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THE D-MARK IN THE CONFLICT BETWEEN INTERNAL AND EXTERNAL EQUILIBRIUM, 1948-75

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

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The author, Dr. Otmar Emminger, has been associated since 1950 with the Deutsche Bundesbank, where in 1953 he was appointed a member of the Directorate and in 1970 Deputy Governor. Dr. Emminger has represented his country on the Executive Board of the International Monetary Fund, on the Monetary Committee of the European Economic Community, and on various committees of the Organization for Economic Cooperation and Development. He took part in the negotiations on the European Payments Union (1949-50), the European Monetary Agreement (1955), the General Arrangements to Borrow with the IMF (1961-62), the Special Drawing Rights in the IMF (1966-68), and the various negotiations on the Reform of the Monetary System (1972-76). This essay is an adaptation of Dr. Emminger's contribution to the centenary volume of the Deutsche Bundesbank, WÄHRUNG UND WIRTSCHAFT IN DEUTSCHLAND 1876-1975.

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PETER B. KENEN, *Director*
International Finance Section

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Introduction

Since the mid-1950s, German stabilization policy has repeatedly been undermined by influences originating abroad. In no other major country has imported inflation played such an important role as in the Federal Republic of Germany. The very term "imported inflation" originated in monetary discussions in Germany in about 1954-55 before finding its way into international usage. Similarly, the "external safeguarding" of stabilization policy has developed into a specific element of German monetary policy. It has, in fact, been embodied in Article 4 of the 1967 German Law on the Promotion of Growth and Stability.

The struggle against imported inflation has dominated German monetary policy, and indeed German stabilization policy generally, over much of the last twenty years. Monetary policy was faced with the impossible task of combining balance-of-payments equilibrium–at fixed exchange rates—with internal stability. This dilemma had first been pointed out by Keynes in the 1920s. At that time, the outstanding example was the situation in the United Kingdom, which from 1925 to 1931 had been obliged to pursue a restrictive policy because of its overvalued exchange rate, whereas its domestic economic situation would have called for an expansionary policy. During the post–World War II period, Germany became the prototype of the opposite dilemma: with a fixed D-Mark exchange rate, recurrent balance-of-payments surpluses developed, undermining internal stability. This dilemma forced the central bank—the Bank deutscher Länder until 1957 and the Deutsche Bundesbank from 1958 on—to compromise time and again in its monetary policy between domestic stability and external considerations. Initially, leading representatives of the central bank believed that it would be possible without payments restrictions to pursue simultaneously internal and external stability, that is, stability of purchasing power and stability of the exchange rate. However, events compelled a revision of this view.

When it was later confronted with such a dilemma, the central bank put internal stability first. As early as 1953, the Annual Report of the Bank deutscher Länder emphasized the priority of internal stability in the event of such a conflict. It explained that it had "deliberately permitted and in part even furthered" the expansionary monetary effect of foreign-exchange inflows, thus following "the rules of the classical gold standard."[1] However, it was quick to add that "this attitude could of course be taken only because there was no indication at all that it was endangering internal financial stability." When, after several painful experiences, it became clear that in some situations the only choice was between an inflationary policy dictated by external considerations and a change in the exchange rate, revaluation was the only acceptable alternative. The first such instance was the D-Mark revaluation of 1961, unmistakably signaling the priority of internal monetary stability. It established the principle of revaluing the currency to protect internal stability against external inflationary influences.

The conflict between internal and external equilibrium periodically recurred. Its original causes, the inflation differential between Germany and foreign countries as well as certain structural developments favoring the German balance on current account, were increasingly compounded by other factors. As the Federal Republic of Germany became more closely linked to the international money markets and as the worldwide pool of easily shiftable funds grew to very large dimensions, money flows from one currency to another, either for interest-rate reasons or in the expectation of exchange-rate changes, became major disruptive factors. The D-Mark began to assume the role of a currency of refuge and an opposite pole to an overvalued dollar. As a consequence, German monetary policy was repeatedly thwarted by large money inflows from abroad. After a number of crises, the fixed exchange rate had to be abandoned, since destabilizing international money movements could be fended off only by recourse to the weapon of flexible exchange rates.

The release of the Bundesbank in March 1973 from its obligation to purchase dollars marked a fundamental turning point in German as well as international monetary policy. German monetary policy was largely freed from the persistent open or latent threat from abroad and thus, at least in principle, from the earlier dilemma. The abandonment of the fixed dollar parity of the D-Mark was the starting point for the generalized floating of all other major currencies vis-à-vis the dollar (although some currencies had already been floated individually before). In this way, the D-Mark dilemma—which in its final stages merely reflected the worldwide dollar crisis—contributed significantly to the downfall of the Bretton Woods system of fixed parities. In U.S. economic literature, the abolition of the dollar's convertibility into gold in August 1971 is often assumed to have marked the end of the Bretton Woods system. Although

[1] See *Annual Report of the Bank deutscher Länder* (hereafter referred to as "DL"), 1953, p. 16.

the suspension of convertibility was certainly an important step in this direction, the final demise of the fixed parities system came only in March 1973.

This essay reviews the development of the D-Mark dilemma and the way Germany's domestic and external monetary policy reacted to it. It also deals briefly with the question of whether the floating of the D-Mark since March 1973 has adequately protected domestic stabilization policy from disturbances originating abroad.

The D-Mark Dilemma between 1950 and 1961

1. Survey

Before the first attempt to cut the Gordian knot with the D-Mark revaluation of 1961, German external monetary policy passed through widely differing phases. Following the domestic currency reform in June 1948, Germany entered the international monetary scene as a deficit country. Between 1951 and 1961, however, the balance of trade and on current account was almost continuously in large surplus. The current account recorded a cumulative surplus of DM 43 billion, with over DM 32 billion finding its way into the monetary reserves of the central bank. The current surpluses in those years were frequently greater in relation to gross national product than in the extreme surplus period of 1973-74. Until 1954, however, they did not present any problem; in particular, they did not conflict with internal stabilization policies. It was only in the years 1955-57 that their persistence became a problem, both internationally and domestically. It was then that the first public discussion of the conflict between the requirements of internal and external equilibrium took place: this conflict culminated in the summer of 1957 in a wave of international speculation on a D-Mark revaluation.

In the course of the worldwide cooling off in economic activity between the fall of 1957 and the summer of 1959, these difficulties abated. However, by 1960 it had become abundantly clear that the German payments surpluses indicated a "fundamental" disequilibrium, the only choice being between adjustment through inflation or revaluation.

2. The Switch from Deficit to Surplus

When the German currency was rehabilitated in 1948 from its postwar eclipse, the Allied military authorities fixed its external value at DM 3.33 per dollar; this appeared at the time to correspond to the existing purchasing-power parity. In September 1949, when sterling took the lead in a general wave of devaluations, the pound and most other European currencies were devalued by 30.5 per cent against the dollar. For the D-Mark a devaluation of 20.6 per cent was deemed sufficient, resulting in a new parity of DM 4.20 per dollar. This dollar parity was also used as a basis when, a few years later, the gold parity of the D-Mark was established in the International Monetary Fund. It remained unchanged until 1961. In the summer of 1950, the external effects of a job-creation program, combined with speculative stockpiling of goods induced by the Korean boom, led to a sudden deterioration in the German foreign-exchange position. As a result, immediately after the formation of the European Payments Union (EPU), Germany became its first major deficit case, and in December 1950 Germany was granted a special credit of $120 million over and above its normal EPU debtor quota. For both external and domestic economic reasons, the Bank deutscher Länder introduced a stringent credit squeeze. In October 1950, despite explicit opposition from the Federal Chancellor, Konrad Adenauer, the discount rate was raised from 4 to 6 per cent, an unusually high rate at the time. In February 1951, a direct reduction in the volume of bank credit was imposed. In the same month, as a result of the extreme shortage of foreign exchange, the liberalization of imports from the area of the Organization for European Economic Cooperation (OEEC) had to be temporarily suspended. For some time, the possibility of devaluation was even discussed, with serious talk of the country's balance of payments being in "structural" deficit (DL, 1951, p. 6). The reversal of the balance-of-payments position in 1951, however, quickly put an end to all such discussion.

The Managing Board of the EPU had made the special credit dependent on a stabilization program proposed by the international monetary experts Per Jacobsson and Alec Cairncross, much of which had been prepared in November 1950 by a group of German experts assisted by central bank representatives. (My own participation in the central bank's external monetary policy commenced more than twenty-five years ago when I served as a member of this group of experts on behalf of the central bank.) This program, emphasizing restrictive measures in the fields of monetary, budgetary, and fiscal policy, laid the foundations both for internal stabilization and for the subsequent balance-of-payments surpluses of the Federal Republic. From the second quarter of 1951 onward, the German position in the EPU was reversed, and the special EPU credit was repaid in advance of maturity.

Starting in 1952, the Federal Republic of Germany became an extreme surplus country within the EPU. During the lifetime of the EPU, from the middle of 1950 through the end of 1958, Germany ran up a cumulative surplus position of $4.6 billion in this institution. However, during this same period Germany was still frequently in deficit vis-à-vis the dollar area comprising countries outside the EPU and without bilateral clearing agreements. In fact, not until 1956 did the degree of trade liberalization achieved vis-à-vis the dollar area match that of the EPU area.

The main counterparts to the cumulative German EPU surplus were the very large deficits of France and the United Kingdom. This polarization of positions led to numerous special consultations in the EPU Managing Board and other OEEC bodies. The recommendations addressed to the Federal Republic of Germany under the heading of "good creditor policy" aimed mainly at abolishing special export promotion, liberalizing imports, avoiding capital inflows, encouraging capital exports by lowering German interest rates and prematurely repaying foreign debts, and conducting a generally more expansionary monetary and fiscal policy (sometimes referred to as a "nice little inflation").

In many respects, Germany was actually already pursuing a policy directed at reducing the balance-of-payments surpluses, chiefly by measures which at the same time helped to promote internal equilibrium and curb price rises. Particularly noteworthy were the unilateral tariff reductions of 1955 and 1956, made mainly for balance-of-payments reasons though also designed to counteract internal price rises. In 1956, capital exports were freed from all restrictions, thus anticipating the formal announcement of D-Mark convertibility at the end of 1958.

In its monetary policy, the central bank, too, took account of the extreme surplus position without, however, foregoing its general commitment to domestic stability. During the years 1952 to 1954, no serious conflict arose. The accumulation of monetary reserves was welcomed by the bank, which stated in its Annual Report for 1954: "A country which has started from scratch without any foreign assets at all must, of course, first of all try to accumulate an adequate currency reserve" (p. 7). Nor did the resultant expansion of domestic liquidity raise any problems; in view of the prevailing underemployment, significant expansion appeared feasible without jeopardizing equilibrium. Last but not least, this was the period in which strong real growth was accompanied by complete price stability, indeed by slightly falling prices. This happy combination—a so-called "Mengenkonjunktur" (expansion without inflation)—was attributable to the coincidence of various circumstances. As the Korean boom petered out, world market prices began to drop, while progressive trade liberalization reinforced the reduction of import prices. In this climate of general stability, the trade unions pursued moderate wage policies, so that between 1951 and 1954 wage increases remained within the limits of improvements in productivity. Lastly, savings soared to an extraordinary degree. However, the initial impulse for this remarkable overall stability was undoubtedly given by the monetary and financial stabilization program put into effect under the pressure of the German EPU deficits of 1950-51.

In this combination of circumstances, the central bank had no difficulty acting in conformity with balance-of-payments requirements, especially as regards interest rates. The discount rate was gradually reduced and by May 1954 was down to 3 per cent, "a level not seen in Germany since the interest-rate slump at the turn of the century," as the Bank deutscher Länder proudly noted in its Annual Report for 1954. Minimum reserve ratios were lowered and other restrictions relaxed. This central bank policy "was not only in accordance with the internal monetary situation but also fully in line with the rules of the old gold standard mechanism as determined by the balance of payments" (DL, 1954, p. 21).

3. *First Indications of a Dilemma Situation between 1954 and 1957*

The situation changed when, under the influence of an inflationary boom in a number of major partner countries, demand pull from abroad gave a strong boost to economic activity in Germany. From 1954 to 1956, foreign orders placed with German industry soared by an annual average of some 26 per cent, while domestic orders increased more modestly (see Table 1). From the fall of 1954 onward, the price climate likewise began to warm up noticeably. While not taking any immediate action, the central bank nevertheless remained on the alert.

In the summer of 1954, there was for the first time some public discussion about whether the persistent German surplus might not in reality indicate a "fundamental disequilibrium." But the question aroused little interest at the time. Only when the signs of a possible fundamental conflict between internal and external equilibrium increased did spokesmen of the central bank themselves begin to refer to a "genuine dilemma" (see Emminger, 1956, p. 16).

By 1955, the Bank deutscher Länder was obviously beginning to experience difficulties in reconciling the requirements of internal and external equilibrium. Starting in August 1955, the bank raised the discount rate in rapid steps, the highly controversial increase in May 1956 from 4.5 to 5.5 per cent all but bringing it into open conflict again with Chancellor Adenauer. But the central bank availed itself of the first opportunity, provided by a temporary slight cooling off, to revert to 4.5

TABLE 1

THE GERMAN ECONOMY'S DEPENDENCE ON EXPORTS, 1952-75

Period	Percentage Share of Exports in GNP[a]	Volume of Orders Received by Industry: Percentage Change from Previous Year	
		Domestic Orders	*Foreign Orders*
1952-57[b]	17.0	+ 9.1	+ 17.1
1958	19.4	− 1.4	− 3.3
1959	20.1	+ 24.2	+ 30.1
1960	20.7	+ 12.3	+ 13.2
1961-66[b]	19.8	+ 2.6	+ 4.8
1967	22.2	− 1.8	+ 10.7
1968	22.9	+ 22.2	+ 18.2
1969	23.4	+ 19.6	+ 15.9
1970	23.1	− 0.8	− 3.2
1971	22.9	− 2.3	− 0.1
1972:			
1st half	22.7	+ 2.8	+ 1.1
2nd half	22.9	+ 5.2	+ 18.8
1973	24.5	+ 6.2	+ 26.2
1974	30.0	− 8.9	+ 4.0
1975	28.2	− 0.6	− 14.9

[a] Exports (of goods and services) as well as gross national product from 1960 include the Saarland and West Berlin. For earlier years, aggregates have been adjusted to this territorial status.

[b] Annual average.

per cent in two steps. In so doing, it explicitly stated that "this was not intended to stimulate activity," but that its main motive was "to narrow the gap in interest rates between the Federal Republic of Germany and other countries in order to contribute toward reducing the balance-of-payments surpluses" (DL, 1956, p. 19).

In 1956 and 1957, the surpluses on both the current and the overall payments balance were still rising strongly, despite pronounced domestic economic expansion and incipient price rises. Since the inflationary Korean boom of 1951-52, moreover, both France and the United Kingdom had been saddled with an inflation "backlog" (see Table 2); the French franc in particular had been devaluation-prone since 1954. Eventually, in 1957, there developed substantial speculation on a D-Mark revaluation and devaluations of the franc and sterling.

In spite of all efforts to reduce the interest-rate differential vis-à-vis foreign countries, and despite a ban on interest payments on foreign deposits, during the first nine months of 1957 more foreign exchange flowed into Germany than ever before. Thus, 1957 saw the first appearance of a phenomenon that was to recur on a number of occasions, the aggra-

TABLE 2

INFLATION DIFFERENTIALS:
MOVEMENTS OF CONSUMER PRICES IN NATIONAL CURRENCIES
(*1950 = 100*)

Country	*1957*	*1961*	*1965*	*1969*	*1972*
Germany	115	123	138	151	173
United States	117	124	131	152	174
France	136	178	208	243	287
United Kingdom	142	154	177	208	260
Italy	128	136	170	187	217

vation of balance-of-payments disequilibria by speculative money inflows. With each subsequent crisis, these speculative money inflows increased in volume, reaching their all-time peak in February-March 1973, just before the D-Mark was floated.

The effective devaluation of the French franc by 16.6 per cent on August 12, 1957, at first failed to halt foreign-exchange speculation; the same was true of a German government statement on August 20 to the effect that "all rumors regarding an impending revaluation of the D-Mark are unfounded." Not until the last week of September 1957, when at the Annual Meeting of the IMF in Washington German and British spokesmen issued coordinated and reassuring statements on the exchange-rate situation—statements immediately preceded by a British bank-rate increase to 7 per cent and a German discount-rate reduction to 4 per cent—did the currency situation quiet down. Speculative positions were partly unwound. The French external payments position, however, was not finally stabilized until the end of 1958, when under General de Gaulle a second devaluation of the franc by 14.9 per cent took place simultaneously with a drastic domestic adjustment program.

4. *The Attitude of the German Authorities toward the External Dilemma in 1956-57*

The attitude of the German authorities during the first D-Mark crisis deserves more detailed description. The government was divided on its assessment of the D-Mark dilemma, and especially on the revaluation question. This division lasted until just before the D-Mark was revalued in March 1961. Ever since 1956, Professor Ludwig Erhard, the Federal Minister of Economics, had been in favor of resolving the dilemma by revaluing the D-Mark. Under the influence of his advisers, Chancellor Adenauer for a long time opposed such a course. In view of this split within the government, the attitude of the central bank was of particular importance. In 1956-57, a large majority of the Directorate (Board of Governors) and the Central Bank Council of the Bank deutscher Länder opposed the idea of revaluing the D-Mark. My own written proposal in November 1956 that the D-Mark be revalued by up to 6 per cent, possibly with a transitional adjustment period of wider exchange-rate margins, was rejected by a large majority of the Directorate.

In April 1957, Professor Erhard reintroduced a proposal he had made earlier to revalue the D-Mark not in isolation but as part of a coordinated "realignment" of exchange rates on a European scale. He was supported by a confidential report of the Economic Advisory Council of the Federal Ministry of Economics dated April 1957. In the then existing circumstances, however, concerted action by all the countries concerned was a Utopian idea. The process of multilateral exchange-rate adjustment, which would indeed have been appropriate as early as 1957, dragged on over a period of ten years and a number of currency crises.

The main arguments of the proponents of revaluation were based on the inflationary impact of persistent balance-of-payments surpluses, the lopsided structural evolution of the German economy arising from overdependence on exports, the disturbing impact of the balance-of-payments disequilibrium on international trade and payments, and the dislike of the mistaken impression of "wealth" conveyed by Germany's mounting foreign-exchange reserves.

The opponents of revaluation argued that the disequilibrium was not structural or "fundamental." They maintained that several causes of the surpluses were of a temporary nature, such as the extremely favorable terms of trade, the foreign-exchange receipts from expenditures of Allied troops in Germany, and the demand pull from several European inflation-ridden countries. The payments deficits of inflation-prone countries, it was felt, ought to be remedied mainly by their own efforts and without prematurely easing the pressure on them by a D-Mark revaluation. Closely connected with this train of thought were misgivings about the *global* effect of a revaluation, i.e., its effect vis-à-vis the dollar area, with which Germany was alleged to be basically in deficit. Finally, it was considered "normal" for the structure of the German balance of payments that large surpluses on current account should gradually be offset by higher net capital exports.

In the public discussion of these matters, a great role was played by the slogan that a revaluation of the D-Mark would be equivalent to "curing the quick instead of the sick." Even people who in general favored a parity change were time and again impressed by this metaphor. For example, Professor Erhard told the press in Dortmund on August 9,