THE CURRENCY REFORM IN THE WESTERN ZONES OF GERMANY

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Judged by the initial effects, the currency reform in Western Germany has been a fair success. Roughly nine-tenths of the war inflated money volume has been eliminated. Hoarded goods have reappeared in the shops, the black market has been dealt a damaging blow, and the renewed incentives to earn money have caused absenteeism to disappear. With one stroke a money economy has been restored. Furthermore the influx of raw materials has increased through the ECA, the food situation has improved thanks to both ECA and the weather, and finally Germany has been incorporated in the plans for expansion of inter-European trade. Prospects for a substantial increase in the present level of production, which is only half of pre-war, should therefore be fairly good. On the purely monetary side, the means are available to prevent both exaggerated deflation and renewed inflation.

However, this relatively bright picture has many dark spots. Not only are there a number of "ifs" on the production side, but equilibrium between the income level and the flow of consumer's goods has not yet been reached. When the extreme scarcity of money immediately following the reform has been mitigated, the question will arise whether production can be stepped up quickly enough to prevent an excessive increase in the price level, now largely free from controls. If not, wage demands and a price-wage spiral can be expected to follow. It will therefore be imperative that wage increases are only allowed to take place in step with the rise in production and that a conservative financial policy is pursued. To bring this about without social unrest will demand the wholehearted cooperation of the German population and authorities.
It follows that the monetary reform must be considered an experiment which only a number of favorable conditions will make a lasting success. Consequently, the international conversion rate of the new currency, the Deutsche Mark, tentatively fixed at 30 US cents, can not be considered more than a starting point from which the final exchange rate will have to be found by trial and error.

1. General Background

During the fourth week of June a radical currency reform was carried out in Western Germany. The reform was based upon the principle of reducing by nine-tenths the nominal amount of currency, bank deposits and claims, and a subsequent blocking of half of the reduced volume of deposits. Following the currency reform, the taxation system was somewhat modified, and a large number of price controls and rationing measures abolished.

The period since the end of the war has been marked by a constant dilution of the German money system. In fact, it has been estimated that nearly half of all transactions were carried out by barter trade and black market operations or by substituting cigarettes and other scarce commodities for money. The irrationality, the social inequity, the waste of time and the lack of working incentives caused by the monetary chaos made a currency reform imperative. It would probably have been undertaken a long time ago but for the prolonged negotiations to initiate the reform under a four-power agreement. It seems that all four occupation powers would have been able to agree on the technical aspects of such a reform and that only the general political tension prevented a settlement.

Under the present circumstances the Western powers had to carry out the reform only in their own zones and at first even omitted their sectors of Berlin. When the Russians then introduced a separate currency reform
in Eastern Germany - similar but far from identical with the Western measure - and included all of Berlin in the area covered, the Western powers extended their reform to their sectors of Berlin. Monetary conditions in Berlin have, therefore, become extremely confused, but the purely economic aspects of conditions there have been overshadowed by the political conflict growing up around the Soviet blockade of the Western sectors, motivated inter alia by the independent Western currency reforms.

In this paper, the situation in Western Germany, not including the Western sectors of Berlin, is treated.

2. The Main Features of the Reform

The old Reichsmark as well as its equivalents, the Rentenmark and the Allied Military Mark, was abolished as of June 21, 1948. In its place a new currency called Deutsche Mark (DM) has been introduced. The new currency has no backing of gold or foreign currency, but the amount in circulation is strictly limited.

All old money not declared and turned in to a financial establishment (banks, post offices, etc.) before June 26 became valueless. For the currency turned in a maximum of 40 DM per head was paid out immediately mark for mark and another 20 DM was to follow within two months. The remainder was placed in a banking account. Subsidiary coin and Rentenmark and AM-notes with a denomination not exceeding one mark remain in circulation, but are only valid for one-tenth of their face value. The same is true for stamps.

Special provisions were made for business firms, tradesmen, and members of the professions in order that they could pay their employees, the general rule being that on application they could get up to 60 DM per employee converted.
Banking accounts are treated in a series of steps. The first step covers the first 540 RM in each account (or, in the case of business firms, etc., having availed themselves of the provision just mentioned, a Reichsmark amount equalling nine times the initial allowance). Nothing is paid for this, so that whether an individual turns in 60 or 600 RM he still gets only the initial payments of 40 plus 20 DM. The second step covers the next 5000 RM. Sums up to this limit are converted at the rate of 1 DM for 10 RM, but only half the proceeds are placed in a free account, the remainder being put in a blocked account. Regulations governing the blocked accounts will be issued before the end of September. In the case of tradesmen and members of the professions the 5000 RM limit is raised to 10,000 RM, and large business firms get additional facilities.

The third step covers the remainder of the account. This is treated in exactly the same way as in the second step, except that clearance with the tax authorities must first be obtained.

An example will clarify the procedure:

Assume a family consisting of two parents and two children having on June 21, 20 Reichsmarks in coins, 1,000 Reichsmarks in notes and a savings bank account of 12,000 Reichsmarks. The 20 Reichsmarks in coins were kept and serve as two Deutsche Marks, the Reichsmark notes were turned in. The family got immediately 4 x 40 Deutsche Marks, that is, 160 DM, and were promised another 4 x 20 Deutsche Marks in two months, that is, 80 DM, making a total of 240 DM. They were credited with the remaining 400 minus 240 Reichsmarks; as a consequence their bank account grew to 12,160 Reichsmarks. From this four times 540 Reichsmarks, or Reichsmarks 2,160, were deducted, leaving 10,000 Reichsmarks in the account. Five thousand Reichsmarks of this was immediately converted into 500 DM, of which 250 DM is placed on free and 250 DM on blocked account. The remaining 5,000 Reichsmarks will be treated in the same way as soon as the family has obtained a certificate from the tax authorities showing that no taxes are due.

The immediate result is that the family in question, instead of a total liquid balance of 12,420 Reichsmarks, got a liquid balance of only 412 DM (2 DM in coins, 160 DM in notes, 250 DM in bank balances). Shortly the family will get another
80 DM in notes, and after tax clearance another 250 DM in
the bank. The total liquid assets will thus be increased
to 742 DM in addition to which amount the family will
possess 500 DM on blocked account. Including this amount
the total becomes 1,242 DM or one-tenth of the original
Reichsmark amount in the family's possession.

Holdings of currency and bank deposits by the German Reich and the
National Socialist Party are not converted but wiped out completely.
However, funds corresponding to one month's operations are given to the
public authorities in order to enable them to continue their activities.
Obligations of the Reich are cancelled but through elaborate rules
financial institutions such as banks and insurance companies receive new
Government paper issued by the Laender in amounts large enough to preserve
their solvency, a procedure which in practice implies a conversion rate of
less than 10 per cent. To debts and bonds of other kinds contracted
before June 19, 1948, the conversion rate 10:1 applies directly, except
that recurrent obligations such as wages and salaries, pensions, rent,
insurance premiums etc. 1/ continue in Deutsche Marks at unchanged
nominal amounts.

The whole procedure necessarily involves substantial inequities and
the German authorities have been entrusted with the task of drafting within
six months legislation for the purpose of equalizing the burden of the
monetary reform which, at the moment, falls exclusively on the owners of
money and money claims. Most important in this respect will probably be a
radical tax upon increase in the value of property since the beginning of
the war which will affect predominantly the owners of real property. On
the other hand, the law states that old currency holdings and claims may

1/ interest, of course, not included.
later receive an additional reimbursement of one Deutsche Mark per 10 Reichsmarks. A limited tax reform has already been carried out. Income taxes have been reduced by an average of one-third but with larger reductions in the low income brackets. The Corporation tax has been simplified to a flat 50 per cent rate. Taxes on capital transactions have been increased by 50 per cent.

3. Effects on the Monetary System

A preliminary ceiling of 10 billion DM has been placed on the circulation of Deutsche Mark notes; it will be raised to 11 billion DM if voted by a 75 per cent majority of the directors of the "Bank Deutscher Laender" (the agency controlling the central banks of the "Laender" and responsible for the new money) and approved by six of the eleven "Laender" in the zones. It was not estimated, however, that the immediate circulation would exceed 4 billion DM. According to the most recent estimates, actual circulation is now around 5 billion DM.

Of the amount of currency in circulation in Western Germany immediately prior to the reform, no precise information is available. In spite of much higher figures published by some newspaper correspondents, informed Allied estimates have put the actual currency circulation in Western Germany at some 30 billion Reichsmarks, of which more than one-third was held by banks. So far only about 14 billion Reichsmarks has been turned in by the public.

Before the war the note circulation in the whole of Germany approached 10 billion Reichsmarks. Therefore, the ceiling upon the circulation of Deutsche Marks initially fixed at the same amount would seem to be ample,

\[1/\] No balance sheet of the Bank Deutscher Laender has been issued as yet.
since it only has to cover the needs of the Western zones with about two-thirds of Germany's pre-war population. In fact, at the present level of production (approximately 50 per cent of 1938, slowly rising) and official cost-of-living (130 per cent of 1938), a circulation of 4 to 5 billion DM seems appropriate and the 10 billion ceiling leaves scope for considerable expansion of production, even at a higher level of wages and official prices than hitherto. In any case, should the ceiling prove too low \( \frac{1}{2} \), it can be lifted. But the limit has obviously been introduced mainly for psychological reasons, and it should not be exceeded too soon in view of the effect on the inflation-conscious population.

The currency circulation has to be treated in connection with the amount of bank money. For this the final estimate must await the outcome of the tax clearances and the procedure adopted for the blocked balances; available statistics indicate that the volume of bank deposits left after the reform is low compared to the standard before the war. At the beginning of 1948 deposits with banks and savings banks in the Western zones (excluding inter-bank deposits and holdings by public authorities) were around 100 billion Reichsmarks, two thirds of which were saving deposits. Assuming this amount to be fully tax cleared, it would be converted into approximately 7 billion DM in savings deposits and 3 billion DM in demand deposits. Half of these amounts would remain blocked at least for some time. The disposable amount left would, therefore, be small compared to the

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\( \frac{1}{2} \)Which even without renewed inflation is a possibility if production increases substantially and at the same time the liquidity habits developed during and since the war prove firmly entrenched.
1938 figures which for the whole of Germany were 21 billion Reichsmarks in current and 24 billion Reichsmarks in savings deposits, corresponding to around 13 and 15 billion Reichsmarks, respectively, in the Western zones.

The various estimates given are summarized in the table below:

<table>
<thead>
<tr>
<th>Currency</th>
<th>1938 Estimated figures for Western Germany</th>
<th>1948 Estimates prior to reform (Billion Reichsmarks)</th>
<th>1948 Preliminary estimates after reform (Billion Deutsche Marks)</th>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Incl. blocked amounts</td>
</tr>
<tr>
<td>Currency</td>
<td>7</td>
<td>35 ?</td>
<td>5</td>
</tr>
<tr>
<td>Private &amp; business deposits</td>
<td>13</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>on current account</td>
<td></td>
<td></td>
<td>1.5</td>
</tr>
<tr>
<td>Total money volume</td>
<td>20</td>
<td>65</td>
<td>8</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>15</td>
<td>70</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>3.5</td>
</tr>
<tr>
<td>Grand Total</td>
<td>35</td>
<td>135</td>
<td>15</td>
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<td></td>
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<td>10</td>
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Judged on this basis, the monetary situation in Western Germany has been thoroughly cleared up, and the acutely deflationary effects immediately following the reform are not surprising. The problem now is to pilot the economy from this starting point safely between renewed inflation and excessive deflation. On the purely monetary side, the chances for success ought to be good. Any tendency towards too much deflation can be countered by release of blocked deposits, followed, if need be, by conversion into Deutsche Marks of additional amounts of old money. An expansionary fiscal and credit policy can support these increases, if necessary. Since the need for deflation was beyond dispute, the problem is not so much how to check it as when to check it. The criterion must be the trend of production. If production tends to decline, or even stagnate, there is cause for
investigating whether money has not been made too scarce.

Inflationary tendencies may prove a little more difficult to counteract, particularly as long as the new currency is still on trial. If confidence in the currency goes once more, the battle for the Mark may be lost for a long time to come, and the political repercussions of a failure of the reform could be very serious. The implications of these premises for the wage and price policy are treated in the next section; on the monetary side, conservatism is called for at the moment. The nearly balanced budgets of most of the Laender of the Western zones (in spite of the occupation costs) are a promising sign and the currency reform laws explicitly prohibit deficits on the budgets of the Laender. But various extraordinary expenditures seem to be kept outside the budgets thus representing a potential inflationary factor. On the other hand, in the management of the local currency receipts for the substantial import surplus made possible under the ERP and as "civilian supplies", a powerful weapon for maintaining the monetary balance in Germany is available.

4. General Economic Effects

It is, of course, the development of prices and production which provides the test for the success of the reform. The immediate effects have been healthy.

The acute scarcity of money brought forth large quantities of hidden stores, both in the retail shops and from the factories. Farmers brought food to the cities to dispose of it legally. Absenteeism practically disappeared. The black market was nearly annihilated. Unemployment has risen, but so far not to dangerous heights.
The currency reform was immediately followed by a German decree abolishing price control on a large number of commodities; basic foods, as well as certain raw materials and clothing, are still controlled. A rather extensive free market is now in existence in Germany for the first time in about 12-13 years.

It is obvious that with such radical changes in both the monetary and the market system it will take some time before a consistent price structure emerges, and too much importance should not be attached to the present day-to-day movements. Most reports maintain that the sharp drop in the free prices which set in immediately and in fact tended to make the official cost-of-living index (30 per cent above pre-war) realistic, has now given way to some reaction. This is only natural since new money is regularly being brought into circulation through wage payments, etc., while on the other hand the hoarded goods are now largely disposed of, so that free prices are now approaching a level which represents a balance between current incomes and current production. And incomes are larger than the supply of consumers' goods at the former official prices. If wages - which are still unchanged - are taken as indicative of the national income, the consumers would, at the former official prices, be able to buy more than 75 per cent of their pre-war consumption, while in fact the actual production is only around 50 per cent (60 per cent for agricultural commodities). Taking into consideration that the population of the area has grown by more than 10 per cent, this points to equilibrium at a price level more than double pre-war, but given the import surplus and a substantial rise in production equilibrium might be attained at a much lower level.

Production should increase not only as a result of the restoration of the incentive to earn money, but also as a consequence of better
nourishment -- the average calory consumption is now estimated at 2000 per day -- and a more ample supply of raw materials under the ERP program. Recent trade agreements with the Netherlands and Denmark also point to a more lively trade with the neighboring countries, improving the productivity in real terms, and the German participation in the new Western European currency scheme should strengthen this tendency. An increase in production to only 60 per cent of the 1938 level -- which many think will be reached within the first few months -- would indicate price equilibrium at a level approaching 170; could 70 per cent of the pre-war supply be reached, prices might even be in equilibrium at less than 150. 1/ Until such a level of production is attained, there will be a substantial pressure on prices. The test will be whether even moderate price increases can be borne without meeting the demands for higher wages which will inevitably result and have in fact already begun to appear. A price-wage spiral would be just as damaging as inflation brought about through purely monetary means.

Therefore, hopes at present must be pinned on restraint on the part of the Germans, particularly the trade unions, so that wage increases can be postponed until the supply situation may justify such steps. If the Allied authorities have to veto wage increases, it will obviously mean a heavy political load. Success of the whole experiment is therefore to a large extent dependent upon the loyal cooperation of the Germans both to limit income demands and increase production as quickly as possible. In the meantime, controls will probably have to be kept on prices of some food items.

1/ These computations, for obvious reasons, do not claim to be exact; they point, however, to the character of the problems to be met.
and other very scarce commodities; in fact, the abolishing of controls for other goods has been criticized by many as being premature, and was also opposed by the Social Democrats in Germany. The psychological advantage of this measure in strengthening the confidence in the new currency may well, however, outweigh the risks involved.

The distribution of increased German production between the home market and the export market is a further complication. In order to stabilize conditions in Germany and make the currency reform succeed, the share going to the home market should not be unduly limited; on the other hand, this implies a slower reduction of the German import surplus then would otherwise have been possible.

The rise in unemployment caused by the reform has so far not assumed critical proportions. During June, unemployment in the British and American Zones combined rose from 438,000 to 509,000 persons, and the beginning of July probably saw some further increase. Should the increase continue, a more liberal credit policy may have to be adopted, bringing interest rates down from the present level of 8 per cent p.a. or more for business credits. By the methods discussed on page 8 it ought to be relatively easy to prevent unemployment caused purely by lack of funds. But to maintain a satisfactory cost-price relationship is more difficult. The factors working for increased production work at the same time for lower unit costs. But with the diminishing of the black market and the barter trade, the average selling price of the manufacturers will also drop,

1/ According to Baseler Nachrichten, July 29 (quoted from B.I.S. Press Review, July 30), an official statement has declared unemployment to be 22% greater July 7 than by the end of May. This would mean an unemployment figure of 534,000.
in spite of some increase in the official price level. Only experience can show which side of the ledger will show the largest decline.

5. The Foreign Exchange Value of the Deutsche Mark

Formally, the "Deutsche Mark" is, for the time being, a purely internal currency, and official exchange rates with foreign currencies have not been established. However, the "conversion rate" in quite general effect in foreign trade since May, 30 US cents per mark, has been given increased importance and for all practical purposes comes very near to being an exchange rate or perhaps rather a clearing rate. For practically all exports except coal and imports except staple foods, this rate is applied when converting payments from and to foreign countries into Marks. It is now also used for the conversion of pay to both military and civilian foreign personnel in Germany.

A rate of 30 US cents per Deutsche Mark represents a devaluation of only 25 per cent of the pre-war Reichsmark of 40 cents. In fact, taking into consideration the system of export subsidies then in force in Germany, the real devaluation may be said to be even less. The present conversion rate is often objected to by Germans as being too high; particularly the export trades would prefer a rate of 20 to 25 cents. The difficulties everywhere in Europe today in arriving at any equilibrium rates of exchange present themselves manifold in Germany so that all theoretical computations have to yield to practical experience. A trial and error method seems to be the only one possible in the case of Germany.

It has, in this connection, only a very limited interest to point out that official prices in Germany have risen considerably less than in the U.S., and that wages hardly have risen at all. The tremendous decline in German productivity no doubt outweighs this, but a quantitative valuation of these factors is not possible without detailed investigation of market
and production conditions for the individual commodities. Even more uncertain is the future trend in productivity. The only general observations which can be made at the moment is that prima facie there seems to be no particular reason to assume the Deutsche Mark to be overvalued. Opposite German views may be influenced by a desire to acquire a preferential position for German exports. But the present conversion rate will of course not be maintainable if a renewed internal inflation gets under way. The chances for and against this, however, are under the present circumstances not much influenced by a somewhat lower or higher conversion rate.

Considerable amounts of Deutsche Mark notes have already been smuggled into Switzerland, where they for some weeks were semi-officially quoted along with other European notes. After the rate had dropped to SF 35 per DM 100 (and for notes of large denominations even down to SF 23) the quotation was suspended. Since 30 U.S. cents per dollar corresponds to 1.28 Sw.fr.s per Deutsche Mark, the Marks have been traded at 1/4 to 1/6 their official value. This is a much heavier discount than applies to most other European notes, which is only natural considering the highly speculative character of trade in a currency not yet firmly established. In any case, the Swiss note quotations are not very useful as indicators of the "real" value of a currency, primarily reflecting, as they do, the rigidity and degree of enforcement of the currency restrictions of the various countries.