

“Banking Crisis in Germany and the first step towards recovery”

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Abstract: Much has already been written about the 1931 German banking crisis, hence this article will focus on two less frequently addressed aspects. With respect to the question of the direct cause of the crisis and of the run which occurred on 13 July, pertinent developments in the area of gold and foreign currency reserves immediately prior to the crisis, ie in the weeks preceding the collapse, will be scrutinised.

Past and current experience teaches us that, from an academic perspective, it is of vital importance not just to investigate the causes of financial market crises but also to analyse the initial steps taken to overcome them. Efforts aimed at restoring public trust in the commercial banks are crucially significant in this regard. While government guarantees and financial assistance are important, they often do not *per se* suffice to re-establish the credibility of the affected players. In this context, there is much to be gained from assuming joint liability, in order to at least enable a resumption of interbank lending between the commercial banks. For this reason, the following article will examine a lesser known episode in German financial history, namely the **Transfer Association** (*Überweisungsverband*) of 1931.

Keywords: Banking crisis, gold and foreign currencies, transfer association

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1. The German Banking Crisis in 1931

Bank failures, combined with abrupt plunges in the prices of shares and foreign exchange rates, are not new events. We can and must learn from financial crises in order to prevent recurrences of future structural weaknesses which are evident at present. In this process, it might help to reflect on an interesting episode in German banking history.

The German banking crisis of 1931 left an indelible mark on the German banking sector, the effects of which are still visible today. Revisiting the past almost eighty years later provides a unique opportunity to examine factors which led to this historical banking crisis. This analysis seeks to focus on the reasons for the crisis and to examine the role played by the Reichsbank.

The factors leading up to the 1931 banking crisis are much more complicated than can be merely explained monocausally by the development of the capital market or the behaviour of German banks. The First World War and its consequences led to a severe destabilisation of Germany's financial situation. Owing to the inflation of the nineteen twenties, the German capital market was weakened so seriously that the rising demand for credit could only be satisfied abroad. Reparations and import surpluses from the war increased the need for foreign currency. This war-time scenario coupled with a restrictive trade policy implemented by the United States made it impossible for Germany to settle its payment obligations.

A major part of the loans which had been granted to Germany was short-term and rolled over on maturity. This critical situation was further exacerbated by a latent flight of capital, with German large enterprises transferring capital to their foreign subsidiaries, which in turn granted loans to their German parent companies. This combined scenario effectively created a drain and an inevitable strain on the local German economy.²

In 1927, in the run-up to the crisis the President of the Reichsbank, Hjalmar Schacht, had already voiced serious concerns regarding the total volume of German foreign debt. A considerable chunk of the foreign debt was due to public sector borrowing as well as competition generated by commercial banks for foreign funds.³

The low equity base of the big German banks (which was due to inflation and the currency reform) plummeted even further in the nineteen twenties as a result of a trend towards concentration, attempts to expand, and increasing competition against the background of a generally deteriorating economy. For example, the *own funds/borrowed funds* ratio of the big banks fell from approximately 1 to 3 and 1

¹ William O. Henderson, Das Bankwesen in der Weltwirtschaftskrise 1929 – 1931, in: Studien zur europäische Geschichte, Internationale Zusammenhänge der Weltwirtschaftskrise von Otto Büsch und Peter-Christian Witt, Berlin 1994, p. 190 – 196.

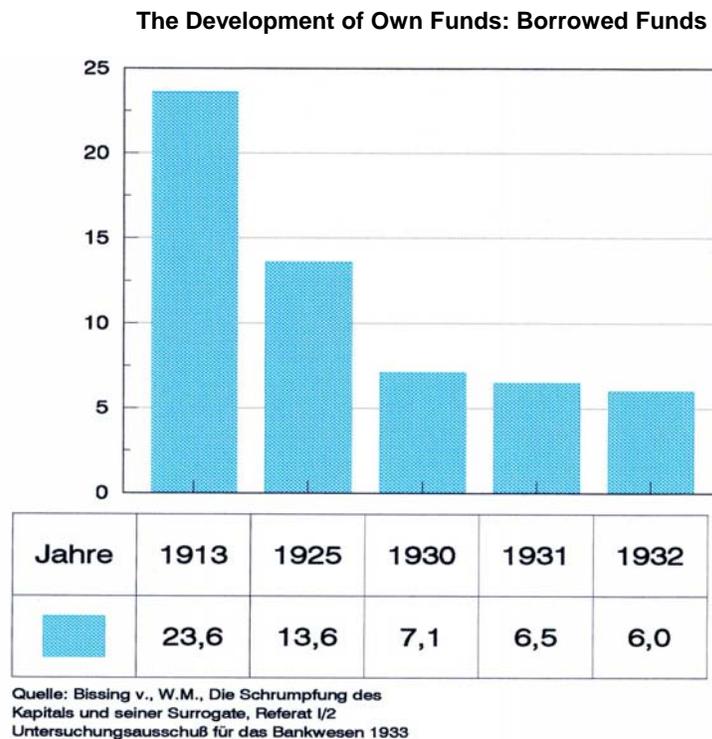
² Christoph Kaserer, Die deutsche Bankenkrise von 1931- Marktversagen oder Staatsversagen? From Publication of Institut für bankhistorische Forschung e. V. Frankfurt, 01/2000, p. 3 – 13.

³ -Ludwig Mülhaupt, Von der Bankenkrise 1931 zur Bankenaufsicht 1981, in Schmalenbachs Zeitschrift für betriebswirtschaftliche Forschung, Jg. 34, H. 5, Mai 1982, p 435 – 445.

- Rudolf Stucken, Die deutsche Bankenkrise von 1931, in Kredit und Kapital, Werner Ehrlicher und Helmut Lipfert, Berlin 1968, p. 393 – 397.

to 4 in 1913 to between 1 to 15 and 1 to 16 in 1929.⁴ Moreover, the rules of maturity matching were neglected. Although the Reichsbank had drawn attention to this rather unfavourable development at an early stage, it had no chance to react.

Chart 1.



By the end of the nineteen twenties, full-blown effects of a deteriorating economy began unleashing its reigns in tandem with the global recession known as the Great Depression.

The 1930 stock market crash aggravated the liquidity situation not only in the German Reich but also worldwide. Additionally, an increased outflow of capital abroad set in after the Reichstag elections on September 30, 1930, in which the NSDAP (the nazi-party) increased the number of its seats by just about nine fold (from 12 to 107 seats).⁵

The first indications of an impending liquidity crisis were leaps in interest rates in the money market during the reparation negotiations. Out of concern for its reputation abroad, and in order to counter a potential resurgence of inflationary fears in Germany, the Reichsbank had to adhere to the cover ratio of 40% stipulated in Section 31 of the Reichsbank Act. This meant that at least 40% of

⁴ Albert Fischer, "Schuld und Schicksal" in der bankenkrise – eine westdeutsche Perspektive, in Vierteljahrschrift für Sozial- und Wirtschaftsgeschichte, 86. Band, Heft 2, Stuttgart 1999, p 183 -189.

⁵ Wilhelm Vocke, DER 13.Juli 1931, in Beiträge zur Bankgeschichte, Sonderbeilage zu Heft 13, Frankfurt am Main 1971, p 1 – 2.

banknotes in circulation had to be backed by gold or a corresponding amount of foreign exchange reserves.⁶

To complicate matters, a segment of the foreign financial news media suspected that the Germans themselves were responsible for the deep crisis and that the Reichsbank simply needed to fight the capital flight vigorously to bring the situation back under control again.

However, it was not fully evident to all that the Reichsbank was in a difficult position in several respects. To recommend a suspension of Section 31 of the Reichsbank Act would have immediately revived latent inflationary fears already existing among the vast majority of the German population and would have resulted in a loss of confidence abroad.⁷

It is now clear that the actual crisis was triggered not by the behaviour of the Reichsbank but by a well-intended policy measure and concerted efforts of the Reich Government.

On June 6, 1931, the Reich Government tried to achieve a more favourable bargaining position for reparation negotiations by posting a public notice which created the impression that a payment crisis was imminent. This immediately triggered an increased outflow of capital abroad. The Reichsbank reacted swiftly, raising the discount rate by two percentage points. It thus set a clear signal of a stability-oriented policy. However, the effect was only short-term.⁸ It was then rumoured that the Reichsbank was about to discontinue payments within a few days, which further shook confidence in the German currency only a week later, affecting both local and particularly foreign interests in an adverse way.

This rumour was probably based on the level of cover of banknotes in circulation which was approaching the 40% mark. However, it was unjustified in view of the fact that the Reichsbank had, at that time, already decided on more restrictive lending through bills of exchange.

With its actions, the Reichsbank sought to calm foreign creditors and domestic savers. At the same time, it could not "stab the Reich government in the back" in the reparation negotiations. To alleviate the critical situation regarding the cover of banknotes in circulation, the Reichsbank decided to ask other central banks for support. On June 20, the Reichsbank received a loan worth \$ 100 million from the three most important western central banks (France, United Kingdom and the US) and the BIS. However, it was not sufficient to satisfy demand for foreign exchange. For that reason, Reichsbank President Luther himself travelled to London, Paris and Basle on July 9. Unfortunately, the trip was unsuccessful. Mistrust of the Reichsbank was growing, in particular at the Banque de France and within the French Government, due to the dreaded aggressive policy of the German Reich. A major

⁶ Christoph Kaserer, Die deutsche Bankenkrise von 1931 - Marktversagen oder Staatsversagen? From Publication of Institut für bankhistorische Forschung e. V. Frankfurt, 01/2000, pp. 3 – 9.

- Reserve bei Reichstagswahlen 69,6 %, vgl. Harold James, Die Reichsbank 1876 bis 1945, in Fünfzig Jahre Deutsche Mark, Notenbank und Währung in Deutschland seit 1948, Hrsg. Deutsche Bundesbank, München 1998, p. 61.

⁷ Ludwig Mülhaupt, Von der Bankenkrise 1931 zur Bankenaufsicht 1981, in Hans-Dieter Deppe, Geldwirtschaft und Rechnungswesen, Göttingen 1989, p. 341 – 346.

⁸ Isabel Schnabel, the Role of Liquidity and Implicit Guarantees in the German Twin Crisis of 1931, in: Preprints of the Max Planck Institute for Research on Collective Goods Bonn 2005/5 p. 5 - 35.

factor contributing to the mistrust might have been the announcement of a customs union with Austria in March 1931 and the arming of the German Navy.⁹

For observers of the international stock market scene, the impending crisis, which was characterised by a flight from the German market, was already discernible since the second week of May 1931. Turnover of German bonds in New York trading had risen by around two-thirds compared to the first few days of May, with the price of the Young bond falling continuously, to cite just one example. The Berlin foreign exchange market, however, remained relatively calm up to the third week of May.¹⁰

The situation worsened when it became known that the textile group – Nordwolle, which was supported by the Darmstädter und Nationalbank (Danatbank i.e. one of the major German commercial banks at the time) was about to collapse. This triggered even further massive outflows of capital abroad.¹¹

Later, the question was often raised whether the outflow of capital abroad or the depositors' and retail customers' cash withdrawals triggered the crisis. This question can best be answered by analysing the weekly reports of the Reichsbank. If one considers that the outflows of capital abroad resulted in a depletion of the gold and foreign exchange reserves and that cash withdrawals led to an increase in the number of banknotes in circulation, the picture is relatively clear. However, the Reichsbank only gradually became aware of the total magnitude of the commercial banks' liquidity problems. If one compares the situation at that time with that of today, various lessons can be learned, although the underlying conditions have changed.¹²

⁹ - Harold James, Haben Goldstandard und freier Kapitalverkehr die Finanzkrise von 1931 verursacht? in: 12. Wissenschaftliches Kolloquium am 30. November 1999 im Hotel Frankfurter Hof in Frankfurt, Frankfurt am Main 2000 p. 15 - 24,

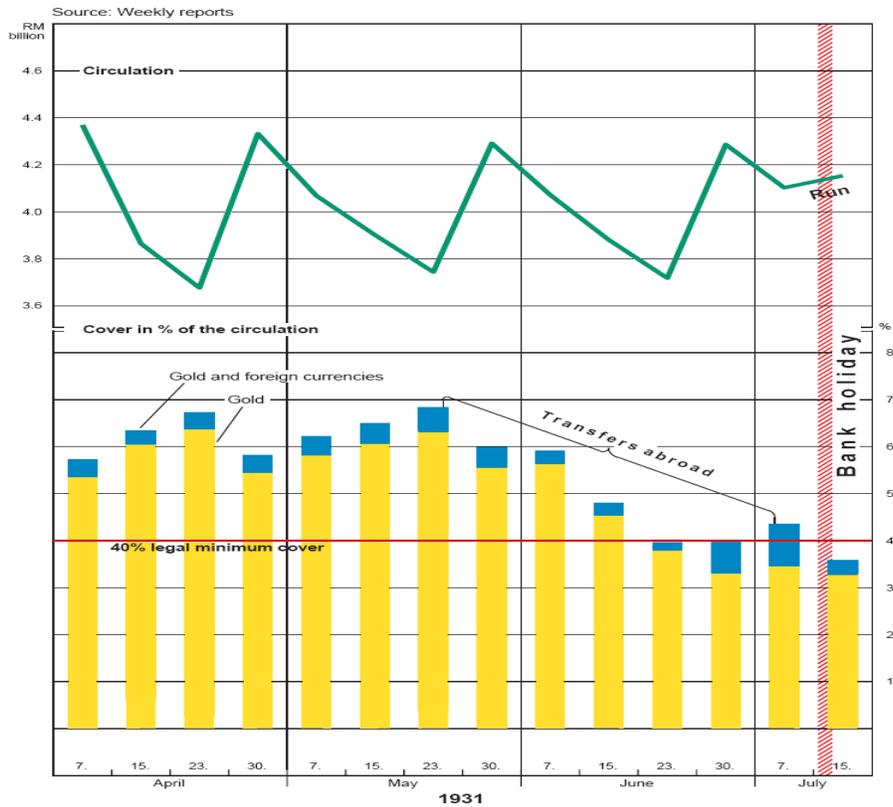
- Christopher Kopper, Hjalmer Schacht, Aufstieg und Fall von Hitlers mächtigstem Bankier, München, Wien 2006, p. 186 - 193.

¹⁰ Walter Federn, The banking crisis of 1931 – how the tremors spread, in Euromoney, November 1976, p. 69 – 80.

¹¹ Christoph Kaserer, Die deutsche Bankenkrise von 1931- Marktversagen oder Staatsversagen? From Publication of Institut für bankhistorische Forschung e. V. Frankfurt, 01/2000, p. 11 – 14.

¹² Hans E. Priester, Das Geheimnis des 13. Juli, Tatsachenbericht von der Bankenkrise, Berlin 1932, p. 26 – 31.

Analysis of the German banking crisis in 1931



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Source: Reichsbank Verwaltungsbericht.

It is paramount that initial steps be taken to ensure that the financial sector of affected countries become more transparent. The prevalence of "insufficient information" surrounding financial institutions in the Tiger countries is shockingly astonishing. This, amongst other factors, also led to Germany's largest banking crisis in 1931.¹³ For that reason, transparency should be the order of the day, even if this leads to painful confessions. A jolting shock at this juncture might prove beneficial in the end.

The next delicate topic to be explored will focus on ways in which countries respond to local currency depreciation. The sharp depreciation of western currencies was, and continues to be, an accelerating factor in financial crises. Fears of administrative controls are prevalent.¹⁴

This begs the question of how, then, will countries and their central banks react to the collapse of financial enterprises and the concomitant liquidity bottlenecks in the "real economy".

¹³ Jürgen Mura Sparkassenorganisation und Bankenkrise 1931, Die Krise: Ursache, Verlauf, Folgen, in: Sparkasse //81, 1981, 252 – 253.

¹⁴ - Reichsbank, Verwaltungsberichte 1931.

- Reichsbank, Untersuchung (Anm. 13) p. 453 – 455.

The Reichsbank's weekly reports show that the cover ratio fell sharply as early as June of 1931, whereas the volume of banknotes in circulation was still fluctuating constantly in line with the monthly pattern. This demonstrates an initial onset of the outflow of capital abroad, and thus decisively reduced the Reichsbank's foreign exchange reserves. The withdrawal of bank credits in Germany then followed with a time-lag.

However, what ultimately triggered the crisis was, for the most part, the behaviour of the Danatbank. Uneasiness in the German money market was additionally fuelled by speculation about the liquidity problems of the Danatbank. The Danatbank refused to extend a loan to the City of Berlin. This considerably undermined confidence in the solvency of the bank and resulted in a wave of short-term credit cancellations - not just at Danatbank.

The Reichsbank learnt only gradually of the losses suffered by the Danatbank, and also became informed of the precarious liquidity problems that the other big banks were experiencing at a very late date. The commercial banks' willingness to cooperate with and provide information to the Reichsbank, even in the crisis meetings of July 11 and 12, can only be described as very restrained.

Efforts by the Reichsbank to push through two official holidays (days when there are no office hours) by emergency decrees (Article 48 of the Weimar Constitution) failed initially: Reich Chancellor Brüning could not be convinced of the necessity of these measures. On Monday, July 13, Danatbank's counters did not open again. The Reich Government believed that it could save the day by providing a guarantee for the Danatbank.

2. The Road to Recovery

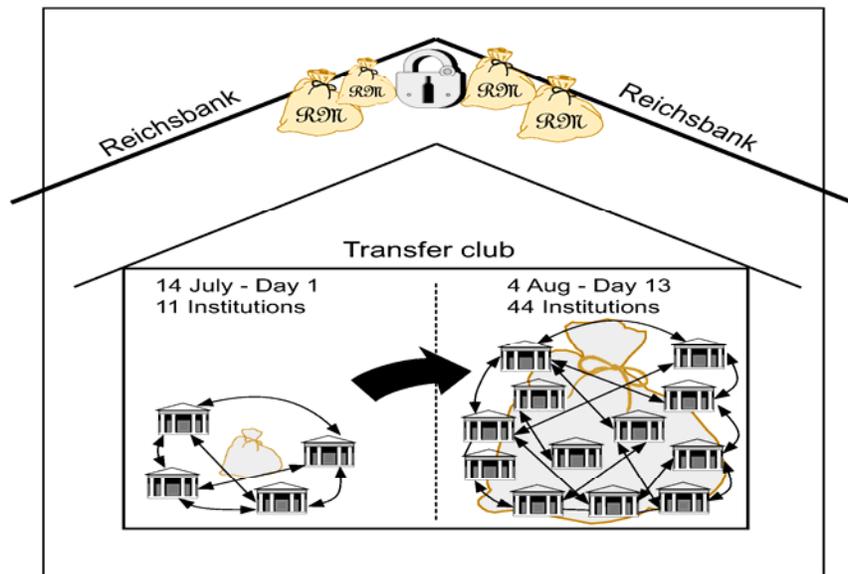
Charting the road to recovery calls carefully thought through decisive moves, and clearly planned survival strategies and tactics. Fortunately, the German Banking Crisis of 1931 triggered a reaction in the right direction. A very important step in achieving this goal lies in reactivating the clearing and settlement activity between the commercial banks. This was the aim of the **Transfer Association** in Germany known as the *Überweisungsverband*. This played an integral role as a temporary institution for restoring payment transactions between banks reactivating a semblance of normalcy and stability throughout the troubled sector.

In this decisive move, bank holidays were declared on 14 and 15 July 1931 in which all monetary and bank transactions in Germany were to be brought to a standstill.¹⁵ Then, as of 16 July, strict transfer limits – with a few exceptions (e.g. for wages and salaries) – were enforced.¹⁶

¹⁵ Decree of the Chancellor of the Republic of 13 July 1931 governing implementation of the Decree of the President of the Republic on bank holidays.

¹⁶ Decree of the Chancellor of the Republic of 15 July 1931 on the resumption of payment transactions following the bank holidays.

Transfer club (1931)



Up until 20 July, transfers were initially limited to a total of RM 10,000 and they were not permitted to exceed a total of half of the remitter's credit balance. These transfers could only be made to the existing account of a third party at one of the institutions affected by the bank holidays.¹⁷ From 20 July, the ceiling was increased from RM 15,000, then to RM 50,000, and finally to RM 100,000 - but with the additional exception of exempted transfers underpinned by the agreements of the *Überweisungsverband*.¹⁸

It was clear that such a tight restriction of transfers between banks could not be maintained for a long time. For this reason, following discussions at the Reichsbank involving the "Prussian Consortium" of prominent bank managers and bankers, it was decided on 18 July 1931 to establish an organisation which came to be known as the Transfer Association.¹⁹ In its articles of association, it was mandated "to broaden the basis for and thus facilitate credit transfers from accounts affected by the ban on transfers and withdrawals held at member institutions of the Association by means of suitable measures, in particular the establishment of a settlement procedure".²⁰

Simply put, the idea behind this Association was to unify the most important financial institutions into a kind of "super-bank" and to ensure the smooth settlement of all "internal" transfers, regardless of their size.

¹⁷ Second Decree of the Chancellor of the Republic of 15 July 1931 on the resumption of payment transactions following the bank holidays.

¹⁸ - Third Decree of the Chancellor of the Republic of 18 July 1931 on the resumption of payment transactions following the bank holidays.

- Karl erich Born, *Die deutsche Bankenkrise 1931*, München 1967, pp. 114 – 117.

¹⁹ Hofrichter H. (1932): *Der Überweisungsverband e.V. Ein Beitrag zur Geschichte der Bankenkrise 1931 in Bankwissenschaft*, 8.1931/32, second half-year, Berlin, pp 625-634.

²⁰ Articles of association of the transfer association of 18 July 1931, chapter I, section 1 (1) (in German only).

The Association's activity was limited to carrying out transfers from one member institution to another via its settlement procedure. Credit transfer orders could be settled for own account or for the account of a third party. Of the transfers for the account of a third party, orders from banks and bankers not belonging to the Association – as in the case of normal customer orders – were made entirely subject to the transfer limits. In the case of transfers for own account, the member institutions were not required to observe the regulations governing transfer limits.

By eliminating cheques and bills of exchange, all members were protected against having to make unforeseen large payments. Mutual exchanges of cheques were carried out directly and mutual payables and receivables were settled by transfer.

The articles of association of the Überweisungsverband provided for the possibility of immediately settling corresponding debit balances via its Reichsbank account.

The positive reactions to the Association's settlement of credit transfers only a few days after its establishment led the five Munich banking institutions that were members to introduce a system of on-site pre-settlement; the balances of these transactions were communicated by telephone on a daily basis in order to be settled within the Transfer Association.

The Association remained in existence from 21 July until 4 August (13 business days). During this period, the number of participating banks rose from 11 to 44. A total of 91,721 credit transfer orders with a total value of RM 280 million were submitted for settlement.²¹ As the number of participants and the volume of settlements carried out through the Association grew, the transfer limits generally applicable to the banking sector were raised in stages.²²

On 5 August 1931, it was declared that the normal settlement of all withdrawals and transfers had been restored. The Association ceased to operate at close of business on 4 August.

The Transfer Association was thus able to successfully fulfil its task of protecting institutions affected by mass withdrawals.

²¹ Hofrichter H. (1932), *op cit*.

²² Fifth Decree of the Chancellor of the Republic of 23 July 1931 on the resumption of payment transactions following the bank holidays and the Sixth Decree of the Chancellor of the Republic of 28 July 1931 on the resumption of payment transactions following the bank holidays.

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