increased incomes. In addition, consumers' goods prices, which had been relatively stable up to the end of 1955, began to rise so that the overall price level became unstable and reflected the increased monetary tension.¹³ The rising trend in demand caused capital investment activity to continue to rise. By relying on their liquid resources, and in many instances being committed by earlier promises of credit, the banks for a time served as a buffer between the Central Bank's credit restrictions and the economy.¹⁴ During early 1956, commercial bank lendings showed a significant further growth, and it was only their investment in securities which reflected the strong pressure exerted on their liquidity. The increasing strain on bank liquidity was due to the continued large Federal budget surpluses, because as Federal balances were concentrated with the Central Bank, their rise

¹³ Bank Deutscher Laender, Report for the Year 1956, pp. 9-10.

¹⁴ Ibid., p. 6.

tended to reduce deposits outside the central banking system. With every strain on liquidity, demand for money on the open-market expanded since it became increasingly the only place where the banks could finance their needs.¹⁵ Although Central Bank credit often cost considerably less than credit in the open-market, the rediscount quotas made heavy access to the Central Bank impossible. Thus, even though the rediscount rate was not raised further during the winter of 1955-1956, interest rates rose considerably. Since deposit rates were officially laid down and were too low in comparison with rates elsewhere, bank deposits began to suffer, and consequently the Central Bank took action on March 7, 1956, by raising the rediscount rate from three and one-half per cent to four and one-half per cent.¹⁶ In view of the substantial rise in market rates during the winter this action was overdue, but it did indicate that the Central Bank regarded a further credit tightening as necessary. The Bank stated that the action was taken not under market compulsion, but because it seemed correct on grounds of cyclical policy to use a higher rediscount rate to support the banks in their attempts to prevent still further excessive credit demand.¹⁷

With the continuance of the excessive demand tenden-

¹⁵ Veit, op. cit., p. 149.

¹⁶ B.D.L., 1955, op. cit., pp. 22-23.

¹⁷ Veit, op. cit., p. 150.

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cies, the Bank Deutscher Laender reacted by carrying out a further substantial tightening of credit policy. The rediscount rate was raised for the third time, from four and one-half per cent to five and one-half per cent, effective May 19, 1956. Subsidiary rates were also raised by one per cent, making the rate for advances on securities six and one-half per cent. It was expected that this one per cent increase would affect the economy more severely than the two former increases since it was at a level only one-half per cent below the highest previous rate. The second measure taken was that export drafts, which hitherto had been accepted for rediscount outside an individual bank's rediscount quota, were not to be excluded from the quota any longer. It was expected that this step would eventually cut the commercial banks' total rediscount volume by up to DM. 2,000 millions. This ended a previous advantage granted to exporters to prevent them from being at a disadvantage in international competition through the relatively high interest rates prevailing in Germany compared with elsewhere. The large balance of payments surpluses and the economic boom made retention of this provision seem undesirable. The third measure, aimed primarily at the exporter, was that all export drafts made out in other currencies, which formerly had been admitted for rediscount at the rate applying in the purchasing country, would no longer be accepted for rediscount at that rate, but only at the German

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rediscount rate which was usually higher.¹⁸ These Central Bank measures caused considerable public discussion. Many felt that, to restrain the building boom and discourage investment, the Central Bank would have preferred a more stringent government policy, which might have made unnecessary the monetary squeeze.¹⁹

The restrictive monetary policy contributed towards causing demand to slacken in some sectors during the second half of 1956. This slackening was particularly noticeable in capital investment which had been heavily dependent on credit conditions. The relief in the industries dependent on investment activity, and the slackening of the previously forced pace of output were able to prevent a further increase of strain in the labor market which showed some signs of easing.²⁰ Since the economy as a whole gave little evidence of a further increase in market tensions during the second half of 1956, the Bank Deutscher Laender recognized this fact by modifying its restrictive credit policy.

In the months following the restrictions, the contractive effect of Federal Government surpluses was offset by an increase in commercial bank liquidity brought about by Central Bank purchases of foreign exchange which arose out of

18 B.D.L., 1956, op. cit., pp. 11-12.

19 The Financial Times, London, (May 22, 1956), p.18.

20 B.D.L., 1956, op. cit., pp. 16-18.

the record balance of payments surplus in June 1956. The Banks used this increase in liquidity not so much to expand their lendings as to reduce their Central Bank indebtedness, which declined from DM. 4,730 millions on March 23, 1956, to DM. 2,590 millions on August 23, 1956.²¹ During this period it was apparent that both borrowers and the banks were showing much greater restraint on their own initiative than during the previous capital investment boom which had prompted the rediscount rate increases. Despite this fact, the Central Bank sought to reduce the credit supply through open-market sales, which in August 1956 amounted to DM. 260 millions. Nevertheless, in September 1956, the Bank Deutscher Laender allowed for the overall cyclical change by reducing the rediscount rate from five and one-half per cent to five per cent. The Central Bank made it clear that this had not been done to stimulate activity, but had been done on grounds that a higher rediscount rate was considered unnecessary, and that the Bank intended to keep its rediscount policy flexible.²² This action denoted no basic alteration of the Central Bank's restrictive credit policy because it continued to use open-market operations to an increased extent, making sales of DM. 530 millions in October 1956. By the end of 1956, the

²¹ Bank Deutscher Laender, Monthly Report for August 1956, p. 3.

²² B.D.L., 1956, op. cit., p. 19.

Central Bank policy appeared to be achieving success as evidenced by the calmer conditions prevalent during the second half of the year. Some felt this quite remarkable in the light of the fact that the Central Bank had largely to meet the dangers of excessive economic activity alone.²³

3. Instability and Monetary Strain During 1957

The monetary policy of the Central Bank was made easier by the economic relaxation which originated in the second half of 1956, and continued during the early part of 1957. Thus, on January 10, 1957, the rediscount rate was again lowered by one-half per cent, to four and one-half per cent, for the same reasons given for the September 1956 lowering. Up to the spring of 1957, the Bank carried out no strong counteracting measures despite the increasing commercial bank liquidity. Nevertheless, throughout this period, through its open-market operations and the provision of a constant supply of relatively liquid securities, it was able to exert a noticeable influence on the money-market and on bank liquidity.²⁴ The Central Bank realized that the securities which it sold to absorb excess liquidity had only a temporary effect, because the Treasury Bills could immediately be converted into Central Bank money through resales to the

²³ Veit, op. cit., p. 152.

²⁴ B.D.L., 1956, op. cit., pp. 21-22.

Central Bank which did not count against the rediscount quotas, and also because the Treasury Bonds were of only short duration, lasting from six months to two years. By the spring of 1957, it seemed that the economic relaxation of the earlier part of the year was reversing, and that economic boom was again becoming intensified as a result of various government measures such as the house-building tax concessions, the substantial raising of farm subsidies, and the continued export boom. In addition, the period of large Federal cash surpluses and their contractive effect had ended with the possibility of future deficits. In consideration of these circumstances, the Central Bank decided to invoke further measures of credit restriction.²⁵

The measures of credit restriction which the Bank Deutscher Laender carried out in April and May 1957, were designed as a check against the new boom mentality, and as a precaution to reduce commercial bank access to Central Bank credit. The first step raised the minimum reserve ratios by one per cent from May 1, 1957, with some small exceptions. The second step reduced the rediscount quotas, which governed commercial bank credit access to the Land Central Banks, by fifteen per cent also from May 1, 1957. These measures were taken in order to limit the unused rediscount facilities

²⁵ Deutsche Bundesbank, Report for the Year 1957, p. 15.

available for providing credit expansion. The rediscount quotas were lowered because they had lost significance as a result of the large increase in the capital and reserves of most credit institutions. It was expected that the higher minimum reserve ratios would compel the commercial banks to increase, by some DM. 660 millions, their obligatory reserves at the Land Central Banks, which in March 1957 were DM. 4,250 millions.²⁶

By the summer of 1957, it became apparent that the inflationary tendencies had eased considerably and the fresh over-expansion was virtually over. Despite the fact that exports continued for a time to show significant increases, while a considerable amount of speculative money flowed in from abroad, the relationship between supply and demand approached equilibrium more closely.²⁷ The Central Bank in its annual report stated that, "the determining cause of the easing of the economic strain apparent after the spring of 1957 was that the expansion of demand remained within narrower limits than originally expected, and hence fell if anything short of the enlargement of productive capacity".²⁸ The result was that no new boom appeared, and economic activity returned to a more normal pace.

²⁶ B.D.L., 1956, op. cit., p. 23.

²⁷ Bundesbank, 1957, op. cit., p. 16.

²⁸ Ibid., p. 19.

West Germany was one of the main participants in the so-called exchange crisis of the summer of 1957. The great strength of the Deutsche Mark was in strong contrast to the weakness of the Pound Sterling and French Franc. The basic reason for the strength of the Deutsche Mark was the large persistent surplus in the German balance of payments, which had risen during the first eight months of 1957 to an annual rate of DM. 7,800 millions, in comparison with DM. 5,499 millions in 1956.²⁹ Expectation of a revaluation of the Deutsche Mark caused a heavy inflow of gold and dollars into Germany, which for the first nine months of 1957 approached \$1,000 million. The monetary authorities estimated that about two-thirds of the net increase in Central Bank reserve holdings could be attributed to the intensification of speculation.³⁰ The result was an exchange crisis of extreme intensity during July, August and September. The speculation had been prompted by the feeling of many European monetary authorities that the Deutsche Mark should be revalued. This group argued that since the German authorities were opposed to any weakening of the defenses against inflation, an appreciation of the Deutsche Mark would be an alternative to a softening of the

²⁹ "The Exchange Turmoil", Economist International Banking Survey, (November 23, 1957), p. 7.

³⁰ "Survey of Foreign Monetary Policies in 1957", Monthly Review of the Federal Reserve Bank of New York, (January, 1958), pp. 12-13.

German internal situation as a means of dampening down the strong German balance of payments.³¹ The German monetary authorities were, however, adamant in their refusal to even consider an appreciation of the currency. They maintained that the Deutsche Mark was not undervalued in relation to the Dollar in view of the large balance of payments deficit with the Dollar Area. With some justification, the Germans argued that it was up to the other countries of Europe to do their duty by devaluing their currencies. They felt it unfair for Germany to be forced to undertake this action when the need for it had been caused by the inability of the other European countries to resist the wiles of inflation.³² Fortunately, by the end of September 1957, the crisis had been surmounted. The statements made by the West German and U.K. governments at the I.M.F. meeting in September, concerning their determination to adhere to the then prevailing exchange rates, caused the exchange speculation to collapse. Not only did the speculative inflows into Germany cease, but a considerable outflow of foreign money began.³³ In November 1957, the Central Bank's reserves recorded the first net monthly loss since 1951.

³¹ F.A. Southard, "Economic and Financial Developments in Western Europe", American Economic Review, (May, 1958), pp. 459-60.

³² "Europe's Problem Currencies", Banker, (July, 1957), pp. 426-27.

³³ Southard, op. cit., p. 461.

The easing of economic conditions allowed the Central Bank on September 19, 1957, to lower the rediscount rate once again by one-half per cent to four per cent. This was possible without endangering monetary stability because German interest rates were higher than elsewhere, and because the reduction was desirable on domestic and external grounds.³⁴ Despite this lowering of the rediscount rate, deposit interest rates offered by the banks remained relatively high, largely because the savings banks desired to keep rates high in order to avoid withdrawals. Thus, for a while the Central Bank rediscount rate reductions did not create as wide a gap between deposit rates and the yield on securities as would have been desirable in order to ease more rapidly the capital market. Fortunately, as time went on, the pressure of growing inter-bank competition, which had been caused largely as a result of the decline in the demand for short-term credit, caused the banks' interest rates to drop more substantially.³⁵ The Central Bank felt that by reducing the rediscount rate it was assisting both psychologically and materially the lowering of interest rates which was already taking place largely as a result of market pressures.

The Bundesbank Law of August 1, 1957, which established the Deutsche Bundesbank, the new Central Bank, will be

³⁴ Bundesbank, 1957, op. cit., p. 35.

³⁵ Ibid., pp. 37-38.

discussed at greater length further on in this chapter. This Law served to strengthen the restrictive controls available to the monetary authorities. The Bundesbank Law provided the opportunity for raising the maximum limit of the minimum reserve ratios on foreign liabilities of the commercial banks from twenty to thirty per cent for sight liabilities, and from ten to twenty per cent for time liabilities. This made it possible to tie up a greater part of the monies which had accrued to the banks from abroad, since the reserve ratios for foreign liabilities had been raised on May 1, 1957, to the upper legal limits then in force.³⁶ The action was taken to counteract the foreign speculative inflows of money which had assumed immense proportions since the spring. The Bundesbank Law, in addition, afforded the Central Bank a further possibility of absorbing liquidity by obliging the Laender to deposit all their liquid resources at the Bundesbank unless allowed by it to do otherwise. Although it was expected that there would be no immediate large movement of monies from the commercial banks, which had formerly held the Land resources, to the Central Bank, there was, nevertheless, a noticeable increase in the proportion of Land resources deposited at the Bundesbank. The result was that a certain counteracting force to the increasing liquidity had been

³⁶ "Survey of Foreign Monetary Policies in 1957", Monthly Review of the Federal Reserve Bank of New York, (January, 1958), p. 13.

created, although at its present state it remained a modest one.³⁷

The third, and probably the most important measure, was that the Bundesbank Law assisted considerably the highly important weapon of open-market operations by creating more marketable securities. The Bundesbank had made available to it, for conversion into open-market paper, an Equalization Claim of DM. 8,100 millions, as compared to the Bank Deutscher Laender's Equalization Claim of only DM. 5,500 millions.³⁸ This increased scope for open-market operations proved essential in 1957, for if the Bundesbank had not been able to sell several billion Deutsche Marks worth of securities, there would undoubtedly have been a highly inflationary glut of money, or else the Central Bank would have had to raise the minimum reserves to a level which would have seriously affected the commercial banks. The open-market sales enabled the Bundesbank to maintain market stability and protect interest rates from extreme downward pressure.

4. Economic Consolidation in 1958

The year 1958 was one of general economic consolidation for the West German economy. In spite of a slackening of activity in certain sectors, the economic upswing continued, and the economy came closer to optimum employment, price

³⁷ Bundesbank, 1957, op. cit., pp. 39-40.

³⁸ Ibid., p. 41.

stability, and balance of payments equilibrium than in any post-war year, and in doing so proved the recession fears of 1957 to have been largely without foundation. During the spring of 1958, the general price level reached a peak at which it remained throughout the balance of the year, making 1958 the first year since 1954 that economic upswing had occurred with prices stable.³⁹ Despite a slackening in the growth of exports, and a further increase in the volume of imports, the balance of payments surplus continued, although at a smaller level than in 1957. The declining business trends abroad, and their effect upon German exports seemed to justify the policy of the monetary authorities in 1957 of ignoring advice to appreciate the Deutsche Mark, for such a measure would undoubtedly have intensified the export difficulties of 1958.⁴⁰

One of the most significant occurrences during 1958 was the strengthening of the German capital market. The real object of the Central Bank's interest rate policy had been to achieve a better functioning of the capital market in order to lower the rate of interest on capital. Significant success was achieved in this regard for total placings of newly issued securities, which in 1957 had amounted to DM. 5,800 millions,

³⁹ Deutsche Bundesbank, Report for the Year 1958, pp. 1-2.

⁴⁰ Karl Blessing, "Economic Problems in Germany", International Monetary Fund Financial New Survey, (May 23, 1958), pp. 361-62, quoting Deutsche Bundesbank, Auszuege aus Presseartikeln, (May 2, 1958).

rose to DM. 9,300 millions in 1958.⁴¹ Long-term interest rates, which at mid-1957 were eight per cent, had fallen to five per cent by the end of 1958. This fall in interest rates had been contributed to by the substantial increase which had occurred in private savings. As a result of the lower rates, businessmen were relieved, to some extent, from the cost-price squeeze caused by rising wage costs and stable prices, and were thus, able to maintain domestic capital investment at a high level, thereby avoiding any significant growth of recessionary tendencies.

The Bundesbank throughout 1958 continued the relaxation of its credit policy. On January 17, 1958, the rediscount rate of the Bank was reduced from four per cent to three and one-half per cent,⁴² and on June 26, 1958, it was lowered to three per cent, which was the level at which it had stood during 1955 prior to the measures of credit restriction. This fresh reduction was induced mainly by the wave of similar measures in other countries which threatened to cause a further influx of foreign exchange into West Germany.⁴³ Both reductions had been prompted by the desire to gradually bring the level of German interest rates closer

41 Bundesbank, 1958, op. cit., pp. 35-38.

42 Deutsche Bundesbank, Monthly Report for January 1958, pp. 3-4.

43 Deutsche Bundesbank, Monthly Report for June 1958, pp. 3-4.

to that existing in foreign countries in order to counteract the persistent foreign exchange influx. Both the external and internal advantages of lower interest rates were closely linked because without the maintenance of adequate internal expansion it would have become virtually impossible to master the balance of payments problems. Despite its desire to achieve external balance, the Bank was still forced, as it had been in 1957, because of the relatively high level of internal activity, to prevent too extreme a reduction of interest rates by offsetting, to some extent, its repeated interest rate reductions with contractive open-market operations.⁴⁴ The policies of the Central Bank appeared to have been justified by the results. During the first half of 1958, there was a net outflow of capital from Germany of DM. 1,900 millions, which was equivalent to approximately one-half of Germany's surplus on current account during this period. This occurrence gave some hope that the balance of payments surplus problems stood a chance of being resolved.⁴⁵

During especially the second and third quarters of 1958, there was a considerable increase in commercial bank liquidity, which had been relatively stable in the preceding six months, due in large part to the increasing surplus on

⁴⁴ Bundesbank, 1958, op. cit., p. 28.

⁴⁵ R. Lueke, "Lending Germany's Surplus", Banker, (October, 1958), pp. 650-51.

goods and services. In order to contract the resulting market pressure and absorb excess liquidity, the Central Bank carried out open-market sales which by the end of August had amounted to nearly DM. 2,000 millions. This meant that "mobilization paper" sold by the Bank had by the end of 1958 risen to DM. 7,200 millions, compared with DM. 4,200 millions for 1957. These sales caused a considerable slowing down of the lowering of interest rates, thereby preventing them from dropping to a level which would have been harmful in the long-run.⁴⁶

The Deutsche Bundesbank, in its open-market dealings, had sold Treasury Bills with a maturity of from thirty to ninety days, and Treasury Bonds with a maturity of six, twelve, eighteen, or twenty-four months. During the summer of 1958, the Bank stopped selling Treasury Bonds which ran for over six months and which provided an interest rate above that of Treasury Bills.⁴⁷ The reason for this action was that since the beginning of the year the market had taken these Treasury Bonds almost exclusively, in spite of their greater illiquidity, and mainly because of their higher yield. The tendency was strengthened by the anticipation of a further fall in interest rates. This practice meant that the sale of long-term "mobilization paper" became increasingly the

⁴⁶ Bundesbank, 1958, op. cit., p. 30.

⁴⁷ Deutsche Bundesbank, Monthly Report for August 1958, p. 3.

factor determining money-market rates, thereby enabling the the banks to evade the wishes of the Central Bank concerning a lowering of interest rates. The action of the monetary authorities terminated this practice by limiting the market to Treasury Bills, the interest rates on which had been lowered several times. The result was that interest rates in Germany came much closer to those existing in other countries, and by the end of 1958 there was an increasing tendency for money to be employed in foreign money markets. This was considered desirable by the Bundesbank for it promised to contribute further to the diminution of the balance of payments surpluses.⁴⁸

On July 1, 1958, the Bundesbank abolished the foreign exchange restrictions on the import and export of capital. It was realized that this action might increase the foreign exchange influx, which would tend to lower German interest rates, and thereby encourage the desired export of German capital. For all practical purposes, the measure had the effect of making the Deutsche Mark fully convertible. This feature was not officially stated by the Bank for it would have meant the dissolution of the E.P.U., an action which Germany was unwilling to carry out unilaterally.⁴⁹ Only on December 29, 1958, was formal notice made that the Deutsche

⁴⁸ Bundesbank, 1958, op. cit., pp. 33-35.

⁴⁹ Lueke, op. cit., pp. 651-52.

Mark had become freely convertible for non-residents. This announcement was synchronized with similar action taken by a number of other European nations, and caused the E.P.U. to be replaced by the new European Monetary Agreement.⁵⁰ Germany welcomed the new arrangement for it meant that with the removal of exchange restrictions the other European countries would have to adopt greater monetary discipline, which in turn would mitigate the balance of payments surplus problems for the Federal Republic.

II. IMPORTANT MONETARY DEVELOPMENTS

1. The Reconciliation of the Big Three Banks

As noted earlier, the 1952 "Law on the Regional Scope of Credit Institutions" had reduced the thirty commercial banks into nine "successor" institutions which were grouped into the three traditional banking groups: the Deutsche Bank, the Dresdner Bank, and the Commerz-Bank. The successor institutions succeeded in becoming quite efficient, yet it was apparent that closer union was inevitable. The nine successor banks advocated full integration in order to be better able to smooth the flow of funds throughout the country, and carry out more successfully large scale financing.⁵¹

⁵⁰ Deutsche Bundesbank, Monthly Report for December 1958, pp. 3-6.

⁵¹ W. Ringleb, "German Banking Changes Back", Banker, (June, 1957), pp. 389-90.

On December 24, 1956, "The Law for Removing the Limitation on the Regional Scope of Credit Institutions" was passed by the German Parliament. This removed the previous limitations on reconcentration and opened the way for the long-desired reunification of the former "Big Three Banks". The Law gave free choice to the successors of the "Big Three Banks" in choosing the desired form of reconcentration since it abolished the provision which prohibited the exercise of a controlling influence on other credit institutions through capital participation, or through interlocking directorates.⁵²

The result of this legislation was that the reconcentrations took place almost immediately. As of January 1, 1957, the successor banks of the Deutsche Bank Group merged into the new Deutsche Bank, making it the largest bank on the continent. Similar action was taken by the successors of the Dresdner Bank which also entered into a merger. The old Commerz-Bank had lost a sector of its business at the time of the formation of the Soviet Zone. Events which followed made it unwise, from a commercial standpoint, to fuse the three Commerz-Bank successors, and it was decided to retain the regional independence of the three while at the same time acquiring a controlling interest in each.⁵³ The

⁵² "The Law for Removing the Limitation on the Regional Scope of Credit Institutions", Bank Deutscher Laender, Report for the Year 1956, pp. 63-64.

⁵³ Ringleb, op. cit., p. 391.

legislation had the effect of restoring virtually intact the old heavily concentrated German commercial banking system. This occurrence vindicated the view of many economists who at the time of the original deconcentration had prophesied its inevitable reversal in the long-run. It meant that the structure of the German commercial banking system had taken a full 360 degree revolution since the end of World War Two.

2. Establishment of the Deutsche Bundesbank

The banking system created in 1948 provided for a Central Bank and eleven Land Central Banks. This, at first sight, gave the appearance of a two tier central banking system. In actual practice, however, the system functioned almost like a one tier central bank. Only in matters of general policy were regional interests considered and, in fact, monetary measures were carried out as in a one tier system with a uniform rediscount rate and minimum reserve policy in effect. It was generally agreed that on the whole the system had operated quite successfully. Thus, the reason for creating a new Central Bank was not due to the failure of the old one. It was occasioned by the fact that when the constitution of the Federal Republic had been drawn up in 1948, Article 88 of the Constitutional Law had placed upon the Federal Government the duty to establish a Bank of Currency and Issue as a "Bundesbank", or bank of the Federation.⁵⁴

⁵⁴ Bundesbank, 1957, *op. cit.*, p. 1.

Attempts to form the new Bundesbank extended over a period of years. During 1952 a Federal Bank Law had been prepared by the Ministry of Finance which would have established a Federal Government influence over the Central Bank incompatible with its recently acquired independence. A similar competing plan which would have provided for a more centralized system, in many respects similar to the former Reichsbank, was introduced in 1953, but both it and the original plan were shelved. As time went on, the main controversy over the question of decentralization or centralization was replaced by the question of how credit policy was to be formed and to whom it was to be entrusted. The problem of achieving an acceptable piece of legislation was intensified by the fact that the Bank Deutscher Laender, in pursuing its policy of credit restriction during 1956, had entered into open conflict with Chancellor Adenauer who had criticized it and described it as "a law unto itself".⁵⁵ As a result, in October 1956, a new Central Banking bill, in a so-called compromise, sought to extend the Federal Government's influence over appointments in the central banking system, while in addition seeking to limit the instruments of open-market operations. The strong opposition of the Laender caused this bill to be rejected. The debate over the form of

⁵⁵ "Battle of the Bundesbank", Economist International Banking Survey, (November 17, 1956), pp. 18-21.

the new Central Bank, thus, centered essentially on the issue of the degree of independence from the Federal Government. Even those who favored a strongly centralized monetary authority, in order to maintain the independence of the Bank, tended to support the continuance of the federal system, for the political influences in the latter were minimized. Nevertheless, with the reconcentration of the "Big Three Banks" in early 1957, it became increasingly apparent that a highly centralized monetary authority was necessary in order to be able to cope with the new powerful commercial banks.⁵⁶ Further studies resulted in a new compromise bill which overcame most of the previous difficulties and became law on August 1, 1957.

The "Law Concerning the Deutsche Bundesbank" amalgamated the Land Central Banks with the Bank Deutscher Laender which was renamed the "Deutsche Bundesbank". The previous Land Central Banks became the principal offices of the Bundesbank while at the same time retaining their old names. The executive organs of the new Bundesbank were the Board of Directors, the Board of Managers, and the Boards of Managers of the Land Central Banks. Whereas the Board of Managers became responsible for the implementation of the resolutions of the Board of Directors, the currency and credit policy of the Bank was determined as before by the

⁵⁶ Ringleb, *op. cit.*, pp. 391-92.

Board of Directors. The Board of Directors consisted of the President and Vice-President of the Bundesbank, the other members of the Board of Managers, and the Presidents of the Land Central Banks - a total of eighteen members. The President, Vice-President, and Board of Managers were appointed by the President of the Federal Republic, on nomination by the Federal Government, after consultation with the Board of Directors. The Presidents of the Land Central Banks were also appointed by the President of the Federal Republic, but on the nomination of the Land Governments. The independence of the new Bundesbank was further safeguarded by the regulation that required appointment of the leading members for a period of eight years in order to avoid their being influenced by any political party.⁵⁷ These were the basic changes which the new legislation brought about. In general, the tasks and manner of operation of the central banking system remained basically unchanged. Minor changes which were made in this regard were designed to further strengthen the future operations of the Central Bank.

3. Evaluation of the Period

The monetary achievements of West Germany during this four year period were both numerous and significant. The

⁵⁷ "Law Concerning the Deutsche Bundesbank", Deutsche Bundesbank, Report for the Year 1957, pp. 119-28.

measures of the Central Bank received, in general, the widespread approval of the community. Some German critics did, however, maintain that the Central Bank had lowered interest rates in 1958 to too great an extent. This criticism was rejected by the Bank which stated, and perhaps correctly, that had interest rates been kept higher during this period of threatened recession, the world-wide recession would have hit Germany much harder than in fact it did.⁵⁸ The fact remained that the monetary authorities were highly successful in restraining inflation, and in maintaining the continued growth of economic activity. For the first time in the history of the Federal Republic, the capital market had been strengthened sufficiently to enable the Central Bank to use open-market operations as an effective weapon of control. This fact enabled the Bank to permit a safe lowering of interest rates, which had the effect of gradually correcting the large balance of payments surpluses that had created such a problem in Germany's external commercial relations. The reconcentration of the large commercial banks finalized a goal which had seemed inevitable to many even at the time of their deconcentration, and which was dictated primarily on grounds of efficiency. Finally, undoubtedly one of the most significant achievements was the creation, after many years

⁵⁸ Karl Blessing, "Current Monetary Questions", Deutsche Bundesbank, Monthly Report for October 1959, p. 5.

of political controversy, of the new Central Bank, the Deutsche Bundesbank which consolidated and extended the powers acquired by the former Bank Deutscher Laender. All of these events made this period one that will be looked back on for many years as an era of formidable monetary significance.

SUMMARY AND CONCLUSIONS

During the fourteen years of the post-war era, the monetary authorities in Germany have been faced with a difficult period of economic reconstruction and recovery from the war. Since its establishment in 1948, the German Central Bank has pursued a monetary policy well suited to the needs of the West German economy. Monetary policy has from the beginning evidenced a coherent application of three major objectives: price stability, the maintenance and growth of production, and the achievement of a favorable international trade position. The maturity of Central Bank conduct was not surprising, for the German banking system had behind it seventy years of central banking experience.

One of the major objectives of the Central Bank has been the maintenance of price stability. The Bank has proven highly successful in the achievement of this goal, for price indexes have risen by a much smaller degree in Germany than in most other western nations. The currency reform caused a severe reduction in the money supply in order to avoid an explosive inflation. With this historical precedent firmly in mind, the Central Bank at no time lost sight of the dangers of rapid price rises. The Bank throughout the period made quite clear its determination to resist the undesirable pressures on real output and social stability which extreme

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inflation threatened to produce. A particular danger in the years immediately after the currency reform was the possibility that inflation would lead to a repudiation of the new Deutsche Mark before it had a chance to prove itself. There has been little inclination to sacrifice the long-run to the short, or to buy an increase in the production index with a rise in the price index. Putting price stability ahead of full employment has sometimes been regarded as a harsh policy. It was harsh, but then all German policy since the war has been harsh. The monetary authorities have been willing to accept hardships for the sake of long-run progress. Fortunately, the harshness has been mitigated by the broad social security system.

In addition to its objective of maintaining relative price stability, the Bank also held the objective of providing adequate credit to finance steady increases in production. The German Central Bank has clearly recognized the role of central bank policy in the maintenance of a high level of output. While it is true that most other central banks also recognize this responsibility, many are more inclined to consider it in terms of full employment. The German Central Bank was certainly not indifferent to full employment, but it did feel that there were several good reasons for placing the greatest emphasis on production.

In the years immediately following the war, production

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presented more problems than unemployment. During this period the most pressing necessity was the lifting of aggregate output to and above the subsistence level. Due, in some degree, to the monetary policies pursued throughout this period, production, with due allowance for seasonal variation, rose steadily, and employment, despite heavy unemployment during the first several years after the currency reform, moved upward after the middle of 1950, until by 1955 the economy had reached a state of virtual full employment. The unemployment which had persisted during the earlier period had been caused by the heavy influx of refugees from the Soviet Zone. It was thus structural in nature, and, in consequence, production furnished a better guide to monetary policy than did unemployment. The Central Bank felt that unemployment could be used as an indicator of general deflation only when the capital structure of the economy was adequate to employ the whole labor force.

The superior balance of payments position ultimately achieved reflected the basic principle of German monetary policy during the post-war period. This principle was priority of external considerations over domestic, and of balance of payments over income and employment. Overriding the two previously mentioned objectives was concern for West Germany's trade with other nations. In the early years it was imperative to maintain short-run equilibrium in the

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balance of payments. This policy was imposed by the near desperate problem facing a country living on foreign aid, with a greatly increased population, and virtually no exports. For this reason, the rebuilding of foreign trade became, without doubt, number one in the order of priority. Due, in large part, to the monetary policies pursued by the authorities, West Germany was not troubled by balance of payments deficits beyond the second quarter of 1951, as a result of the substantial expansion of exports. From this time onward, the balance of payments surpluses continued to increase along with the level of economic activity. The objective of maintaining a favorable balance of payments position required a continued rise in exports, and this was reflected in monetary policy. Wherever possible, measures of credit restriction had exempted loans for financing the production of export goods. The result was that in some instances the attack on price increases was weakened to promote exports. Even after 1955, the external position continued to improve despite a sharp rise in imports, and in 1956, because of the record balance of payments, some of the previous advantages granted to exporters were terminated. The Central Bank may, to some extent, have overemphasized its policy of giving predominance to the achievement of a favorable balance of payments. This conclusion may be drawn from the fact that, during the last four years of the period under study, the Central Bank sought to lower its

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rediscount rate to reduce domestic interest rates, in order to cause an outflow of funds, and to mitigate the excessive balance of payments surpluses which themselves threatened German external commercial relations.

These were the major objectives of West German monetary policy. They were not always consistent with one another. On those occasions when they conflicted, precedence was given first, to foreign trade considerations; second, to price stability; and, third, to the maintenance and growth of production. The strength of the monetary policy of the German Central Bank rested primarily upon its ability to balance these objectives, the one against the other, in such a manner as to resist inflation and adverse payment positions, and yet at the same time to afford maximum economic recovery.

This description of the basic goals of German monetary policy would seem to suggest a severely restrictive policy. Indeed, this characterization has often been applied both by critics and by the policy makers themselves. The facts bear out this contention only in part. Even during the inflationary periods, monetary restraint was fairly moderate in intention as well as in outcome. In intention, moderation was shown through the flexible handling of credit ceilings and related measures, and through the exemption of various types of credit from the restrictions. In outcome, policy was moderate because, even in those instances where it was

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meant to be severe, its implementation did not reflect severity. Even at times of maximum restraint the expansion of short-term credit was never reversed. The volume of money expanded uninterruptedly through both periods of monetary ease and monetary restraint. During slack periods the monetary authorities were slow to take off restrictions put on during the preceding boom. They were also slow, or refused altogether, to accede to demands for positive expansionary financing. In this sense their policy was restrictive, and it was over this issue that debate was liveliest. The monetary authorities relied on the strength of the production incentives in the German economy, and allowed them to become effective by making credit available with moderation. But the state of the economy at which they aimed was always one of buyers' and not sellers' markets. If the Central Bank had accepted the recommendation of its critics, and had conducted an extremely expansionary policy during periods of economic relaxation, it is possible that Germany would not have gone as far internationally as it did. Whether domestically it would have been any further ahead is open to question.

The period between 1945 and 1958 will undoubtedly be remembered as one of great monetary achievement in the Federal German Republic. During this era of economic reconstruction, the banking system was transformed from a state

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of virtual ruin into one of the world's most competent and efficient monetary organizations. The currency which, in the years immediately following the war, had been practically worthless, gradually became one of the hardest and most desired currencies in existence. The West German monetary authorities proved more successful in curbing inflationary price increases than those of most other nations during the post-war period. The sound monetary policies of the Central Bank have made a significant contribution to the economic recovery of the West German economy. There is every reason to believe that the monetary competence which has been in evidence in the past will continue to enhance the future expansion of the Federal Republic.

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