

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

March 17, 1967

Jan W. Karcz

The German Mortgage Market in 1966.

11 pages

This paper reflects the personal opinion of the author and must not be interpreted as representing the opinion of the Board of Governors. It was prepared primarily for internal circulation within the Federal Reserve System, and must not be cited, quoted, or reprinted without permission.

March 17, 1967

Jan. W. Karcz

The German Mortgage Market in 1966

Despite a program of severe credit restraint which produced acute tensions in financial markets and a downturn in industrial output in Germany after mid-year, residential construction activity was relatively well maintained during 1966. Demand for housing did weaken progressively during the year, but completions of residential units actually registered modest gains over the preceding year, thanks largely to a substantial backlog of orders at the beginning of 1966 and to continuing public subsidies to homeowners and lending institutions.

Yields on mortgage bonds rose from 7.2 per cent at the end of 1965 to a third-quarter peak of 8.0 per cent and then declined to 7.5 per cent by the end of the year. Mortgage firms found funds from the capital market not only more expensive but limited in amounts, and net mortgage bond issues declined from DM 3.9 billion in 1965 to DM 2.7 billion last year. Savings inflow to mortgage credit institutions also declined. As a result, the government financing assistance increased materially during the year.

The outlook for 1967 is uncertain. The weakening of demand for housing became more pronounced toward the end of 1966. The order book position for residential construction at year-end may be estimated-- on the basis of projections for the fourth quarter--at around twelve months' capacity output. The principal factors likely to affect new orders will be the speed with which aggregate demand expands

again and the extent to which financing stringencies will be eased, either as a result of the recent reversal in credit policy in Germany or of additional government financial assistance.

Demand for housing weakens progressively

During the course of 1966, demand for housing weakened progressively. The construction industry's backlog of orders covered by mortgage commitments continued to rise up to September, but total mortgage commitments through November were slightly below the comparable figures for 1965. (See Table 1.) In addition, building permits for the first quarter of 1966 were 11 per cent above those a year earlier but thereafter the monthly average for each succeeding quarter (in terms of thousands of dwelling units) was progressively below that of the preceding three months.

Two factors contributed to the weakening of housing demand last year--the deterioration in the general economic situation and the financing limitations growing out of credit restraint measures. In addition, longer-term factors may have contributed to this weakening. For example, war-time destruction had probably already been fully replaced earlier and the housing needs of refugees from East Germany and of foreign workers were probably at a reduced level.

House completions continue strong in 1966

Throughout the year, backed by a strong order book position, the residential construction industry operated at or near capacity and in 1966 house completions (in numbers of structures) were slightly higher than in 1965. (See Table 2.)

Table 1. Germany: Residential Building Permits and Mortgage Commitments, 1965 to 1966

<u>Month</u>	<u>Building Permits Issued</u>		<u>Average Monthly Rate of Change in Quarter</u>	<u>Mortgage Commitments^{2/}</u>	
	<u>in Thousands of Dwelling Units^{1/}</u>		<u>in Per Cent</u>	<u>DM Billions in Current Prices</u>	
	<u>1965</u>	<u>1966</u>		<u>1965</u>	<u>1966</u>
January	36.2	35.5		1.25	1.24
February	37.5	37.5		1.24	1.12
March	40.0	53.3	+11.1	1.50	1.38
April	52.5	47.3		1.36	1.47
May	56.5	50.8		1.36	1.63
June	54.3	51.8	- 8.1	1.39	1.26
July	60.5	54.3		1.65	1.36
August	55.8	51.0		1.35	1.25
September	57.5	50.0	-10.6	1.40	1.30
October	57.3	48.8		1.43	1.45
November	48.0	39.8	-15.9	1.48	1.51
December	<u>45.3</u>	<u>n.a.</u>		<u>1.35</u>	<u>n.a.</u>
Total for year	501.4	n.a.		16.76	n.a.
Total for 11 months	556.1	520.1		15.41	14.97
Total for 11 months at 1962 prices				13.45	12.56

^{1/} Converted to permits for dwelling units from figures on permits for structures.

^{2/} Excluding commitments by insurance companies and social insurance funds.

Sources: Wirtschaft und Statistik, 1965 and 1966. Federal Ministry of Economics, Die Wirtschaftliche Lage in der Bundesrepublik Deutschland, monthly editions, 1965 and 1966.

The non-residential German construction industry did not fare as well in 1966 as did residential construction. A sharp decrease in demand for industrial construction resulted in some unemployment and, subsequently, in structural shifts within the industry. Several big firms switched from industrial to residential construction; because they could not compete with these larger firms, numerous small construction establishments went into bankruptcy. However, the entry of these larger firms into house-building apparently resulted in some expansion in industry capacity; the efficiencies of the firms may also have helped to slow down the increases in construction costs.

Table 2. Germany: Structure and Dwelling Unit Completions
1961-1966
(in thousands)

<u>Year</u>	<u>Residential Structures</u>	<u>Number of Dwelling Units</u>
1961	214	556
1962	215	563
1963	218	560
1964	238	613
1965	233	581
1966	236 ^{e/}	604 ^{e/}

e/ Estimated.

Source: Wirtschaft und Statistik, January 1967, p.19.

Mortgage market in difficulties, increased government assistance

Financing the high level of construction activity in 1966 presented severe difficulties to the German mortgage market. The market relies on two market sources of funds: the mortgage bonds and the direct savings inflow from the public. Credit restraint fell most heavily on the bond market, but the general weakening of economic climate also affected the savings inflow. However, the continued and increasing government financial help enabled the market to supply sufficient funds to sustain residential construction activity at a continuing high level.

(1) The bond market suffered a drastic decline in 1966.

The market's weakness forced the authorities to declare a moratorium on new public authority bond issues in May. This ban was partially lifted in January 1967, but the authorities still ration new issues of public authorities bonds. New issues of all bonds fell very sharply from DM 12.5 billion in 1965 to DM 5.5 billion in 1966 or about 57 per cent.

By contrast with the market total, mortgage bond new issues declined by only 39 per cent. These bonds form an important part of the total bond market--38 per cent of all bonds currently outstanding--and most of them are issued by the mortgage banks, without government guarantee. These banks use the proceeds for mortgage loans of maturities up to 33 years and the rate of interest varies with the bond yields. In 1966, the gross rate of interest on mortgage loans granted by mortgage banks ranged between 8 and 9 per cent as opposed to an average of 7-1/2 per cent in 1965. However, the effective rate of interest paid by the borrowers was lower due to the government interest rate subsidy.

The stringent credit conditions in 1966 were also reflected in the yields on mortgage bonds. From the January level of 7.2 per cent (it was 6.3 per cent in January 1965), the average yield rose sharply to 8 per cent in the third quarter, and then declined gradually to 7.5 per cent in December, as credit conditions eased. (See Table 3.) Yields on these mortgage bonds did not fluctuate as much as those on industrial and public authorities bonds. This is partly due to the greater marketability of these bonds and partly to the support purchases of these bonds by several mortgage banks during the year.

Table 3. Germany: Selected Bond Yields, 1961-1966
(Yearly or monthly averages, in per cent per annum)

<u>Year</u>	<u>Mortgage Bonds (including ship mortgage bonds)</u>	<u>Industrial Bonds</u>	<u>Public Authorities' Bonds</u>
1961	6.0	5.9	5.9
1962	6.0	6.0	5.9
1963	6.1	6.0	6.0
1964	6.2	6.2	6.2
1965	6.7	7.0	7.1
1966	7.6	7.9	8.1
1965 - November	7.1	7.4	7.5
December	7.2	7.6	7.7
1966 - January	7.2	7.5	7.6
February	7.2	7.5	7.6
March	7.4	7.6	7.7
April	7.4	7.9	8.0
May	7.6	8.0	8.2
June	7.7	8.2	8.4
July	8.0	8.3	8.6
August	8.0	8.2	8.6
September	8.0	8.2	8.5
October	7.8	8.1	8.4
November	7.9	8.1	8.2
December	7.5	7.8	7.7

Source: Deutsche Bundesbank, Monthly Report, January 1967, Table V/18.

Loans granted by the mortgage banks account for about one-third of all mortgages currently outstanding. (See Table 4.) However, in 1966 loans granted by these institutions declined very sharply, by 75 per cent from the 1965 level. It seems clear that, in spite of the issue ban on public authority bonds, the market was unable to generate funds at a sufficient rate and at acceptable rates of interest. The higher cost of borrowing from the mortgage banks and their shortage of funds caused borrowers to switch to other lending institutions, mainly those financed by government loans, as may be seen in the sharp growth in "all others" loans in Part A of Table 4.

(2) Direct savings inflow declined irregularly in 1966. Some financing institutions do not appear to have been adversely affected by business conditions. For example, building and loan associations, which are institutions specializing in intermediate mortgage loans (10 to 12 years maturity) at relatively low rates of interest (4-1/2 to 5 per cent), continued to receive savings at about the 1965 rate. Savings inflows were also maintained by insurance companies, where commitments are of a contractual nature. Consequently, lending activity of these two types of institutions did not significantly change during 1966.

By contrast, the savings inflows to the savings banks were adversely affected by business developments in 1966. Savings banks are the most important source of mortgage loans in Germany, accounting for 38 per cent of all mortgage loans outstanding. Data through November (1966) show a decline in their savings intake of over 15 per cent over

Table 4. Germany: Mortgage Loans Granted and Outstanding and Sources of Mortgage Funds, 1961-1966
(in billions of DM)

	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u> <u>Nov.</u>
A. <u>Net mortgage loans granted</u>						
Savings banks system ^{1/}	3.7	4.1	3.6	5.5	5.4	4.2
Mortgage banks	3.0	3.8	3.9	4.8	4.0	1.0 ^{2/}
Building and loan associations	1.0	1.2	1.2	1.2	1.3	1.3 ^{2/}
Insurance companies	0.8	0.8	0.9	1.1	1.5	1.1 ^{2/}
All others ^{3/}	1.3	1.7	2.8	1.1	1.0	3.4
Total	9.8	11.6	12.4	13.7	14.2	11.0^{e/}
B. <u>Sources of funds</u>						
Government loans ^{4/}	3.6	3.7	3.8	5.2	4.6	n.a.
Net mortgage bond issues ^{5/}	3.2	3.6	3.7	4.5	3.9	2.4
Direct savings inflow ^{6/}	3.0	4.3	4.9	4.0	5.7	n.a.
Total	9.8	11.6	12.4	13.7	14.2	11.0^{e/}
C. <u>Mortgage loans outstanding, end of period</u>						
Savings banks system ^{1/}	25.4	29.5	34.1	39.6	45.0	49.2
Mortgage banks	21.6	25.4	29.3	34.1	38.1	39.1
Building and loan associations	5.8	7.0	8.2	9.4	10.7	12.2 ^{2/}
Insurance companies	4.8	5.6	6.5	7.6	9.1	10.2 ^{2/}
All others ^{3/}	9.5	11.2	13.0	14.1	16.1	19.5
Total	67.1	78.7	91.1	104.8	119.0	130.0^{e/}

^{1/} Includes savings banks and their central institutions, but not the central bank for savings banks, which is included in "all others."

^{2/} Data through September 30, 1966.

^{3/} Includes commercial banks, specialized credit institutions, credit co-operatives, post office savings bank, social insurance funds. Totals include small amounts of loans granted against mortgage on agricultural land.

^{4/} Loans by Federal, Länder, and local governments as well as by the Equalization of Burdens Fund, which are channeled to the market through public credit institutions.

^{5/} Sales net of redemption at issue value.

^{6/} Estimated as residual.

^{e/} Partially estimated.

Sources: Deutsche Bundesbank: Monthly Reports, 1963 through January 1967, Wirtschaft und Statistik, 1960 through January 1967.

the comparable period in 1965. Savings in these institutions are rarely contractual, and they do not offer the incentive of cheap, guaranteed mortgage loans which attract savers to the building and loan associations. The shortage of loanable funds forced the savings banks to reduce their loans by 20 per cent from the 1965 level.

(3) Government assistance increased in 1966. The pronounced weakness of the bond market and the decline in direct savings inflows forced the mortgage market to rely more on government financial assistance in 1966 than it had in previous years. Data for the year are not yet available, but preliminary figures published by the Federal Economics Ministry indicate that government financial assistance to the mortgage market increased substantially in 1966.

Government loans are now granted by the Länder and local governments. The Federal government granted loans in moderate amounts in 1966 but, under the provisions of the 1958 Second Housing Act, it terminated this kind of assistance at the end of the year. Government loans are not granted directly to house owners but provide long-term funds (with maturities up to 100 years) to various specialized public credit institutions. The rate of interest charged on these loans is substantially below the market rate; in 1965 it ranged from 3 to 3-1/2 per cent.

The majority of public credit institutions, the main recipients of government loans, are grouped under the heading "all others" in Table 4. Loans granted by these institutions more than

tripled during the year and it seems clear that it was the increased government assistance in 1966 that enabled the housing industry to perform as well as it did.

Government assistance to the housing and mortgage markets in Germany is not confined to loans. In addition, savers and house buyers obtain various types of tax relief, and the Federal and Lander governments in some cases act as mortgage guarantors, mainly on low-cost housing. More important than these--and more controversial--is the government interest subsidy program, which substantially reduces mortgage costs to borrowers and undoubtedly acts as a demand stimulant. The interest subsidy has been criticized by Bundesbank officials on grounds that this form of government assistance renders the demand for housing credit relatively interest-inelastic. The exact figures, indicating the extent of the government interest-subsidy expenditures, are difficult to obtain since not all Lander governments report on a uniform basis. It is evident, however, that interest subsidies are of a substantial assistance to the mortgage market. Some data for Federal and Lander participation in the program, partially estimated by the Bundesbank, are given in Table 5.

Table 5. Germany: Government Interest-Subsidy Expenditures
1962-1965
 (in millions of DM)

	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>
Federal government	45.2	69.2	83.7	97.7
Länder governments ^{*/}	<u>264.9</u>	<u>373.7</u>	<u>428.5</u>	<u>n.a.</u>
Total	310.1	442.9	512.2	n.a.

^{*/} About one-fifth of Länder expenditures listed above have been made out of Federal grants. The role of the Federal government in the program has been, therefore, larger than the above figures indicate.

Source: Based on "Staatliche Zuschüsse zum Kapitaleinsatz anderer Kreditnehmer," Wirtschaft und Statistik, March 1966 and Deutsche Bundesbank, Monthly Report, April 1966.

The 1966 Federal budget provided DM 130 million for direct federal interest subsidies on mortgage loans; there are indications that the Länder expenditures also rose proportionately during the year.